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Investment opportunities in the GCC education sector

Four plays for private equity and strategic investors

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Executive summary

Over the past decade, a strong market for private education has attracted increasing numbers of investment companies and strategic investors to the education sector in the Gulf Cooperation Council (GCC).[1] This trend will likely continue unabated given the regional growth in student populations, a widespread consumer preference for private education, and governmental privatization initiatives.

It will not be enough, however, to simply buy into the strong market for private education in the GCC and ride its growth. The sector's projected growth is already being priced into valuations, and the high levels of investment capital earmarked for the sector should ensure that valuations continue to rise. As a result, investors will need to identify the investment plays best suited to their risk/return profiles, and utilize a tailored set of value creation levers. Only those who do this will unlock the full potential of their investments.

The question for investors is how to capitalize on the opportunities the sector offers. They can pursue one or more of four plays in the GCC education sector: *Growth-focused acquisitions* are best pursued in the education delivery subsector in the GCC because it is relatively mature and well-populated with established local institutions. *Greenfield ventures* are best pursued in the nascent subsectors of education services, such as online tutoring and student assessment services, and education support services, such as school management systems. *Consolidation plays* are rare in the GCC, but they will become more common as the sector matures and investors seek to optimize fragmented investments, realize scale advantages, and unlock incremental returns. *Real estate sale-leasebacks* are best pursued in the education infrastructure subsector and typically target the campuses of companies operating in the education delivery subsector. Each of the four plays offers its own risk/reward ratio and cash flow profile.

Compelling fundamentals

The rich opportunities in the GCC education sector have not been lost on investors inside and outside the region. The rationale underlying their intense interest in the sector is driven by the following favorable investment fundamentals and conditions:

- A sustainable demand, because of population growth;
- Non-cyclical performance, given the resilience of the demand drivers;
- Long-term revenue visibility, because of fixed durations on the education path;
- A negative working capital profile, because the capital requirements for operational expansion are limited.

In the GCC, these investment fundamentals are bolstered by an additional set of sector growth drivers. GCC governments are actively encouraging private-sector participation to help relieve the budgetary strains created by low oil prices. The region has a young and growing population, which is projected to approach 65 million people by 2030, a third of whom will be under the age of 25. Disposable income levels are on the rise, and GCC consumers are willing to spend on high-quality private education.

The above conditions have translated into enrollment growth across the GCC's education sector, with private enrollments outpacing public enrollments in K–12 and, in half the GCC countries, in higher education, as well (*see Exhibit 1*).

Exhibit 1

Enrollment is growing throughout the GCC education sector

Compound annual growth rate %, academic years 2009/2010–2014/2015

	K–12		Higher education	
	Private	Public	Private	Public
Bahrain	6.3%	4.4%	-7.1%	15.2%
Kuwait	5.6%	1.0%	7.4%	9.5%
Oman	22.7%	0.5%	11.9%	2.1%
Qatar	12.1%	4.3%	5.9%	19.4%
Saudi Arabia	4.6%	3.0%	42.3%	11.0%
United Arab Emirates	5.5%	0.5%	9.4%	6.5%

Note: Kuwait K–12 and higher education figures are for 2009–2014; Bahrain and Oman higher education is for 2012–2015, United Arab Emirates higher education is for 2009–2014.

