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Reflections on the Development of the Private Education Industry in China 2012.

Contents

Foreword

In the 2012 "Government Work Report," Premier Wen Jiabao re-emphasized education as a national priority and re-iterated the importance of achieving the goal of increasing spending on education to 4% of Gross Domestic Product (GDP). Such support and focus by the top leadership is certain to have a positive impact on the growth and development of China's education industry.

The policy environment has always significantly influenced and shaped this sector. Indeed, the "National Mid- to Long-Term Education Reform and Development Plan 2010 – 2010" outlines a clear aim to building a complete set of criteria to differentiate between "for-profit" and "not-for-profit" educational institutions (and what should be defined as successful benchmarks for each). This includes the development of management systems for"for-profit" and "not-for-profit" educational institutions, allowing each the bandwidth it needs to operate efficiently and to best serve the needs of its constituents.

It is clear that private education is facing a sensitive - but very critical - turning point. It is equally obvious that even as overall economic growth rates in China begin to slow down, private education will maintain steady growth as incomes continue to rise and as demand grows. Indeed, Deloitte predicts that by 2015, the private education sector will have reached a market size of RMB640bn (US$102bn).

In fact, with such strong policy support, growth is already exceeding expectations in certain areas. In the early education space, for instance, growth goals are expected to be met approximately two years in advance of the timeframe originally laid out in the state's "Long Term Plan for Education." Meanwhile, in the after-school tutoring space, intense competition is driving expansion and a wave of M&A activity. The growth of the online education market has also been remarkable and is allowing industry players to break into new customer demographics, geographical markets, and product lines, as well as allowing consumers improved access to a wider range of services. The industry is thus becoming increasingly integrated and consolidated, and market leaders are emerging. Healthy demand for their products, coupled with strong cash flows at many domestic companies, have also caught the eye of private equity players, who are increasingly interested in investing in this maturing sector.

With such political support, rapid growth, and increasingly diverse set of customers and services, this is an industry ripe for a surge in mergers and acquisitions (M&A) activity; and indeed, the past twelve to twenty-four months have seen this begin to unfold. Sub-sectors of particular interest to deal-makers will be the pre-school education space, the after-school tutoring and professional training spaces, and private universities. Strategic investors are expected to demonstrate an increasingly keen interest in the domestic market while inbound deal-makers in this arena are anticipated to continue to stem mainly from North America (especially as many Chinese educational enterprises are listed on US exchanges).

On the whole, the Chinese educational sector is bolstered by ongoing corporate innovation, overall economic growth and rising per capita incomes, and a robust domestic M&A market. This report provides a thorough analysis of recent trends in this industry, including special focus on developments in the after-school tutoring sector, growth in the early education market, and opportunities associated with the development of overseas educational institutions. We also discuss five recent controversial issues facing the industry, and give competing perspectives for both sides of each argument. We end the report with a forward-looking analysis of the potential future opportunities in this interesting and exciting sector.

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Chapter 1. Analysis of the private education industry in China

1.1 Research Scope

In China, "private education" is distinguished from the public or state-run education system, and refers to non-state funded individuals or organizations that provide educational services or activities. The market segments of the educational industry in China are described in the table below.

Structure of the Chinese private education industry

Education Industry		Subsector	Educational Level					
			0-3 years	Nursery School & Kinder-garten	Primary School	Middle & High School	University	Vocational or Professional School
Public Education		Public School		✓	✓	✓	✓	✓
Diploma-Oriented Education	Private Schools	Private Schools			✓	✓	✓	
	Test Prep	Extracurricular / Supplementary Tutoring			✓	✓	✓	
		Language Training	✓	✓	✓	✓	✓	✓
		Certificate or Professional Qualifications Prep			✓	✓	✓	✓
	Technical / Skills-oriented Training	Arts, Sports, and Other Training		✓	✓	✓	✓	✓
		Vocational Training				✓	✓	✓
		Management Education						✓
	Online Education	Online Education	✓	✓	✓	✓	✓	✓

Source: Deloitte analysis

1.2 The development of the private education industry

• Private education is experiencing rapid and sustained growth

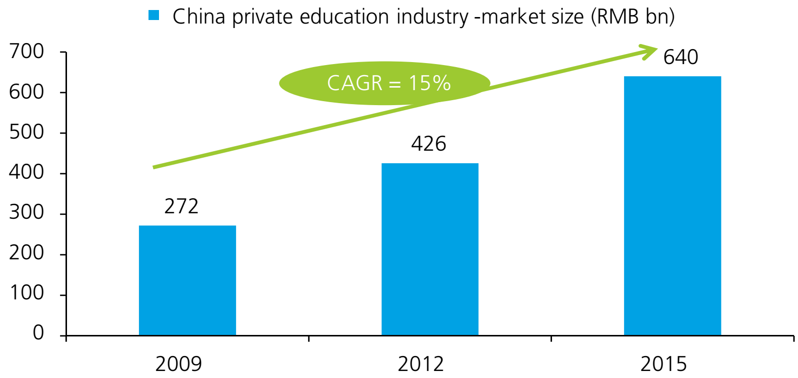
The Chinese private education market is continuing to heat up, even after years of solid growth. This growth in the space has been fostered in part by public demand, but also primarily by national-level plans to significantly increase enrollment in higher education to 40% by 2020 [1]. With such strong government support, a new era of prosperity has dawned for private educational institutions, and the sector has seen a marked uptick in the trading of equity in private colleges, the buying and selling of property rights for schools, and the levels of investment in such ventures.

Beyond this, the overseas vocational training market is another distinct hot-spot in a country that is rapidly internationalizing. Hand in hand with that is the practically white-hot demand for English language training, a subsector that has reached a market size of RMB 30 billion (US$4.8bn). Training and tutoring services for primary and secondary school students are also expected to represent one of the highest-growth subsectors going forward.

Additionally, vocational or technical training schools that provide services to meet the needs of today's businesses remain relatively rare – and thus represent a lucrative opportunity for growth. Deloitte predicts that given the prospects for these various types of training organizations described above, this subsector will maintain a compound annual growth rate of 15% over the next three years, to reach a market size of RMB 640bn by 2015.

1 40% refers to the ratio of the number of students actively enrolled at institutions of higher learning, over the total population of school-aged individuals.

Extracurricular and Vocational Training Services - Market Scale and Growth



Source: Deloitte Research

In the context of this growth, the private education market in China is notable for the following characteristics:

- Due to shifts in population demographics (both age- and income-related), the absolute number of students enrolling in private education in China is actually beginning to decline, and business models are beginning to shift away from an emphasis on student quantity and to focus instead on improving the quality of their services. Over the last ten years, the number of pupils in mainland China enrolled in elementary through high school has dropped from 270 million to around 200 million. Additionally, the number of students taking the *gaokao*, or national university entrance examination, fell from 10.5 million in 2008 to 9.33 million in 2011, a drop of more than 11%. Because the overall number of students is steadily declining, the remaining student body will become more concentrated in the best schools, and educational institutions will be forced to focus on differentiating themselves through quality of instruction.

