Private Equity

Professor Claudia Zeisberger

Paper:

Outlook on the Private Equity Potential in India's Education Sector Based on Lessons from the US

Section B
Miranda Berkhof
Wai Keng Kwok
Francisco Mendes
Harish Nalinakshan
Ajay Sohoni
Zuwairi Zakaria

Executive Summary

One of the recent developments in the PE landscape is an **increased focus on less traditional PE sectors, such as education and healthcare.** Education is an attractive asset class for LPs as there is less correlation with the broad economic trend line (potentially there are even more people in school in crisis years). Another interest shift for PE funds is the move into more emerging markets (China funds, etc.). **India seems an ideal market because of demographics** (young population) **and an economy focused on services** (instead of industrial production like China) which makes education a key factor, illustrated by Indian presence in sectors like software, generic pharmaceuticals, and other areas that require high level of education.

The US, as the more mature and successful big brother of the Indian education sector, offers rich insights for an outlook. although **three key process differences** need to be taken into account in India: the need to assess more companies before making an investment, longer deal turnaround time, and tendency towards all-equity financing. In addition, there are **huge challenges around regulation, corruption and valuations.**

Overall, the opportunities for PE firms in the educational sector of India are large. Several strategies that private equity firms have employed in the US education sector are also applicable to the Indian market: **take advantage of deregulation, consolidate for scale in a fragmented industry, and look beyond traditional educational institutions**. We are **cautiously optimistic** and suggest that more PE firms **take an option position on the IES** through investments across all sub-sectors, both regulated and non-regulated.

In order to come to these conclusions we conducted extensive secondary research and were fortunate to use the insights coming out of the PE panel held at INSEAD on Oct 8, 2009 and an interview with Raj Ayadurai, Investment Director at Navis Capital Partners on Oct 7, 2009.

Table of contents

Part I Understanding PE in India: General and Education Specific

Growth in India's private equity market has been a short but bumpy ride

The India private equity market has grown by leaps and bounds since its humble inception in the late 80's, becoming the second largest Asian PE capital recipient after Japan less than two decades later. Despite a relatively young age, the industry has already seen its fair share of ups & downs. In the late 90's, the dot-com boom in Bangalore fuelled a rapid growth of VC/PE companies, with the bubble-bust ending up wiping most of these players from the market. Demonstrating its resilience, the industry recovered from a deal-value low point of $470 million in 2003 to a peak of $19.03 billion in 2007. In line with the increasing needs to improve India's facilities, the two biggest sectors for PE investment are Real Estate & Infrastructure Management and Telecom. Overall PE deal distribution, however, indicates large investments across varied sectors such as Power, Banking, Pharmaceutical and Media (see figure 1).

The current hot sectors for Private Equity are:

- **Education**: Highly attractive with an estimated $40 billion market for private institutions. Over $300 million has been invested in Education ventures since 2006, and more than $800 million investment is being planned over the next 12 months.
- **Healthcare**: Significant capabilities in India for clinical research. Low average number of hospital beds will bring in massive investment to build more hospitals throughout the country. Over $686 million investment has taken place during the last 18 months.
- **Clean tech or renewable energy**: Dire need for a more reliable power supply throughout the country. Supportive regulations are providing a boost to clean tech/renewable energy. About $3.5 billion PE investment is expected over the next few years.

The India PE market is dominated by non-India GPs, even though many large domestic GPs already exist in the market. A key explanation for this phenomenon is the tax regulations, which make it more conducive for GPs to be incorporated outside India. LPs consist of foreign players due to non-existent Indian endowment funds; Indian pension funds are not permitted to invest in private equity. Indian high net worth investors, on the other hand, prefer to invest in their own businesses or real estate. The Private Equity market in India has revealed a lot of potential but also in India, the economic downturn has caused a sharp fall in total PE activities. 2008 saw a decrease of 44% in PE deal value compared to 2007, while the first half figures for 2009 have not been encouraging as it shows less than 10% deal value of the whole of 2007. Nonetheless, with slowdown in funding from banks & IPOs, Private Equity is expected to remain a primary source of raising capitals in India (see figure 2).

In general, drivers of private equity industry growth in India can be identified:

1) **Sustained rapid economic growth** averaging 7% - 8% annually since 2000.
2) **Burgeoning domestic customer market** with the middle class projected to grow from 50 million currently to 500 million in 2025.
3) **Well-established public equity market** consisting of over 6,000 companies listed on Mumbai Stock Exchange with reasonable levels of liquidity and trading volume.
4) **Human capital & competitiveness in high-growth sectors**, with one of the best higher education systems in the emerging market and widespread knowledge of English.
5) **Stable democratic government & credible legal framework** as its common-law legal origin has provided the foundation for a well-established, credible legal system.

Education is a key priority for India's growth but is not free from barriers

Education is a necessary ingredient for social and economic progress in India. The country's minister of human resources development, Mr Kapil Sibal recently said that he hoped to attract some of the leading education institutions of the West to India. The idea of providing better education to those seeking to improve their quality of life and business skills has caught on. Originally based on the British system of education, the education sector in India has evolved over the last few decades into a large, fragmented and multi-faceted industry. The industry can be broadly classified based on three dimensions to better understand the different segments operating within it. 1) K-12 and HEI: The term K-12 stands for Kindergarten plus 12 years of schooling. The average kid will enter Kindergarten at age 3 and after spending 2 years will continue on to 12 years of schooling before he/she is ready for higher education. The HEIs, the Higher Education Institutes then take over providing undergraduate, graduate and vocational level university education, 2) Public education and Private education: The government of India allocated a percentage of its annual budget to the education sector and operates educational institutes. More than 90% of the government's spend on Public education flows into K-12 level education. In addition to government run public schools, private investment in the education sector is seen traditionally in the form of not-for-profit trusts which run what can be termed as Private educational institutes and 3) Formal and Non-formal education: The Formal education system in India broadly comprises the K-12 and HEI level education falling under the purview of the Ministry of Human Resources.