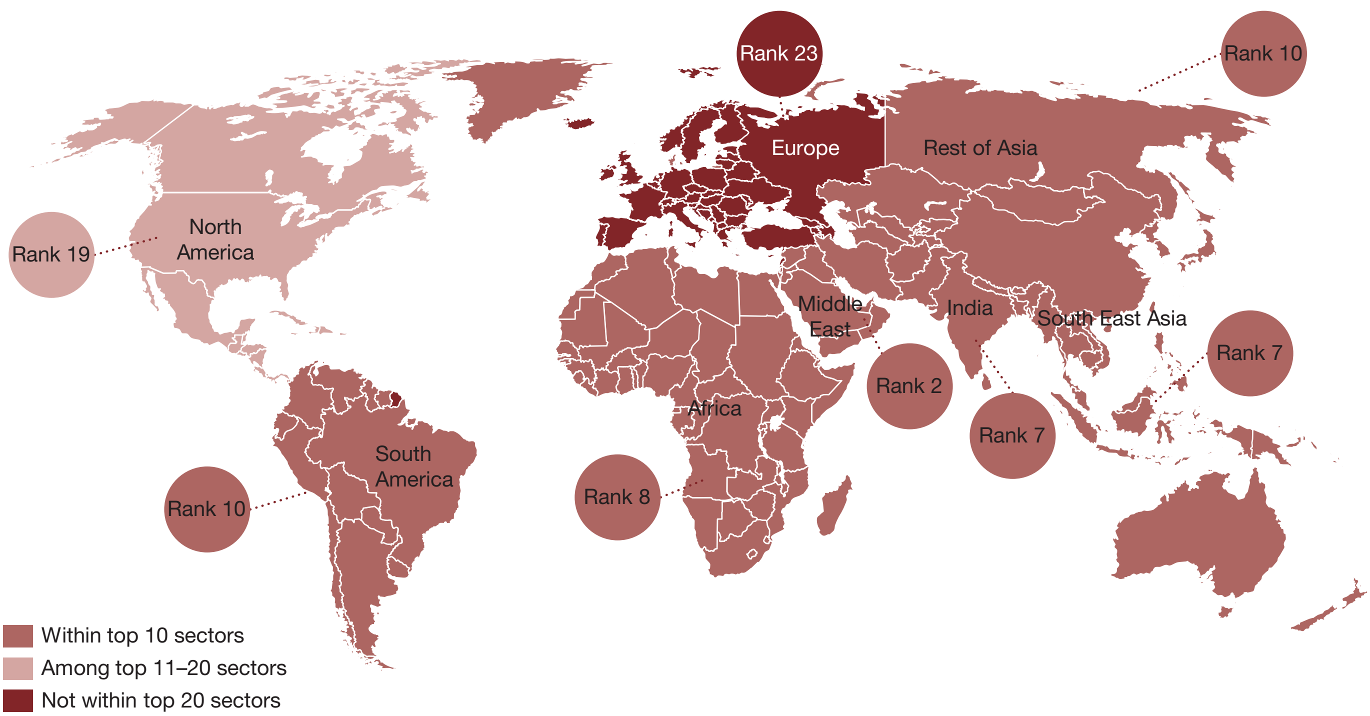
Source: Government statistics centers; ministries of education; ministries of higher education; Strategy& analysis

Unsurprisingly, the demonstrated growth produced by the potent combination of growth drivers in the GCC education sector has attracted significant interest in its investment landscape (*see "The investment landscape in the GCC education sector," page 7*). The sector ranks second in terms of private equity transactions among all sectors in the Middle East and first in terms of private equity transactions among education sectors globally (*see Exhibit 2*). Moreover, the number of announced private equity and M&A transactions has increased three-fold over the past decade, from nine transactions in the three-year period between 2005 and 2007 to 24 transactions in the period from 2014 to 2016.

Exhibit 2

The GCC education sector ranks higher than education elsewhere for private equity transactions

Education sector rank in deals (2011–2015)



Source: Thomson Reuters Eikon PE Database; Strategy& analysis

The investment landscape in the GCC education sector

The investment landscape in GCC education spans four subsectors: education delivery, education services, education support services, and education infrastructure (*see Exhibit 3*). Currently, education delivery, from pre-K through higher education, and education services, ranging from professional development to education consulting, account for a majority of the deals we have examined in the sector. As the sector matures, new opportunities are likely to emerge in education support services, such as textbook distribution and catering; and education infrastructure, such as property maintenance and information, communications, and technology networks.

