
Investing in education

In Brazil and India

by **MARK BUTLER**



MARK BUTLER has 13 years' experience investing in emerging markets. Prior to joining Coronation's emerging markets unit in 2008, he was based in London with Aberdeen Asset Management and Baring Asset Management.

Education is a key ingredient to the growth of an individual and a nation. The benefit for a country to invest in education is most apparent when one looks at a country which is still classified as emerging, yet outshines developed markets. The country I'm referring to is South Korea, which since the 1950s has improved access to education to such an extent that it has moved from 21st place in the OECD ranking tables, to first. Without this investment in education, the country would not be where it is today and Samsung and Hyundai would not be global household names.

Coronation's Emerging Markets funds hold two education companies, totalling around 8% of the portfolio, namely Brazil's Anhangera and India's Educomp. Education increases the earnings impact of an individual, and this is most apparent in Brazil where an individual with a tertiary qualification earns two and a half times that of a person with just a high school diploma.

Tertiary education participation by Brazilians between 18 and 24 years old is low, with only 20% enrolled at a university or college. In contrast, the participation rate in Argentina and Chile is three times higher.

Even though Brazil's education spend is 5% of GDP, the quality of state school education is poor and does not equip scholars for university. There are limited places available within the state university system – less than 10% of total students – which tends to be taken up by those educated at elite private schools. The remainder are catered for by the private sector, of which a quarter are in religious and philanthropic institutions which cannot cater for increased

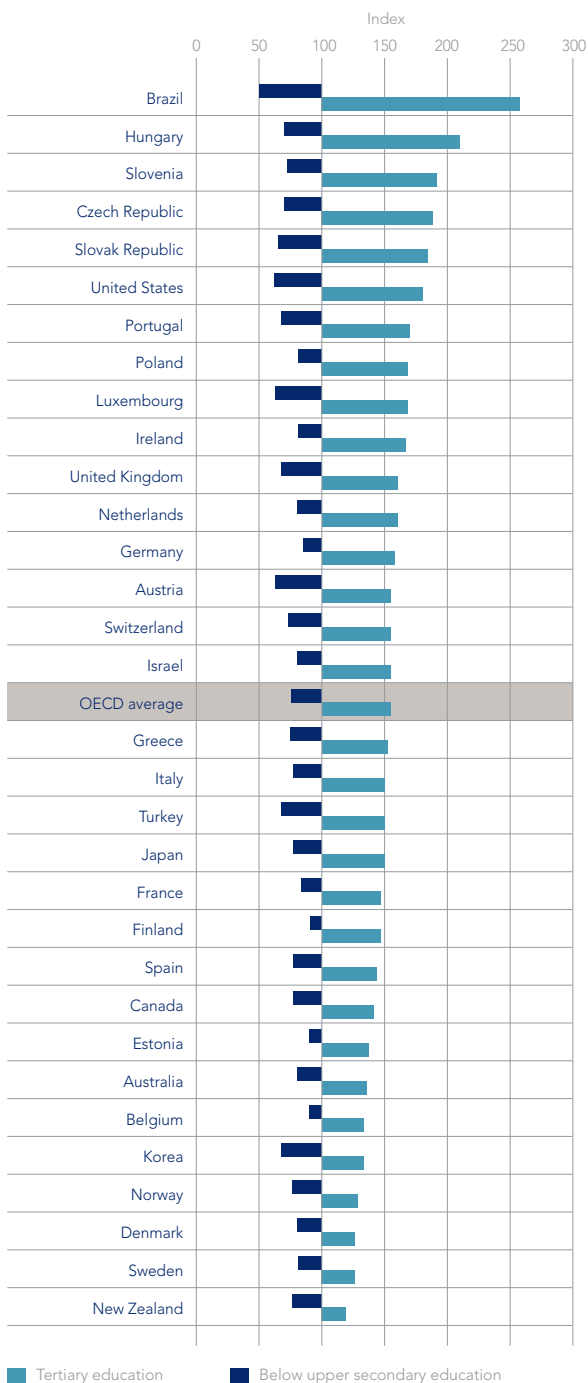
demand. Hence, an opportunity was created for 'for-profit' private sector universities. These are mainly in the form of small, family-run independent institutions operating from a single location. They lack scale, operational efficiency, and some are in financial distress and struggle to attract and retain quality academic staff. An additional concern by prospective students is that these 'brands' are not well recognised and while their earning capability will increase, it will not be the two and a half times increase in salary they had hoped for.