- Despite a drop in total number of enrolled student nationwide, China's education system is rapidly expanding as demand grows for a wider variety of services. Many systemic developmental issues in the sector have been ironed out over the past decade or so, and prominent contradictions in the way learning is approached have not been largely resolved. With this as a foundation, the transition of the education industry to a quality-oriented growth sector appears to be an irreversible trend.
- National industry giants are beginning to emerge, indicating the increasing maturity of the sector. With significant support from venture capital and private equity investors, awareness has grown about the breadth and depth of the industry; the number of chain or franchised educational companies has soared; and industry leaders have begun to appear at both the regional and national levels.
- Channels of private financing for educational enterprises have grown significantly. In April 2011, North Sea Education successfully listed on the Tianjin Stock Exchange, marking the first private educational institution to go public on the domestic market. It is also an indication of the increasing robustness of domestic financing in this space, both from public exchanges and private investors. The growth of capital markets serving this industry will be a leading catalyst in promoting the sector's development.

• The number of publically listed education companies has steadily grown

In 2011, a Hong Kong-based education organization, Modern Education, listed on the Hong Kong Exchange, bringing the total number of educational enterprises that have listed on overseas or non-Mainland stock markets up to 13 since 2006. In the cases of ChinaCast Education and the China Education Alliance, the companies' listings were a result of reverse take-overs, but the other 11 companies all went public directly through IPOs. Of these 13, ten companies remain publicly-listed at the time of writing; Oriental Century delisted in 2009 due to financial problems, while 2011 saw China Education Alliance delist as a result of persistently-low stock prices, as well as the privatization and sale of Global Education to the UK's Pearson Group.

Chinese Educational Organizations Listed Overseas

Company	Date of IPO	Stock ticker symbol	Company HQ	Listing Market	Listing type
Modern Education	2011-07-04	01082	Hong Kong	HKEx	IPO
Xueda Education	2010-11-02	XUE	Beijing	NYSE	IPO
TAL Education	2010-10-20	XRS	Beijing	NYSE	IPO
Global Education & Technology	2010-10-08	GEDU	Beijing	NASDAQ	IPO
Ambow Education	2010-08-05	AMBO	Beijing	NYSE	IPO
China Education Alliance	2009-07-20	CEAI	Heilongjiang	NYSE	TL
China Distance Education	2008-07-30	DL	Beijing	NYSE Arca	IPO
ATA Inc.	2008-01-29	ATAI	Beijing	NASDAQ	IPO
ChinaEdu Corp.	2007-12-11	CEDU	Beijing	NASDAQ	IPO
Chinacast Education	2007-10-29	CAST	Shanghai	NASDAQ	TL
Noah Education	2007-10-19	NED	Guangdong	NYSE	IPO
New Oriental Education & Tech	2006-09-06	EDU	Beijing	NYSE	IPO
Oriental Century	2006-06-01	5II	Guangdong	SES-SESDAQ	IPO

Source: ChinaVenture, Deloitte analysis

The ten Chinese education companies that remain listed on overseas exchanges posted total revenues of US$1.4bn in fiscal year 2011, as well as combined net profits of US$178 million, representing an average net profit margin on 12.4%. Of these, only Noah Education saw a significant shift in its earnings; the company saw profits fall sharply as it underwent a period of transformation. The remaining nine enterprises demonstrated strong performance and steady growth in 2011.

Publicly-listed Chinese Education Companies

Company	Stock Ticker Symbol	2011 Fiscal Year Revenue, US$m	Revenue growth over prior FY (%)	Net Income, US$m	Profit Margin (%)	Financial reporting cut-off date (ie, most recent)
New Oriental	EDU	558	44	99	18.2	2011.05.31
Ambow Education	AMBO	273	31	36	13.2	2011.12.31
Xueda Education	XUE	222	44	5	2.2	2011.12.31
TAL Education	XRS	111	59	24	22.0	2011.02.28
Chinacast Education	CAST	76	50	10	13.7	2010.12.31
ChinaEdu Corp	CEDU	68	18	3	3.9	2011.12.31
ATA Inc	ATAI	45	26	3	6.5	2011.03.31
China Distance Education	DL	42	20	-1	-1.2	2011.09.30
Modern Education	jB1082	35	-24	3	7.6	2011.06.30
Noah Education	NED	14	-86	-4	-30.8	2011.06.30
TOTAL		1,442		178	12.4	

Source: Factiva, Deloitte Research

1.3 Analysis of private education industry subsectors

In the following section, we will review the market dynamics of the pre-school, extracurricular or after-school tutoring, private colleges, and online education market segments.

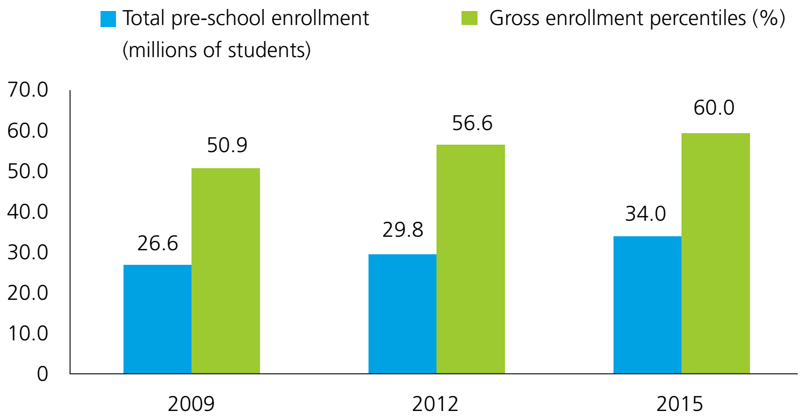
• Pre-school education has seen rapid growth [2]

A national-level three-year action plan for Chinese pre-schools and kindergartens was implemented in 2011, with a specific focus on guiding the development of rural pre-school education. By 2015, the goal is 60% pre-school enrollment.[3] The speed of growth of these institutions has been impressive. Indeed, in 2010, pre-schools nationwide recorded a gross enrollment of 3.19 million pupils more than the total in 2009, an annual rate of expansion of around 12%. If this growth rate continues, it is expected that the development goals set for 2015 may be realized as early as 2012.

2 'Pre-school' here includes nursery or pre-school programs as well as kindergarten – any schooling before primary school enrollment at six years of age.

3 60% refers to the ratio of the number of students ages three to six years actively enrolled at pre-school/kindergarten institutions, over the total population of similarly-aged individuals.

Total pre-school enrollment and gross enrollment percentiles



Source: Deloitte Research, publicly-available data

Although the kindergarten and pre-school market is growing with remarkable rapidity, an unfortunate phenomenon has emerged in first-tier cities such as Beijing, Shanghai, Shenzhen, and Guangzhou. Many families find themselves in a situation wherein they cannot get their child into public school (there are too few slots for too many students) and cannot afford the increasingly astronomical tuition fees for private institutions. Public pre-schools and kindergartens (especially of high quality) remain relatively rare and demand has far outpaced supply. For this reason, private kindergartens and pre-schools have significant space in which to grow to meet this excess demand.

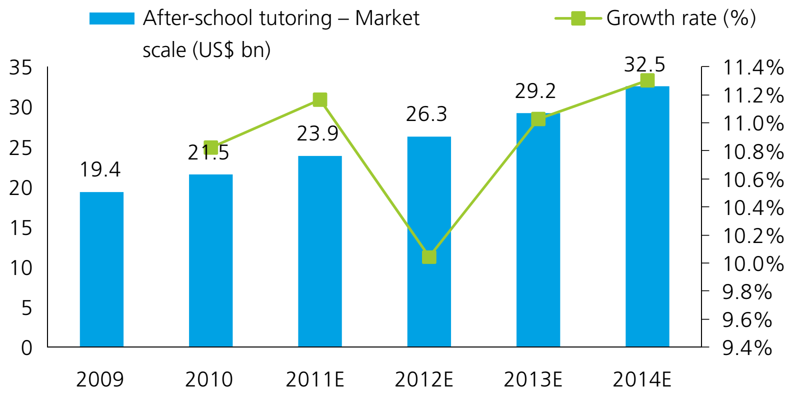
Because the early education sector is still in the developmental stage, the market will continue to further segment itself as the number and variety of schools and teaching models grow. Foreign brands are expected to make significant headway in the marketplace, as the standardization of curricula and teaching methodologies become the norm, and also as the need grows for proven management and administrative techniques for large or multi-branch school systems. Over the coming five years, the early education space will undoubtedly see a number of brands – both foreign and domestic – emerge as market leaders and compete to cement market share as the sector matures.