Exhibit 3

The education landscape spans four main areas of education-related activity

Core education

Education delivery	Pre-K education (and childcare)	K–12 education	Vocational education	Higher education			
Education services	Professional development	Curriculum development	Development of education content	Student assessment			
	Student tutoring	Test preparation	School inspection	Education consulting			
Education support services	Textbook distribution	Transportation	Housing facilities	Healthcare	Extracurricular activities	IT services[1]	Non-teaching HR management
	Career advisory	Remedial support	Libraries	Catering	Student counseling	Facilities management	
Education infrastructure	Infrastructure provision and ownership	Infrastructure maintenance	Infrastructure sales and rental	Infrastructure equipping	ICT infrastructure (including national school network)		

Ancillary

[1] Including school management systems.

Source: Strategy&

Four investment plays in the GCC education sector

Investors seeking exposure to the GCC education sector can pursue multiple plays based on their risk/return appetite and cash flow preferences. There are growth plays, such as the investment stake in Dubai-based, K–12 school operator GEMS Education, purchased by Blackstone and a consortium of other investors that same year. There are greenfield plays, such as those targeted by a portion of Amanat Holdings' education and healthcare investment fund, which was oversubscribed 10-fold on its launch in 2014. There are real estate plays, such as the sale-leaseback agreement that PineBridge Investments struck with GEMS in 2013. In addition, as the GCC education sector matures, we expect to see a fourth type of play emerge — consolidation plays.

1. Growth-focused acquisitions

The least complicated way to participate in organic growth in the GCC education sector is through acquisition of established companies. The education delivery subsector in the GCC is best suited for such investment plays because it is relatively mature and well-populated with established local institutions. When properly executed, these investments offer high levels of risk/return with cash flow profiles that enable incremental monetization of the investment through recurring dividends coupled with a capital gain upon exit.

The K–12 and higher education segments in Saudi Arabia and the United Arab Emirates (UAE) offer the most attractive growth acquisition opportunities in the region, with numerous investment targets and regulatory environments that encourage the private sector. Both countries have large student-age populations — combined, they represented 69 percent of the GCC's private K–12 enrollments in 2014–15 and 73 percent of the GCC's private higher education enrollments in 2013–14. As a result, there have been multiple transactions in both markets. A few recent examples include, in Dubai, GFH Capital acquiring an American curriculum school for US$34 million and a British curriculum school for $54 million. In Saudi Arabia, in 2016, Alkhabeer Capital acquired a controlling stake in the privately held Adwa'a Al Riyadh National School.

When pursuing ownership stakes in established institutions, investors should consider a number of key factors necessary for achieving target returns.

At the identification stage, these factors include selecting institutions that:

- Operate in growing market segments, such as universities offering undergraduate programs that are aligned with economic sectors prioritized for growth and investment by the government
- Occupy defensible markets, such as locations near residential neighborhoods with large student populations
- Feature established reputations for quality, as demonstrated by superlative government inspection scores and accreditations
- Offer proven track records of transforming revenues into profits and room for upside growth

Post-acquisition, investors can use many value creation levers to maximize their return on investment (*see Exhibit 4*).

Exhibit 4
There are multiple value creation levers for investors in GCC education

Top-line growth		Margin improvement		Financial optimization		Enabling levers	
Market segment focus	Neighborhood or catchment area, curriculum, age group	**Staffing efficiency**	Student-teacher ratio levers (class size), scheduling optimization, admin staff ratios	**Capital structure**	Leverage ratio, cost of capital	**Tools**	Reporting and information dissemination
Market positioning	Brand awareness, quality/reputation, accreditations, partnerships	**Capacity utilization**	Student capacity, idle-time utilization (e.g., campus and amenities)	**Cash cycles**	Working capital management, cash conversion cycle (e.g., bookstore)	**Organization**	Structure, capabilities, incentives, development
Customer lifetime value	Drop-out ratio, student acquisition costs (e.g., marketing)	**Procurement/ supply chain**	Outsourcing functions, service provider rates, classroom material	**Non-core assets**	Non-core investments, real estate asset sale-leaseback	**Governance**	Structure, capabilities, representation
Expansions	Organic (e.g., new market segment, ancillary services) or inorganic (e.g., feeder network linkage)	**Automation**	Back-office processing (e.g., grades reporting), parents' interface				
Pricing	Tuition price points, ancillary services price points, other fees (e.g., registration)						

Source: Strategy&

Top-line growth, for example, can be enhanced through improved market positioning. To illustrate, higher education institutions can establish partnerships with employers, or they can pursue "bolt on" acquisitions (i.e., when the acquirer provides the strategic capabilities) and joint ventures to create multi-segment networks that feed students from K–12 to higher education.