The non-formal education segment includes preschools (1.5-3 years), coaching classes, multimedia/IT to schools and colleges, vocational training and the books market. There is a massive demand for education in India and the demand is expected to grow strongly over the next decade. India has the world's largest population in the age group of 0-24 years. This is expected to continue to be so for the next decade. This large pool will represent a large demand for K-12 and HEI education. India's current spend on education is at 5% of average household income, showing a

CAGR of 8.6%. Going forward the consuming class i.e. Households with an annual income >Rs.90000 (~$2000 in today's $ terms) is expected to burgeon from 28% of the total population in 2002 to 48% in 2010. The increasing affluence is fostering higher aspirations for India's populace and the willingness to pay is on the rise as can be inferred from the $13 billon spent by Indians on higher education in the overseas markets. These trends indicate a continued growth in demand for education. The supply of public education is however inefficient and leaves a shortfall which is being filled by private education institutions. The government currently spends 3.7% of the GDP which amounts to around $30 billion. This allocation is up 6X in the 11th plan period (2007-2012). This is subsisted by around $50 billion of private spend which is expected to increase to $80 billion by 2012 growing at a CAGR of 14%. The country has a network of ~1 million schools out of which 7% are private, with ~40% of enrolled population attending private schools. In addition there are 18000 HEIs. In spite of the higher budget allocation the 11th planning commission has identified a resource gap of Rs.2.2 Trillion (~ $25 billion) which needs to be filled by private funding. Education is as counter-cyclical as it gets which makes it an interesting PE target sector. It's a sector where people are willing to spend a disproportionate amount of their income to go back and re-skill themselves even in a downturn. In the Indian market, even more the issue, there is often a gap of time between the K-12 segment of education and the Higher Education segment of education and yet another gap of time between education and work. These gaps are usually used to augment skills through vocational training or to prepare for placement exams.

It is in these areas that there has been significant PE activity. The education sector is however not free from its problems as is seen from the barriers present within it. The not-for-profit diktat associated with private investment wherein no dividends can be paid to the investor has traditionally discouraged private funds from flowing into the educational sector. The sector is over-regulated and sees rampant corruption as a large majority of private institutions are owned by politicians making it more unattractive for the corporate or private investor. Privately run HEIs can choose not to affiliate to the system and effectively escape the over-regulation but then have to overcome the burden of getting industry acceptance as there are no regulations in place to recognize such HEIs that have no accreditation. The non-formal segment of the education sector lacks the necessary scale needed for it to be an attractive investment opportunity. In the K-12 segment, where there is currently tremendous underinvestment, there are challenges in PE investing. Specifically, there are regulatory hurdles in this process and this is often cited as the major impedance to free flow of PE funds. Some of these concerns are:

1) Non-profit requirement for schools & colleges.
2) Requirement for certification/affiliation to boards like AICTE.
3) Restrictions on Foreign Investments in higher education.
4) General lack of clarity on what is allowed and what is not allowed.

Part II Outlook on PE Potential in India's Education Sector

Comparison between US and India: The Facts

When using US insights to come to an assessment of the PE potential in India's education sector, the natural starting point is to analyze the different climate facilitating investment. In 2007, the US had *the* largest private equity activity, both in PE investments as a percentage of GDP as well as in $ billion of funds invested. India ranks among the top three of emerging countries when it comes to $ billion of funds invested, but there is still a lot of potential - shown by the relatively low % of PE investments over GDP (see figure 3).

India's attractiveness and improvement areas

India has shown an amazing growth trajectory but is still considered as part of the emerging country within the PE landscape. An interesting study conducted by Groh and Liechtenstein in 2009 revealed more insights into the importance of investment criteria (see figure 4), specifically for emerging markets and helps understand why India offers an interesting opportunity for investment. The criteria can be grouped into Economic Activity, Capital Market, Taxation, Investor Protection & Corporate Governance, Human & Social Environment and Entrepreneurial Opportunities. In combining the most important criteria with the attractiveness of different emerging regions, we can begin to understand why India has shown such enormous potential and where the improvement areas can be found (see figure 5 and 6) such as protection of property and investor's rights, presence of qualified GPs, entrepreneurial management quality and skills, deal flow and regulation against bribery and corruption.

Differences in process and execution of deals between the US & India

Our research highlights three key process differences when comparing a typical PE deal in India compared to the US:

1) Need for assessment of more companies before making an investment

In general, it takes a lot more analysis to identify a suitable company for a PE investment in India compared to the US.

One of the primary reasons for this phenomenon is the deal size, or rather the lack of it. Most of the companies assessed by PE firms in India turn out to be too small for a meaningful investment and provide few opportunities to scale up. Most of the investment opportunities assessed are also halted halfway as the company promoters are only receptive towards a minority investment from a PE fund, since these promoters prefer to maintain control of the company. In addition, sector-specific reasons, such as over-regulation in Education, prevent an investment in many attractive companies.

2) Longer deal turnaround time

According to Raj Ayadurai of Navis Capital, a PE deal in India could easily take twice the time to complete when compared to a deal in developed markets. A key reason for this is the need to conduct a more thorough due diligence. The Indian due diligence process often includes a comprehensive promoter background check, as stories abound of con-artists trying to sell their fake shell companies, or serial entrepreneurs who repeatedly sold their run-down companies that appear attractive due to doctored financials.

On this note, insufficient accounting records, or reliance on cash-based accounting rather than accrual-based accounting, have prolonged many due diligence activities as PE funds often have to rebuild the company reporting system to determine the viability and profitability of the target's business prior to making a significant investment in the company. PE funds also complain of the lengthy duration taken by companies to respond to their request for information. The deal turnaround time is also prolonged due to the promoters' lack of familiarity with the PE financing model. Despite the numerous PE investments made in India over the last twenty years, many company owners still do not understand how PE financing works, and view the PE funds with suspicion. Therefore, PE funds are forced to take the time to persuade these owners to be more receptive towards PE investments, rather than falling back on banks or angel investors as the primary source of funding. As most promoters are dealing with PE funds for the first time, they also tend to spend more time dissecting the term sheet or consulting with their lawyers, further delaying the deal completion.

3) Tendency towards all-equity financing

Reserve Bank of India (RBI) regulations stipulate that PEs cannot purchase companies with a structure that involve part equity and part debt. All transactions have to be an all equity deal. This forces the need to have a large equity base and limits the size of LBO transactions, involving limited or no leverage. Consequently, the financing aspect of the deal is made simpler with the reduced or even non-existent needs for bankers' involvement to raise debts. Further on the lending side, RBI is not clear whether loans for acquiring huge tracts of land needed by colleges are to be treated as "education" or "real estate".

Challenges for PE in Education in India

All of the differences cited above translate into challenges of doing business in a new environment such as that of India. However, in addition to these differences, there are specific set of new challenges that are faced by PE firms operating in India.

1) Regulation

At present, the Indian education market, specifically the K-12 and higher education, is heavily regulated by the government. The unregulated areas include vocational training, exam preparation, tutoring services, etc. Regulation goes hand in hand with accreditation – if an institution wants to be accredited, it will need to subject itself to a government mandated intake acceptance quota and follow rules related to affirmative action for the underprivileged classes of people. While public institutions have to fully comply, even private institutions have limited choice for fear of losing accreditation and/or lower intake quota. Accredited institutions have a higher draw of students as the students feel that they are getting an internationally recognized degree. Archaic rules mandate all formal educational institutes in India to be run as 'not-for-profit' centers under a society (registration under the Societies Registration Act 1860) or a public trust (Registration Act 1908). Any investment in an accredited institution, such as an education trust, will limit the ability to exit from that investment as distributions of dividends cannot be made. In such cases, the PE firm sets up another vehicle external to the trust that provides services to the trust.