• Competition is heating up in the after-school tutoring market

After-school tutoring and subject-specific coaching operations already number in the tens of thousands in China. A number of these companies have successfully listed on IPO markets, and investment capital is continuously pouring into the sector; indeed, the tutoring space for primary and secondary school students has quickly become one of the largest and fastest-growing subsectors of China's private education arena. According to a report by the research firm IDC, this sector's compound annual growth rate is expected to hit 11% over the 2011 – 2013 period. Companies like TAL Education and Xueda Education are quickly solidifying reputations as market leaders, and are expected to aggressively pursue strategies of market integration and brand expansion in order to capture revenues above 30% over the next few years.

Although the overall number of primary and secondary school students nationwide has declined gradually over the past decade, average spending per household on education has risen steadily. As per capita income increases, and as demand grows for access to high-quality educational resources, growth in tutoring services for primary and secondary students has followed. Therefore, in 2012, this market is expected to see a wave of M&A activity.

Scale of China's after school tutoring market



Source: IDC, Jefferies

• Private colleges and universities are facing declining student bodies and earnings difficulties

Private institutions of higher education have seen their applicant and enrollment numbers steadily falling as a result of several factors. First, study-abroad programs are of increasing popularity and many Chinese students now choose an overseas education over a domestic one. Admissions offices are thus facing difficulty attracting the best students to private schools. Second, the number of students taking the *gaokao*, or university entrance exam, is also on a broad decline, mainly due to shifting population demographics as a result of years of policy-directed single-child families. In 2008, 10.5 million high school students took the *gaokao*, while by 2011, just 9.33 million took the exam. This drop of nearly 13% is indicative of a wider trend, and is one that is not likely to slow immediately. Taken together, these two factors are placing significant downward pressure on the number of applicants to domestic universities, and private schools are feeling the pressure.

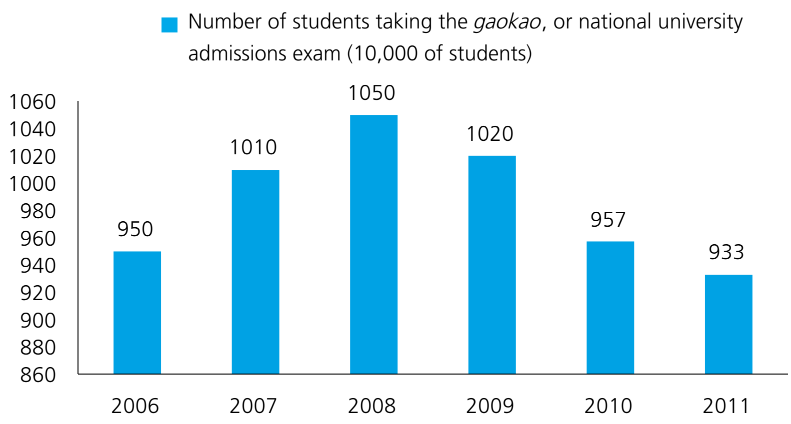
The fact that student bodies are continuing to decline in size is expected to drive much-needed reform in higher education. This is particularly true for private universities, who are finding themselves increasingly unable to compete with public universities in either the number of enrolled students or quality of instruction. If they are unable to quickly adapt to their changing circumstances by identifying new growth models and improving branding, they will likely face bankruptcy or take-over. In 2009, the Chongqing North Software Education Group Software Engineering Institute filed for bankruptcy after attracting just eight applicants in its most recent admissions cycle, and has since become an iconic example of the difficulties private schools are facing in generating interest among prospective students and in staying afloat financially.

However, this is not to say that private colleges and universities do not have substantial opportunities for development. From a policy perspective, there are numerous provinces currently exploring and implementing an "Education Plan," purportedly to "actively investigate management needs of "for-profit" and "not-for-profit" private schools." If implemented, such plans could help to define what exactly is a "reasonable return" for private universities. With more clear guidelines in place, schools might have an easier time attracting capital – which would feed into a positive cycle of higher growth and higher returns.

• Online education market expanding across numerous product areas

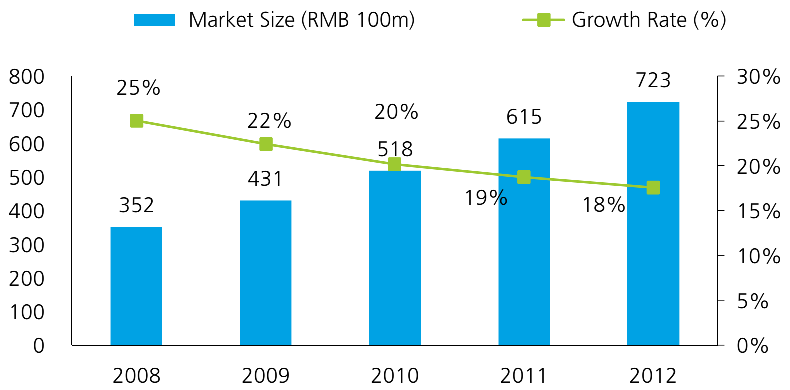
The expansion of the education and training markets into the online space is in full swing. A growing number of established educational institutions are offering online courses, and web-based offerings now include many specialized areas, such as language training, exam preparation and tutoring, training for professional certification, skills-based technical courses, and primary and secondary school tutoring. These institutions have the reputational and financial power to expand online course offerings, partner with other online content outlets, and to attract more students to the medium. In this way, the market is steadily expanding; however, it is certainly still in a "maturing" lifecycle stage. According to data from iResearch, an independent market research firm, the online education market in Mainland China will reach a market size of around RMB 72.3bn (US$11.5bn) in 2012.

The changing face of China's university admissions



Source: 2012 China Education Development Report

Overview of the Chinese online education market



Source: iResearch, Chinese Online Education Development Report 2008-2009

Additionally, with the increasing prevalence of 'smart' mobile devices, students and working professionals have started using these portable devices for online learning, further increasing popular access to, and enthusiasm for, web-based courses and training offerings.

1.4 Analysis of the policy environment for private education

The development of the private-school industry in China has been largely influenced by the domestic policy and institutional environments in which it operates. Here follows an analysis of the political context that is shaping the growth of this sector.

• Aiming to bring spending on education up to 4% of GDP

There is an increasing focus on a long-standing but newly-refurbished goal that aims to spend 4% of GDP on education, a target based on the worldwide baseline levels of state spending on education. As early as 1993, the "China Educational Reform and Development Agenda," issued by the CPC Central Committee and State Council, proposed that government financial educational expenditure should aim to reach 4% of national GDP. However, because China's GDP grew so rapidly over subsequent years, and because fiscal revenues remained a relatively low percentage of GDP, this percentage-based goal was not accomplished as planned. However, by 2010, spending on education had gradually risen to 3.66% of GDP. Further, on March 5, 2012, during the Eleventh National People's Congress, Premier Wen Jiabao re-emphasized the importance of meeting the original targets. Indeed, local governments in various regions are obligated to cooperate towards reaching this 4% goal for education.