Another effective means of revenue growth in higher education is the use of preparatory curricula that support the staged entry of qualified students. Such programs enlarge the pool of viable students, lengthen the student life cycle, and generate additional fees.

The financial restructuring of core assets is another value creation lever that new owners can use to optimize the financial position of acquired companies. For example, they can sell off real estate in sale-leaseback transactions to unlock significant capital for expansion or shareholder returns.

No matter which levers investors choose to use in their value creation plans, they must ensure that their schools are aligned with the needs and desires of their customers. This may require investments in teaching quality through new teacher accreditations or lower student-to-teacher ratios. Exactly how the value proposition can be enhanced depends on the specific target segments. Although an expansion in extracurricular activities may serve to increase demand at a high-price-point international school, it may not be as effective in a local school in a smaller city, where customer choice is more related to geographic proximity, success rate in official exams, and/or tuition.

2. Greenfield investments

Investors with a greater appetite for entrepreneurial risk will find the GCC education sector a good incubator for startups. To succeed, greenfield plays must be based on proven business models and supported by the strategic oversight and resources needed to realize their potential.

Greenfield plays are best pursued in the nascent subsectors of GCC education. Opportunities exist in subsectors that are expected to experience supply gaps. For example, we expect sustained demand growth in pre–K due to the growing numbers of women entering the workforce. The demand for vocational training also should remain high: GCC governments and employers, especially in countries with higher numbers of private-sector companies, such as Saudi Arabia and the UAE, need to ensure the supply of skilled workers. Other subsectors include education services, such as online tutoring and student assessment services, and education support services, such as school management systems.

Given that new ventures can encounter unexpected problems and have long-term holding periods, they naturally entail higher levels of risk. This is manifested in a cash flow profile that often requires periodic injections of capital during launch and early growth stages of the business. However, it can yield sizable gains when the business matures and when the venture is sold.

To succeed in a greenfield play, investors should first identify a niche in which a supply-demand gap exists in a new, mature, or local market. One way to identify such gaps is by monitoring government plans to launch specialized services. For instance, the government of Abu Dhabi is seeking to expand the number of education institutions serving autistic children. Niches can also be revealed through supply-demand analyses of curriculums and price-points.

Although capturing a first-mover advantage in new market niches can be advantageous, greenfield investors should keep in mind that fast followers can also win in growth markets, especially if they can establish a reputation for quality.

Once a market opportunity is identified, greenfield investors should select business concepts and models that have a proven track record in other markets. They should then adapt these concepts and models to regional preferences, such as content localization and gender segregation. In this regard, selecting a management team or a partner that brings deep sector expertise, an extensive network of local contacts, and knowledge of the regulatory environment to the table is a key ingredient in the successful realization of greenfield business plans in the GCC.

Once they reach the operational stage, greenfield investors can use many of the same value creation levers as growth-focused acquisitions (*see Exhibit 4, page 9*). They should pursue strategies that seek top-line growth and scale, while operating as cost-efficiently as possible.

As in growth-focused acquisitions, greenfield investors can use partnerships to enhance market positioning and establish linkages with other educational institutions to drive volume intake. For example, investors could link an online tutoring venture to established K–12 schools to reach students who require learning assistance. Greenfields must monitor their drop-out and churn rates to ensure sustained demand and maintain fees over the student life cycle. On the cost side, they need to maximize capital utilization by managing the inevitable rise in operating expenses, ensuring that increases in overhead do not outstrip revenue growth.

3. Consolidation plays

Consolidation plays are rare in the GCC education sector because of its relative youth and strong demand, both of which favor less complex value creation plays. That will change as the sector matures. Investors and strategic buyers will be able to pursue consolidation to optimize fragmented investments, realize scale advantages, and unlock incremental returns.