This is effectively one mechanism to siphon off cash flow from the trust in a legal manner. For an exit, the PE firm sells the trust and the external vehicle. The regulatory aspect is probably the single biggest hurdle for PE investment in India. Raj Ayadurai of Navis Capital cites investment in the Indian PE sector as an "taking an option position on future deregulation". After the general elections in India in May 2009, there has been increasing talk about bringing about deregulation in the education sector. However, there are huge incentives for existing players, especially the politicians, to maintain status quo.

2) Corruption

We see corruption as another big challenge to PE firm operation in India. Nicholas Macksey (SVP, Barings Private Equity Asia) and Simon Griffith (Partner, EQT Asia) during a panel forum on PE in Asia at INSEAD, both cited corruption as a huge problem in the legitimacy of company operations in India. In the context of education, however, the problem takes on a different shape. Most of the accredited private institutions are notorious for accepting "donations" from individuals to compensate for shortfall in fees mandated by the government. Not all of the transactions are recorded and a lot of transactions occur with cash, often with payments for unexplained purposes. Most school operators do not show this money in their books and effectively siphon off the excess cash. These institutions have to live within the means of the base fees collected and not on the donations - a challenge that is difficult to overcome. In the unregulated education market, this is much less of an issue as the service providers here do not have any quota to abide by and can thus offer supply to match demand and do not have to resort to artificial pricing. PE firms have to exercise extreme caution in this area and have to expend more time in due diligence.

3) Valuations

Because of the investment interest from large number investors, there is tremendous competition to seek out and find the best possible deals. The Bombay Stock Exchange (BSE) index, SENSEX, a reflection of the Indian stock market, has gone from a high of 20,800 in Jan 2008 to a low of 8,200 in Mar 2009 and back to a high of 16,600 today. This extreme bullishness on the market again has driven up valuations of companies. Arun Natarajan of Venture Intelligence offers that valuations became more attractive with the stock market decline. However, as more PE poured in it could lead to overcrowding again. "It's possible that valuations get stretched again," he adds. This is becoming more evident as there has been increasingly more shopping around of deals to get a better price or better terms.

This is especially the case when the founder/promoters have an emotional attachment to the firm and feel that by shopping around a deal, they may be able to get terms that are favorable to their position in terms of control.

Opportunities for PE firms in the Educational Sector in India

As outlined in the previous section the educational sector in India is fraught with challenges in terms of it being free for private investment. These challenges however do not absolutely exclude any opportunity for investment and in this section the paper tries to address the question of what a PE firm can actually do to get around or address these challenges to still capitalize on the booming education market in India. The primary challenge being the not-for-profit regulation covering most of the educational sector in India the central question is "How can a PE firm address the Section 25 of the Companies Act?" This refers to the Government of India (GOI) regulation that stipulates that income from entities that fall under Section 25 (which include 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." We believe that the answer to this question lies in either finding a way to bypass the regulation, in investing outside the scope of the regulation or simply taking "an option" on the regulation to change.

How can a PE firm bypass the not-for-profit regulation?

The innovative structures approach

Taking a cue from independent school-owners 'extracting' profits from trusts (schools and HEIs) in the form of lease rentals and management fee, some players have taken the age-old informal structure to the next level. The 'innovative structures' have emerged to break the 'trust' issue. The company creates a trust (a not-for-profit body) that runs the educational institute at one level. It further creates a subsidiary that supplies land, services and infrastructure to the trust in lieu of rental/ fees. In this way, the entity manages to unlock the 'surplus' and distribute it as dividends or use it to fund other ventures. This approach has the benefit of possessing ample scale for it to be interesting for PE investment. Potential acquisition candidates are however scarce and there is the ever present risk of this model being struck down in this "socially sensitive" sector.

How can a PE firm invest outside the scope of the regulation?

Unlike in the K-12 segment wherein a school *has* to be affiliated to one board or the other for its high-school graduates (10^{th} and 12^{th} grades) to be recognized as part of the formal education system and eligible for further studies, it is possible to set up an HEI outside the purview of University

Grants Commission (UGC) regulations. The products of these institutes (college graduates) do not have to conform to acceptance standards of the education system but of the industry.

The ISB approach – Using the strength of brand and quality

As long as industry quarters perceive the products to be of superior quality, the HEI can do without cumbersome affiliations and regulations. For example, ISB (Indian School of Business, Hyderabad) is a venerated name in the industry corridors despite it not being affiliated to any regulatory board. The diploma offered by ISB holds as much (arguably more) value as any UGC-accredited certification. But importantly, this status requires maintenance of world-class quality and strong industry support, something that can only be achieved through significant investment of capital.

Tying up with a foreign institute

The above approach is however not possible for doctors, architects, lawyers and pharmacists who according to the constitution *have* to be products of accredited institutes to be able to practice professionally in India. The regulations however do recognize a number of foreign degrees in the country, holders of which are indeed allowed to practice professionally in India. Another avenue for PE investment in India is to tie up with one of these foreign institutes and set up shop in India.

Going the non-formal way

Non-formal education though fragmented presents an attractive regulation-free opportunity for investment. Spanning preschool to vocational training and including peripherals like multimedia and books, this segment is growing equally fast due to the imbalanced education supply-demand equation. The chart (see figure 7) below shows main players in the different non-formal segments.

Rolling it up

While scale is the main issue in the non-formal segment one way to deal with it is the possibility to make multiple small acquisitions and rolling them up at a later stage. Especially in the tuitions and tutorials space there is a possibility to combine multiple small companies into one large company, push for efficiencies, build a brand and plan an exit at a later stage.

How can a PE firm take a bet on the regulation?

While there seems to be visible sign of change in the trust status regulation, there is a Foreign Universities Act currently in deliberation in the parliament. A PE firm at this stage might be well placed to take an "option" on deregulation by buying small stakes to maintain presence in some well performing educational trusts. At the same time starting to look for potential partners to tie up with in foreign universities could prove helpful if deregulation does take place. Navis Capital, through its investment in The Institute for Technology and Management (ITM), has done exactly this and positions its investment thesis as an "option on future deregulation".

US Lessons and Strategies for Application in the Indian Education Sector

We believe that several strategies employed by private equity firms in the US education sector are also applicable to the Indian market.