Most of this expenditure has been focused, to date, on the public sector, particularly local public schools located in central and western China. As such, a lock on government funding for private schools has persisted nationwide, forcing them to seek capital via other means.

• Authorization of degrees from Chinese-foreign joint venture schools

As of September 2011, the Ministry of Education (MOE) has implemented a strict system of authorization and recognition of undergraduate certificates issued by official "Sino-foreign cooperation" schools. The issuance of all Sino-foreign undergraduate diplomas or degrees must be preceded by registration in an official registry system via a Ministry-sponsored website (www.jsj.edu.cn), which is currently in a preliminary testing phase.

Moreover, the MOE is building a database to authorize undergraduate diplomas distributed by these Sino-foreign educational institutions. In order to ensure comprehensive oversight of degrees from foreign academic institutions– to ensure quality and validity – the MOE also plans to roll out a similar registry for all overseas schools, with information being publicly-available for students, schools, employers, and other users. Students considering a potential overseas education, for example, will be able to use the system to run checks and / or searches for relevant educational information and school profiles in their target geography. Local Chinese students, on the other hand, can also order copies of their degrees and transcripts online by presenting their name and identity card number. The regulations are designed to more strictly monitor and benchmark what is currently a somewhat chaotic market in the Sino-foreign education space. Those Sino-foreign cooperation schools– or overseas institutions – that fail to meet the MOE's standards for quality or reputability reasons will not "make the cut" under this new system and will not have their diplomas approved. It is unlikely that such domestic institutions will survive for long without official government sanction.

• Private schools are now eligible to enroll PhD students

The "National Mid- to Long-Term Education Reform and Development Plan 2010-2020" stipulated that the government would gradually make available resources to support qualified private schools to launch bachelors, masters, and doctoral programs, marking a significant expansion in scope for many of these schools. In October 2011, five private educational institutions, including Jilin Huaqiao Foreign Languages Institute, Beijing City University, Hebei Institute of Communications, Xijing University, and East University of Heilongjiang, were granted approval from the Ministry to launch graduate educational programs.

Approval for private schools to provide graduate programs has enhanced academic culture in China by providing a greater variety of programs; previously graduate education has been entirely monopolized by public universities. With a larger number of programs available, students will have improved access, more choices, and ultimately more power. Additionally, Chinese universities will have more space to accommodate qualified international applicants who are interested in completing their graduate work in China. These developments have been a boon to many private schools and will certainly be an active driver of future growth.

• Ministry of Education to more closely legislate pre-school education

The MOE is paying increasing attention to early education issues, indicating that from both a policy and a financial investment perspective, a greater degree of support is to be offered to these schools over the coming years. In 2011, the State's three-year pre-school educational plan was put into effect; according to as-yet incomplete statistics, that policy helped to build 90,000 new nursery schools, thus creating five million new pre-school vacancies. In part because of this significant effort, the goals for early education laid out in the 12th Five Year Plan (2011 - 2015) are expected to be achieved well ahead of schedule.

The 12th Five Year Plan has also allocated RMB 50bn (US$8bn) towards seven major early education initiatives, which are mainly aimed at supporting the development of - and access to - strong early education programs in Central and Western China and in any Eastern regions that remain economically underdeveloped vis-a-vis their seaboard peers. Under this program, 18 counties in 15 provinces and/or cities have been selected for initial implementation. The initiatives focus on reforming and modernizing educational policies in those districts and on restructuring educational institutions to better meet the needs of local school children - and to create a more equitable and sustainable education system going forward.

Lastly, the Ministry of Education is also developing an "Early Education Policy," the initial research for which is beginning at the Ministry over 2012. Although few official documents have been released regarding the drafting of this plan, it is rumored that the government is assessing the feasibility of requiring compulsory pre-school/kindergarten education, among other issues.

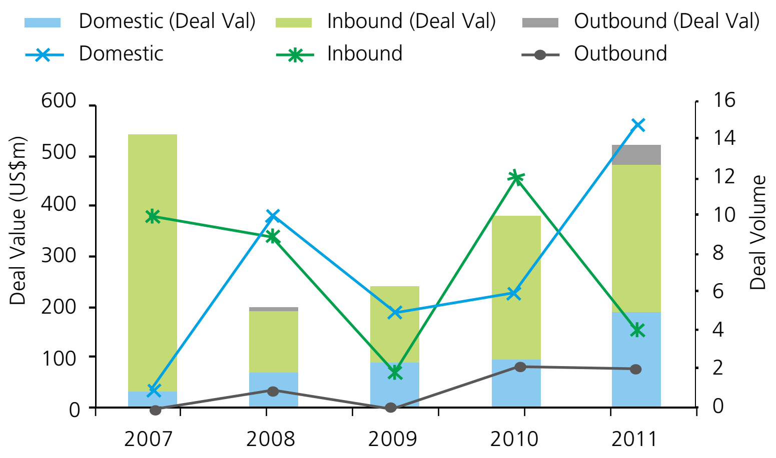
The importance of pre-school education to the future of individual students and to the success of the education system as a whole has repeatedly emerged as a point of focus in national dialogue. Equitable access to education is improving, and resources are growing rapidly, especially in Central and Western China. However, financing is still mainly channeled to public schools, and investment in private institutions remains quite limited.

Chapter 2. M&A in the private education industry

2.1 Overview of the M&A market

The education industry comprises a small but robust portion of the wider Chinese M&A marketplace. Indeed, with such demographic and regulatory pressures as discussed previously driving growth, it is attracting ever-more substantial attention from strategic and financial investors alike. In fact, 2011 saw the strongest year yet for investments in this sector: 24 deals, totaling US$528m, came to market, an increase of 4% by deal volumes and a more impressive 29% by deal values over the prior year.

M&A Activity in the Chinese Education sector, 2007-2011



Source: Thomson Financial

M&A activity in the education space is mainly characterized by the following trends:

- There exists solid demand for investment. A Deloitte survey conducted in 2009 indicated that around 80% of educational enterprises have demand for equity financing, but in light of their steady profit margins and strong cash flows, demand is not extremely urgent – many companies are willing to wait for the right investor to come along before accepting a deal.
- Much of the rise in overall M&A activity has been driven over the past several years mainly by an uptick in domestic activity. Inbound activity also remains relatively consistent, keeping in mind that many inbound strategic investors many actually be Chinese companies listed on overseas exchanges.
- Currently, investment data indicates that M&A activity is mainly concentrated in the tutoring and vocational/professional training subsectors. However, private colleges, especially independent institutions affiliated with well-regarded public universities, are also attracting increasing investor interest. These types of schools are likely to be the M&A targets of the future for both institutional and venture capital & private equity (VC/PE) buyers.
- VC / PE buyers have an important role to play in shaping the development of China's education industry. This is an emerging industry with a variety of players, most with distinct need for growth capital. With domestic exchanges at the moment closed to domestic players, VC / PE firms will need to step up to provide much-needed cash to fund growth and expansion.
- However, one main concern facing VC / PE investors alike is the ability to successfully exit their acquisition and turn a handsome profit for their investors. So far, overseas listings have been the norm, but domestic capital markets need to further open up in order to offer these investors viable onshore exit opportunities through formal markets.