The education sector is being consolidated which is where the company in which we have invested, Anhangera, comes in. The product is aimed at working adults and is a strong brand in Brazil's fragmented education market. Anhangera is embarking on a process to consolidate the market and create a national number one. Campuses use the same content per subject and share central administration which dilutes fixed costs, increasing earnings as additional campuses are added to the network and existing campuses mature. Mature campuses operate with gross margins of 50%, while acquired campuses operate on gross margins as low as 20% because small operators lack scale. On average, the existing 60 campuses in the portfolio are operating at less than 70% of capacity. The number of students has increased to 200 000 from less than 50 000 five years ago, and when fully matured, Anhangera expect to cater for 300 000 students. The company benefits from an exemption on income tax on undergraduate education provided they grant a specified number of bursaries to students from underprivileged backgrounds.



RELATIVE EARNINGS FROM EMPLOYMENT BY LEVEL OF EDUCATIONAL ATTAINMENT FOR 25 – 64-YEAR-OLDS (2009 OR LATEST AVAILABLE YEAR)

Upper secondary and post-secondary non-tertiary education = 100



Source: OECD

The Anhangera share price has halved since late 2010 on the back of concerns over Brazilian customer defaults. Those who default do not return at the end of a semester and are typically replaced at the next intake. We have met with management on numerous occasions during the last year, have performed detailed analyses on the company and believe that it is significantly undervalued. It is trading on 11 times next year's earnings, which we believe is substantially below what the company can earn once the campuses mature.

Our second education company is Educomp in India which has four segments: smartclass™ technology-based teaching aid (William Smith/Star Schools but for all subjects and all years), K-12 (primary and secondary) physical schools, higher education and an on-line platform. The principal products are smartclass™ and the K-12 rollout.

The quality of state-run education is extremely poor and education is a high priority among Indian families. The middle class in India has expanded in the last two decades as the nation has become wealthier, driving the demand for quality private education higher. In India, tuition fees vary dramatically from US\$20 per month to over US\$1 000 per month.

The lack of well-qualified teachers in the country is where smartclass™ provides a world class solution, and having personally sat through a demonstration I can attest to the 'wow' factor. smartclass™ consists of a hardware platform which allows the teacher to retrieve and display all course material from a content library through projector or LCD screen. Subscribers have access to more than 16 000 modules which cover the entire primary and secondary school syllabus in India. The modules were developed over a period of 10 years and are seven to eight times larger than the next competitor. Independent research indicates that Educomp has close to 90% market share, which together with the lead time to create curriculum material, makes it extremely difficult for a competitor to compete on anything other than price. So with the cost per student at around US\$2 per month there is little incentive for schools to skimp on quality and offer an alternative product. Around 7 000 schools subscribe to smartclass™ with the product

reaching about 50 000 classrooms. However, this represents just 9% of private schools and 3% of individual classrooms. Management's target is to increase the number of classrooms covered to 350 000. Historically, the cash-generating capability of this division has been poor due to Educomp incurring large upfront expenses from supplying hardware to the school, with the school only paying in monthly instalments. This has now been outsourced to a third party in return for a portion of the profits. Educomp now receives their cash within a period of two years and incurs no capital outlay for each new school added.

The operation of physical K-12 schools is the second key business segment. It is estimated that there is a shortage of 200 000 private schools in India. The building of a new school is capital intensive and Indian bureaucracy draws out the process substantially, limiting schools to only admitting students into the first few grades in their first year of operation (even though there is sufficient demand to fill Grade 1 through to Grade 12 on their first day of operation). Under current regulations, it takes four years of operation before all classrooms are filled. Educomp has 59 schools in operation today with another 30 planned, but because of the

drawn-out enrolment process, only four are operating at full capacity, with the other schools in various stages of maturity. Therefore, it will take around four years before these schools mature and as they do revenue will increase by more than 400%. Given the fixed-cost structure, profits will increase by a multiple of this amount.

Educomp's share price had, at one stage, fallen by almost 80% from its high in the final quarter of 2009. This was primarily over concerns that the company was not generating enough cash to meet its financial obligations. We believe that the steps management have taken to slow the growth of the business and improve cash generation will start to come through in the next two years, and the company will comfortably meet its obligations. It currently trades on less than eight times earnings for the year ahead and these earnings are very depressed for the reasons outlined above. This makes Educomp one of the cheapest stocks in our entire coverage universe – which is very rare for an Indian company. While there are certainly execution risks involved, our assessment of its business strengths coupled with the extremely cheap valuation suggest there is substantial risk adjusted upside in Educomp. 