Take Advantage of Deregulation

The repeal of the Public Utility Holding Act in 2005 eliminated a number of restrictions on ownership of utilities companies, particularly in electricity. It opened the door to consolidation of utilities and the possibility of expanding into non-utilities businesses. Despite the legal reforms, energy acquisitions were difficult to achieve given the regulatory and political oversight that still existed especially at the state level. However, private equity firms still saw an opportunity and invested capital in the energy sector, which grew from approximately $2 billion in 1998 to over $30 billion in 2007. Private equity firms closely monitor the political and regulatory discussions surrounding highly regulated industries to be able to take immediate advantage of opportunities. The financial services industry is one such sector under intense scrutiny with the possibility of private equity firms taking more stakes in failed banks.

Consolidate for Scale in a Fragmented Industry

A strategy that has worked well in the US education landscape has been the consolidation of small institutions under a single corporate umbrella. For example, the partnership of Education Futures Group and Prospect Partners, LLC, a Chicago-based private equity firm, focuses solely on acquisitions of smaller schools with revenues of $1 - $10 million in secondary markets across the US. On a larger scale, the Apollo Group acquires and develops portfolio businesses to leverage its core competencies and broaden its platform.

Their North American holdings consist of three universities (including the University of Phoenix), an online high school, a distance education center and a provider of adult education programs to colleges and universities across the US. Additionally, Apollo has partnered with the Carlyle Group to form a joint venture to invest in international education opportunities.

Look Beyond Traditional Educational Institutions

Significant opportunities for private equity firms exist in the ancillary sub-sectors of the education industry that focus on adult learning. If we move beyond the traditional K-12 or higher education institutions, examples of fast growing sectors include the online e-learning market, vocational training schools, professional certification institutes and language schools. These sub-sectors also have the advantage of being less formally regulated. Out of the ten largest LBOs in the education sector (see table 1), only two (Laureate Education and Education Management Corp.) operate in the post secondary education market. The remainder falls within a wide range of services from corporate training and development (Meltec) to vocational training (Concorde Career Colleges and Vatterott Educational Centers).

Conclusion

The education sector in India is a promising sector with huge potentials for large PE investments. However, regulatory restrictions have prevented a floodgate of PE investments in the regulated education market. Many PE funds have invested in the non-regulated educational institutions, while some have gone further by investing in the regulated education institutions through "innovative structures" to bypass the regulatory restrictions. Nonetheless, deregulation will remain as the long-awaited catalyst that will completely shift the Indian PE market, triggering a massive investment into the Indian education sector. With increasing shifts towards deregulation seen post the recent election, it will be just a matter of time before Education becomes the key driver of growth in the Indian PE market.

We conclude by advocating a cautiously optimistic position whereby PE firms take advantage of the growth potential of the market by making investments into the unregulated market as a means of having a foothold into the sector. These firms can then increasingly take small equity positions in the regulated market through the innovative structures described above and effectively take "an option position on the future deregulation" of the sector. We believe that the first movers in this sector will have a have a significant market advantage in terms of market knowledge, deal flow and overall better deal economics.

***

References

<u>Articles & Publications</u>:

Advisory Research Consultancy, '*Private Equity in India'*, July 2009

Apollo Group, *'BMO Capital Markets Back to School Education Conference'*, 17 September, 2009

Asia private equity review, '*Indian corner'*, August 2009

BMO Education Market Equity Report, September 2008

Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth, '*Private Equity Glossary*'

Economist Intelligence Unit, '*Mapping the recovery: New strategies for private-equity markets'*, 2009

Ernst & Young, '*2009 US private equity watch: an industry in flux'*, July 2009

Groh, Alexander Peter, '*Private equity in emerging markets'*, Montpellier Business School, 2007

Groh, Alexander Peter and Heinrich Liechtenstein, 'International Allocation Determinants of Institutional Investments in Venture Capital and Private Equity Limited Partnerships,' IESE Business School Working Paper 726 - 2009

Indian Education Sector, IDFC-SSKI Securities Ltd.

INSEAD, '*The Evolution of Private Equity in India'*, 2008

Liang, Nellie, Chief Capital Markets of Federal Reserve Board, '*Development of the US Private Equity Market*', presentation at the workshop on SME access to risk capital financing Inter-American Development Bank, February 6 2001

New York Times, '*Raising Taxes on Private Equity'*, June 25 2007

Nolan, Kevin, 'United States: The Obama Administration Proposes the Private Fund Investment Advisers Registration Act of 2009', July 21, 2009

Stifel Nicolas Post Secondary Education FactBook

The Parthenon Group, '*Investing in Education'*, Summer 2009 report

Thornton, Grant, 'Dealtracker', 2009

Venture intelligence, *'Private equity pulse on education*', April 2009

Wharton, '*Will Changes in Taxation Affect the Competitiveness of US Private Equity?*', Knowledge @Wharton, May 6, 2008

Wharton, *'Private Equity Firms Discover Electricity – And Lead the Charge for Energy Investment'*, Knowledge @Wharton, May 16, 2007

World Economic Forum, '*Globalization of Alternative Investments Working Papers Volume 1',* Global Economic Impact of Private Equity Report 2008

Websites:

http://www.nytimes.com/2006/03/06/business/06education.html

http://www.cambiumlearning.com

http://www.cengage.com/press/release/20070724.html

http://query.nytimes.com/gst/fullpage.html?res=9B01E2D6103FF932A05753C1A9649C8B63;

http://query.nytimes.com/gst/fullpage.html?res=9504E2DC133FF932A35752C0A9659C8B63;

http://www.boston.com/news/local/massachusetts/articles/2006/12/22/irish_company_completes _houghton_mifflin_acquisition

http://www.ft.com/cms/s/8d158afe-63c5-11db-bc82-0000779e2340.html

http://www.bpnews.net/bpnews.asp?id=17607

http://www.devryinc.com

http://en.wikipedia.org/wiki/BPP_Holdings

http://www.laureate-inc.com/index.php

http://www2.gtlaw.com/pub/alerts/2005/0802.asp

http://www.educationfuturesgroup.com

http://www.scribd.com/doc/20125325/Private-Equity-Investments-in-Education-Companies

http://www.indiape.com/blog/_archives/2008/8/29/3859456.html

http://www.usdoj.gov/criminal/fraud/fcpa/

Interviews:

Interview with Raj Ayadurai, Investment Director at Navis Capital Partners on Oct 7, 2009

INSEAD panel presentation at Singapore campus '*The Future of Private Equity in a Challenging Economic Setting - Opportunity for Asia?*', Oct 8, 2009.