- The standard payback period for a normal venture capital investment is three to seven years and requires the investment to maintain an annual growth rate of 30% to 50%, or even 100% or above. However, the education industry is characterized not by its high short-term growth rates, but rather by its steady performance over the long term. Balancing the conflict between the long-term educational missions of institutions and the short-term business goals of their investors is a challenge to all parties involved.
- The very largest transactions that have taken place to date are inbound transactions – those bidders with the scale and financial firepower to conduct larger-scale deals. From 2007 to 2011, 70% of the industry's Top 10 deals were completed by foreign buyers, accounting for more than 80% of capital deployed. However, a critical shift occurred in 2011, when 80% of the Top 10 deals in that year originated from domestic bidders (including one outbound deal), accounting for almost half of total deal value. This demonstrates the increasing ability of domestic education sector players to successfully undertake acquisitions, as well as their ability to compete with their international counterparts to win bids for the most attractive targets.

2.2 Deep Dive: Domestic M&A

Average domestic deal valuations have remained quite steady over the past three years (averaging US$15m per transaction), demonstrating that the space may be achieving some level of maturity. However, it is quite likely that the education marketplace will see a number of large transformation deals take place over the coming two to five years as big players make increasingly bold moves in an effort to assert dominance over competitors.

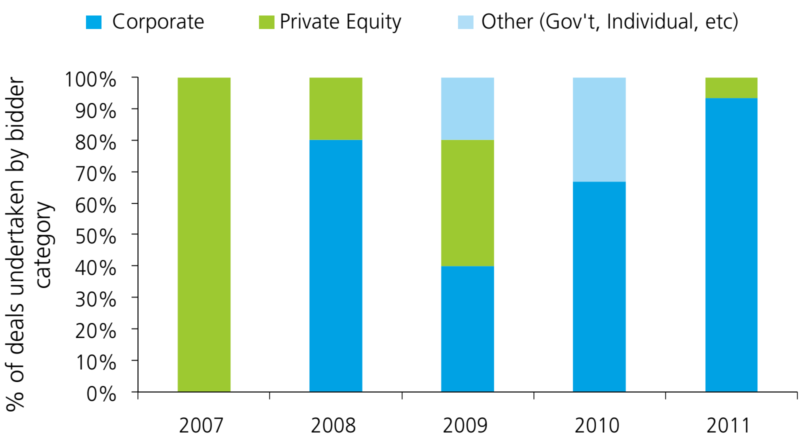
The growth in domestic deal-making has been fueled by a combination of factors. First, local financial investors, be they private equity funds, venture capitalists, or individuals, are taking an increasing interest in the education space. China's education and training institutions have long held the interest of venture capital (VC) and private equity (PE) firms, because of their steady cash flows and the fact that demand for education is relatively resistant to economic fluctuations. However, growth rates in the education sector are not the mouthwatering percentages that attract investors into other industries; moreover, reliable exit opportunities are more complicated. For this reason, investment flows have tended to be steady but not eye-popping.

While in the past, earnings multiples were somewhat low in this industry, a spate of recent buyouts indicate that they may be inching upwards – a good sign for PE investors.As of year-end 2011, the average P/E in the education industry stood at about 22x, which compares favorably to the 16.3x average in the domestic marketplace, across all industries.

Second, strategic investors are operating in a relatively fragmented marketplace with few centralized or dominant players. From an industry lifecycle perspective, if they can successfully consolidate market share early on through M&A, they are better positioned to be a strong player in the marketplace of tomorrow. Strategic investors are also doing deals in an attempt to strengthen core competencies, expand regionally, or diversify their service offerings.

Indeed, from the figure below, it is clear that strategic (ie, corporate) bidders have played an increasingly large role in the domestic M&A arena in recent years, with 94% of domestic deal making being undertaken by corporate bidders in 2011.

Domestic M&A activity in education sector, by bidder category (deal volume)



Source: Thompson Financial

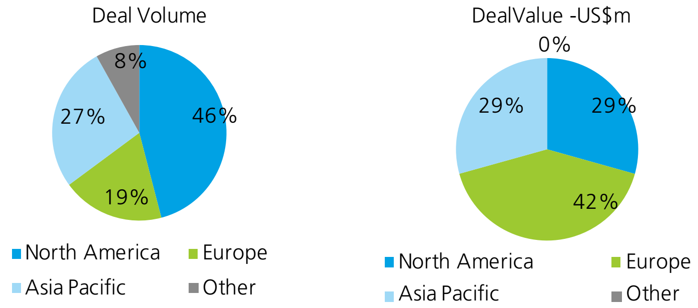
Domestic activity sees no sign of slowing down over 2012, with numerous players considering buy-side and sell-side activity. For instance, Mingshi Education, a private Chinese education service provider based in Foshan, is currently in talks to raise US$ 7.9m via a 20% stake sale, as of Q1 2012, according to intelligence from mergermarket, an independent M&A research provider. This first round of fundraising since the company's establishment in 2004 will be used to finance domestic expansion, particularly into other cities in the Pearl River delta; the current 27 branches will be expanded to over 100 by the end of 2012, according to the report. The company has been approached by several local private equity investors, is in serious discussions, and hopes to close a deal within three months.

2.3 Deep Dive: Inbound M&A

Inbound M&A activity, not surprisingly, has yet to fully recover from shock waves of the Global Financial Crisis. However, there are some positive indications that things are looking up: in terms of deal volumes, 2010 was the strongest year since 2007; in addition, average deal value has climbed steadily over the past three years, with a mean of US$35.6m per deal in the 2010 to 2011 period, compared to US$24m on average over 2008 through 2009. Indeed, in 2011, average deal values reached nearly US$100m per transaction, mostly bolstered by the largest inbound deal to date, the US$289.6m acquisition by the UK's Pearson PLC of a 100% stake in Global Education and Technology, a provider of language training services.

North American (mostly U.S.) bidders continue to demonstrate the strongest interest in China's education sector, while UK, German, and Singaporean companies also wield significant clout. Over the 2007 - 2011 period, over 60% of deals originated from English-speaking countries, indicating perhaps that domestic institutions - among other things - looking to attract investors with some measure of competency in the English-language training space.

Inbound M&A activity in the Chinese education sector, 2007-2011, by bidder geography

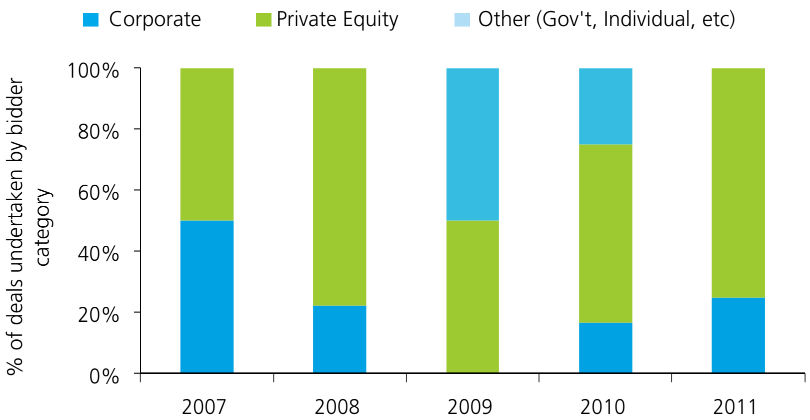


Source: Thompson Financial

In the inbound space, strategic investors have consistently dominated the scene and will likely continue to do so. For example, Singapore-based Informatics Education, a listed provider of information technology (IT) training and business education, is rumored to be interested in bolt-on acquisitions in China, according to mergermarket, cites a source familiar with the company, with Informatics having approached a number of potential candidates in early 2012. The company's market cap stands at US$76m, and it has operations globally, but its exposure to the Mainland China market remains limited. Such a potential acquisition or partnership would be designed to diversify its geographical exposure, and to take advantage of the fast-growing education market tin China.