Appendix

Appendix I – Key learnings from the US private equity market

History provides insights in key success factors of US private equity growth

The US private equity market reached its peak in 2006 with an overall deal volume of $1,622 billion. Especially in the early 2000s, the US private equity market experienced multiple years of exponential growth where multibillion dollar funds and large-scale LBOs were witnessed for the first time. The growth in the US private equity market was made possible through:

1) **Legal and regulatory developments surrounding institutional investors**. The Employee Retirement Income Security Act of 1974 (ERISA) originally restricted the level of risky investments (such as many investments in private companies) by pension funds. Within ERISA, the "prudent man rule" states that an investment manager should "act with prudence, discretion, intelligence and regard for the safety of capital as well as income." In 1978, the US Labor Department eased this rule to enable pension fund managers to invest in venture capital for the first time. Pension funds were also allowed to invest in high yield bonds, which further provided liquidity in LBO transactions.
2) **Reduction of capital gains tax** from 49.5% to 28% in 1978 and then a further reduction in 1981 through the Economic Recovery Tax Act of 1981 (ERTA), which lowered the top tax bracket from 28% to 20%. A further reduction to 15% occurred in the 1990s.
3) **A liquid and well-capitalized public equities market**, which created multiple exit strategies and allowed investors to exit their investments profitably.

The three factors above created the investment framework for several US private equity boom-and-bust cycles from the 1980s through the dot-com bubble in the early 2000s. Beginning in 2003, the US experienced a period of falling interest rates and relaxed credit standards. This enabled the private equity firms to obtain cheap debt and lever up their investments to generate superior returns, thus making the industry even more attractive. A cycle was initiated where the search for high yielding investments would lead to larger funds, and in turn to larger deals, and back again to ever-increasing returns. Other more qualitative benefits that the US enjoyed due to the booming P.E. activity were numerous technological innovations, job creation, and a more active market for corporate control.

The recent financial crisis will force PE firms to investigate non-traditional industries such as education even more

An analysis of the US private equity market would not be complete without including the effect of the recent financial crisis. The private equity industry in US has been severely shaken by the recent financial crisis. Total deal flow in the US fell to $77.4 billion in 2008 and this trend has continued into 1Q 2009 where total reported deal volume was $5.5 billion, the lowest reported volume within the last 10 years. In number of deals, 2008 showed a drop from 1,527 to 1,072. Again in 2009, the downward trend carrier forward with 184 US private equity deals announced in the first three months of 2009 which represents the lowest quarterly volume since the fourth quarter of 2002. The industry will need to adapt to face the challenges ahead. Firms are finding it harder to raise capital and obtain leverage and additionally, legal and tax regulatory changes may force firms to change the way they do business.

Of particular importance are proposed tax changes that would potentially reclassify a fund's carried interest as ordinary income rather than capital gains meaning a tax bracket of 35% as opposed to 15% for the fund. The higher tax bracket would significantly impact any fund's IRR calculations and actual profits.

The Obama administration proposed other regulatory changes in the proposed Private Fund Investment Advisers Registration Act of 2009. This, in essence, would force funds with over $30 million in assets to register with the Securities and Exchange Commission (SEC). The funds would be obligated to adhere to substantial regulatory reporting requirements about characteristics such as their fund valuations, use of leverage and investors. As such, private equity funds would essentially no longer be "private" as they would come under increased scrutiny, and possibly supervision, by the government. Fund administrative costs would skyrocket and more importantly, this might create a completely different environment in which to do business.

As a result of the economic crisis, private equity may head in either of two directions. The pessimistic view is that the industry will not be able to provide the high returns demanded by investors. This could be due to (1) the lack of liquidity in the capital markets, which will make PE exits longer and more difficult, (2) higher equity requirements and reduced leverage and (3) "flight to quality" as deals and/or funds fail, which will create a more competitive market and higher barriers to entry. As a result, E&Y predicted that as many as 50% of PE funds may disappear over the next several years. On the other hand, the optimistic view is that the financial crisis has created an opportunity for funds with capital at hand to take advantage of low valuations and distressed opportunities.

Combined with PE's focus on improving operational performance and management of companies, this will have a positive impact on the global economy. In either scenario, it is likely that the US private equity industry will face tougher scrutiny from tax and government regulators.

Currently, private equity firms examine a host of opportunities to safeguard their future and to get out of the crisis stronger. The options range from minority investments, direct equity investments in public companies and public/private partnerships to "loan-to-own" transactions and smaller, more traditional private equity buy-outs. Firms with ample stores of capital will have more options, but are also likely to face longer holding periods and higher equity requirements. As private equity firms seek opportunities that require less leverage, they may encounter more risks than traditional investment strategies.

Based on their view on the future and likely scenario, private equity firms might keep on pursuing their traditional strategies or show some appetite for adventure. The Economist surveyed at the end of 2008 222 private-equity professionals across markets and levels of seniority and identified that more than 40% of the respondents were inclined to venture outside their comfort zone which was translated in 44% in terms of sector, 45% in terms of geography and 42% in terms of size range. Of the sectors likely to attract investments from private-equity, healthcare tops the list for almost half of respondents, a clear reflection of its growth potential irrespective of economic cycles. We dare to argue that as the end of 2008 didn't feel the full force of the crisis yet, the percentage of firms that needed to pursue a new strategy has even increased. Healthcare is no longer only attractive by its growth numbers, but also because the stability it brings to investment. A similar reasoning is applicable for a sector such as education.

Investments in US education require a customized approach and an active role for the investor towards regulations

The US has the largest for profit education sector in the world with an estimated value of approximately $95 billion. This market can be divided in five main segments: pre-k, K-12, higher education, corporate training and other. Higher education represents the largest segment in dollar terms (with roughly $45 billion of $95 billion mentioned), while K-12 has the highest number of enrolled students (roughly 50 million in public schools and 6 million in private schools). Investments in the sector take various shapes; on top of the more evident for profit-schools, universities and colleges, many other businesses play be considered when analyzing the sector, namely: corporate training companies, schoolbook publishers, education software providers, textbook publishers, college bookstores, etc. The sector high growth rates (estimated CAGR of 18% between 2000 and 2004 and of 12% between 2005 and 2008) combined with market counter cyclicality have made education an attractive and active sector for investors with over 250 deals taking place in US during the last 4 years (some relevant deals that illustrate this activity are included in appendix I).

Insights from the US market will be valuable to PE firms looking to become active in this sector in the Indian market. Main strategies that have proved successful for investors in the US can be fit in two main categories: (1) optimization of under-managed (and under-valued) companies and (2) expansion and scale building. For the first category main opportunities will be found in improving marketing, student experience and pricing abilities and improving overall retention and utilization rates. The second category includes expansion of current offer (new degrees, online expansion, etc.) and industry consolidation plays (marketplace remains extremely fragmented, the US has ~97,000 public K-12 schools and 4,200 degree granting institutions).

Investor experience in the US has shown however that when moving abroad or launching new investments some key factors need to be taken into account:

- Each segment in the education sector will have different business models with different drivers which makes generalizations dangerous.
- A key driver of the sector is public expense (for example: in the US textbook sales seem to be significantly correlated to state budget surpluses; current stimulus packages included more than $75 billion earmarked for K-12 education), making a good understanding of regulatory environment and eventually some lobbying capacities are important.

Almost all investments will require either supplement or replacement of management teams and a fairly active role by the investor.

Appendix II – Relevant education deals in the US

Some relevant deals that illustrate this activity are:

- EDMC (Education Management corporation) - provider of post-secondary career-focused educational programs mainly in the US acquired in 2006 by $3.4 billion by a consortium of private equity investors (including Providence Equity Partners, Goldman Sachs Capital Partners and Leeds Equity Partners). The leveraged buyout of EDMC was the largest buyout in the for-profit education sector to that point.
- Cambium learning - publisher of materials for pre k and k-12 students that in recent years acquired several companies and assets in the sector, namely Kurzweil Educational Systems (2005), IntelliTools, Inc. (2006), The Herman Method from Lexia Learning Systems (2006), etc. In January 2007, the company was acquired by Veronis Suhler Stevenson, a leading private equity investor.
- Cengage Learning - publisher of academic and library information. The company was bought by a private equity consortium consisting of Apax Partners and OMERS Capital Partners for $7.75 billion in 2007.
- Houghton Mifflin Harcourt - publisher of textbooks and other educational materials. The company was acquired in 2001 by Vivendi for $2.2 billion and sold one year later for $1.66 billion to Thomas H. Lee Partners, Bain Capital, and The Blackstone Group. In 2006 the company was again sold, this time to Riverdeep PLC that paid $1.75 billion in cash and assumed $1.61 billion in debt. In 2007 the company acquired Harcourt Education, Harcourt Trade and Greenwood-Heinemann divisions of Reed Elsevier for $4 billion.
- Grand Canyon University suffered significant hardship in recent years and was close to closure in 2003. In 2004 it was acquired by California-based Significant Education, LLC.

- Ross University, a provider of medical and veterinary education located in the West Indies was acquired by DeVry, Inc. in 2003 (DeVry also owns DeVry University, Apollo College, Western Career College, and Chamberlain College of Nursing).
- BPP is an United Kingdom-based provider of professional and academic education. It has been a subsidiary of the American for-profit higher education company Apollo Global since July 2009, having formerly been listed on the London Stock Exchange and a constituent of the FTSE 250 Index.
- Laureate Learning Systems owns several colleges and online learning companies. Acquired a controlling interest in Walden University.

Appendix III – PE Investment Best Practice Examples

Manipal University and Educomp have both been cited as extremely good investments which take into account the challenges and opportunities being so typical for India' Education sector and take a innovative approach in the current climate. An analysis performed by the IDFC-SSKI research show the main points of their analysis on the basis of their 4Cs – Credibility, Creativity, Capital and Content (see figure 8).

Manipal University Learning

Manipal Universal Learning (MUL) has strong brand equity within the HE space through Manipal University and Sikkim Manipal University (MUL sells services to the two Indian universities within the Manipal Education group). While the Indian operations are at ~49% of revenues, its international HE businesses dominate the topline (revenues primarily from four institutes in Nepal, Dubai, Antigua and Malaysia, run as private limited companies). Its ability to attract capital has been based on a strong credibility of execution from its management team. MUL also has branched outside of India making the investment more geographically diverse, potentially also allowing for easier movement of funds within the system. The other key differentiator of MUL is its ability to differentiate itself from other institutions of learning. Its program offers cross region campus exchanges within its system, much like the INSEAD model.

Given a strong brand position, it has been able to offer a number of different programs that include vocational training as well as distance learning. It has also been able to tap into the business sector and establish collaborations for training. Its attractiveness is based on its diverse mix of educational offerings, competent management team, strong brand and risk diversification.

IDFC Private Equity and Capital put in US$30m and US$40m respectively in May 2007. It is one of the few formal players in the higher education sector that has made a name for itself by being diversified and different.

Educomp

Another player that is operates in the Preschool and K-12 segments is Educomp. This is a very good example of how an innovative investment thesis can be formulated even in the highly regulated K-12 market by establishing a vehicle that caters to these markets. The graphic below depicts the mechanism for how funds travel through the structure (see figure 9). For each owned school, Educomp Solutions forms a trust that runs the school's operations Educomp has two formed two subsidiaries -

- Educomp Infrastructure (69.4% stake with Educomp Solutions) - owns the real estate and leases it out to the schools. Edu Infra gets: i) Returns of 14.5% on capital employed in setting up schools ii) 4.5% of annual tuition fee and iii) one-time fee of Rs5m per school
- Educomp School Management (68% stake with Educomp Solutions) provides IP/ content and management services (content, delivery, canteen, transportation, text books etc) to the schools

In both these examples, the PE investor has taken a novel approach to the regulatory hurdles that beset the Indian education sector. We see a vast potential for investment but also the need for straightforward investment mechanisms. Also, we are not sure how successful these investments will be when an exit is sought. Aside from an economic downturn, if there are no willing buyers, the PE investors will have to go to the secondary market – something that is still immature in India today.

Appendix IV – Tables & Figures

Figure 1: India PE Deal Value by Sectors in 2008 (US$ million)

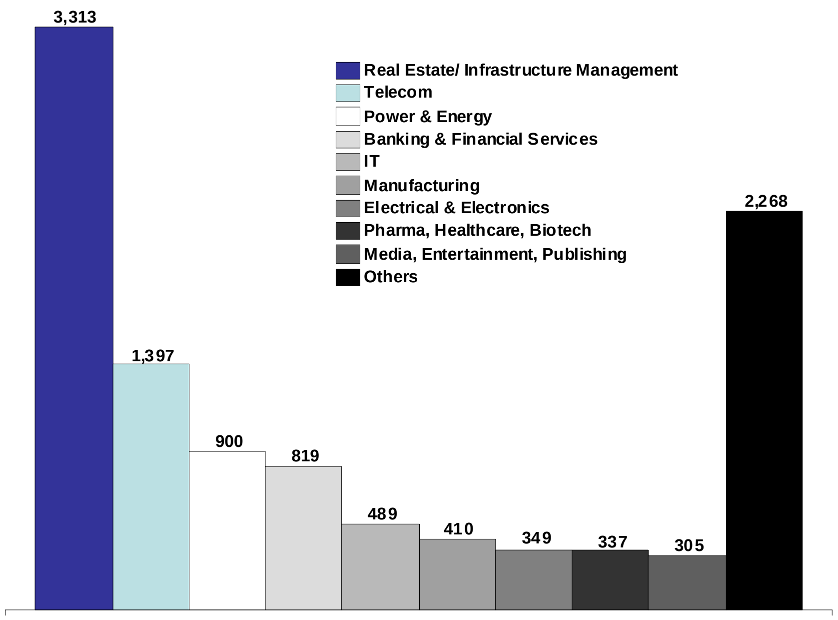

Figure 2: PE Deal Value in India (US$ 'billion)