Private equity investors, for their part, are not to be discounted: this could certainly be a hot sector for private inbound capital flows in the coming years. Indeed, players like Baring Asia, ARC Capital, the Carlyle Group, and Actis Capital have active holdings in the space; their competitors would be wise to consider possible entries as well.

Inbound M&A activity in education sector, by bidder category (deal volume)



Source: Thompson Financial

2.4 Deep Dive: Outbound M&A

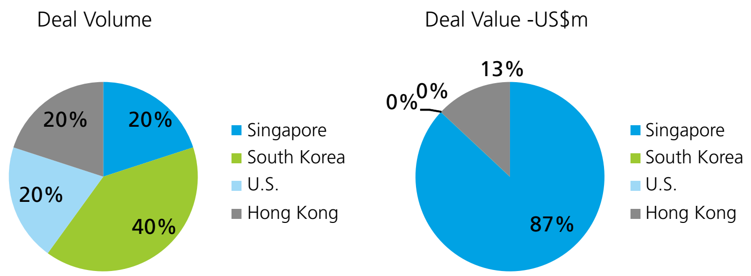
Outbound M&A activity in China's education industry has remained limited to date. This is likely a lifecycle issue: as a still-maturing industry, the education marketplace will have to consolidate to create large, dominant domestic players before there is capacity for outbound growth. In a more mature marketplace, these strong players, backed by adequate capital, will begin to have the firepower to seek expansionary opportunities abroad.

With this in mind, 2011 saw the largest outbound education transaction to date: the US$37m acquisition of a 50% stake in Value Vantage Pte Ltd, a Singapore-based provider of education and training services, by Ding Fu Ru, a private individual investor.

All outbound activity to date has been concentrated in just four geographies: Singapore, South Korea, Hong Kong and the United States. The big question going forward is whether outbound buyers will be bold enough to expand to new territories or search for new products or technologies offered in different jurisdictions.

In summary, as a vehicle for corporate expansion and driven by the power of private capital and alignment of strategic investment, M&A activity among educational institutions is currently seeing its strongest wave of growth to date. The appendix includes a summary of top deals in the sector from 2007 through 2011.

Outbound M&A activity in Chinese education sector, 2007-2011, by target geography



Source: Thompson Financial

2.5 Education M&A Outlook for 2012

Looking ahead into 2012, we expect to see a number of M&A trends continuing to gain strength.

- Domestic activity will continue to ramp up most noticeably, with larger players finally able to compete with their international counterparts, and become bolder in conducting large transformational deals. Expect to see deals coming to market in tutoring and training services, as well as in private preschool and post-secondary education (universities).
- On the inbound side, expect to see JVs in the language-training area originating from English-speaking and European, as well as Singaporean, jurisdictions. Also expect to see international private equity players eyeing domestic targets over 2012.
- The increasing importance of corporate players in the M&A landscape will become apparent, as private education players look to make strategic tie-ups to cement market share, build brand, diversify service offerings, and expand regionally.
- Meanwhile, private equity players will take a growing interest in this increasingly attractive space. As IPO markets open and up and exit opportunities are further clarified, PE players will be even more ready to snap up attractive targets.
- Outbound activity in this space will remain limited, but don't be surprised if a few large domestic players began undertaking bold deals within the region over the coming years.

Chapter 3. Debates and reflections on the private education industry in China

In the report Reflections on the Education Industry Development in China 2011, Deloitte has identified five areas of debate concerning the education industry in China. These included: the issue of specialization versus diversification; the advantages of domestic listing for education and training firms; the pros and cons of franchise chains versus direct chain operation; the developmental path for kindergartens; and the relative value of educational diplomas versus employment. We feel that these issues remain key in 2012 to the development of the education and training industry. 2012 also presents new challenges and issues, and we will continue to monitor these developments within the industry.

3.1 Is the"4 percent fiscal expenditure target" on education an advantage or disadvantage for the private education sector?

In 2012, China's fiscal expenditure on education will account for 4 percent of GDP, with the bulk of this spending invested in public education. This investment will be focused particularly on the central and western regions. However, will increased public education spending benefit the private education sector given a continued lack of public subsidy support for private education?

[Pros:] The increase in total government education expenditure should promote the development of the entire sector. The expansion and investment across all school levels is expected to enhance teacher's benefits, thus attracting a higher number of qualified professionals to work in education. This much-needed boost to China's educational human capital should entail positive spillovers to the private education sector.

In the Government Work Report of 2012, Premier Wen Jiabao has stated an aim "to promote the balanced development of obligatory education, with resource allocation biased towards the middle and western region, rural areas, remote places, the concentrated regions of minority nationalities and underserviced schools in urban regions." This policy not only creates growth opportunities for private institutions committed to the development of preschool, high school and vocational education, but also puts them in a relatively advantageous position. The Government Work Report also signals the central government's positive attitude and broad support for the private education sector by stating its intention to "develop private education by encouraging the channeling of social capital into the education domain at different levels and in various forms." This is a clear indication that the government intends to play a supporting role in the development of private educational institutions.

[Cons]: Private education has yet to receive comprehensive public fiscal support. At present, only a small fraction of private institutions in specific regions have access to subsidies, and public support for private education institutions is especially limited in urban areas. Furthermore, increased government spending on education could increase competition with in the private education sector for high quality education professionals.

There are a number of other challenges facing the private sector. These include policy restrictions, insufficient funding and limitations on their curriculum. This may force them to lower the quality of service they can provide or raise their fees. In the absence of proper fiscal support, this may in turn raise the financial burden on families, limiting people's access to the education sector as a whole.

In light of this, the government needs to have a more clearly-defined policy regarding the classification of for-profit and non-profit private educational institutions in place as soon as possible. In order to promote the overall advancement of the private education sector, non-profit private institutions should have access to public fiscal support, whilst more liberal policies are required to give for-profit institutions more room to develop.

3.2 Should enterprises improve their competitive edge by focusing on the development of their marketing and branding strategy, or by increasing the strength of their product?

The competition between education and training institutions has undoubtedly intensified. The education and training industry is entering an age of branding, and it seems that, without strong branding and marketing, education companies will be unable to retain market share. Is it true that education and training companies are now obliged to continually expand their marketing and branding to remain competitive?

[Market development]: The education and training market in China has grown at a rapid pace over the past decade. Going forward, established, well-branded educational institutions are expected to be the market winners in an environment of intensive competition. Smaller, less well-known training institutions are expected to struggle to maintain a foothold in the market.

The education and training market in China is not yet saturated, and there are two main options for gaining access to untapped market potential: one is expansion through M&A or via direct chain operations; the other is to penetrate into economically-undeveloped regions by capitalizing on network (online) education. Under both approaches, creating a strong brand with broad market coverage is the primary goal. For example, the dominant brand in the market, The New Oriental Education Group, continues to seek greater market share through M&A. The pressure to expand the bottom line is particularly intense for listed companies who must satisfy growth-hungry shareholders.

Attracting top industry professionals is key to establishing a competitive edge in the education industry and doing so requires well-established brand appeal. The large, well-branded training institutions in the top-tier cities of Beijing, Shanghai and Guangzhou in China have dominated this sector, where a few renowned branded institutions, including Xueersi, XueDa, Ambow, Juren and Beststudy, have secured the overwhelming majority of quality teachers and students and therefore market share. These well branded firms expand their market share through the constant acquisition of smaller training institutions, which has helped these strong brands become even stronger. These firms consequently enjoy a positive growth cycle with reinforced capacity in product R&D and teaching resources. In contrast, the training institutions without brand awareness are likely to gradually fade out of sight, as they lose their best teachers thus slowing their product innovation. In sum, education and training firms need to actively and increasingly build on their brand and brand awareness to remain successful.