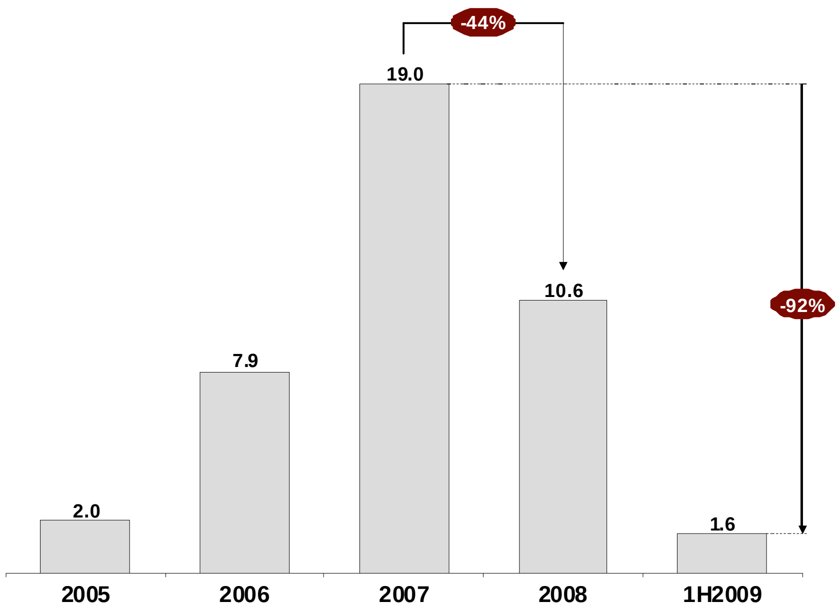

Figure 3: World-wide comparison of private equity activity

The year 2007 allows for a clean-cut comparison in world-wide private equity activity before the influences of the credit crisis.

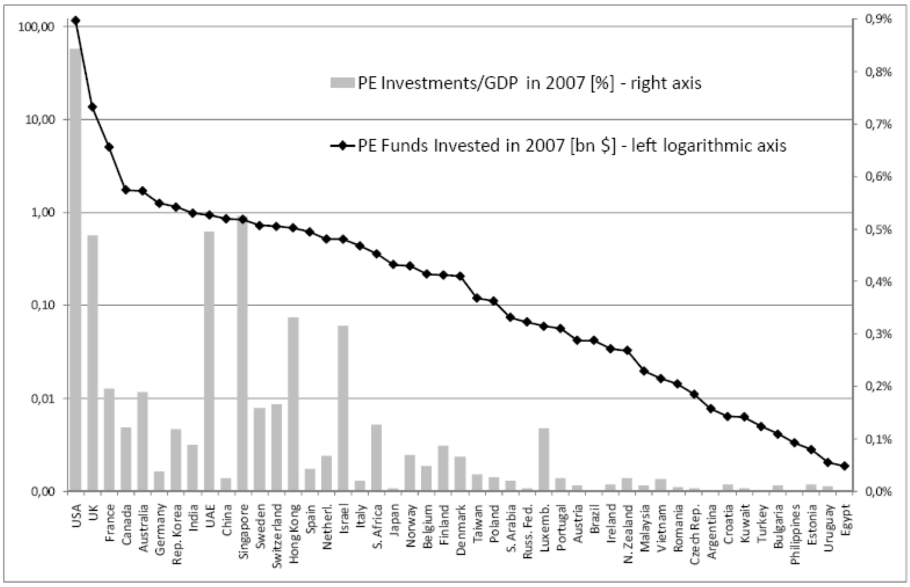

Figure 4: Importance of investment criteria

The Figure presents mean nominations on a seven point Likert scale and standard deviations of importance nominations of several criteria when deciding about PE emerging market allocations.

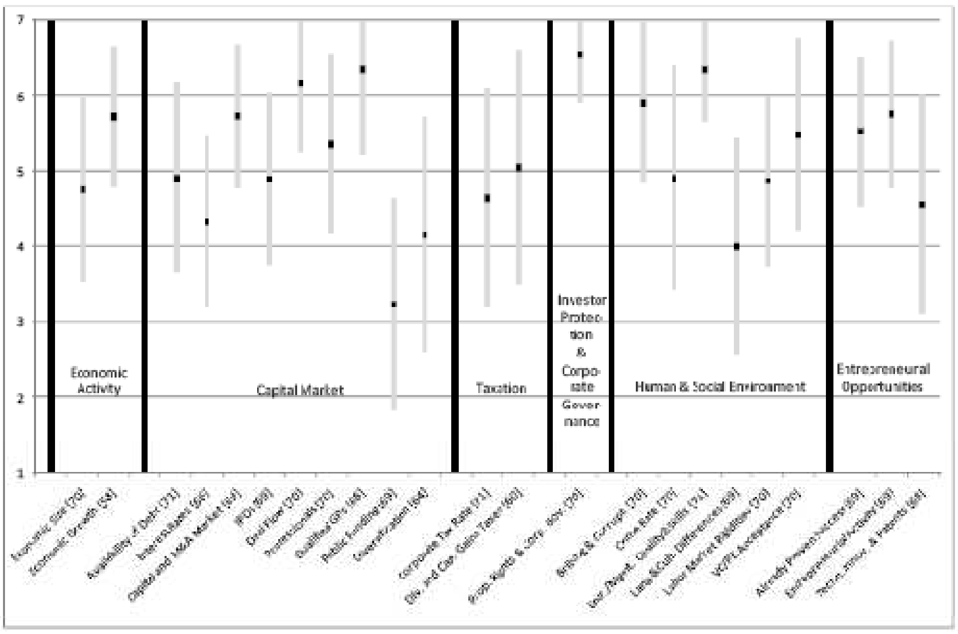

Figure 5: Five Most Important Criteria for LPs' International PE Allocation Decisions in Emerging Markets

Criteria	Possible Ranks
Protection of Property and Investor's Rights	1 or 2
Presence of Qualified GPs	1 or 2 or 3 or 4
Expected Entrepreneurial Management Quality and Skills	2 or 3 or 4
Expected Deal Flow	2 or 3 or 4 or 5
Bribing and Corruption	4 or 5

Figure 6: Attractiveness ranking of different emerging regions

CEE stands for Central Easter Europe

Region	Rank(s)
India	1 / 2
CEE	1 / 2 / 3
China	2 / 3 / 4
South East Asia	3 / 4
CIS	5
Latin America	6
Africa	7