[Internal efforts]: It is not enough to simply focus one's efforts on marketing and branding. Apple's success comes more from the excellence of its products than its massive size or successful branding. Its brand building is product-driven, and the main appeal of Apple to its customers is still the products themselves. Similarly, the education and training firms must constantly enhance their product, rather than simply pursue size expansion.

In 2012, the education and training market in China will become more defined, whilst the courses themselves will become increasingly refined. Firms that fail to focus on curriculum and product innovation will quickly lose market competitiveness. Although numerous firms are aware of the importance of product development, a large portion of their funding is still being invested into simply increasing market share rather than product improvement. This problem is certainly not unique to the education and training industry and can be found across many Chinese industries.

The sudden and significant influx of money into the education and training market has left the industry in an un-defined state. Even the largest brands can collapse if they pursue blind expansion. Product innovations and teaching resources must be the key focus for an education and training company. Branding is complementary to this, as a brand is naturally enhanced when good products and services are offered. New Oriental may rank as the top brand in the market, but they still stress the importance of management, in-depth integration and innovation. No amount of branding is enough to prevent an education and training firm from failing if its product quality is sub-standard.

Crucially, in contrast to other industries, word-of-mouth marketing is more effective than media advertizing within the education and training industry. Whilst larger firms can afford the high costs of advertizing, there is still room for smaller firms to succeed through other means. They can establish their place in the market if they are equipped with unique products and outstanding human resources.

3.3 Should an IPO be an ultimate growth goal for education and training companies?

A seminal event took place in the education industry on November 21, 2011. The Global Education & Technology Group announced that it had entered into a final merger agreement with Pearson in the UK, through which it would become an indirectly wholly owned subsidiary of Pearson. As one of the largest providers of education and related services in China, the Global Education & Technology Group was listed on the Nasdaq stock in exchange on October 8, 2010. Following its merger with Pearson, announced a year and one month after the company's initial listing, it was delisted from the exchange.

Given that current valuations of Chinese public companies listed overseas are low, is going public truly the top growth goal for Chinese education and training firms?

[Listing supporters]: The objective of a public listing is to raise capital for investment in growth-yielding projects. The delisting of Global Education does not mean all firms should give up their listing plans. It is expected that more Chinese educational firms will go public in the next three to five years, regardless of the current challenges in overseas listing.

It is obvious that the largest international firms have all, by going public, gained much-needed financial support from their investors. Only a very small proportion of private businesses have managed to grow to become billion-dollar companies. Given the great potential of the education and training market in China, listed companies can obtain more funds for market and product development. Provided that they have the right strategy in place and operate properly, this will enable them to successfully grow.

In addition, going public can significantly enhance a company's brand awareness, thus also attracting better human capital in addition to improvements in their product, all of which leads to faster pace of growth.

[Listing opponents]: While the Global Education / Pearson tie-up and subsequent de-listing is undoubtedly borne out of a desire by Pearson to take the company private, not all such de-listings have happy endings. For instance, the China Education Alliance was delisted by NYSE for alleged financial fraud at the beginning of 2012. Furthermore, Oriental Century delisted in 2009 due to financial problems.

In recent years, many Chinese private educational firms, including Global Education, have not performed well in the stock market following their listings. Meanwhile they have still had to take on the pressure of listing costs and the costs incurred by maintaining their listing status. Even more to their detriment, the overseas investors have not yet given the listed Chinese educational firms the recognition they deserve, and their stock prices are currently undervalued.

Given these circumstances, listing has lost its appeal as the companies end up under pressure to meet the growth expectations of their shareholders, whilst the market does not recognize their value. This is especially difficult as the education industry requires long-term investments, and the pursuit of short-term high growth has disrupted appropriate growth rates.

Some of the other common problems faced by listed educational companies after they raise capital include inefficient fund use and decreased growth caused by excessively quick expansion. In sum, listing should not be the ultimate goal for companies. Instead, education and training firms should now focus on building their capacities through a more sustainable growth policy.

3.4 Will classroom-based teaching or network-based teaching become the mainstream approach in education?

Network education, which is provided using web-based resources and connections, already spans the entire spectrum of the education industry, from preschool to vocational curricula, and it is growing rapidly. Will traditional classroom teaching be replaced by network teaching?

[Network education will outstrip classroom teaching]: The growth of modern online education is a global trend. Governments in many countries now regard the promotion of modern remote education processes as a crucial strategic decision that can help address the problem of insufficient educational resources and enable resource sharing. Online education has become a key educational directive for many different types and levels of schools, as well as an essential method for businesses' knowledge management.

As the traditional education market keeps growing, teachers, along with other educational resources, are restricted geographically. This problem can be easily solved via the networked classroom. In addition, the online classroom has lower costs and is thus cheaper for the consumer; so network education has access to a broader market than traditional classroom teaching.

Currently, network education is primarily built on hardware platforms and is supported by multimedia, videos and cyber communities. Although the current internet network in China is not capable of supporting real-time online teaching in all regions - online knowledge sharing is still the primary approach adopted in network education - network education has huge growth potential. As the technology improves, it will increasingly become a mainstream approach to education.

[Network teaching cannot take the place of classroom teaching]: Online teaching might be able to take the place of classroom education in adult education. However, it is still too early to tell to what extent online learning can replace classroom education for children whose independent learning ability remains undeveloped. This is especially true for preschool, primary and secondary school students. The dominant model of classroom teaching in schools will not be subject to significant material changes in the next five years.

Overall, the standard of both the underlying technology and course material is not yet adequate for firms to rely completely on online education in China. Instead, internet resources can currently only be used to supplement classroom education.

3.5 Should the private education sector embrace the official education system, or create new independent models of its own?

At present, the private education model is centered on supplementing the traditional education system. Private colleges, extracurricular tutoring, and language and IT training dominate the sector. However, a new personalized, international model, that is independent of the official system, has emerged in Beijing, Shanghai, Shenzhen and other economically developed regions. In light of this, what should the future focus of private education be: to continue to compete with the official education system, or to develop new innovative education models?

[In favor of compliance with the official education system]: Private education is largely still a supplement to official public education. There are nearly 200 million students in primary and secondary schools in China, and most of them still follow the official education path. Supplementary private education still has a large potential for growth.

In addition, private education is obliged to follow the official education system, given that most employment options require recognized qualifications. At the moment there are some independent education models, but they only represent a small proportion of the industry and are limited to preschool and primary education. Students who do not follow the recognized official education system cannot obtain the related qualifications, posing serious problems for later employment. Therefore, private education has to compliment the official education system to remain relevant to its consumers and continue to grow.

[In favor of expanding independent educational models]: In contrast to the one-size-fits-all model of public education, new models developed in the private sector like schools with private tutors, featured international schools and home schools, offer a tailored educational experience to the individual student.

Whilst the state continues to invest in the public education sector, private education cannot hope to compete with it using official models. It will remain the inferior choice for consumers in terms of campus quality, teaching quality and curriculum. Private colleges are already at a growing disadvantage in competing with their public counterparts due to smaller student bases and lower profits; so they must consider transformation to survive.

An increasing number of families (especially urban families in economically developed cities) are dissatisfied with public education and are considering alternatives. Private institutions have the freedom to offer these consumers independent education models based on mature overseas schooling formats, allowing them to compete with the public education at a new level.

The best education is simply the right education for the individual. Private education can carve out its own niche in the education industry by addressing students' need for personalized development.

Chapter 4. Deloitte's outlook on the private education industry in China

Standardization is increasingly important as the education market matures in China

Today's education and training market in China is slowly on track to becoming more standardized and mature. One of the indicators that an industry is entering a maturing period in its life cycle is that it shifts from disordered competition to more refined and defined processes. At present, the different sectors within the education and training industry in China are deciding how to define their market niche, how to fully develop these markets, and how to provide the best products and services for their consumer.

Meanwhile, regulations and standards in the entire market are becoming stricter. Without quality teachers or high course standards companies are set to struggle in the market and ultimately fail. As the industry develops and becomes more mature, the market leaders will drive standardization in different sectors. A government-run monitoring system for the private sector will soon start, meaning the days when tuition and training could be provided with just a few ads and teachers are over.

In the long run, industry competition will be beneficial, provided that companies standardize their services rather than seek profit by undercutting the market. This is especially true of the more mature training markets such as English and IT training.

Consolidation and M&A are major trends

Deloitte pointed out in its education report in 2011 that M&A activities would become the key trend in the education industry, and this trend will continue to grow into 2012. The Chinese education industry undoubtedly has the greatest growth potential in the world over the next 10 years. Despite this, of the 10,000+ private education and training institutions in China, only a handful boast a market cap exceeding RMB 1 billion. Smaller institutions face several pressing issues, including talent shortages, weak teaching and research capacities, and high vulnerability to risk.

As large institutions seek greater diversification and differentiate themselves in strategy and management, a new round of reshuffling in the education and training industry is inevitable. Larger companies seeking regional dominance will be key to this, achieving their market expansion through the acquisition of smaller businesses in the tier-2 and tier-3 cities. As a result, many smaller training institutions are being approached by larger companies looking to make acquisitions.

Online education will continue to grow in popularity in the next three years

Deloitte believes that classroom education will still dominate the market up to the senior high school level and online education will primarily play a supplementary role. However, the role of online education cannot be underestimated in the adult education market. Online education has large potential for development in these markets because adult education is compatible with independent learning. As Bill Gates put it at the Technology Conference 2011, "five years from now, you'll be able to find the best lectures in the world on the web for free. It will be better than any university." This is an illustration of the unlimited growth potential of online education.

At present, 7.08 percent of global mobile internet applications are classified as educational, and this number is likely to continue rising. That educational games, entertainment, books, and teaching utilities rank in the top five in all application categories, with a combined share over 55 percent, according to the 2011 Report on App Store Data, China Region, is testimony to this growing trend. As more people have smart mobile phone devices and the technology advances, the development of the online education market is set to soar.

The trend for international education in China presents strong growth opportunities

In recent years, education programs with international features have been embraced by all sectors of the industry. Many local education and training companies have cooperated with international colleges or groups, for example the international high school exchange programs that are currently popular. At the same time, some education and training institutions are starting to go overseas. New Oriental now has schools in Canada, and Beijing Normal University has launched a Confucius Institute initiative on campuses across the world.

In particular, private school's high school programs are expanding in size thanks to Chinese students continued desire to study abroad. Between 2009 and 2011, the number of Chinese students going abroad to study grew by more than 25 percent a year, according to the Investigation Report on the Trend of Going Abroad for Study 2011 released by www.eol.cn. Industry insiders predict that international high school programs will maintain a growth rate of up to 30 percent. Strong customer demand for overseas study is the driving force behind this.

The employment market has a higher demand for individuals with an overseas education background and graduates from local universities are less highly regarded than in the past. Thanks to their ability to develop students' language skills and address international course transitions, international high schools can send students to overseas universities for further education either directly or through pre-college programs. Furthermore, Chinese families are sending their children to international high schools with the hope of starting their overseas college education earlier. This customer demand includes middle-income families in the top-tier cities and wealthier families in the tier-2 and tier-3 cities. However, whilst private schools are established in the market, the market barrier is also high; investors need to be cautious given the fact that on average capital recovery takes ten years or longer in this particular market niche.

Deloitte's conclusion

As the private education industry in China matures, it will meet more challenges and competition. We wish to give some suggestions to the educational firms within the industry from multiple perspectives.

The competition ahead will become more intensified as the entire education industry matures; work will have to be done in both market development and product enhancement. With regard to establishing a company's core strategy, we believe that educational companies at the initial stage of growth need swift expansion and market development to elevate their brand awareness and market influence quickly. For firms of a significant size, however, policy should prioritize providing outstanding teacher resources, product innovation and standardized management. Given the challenges of overseas listing, education firms must focus their energy on shaping a unique, personalized education system for the foundation of their future growth.

With regard to online teaching, we think that for students at primary and secondary schools, as well as those receiving preschool education, classroom learning will remain the primary model, supplemented by online education. However, classroom education and online learning could both be part of the teaching model for students at college level and above, as well as for adults receiving vocational education. Online education might be fully integrated with classroom teaching in the future. Advancements in technology and the internet could make virtual classrooms the most convenient and effective teaching model.

Finally, private education in China will have to improve in terms of both product quality and management. Sectors that already have a healthy growth potential can continue to follow the official curriculum, which remains very profitable. However, sectors where competition has intensified and the prospects are challengingshould consider independent education models. The consumer must be the primary driver of product development, not the official curriculum. A company can enter into any sector where there is a market demand that is increasing, be it the traditional Chinese curriculum, private home schooling, or international education.

The critical point when considering whether or not a country's growth will be sustainable in the future is assessing the strength of its education system, asking if it is capable of nurturing national talent to satisfy the national need. As the Chinese economy maintains its fast, stable growth tragectory, urban families are focused on education more than ever. Going forward, the education and training market in China will continue to grow at a fast pace, heavily featuring M&A and consolidation. Moreover, it will be elevated to a new level in terms of standardization, specialization and branding.

Appendix

Top Ten M&A Transactions in China Education Market, 2007 – 2011

Announced Date	Deal Type	Target Company	Bidder Company	Bidder Sector	Bidder Dominant Jurisdiction	Deal Value (US$m)
11/21/2011	Inbound	Global Education & Technology	Pearson PLC	Media and Entertainment	United Kingdom	289.58
10/11/2007	Inbound	Oriental University City Development	Raffles Education Corp Ltd	Consumer Products and Services	Singapore	266.70
12/31/2010	Inbound	China Education Services Ltd	USChina Channel Inc	Financial Services	United States	155.40
04/15/2009	Inbound	Wall Street English	Pearson PLC	Media and Entertainment	United Kingdom	145.00
09/09/2011	Domestic	Shanxi Rising Educational Invest Co	China Bilingual Tech & Educational Group	Consumer Products and Services	China	108.02
10/21/2008	Inbound	Ambow Education Holding Ltd	A private investor group	Financial Services	United Kingdom	103.00
06/08/2009	Domestic	Chengdu Institute Sichuan Intl	A private investor group	Financial Services	China	75.32
03/30/2010	Inbound	Hubei Industrial University	ChinaCast Education Corp	Consumer Products and Services	Hong Kong	66.18
12/04/2007	Inbound	Chongqing Normal Univ Foreign	ChinaCast Education Corp	Consumer Products and Services	United States	64.97
10/09/2007	Inbound	Ambow Education Holding Ltd	A private investor group	Financial Services	Australia	54.00

Source: Thomson Financial

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