Figure 7: Non-Formal segments

Preschool	KIDZEE Rs253m (Private)	Rs240m (Listed)	Rs60m (Private)	Rs60m (Private)	
Multimedia/IT in schools	Educomp Rs2861m (Listed)	everonn Rs932m (Listed)			
Coaching Classes	FIITJEE Rs1200m (Private)	ims Rs1000m (Private)	T.I.M.E. Rs1000m (Private)	CAREER LAUNCHER Rs900m (Private)	MAHESH TUTORIALS Rs700m (Private)
Vocational Training	NIIT Rs10068m (Listed)	ica Rs1200m (Private)	APTECH Rs995m (Listed)	veta Rs800m (Private)	
Books Market	NAVNEET Rs4111m (Listed)				

Source: Company, IDFC-SSKI Research

Figure 8: Investability Quotient (IQ) of Manipal University and Educomp

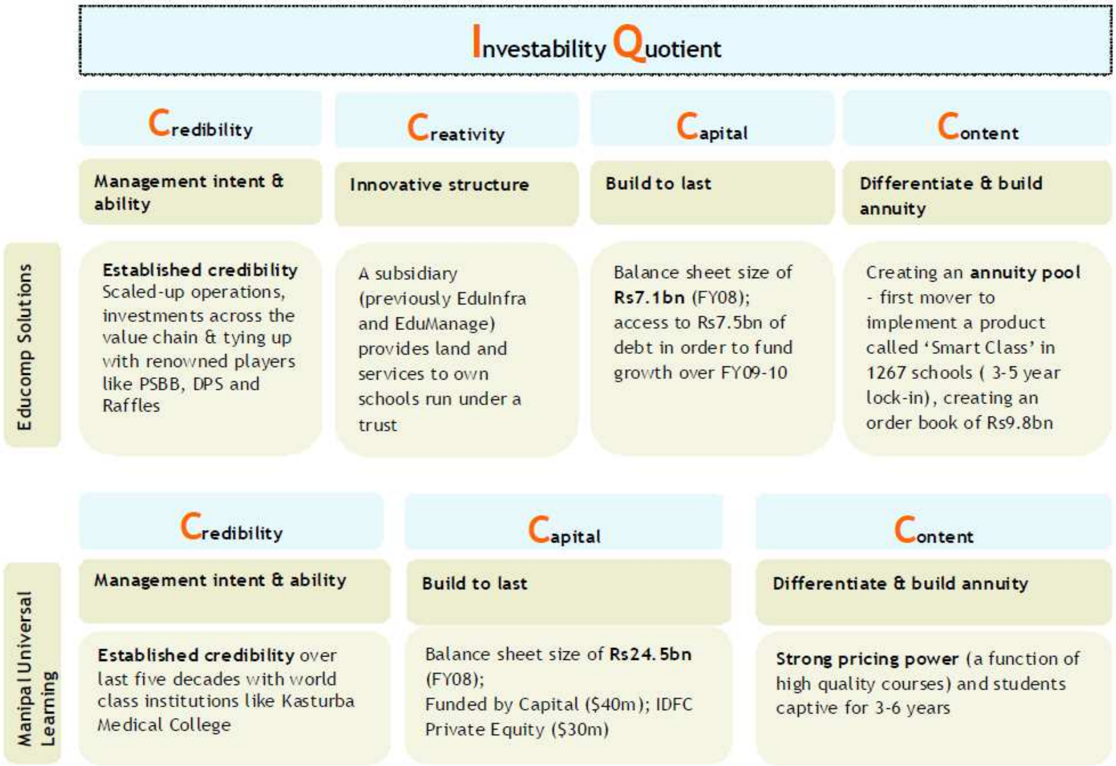

Figure 9: Innovative Structure for Transactions

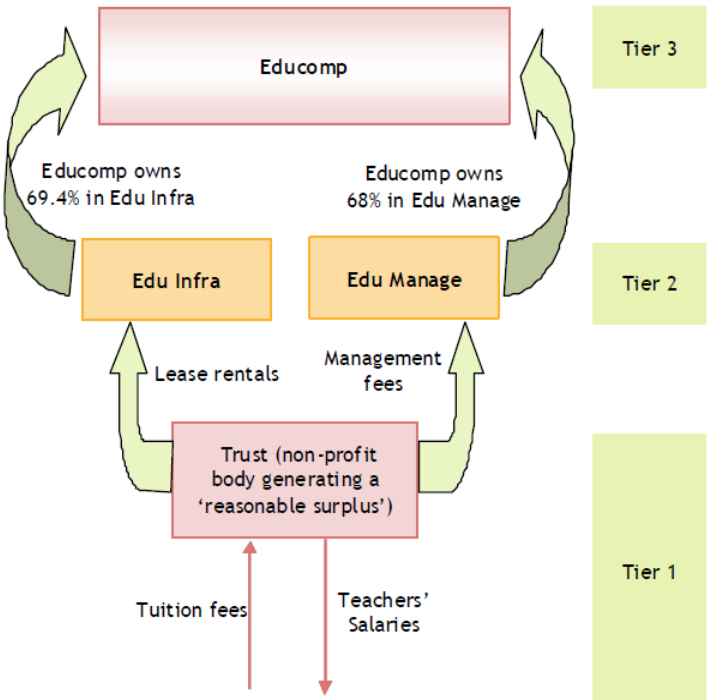

Table 1: Sample of Education Deals in the US

Ten Largest Educational Services LBO Deals By U.S.-Based Sponsors.
peHUB.com

Date	Target Name	Value ($ Mil)	Acquirer
07/20/07	Laureate Education Inc.	3,704.229	Management-led investor group that includes Kohlberg Kravis Roberts & Co., Citigroup Private Equity and others.
06/01/06	Education Management Corp.	3,144.959	Providence Equity Partners LLC and Goldman Sachs Group Inc.'s EM Acquisition Corp.
08/22/06	Meitec Corp.'s Novations Group Inc.	913.000	MCG Global LLC
06/14/07	Educate Inc.	518.450	Management-led investor group that includes Sterling Capital Partners and Citigroup Private Equity.
11/17/06	Aspen Education Group Inc.	291.000	North Castle Partners LLC's CRC Health Corp.
07/01/03	Laureate Education Inc.'s 'Sylvan Learning Systems Inc.--Tutoring Centers	290.448	Apollo Advisors LP's Apollo Management LP
02/11/00	SoftBank Corp.'s 'ZD Education	172.000	Wasserstein & Co.'s US Equity Partners LP
01/17/03	Vatterott Educational Centers Inc.	105.000	Wellspring Capital Management LLC
09/01/06	Concorde Career Colleges Inc.	98.274	Liberty Partners LP
07/27/06	JW Childs Associates LP's Pan Am International Flight Academy--Certain Assets	58.000	American Capital Ltd.'s American Capital Strategies Ltd.

***