In terms of risk and return, consolidation plays are positioned between growth-focused acquisitions and greenfields. They tend to command slightly higher returns than growth-focused acquisitions due to integration risks, but they entail less risk than greenfield ventures because they acquire already established businesses. Typically, the value creation plan for consolidations relies heavily on assets that can be acquired at low multiples, in which margins and multiples gains can be quickly attained from integration on a more efficient platform. Consolidation cash flows usually include incremental monetization of the investment through some recurring dividends and a significant capital gain upon exit.

To identify suitable consolidation opportunities, acquirers should seek out education subsectors that feature multiple, fragmented targets with similar value propositions (e.g., curriculum and price-point combinations), operating models, and geographies. In the GCC, the education delivery subsector is best-suited for consolidation plays. The high number of well-established, sizable local institutions combined with the fragmented competitive landscape in segments such as pre-K and vocational institutions offer clear scale benefits. Further, consolidation strategies have proven successful in more mature markets. For example, in 2005, Chicago-based private equity firm Prospect Partners founded Education Futures Group and since then has acquired and consolidated a number of continuing education institutions in the U.S. Southwest.

In the GCC, the education delivery subsector is best-suited for consolidation plays.

Once the asset is acquired, owners can use the value creation levers to unlock value from their investment (*see Exhibit 4, page 9*). The most promising levers for consolidation plays are margin improvement levers. For example, the centralization of back-office administrative functions across multiple schools and sharing teacher resources can enhance administrative staff and student–teacher ratios. Combining suppliers and service providers, such as consumables, books, and facilities management, can reduce procurement expenses and enhance margins. On the revenue side, synergies often arise in the cross-selling of ancillary services. For example, facilities can be shared to bolster extracurricular sports activities or to increase how long they can be used (by consolidating preschools with K–12 schools, for instance).

4. Real estate sale-leasebacks

The dynamics of the GCC education sector offer opportunities to real estate investors. They can acquire and lease back the land and property assets of educational institutions.

Real estate sale-leasebacks tend to fall on the lower end of the risk/return spectrum. They offer a bond-like cash flow profile that includes periodic dividends from rental yields and the recouping of investment capital upon asset disposal.

The best focus for real estate sale-leasebacks is the education infrastructure subsector, in particular the campuses of entities operating in the education delivery subsector. These investments provide benefits for buyers and sellers: Buyers secure a long-term stream of predictable returns with yields that typically range from 9 to 11 percent; sellers free capital that is locked up in non-core assets for growth and/or distribution and increase the return on equity on their operations.

In the face of high land costs, an expanding market, and a more restrictive funding environment, GCC educational institutions, in Saudi Arabia and the UAE especially, are showing an increased appetite for sale-leaseback transactions. One of the first sale-leaseback deals in GCC education was completed in 2013 when PineBridge Investments acquired a GEMS campus in Dubai, leasing back the property for over 20 years. That same year, GEMS sold a second campus in Dubai to UAE-based real estate investment trust Emirates REIT, raising additional capital for expansion.

A successful investment in GCC education real estate depends on the investor's ability to secure a stable asset and structure a favorable lease agreement. The selection of the asset is critical to ensuring target returns are met because of the risks inherent in a single-tenant lease. Investors should look for a school operator with healthy finances and a strong position in an established market segment. A thorough property inspection is also essential to ascertain the condition of the property and its maintenance history. This will help limit return leakage due to major unexpected maintenance-related capital expenditure.

Once asset selection is complete, investors should negotiate a long-term lease agreement that is inflation-protected and price-indexed. Investors also should closely monitor facilities management costs to ensure returns are realized. Here, as in consolidation plays, the ability to achieve scale within a city or region can enhance the negotiating power of the buyer and reduce operating expenses.

Conclusion

As the second-most-active sector in GCC deals, the education sector continues to beckon private equity and strategic buyers with attractive returns. The demand for private education is strong as it is driven by an expansion in the student population, discretionary income growth, a consumer preference for private education, and governmental privatization initiatives.

However, to capitalize on these deals, investors in GCC education will have to remain mindful of the value creation levers that enable the achievement of target returns. They will identify opportunities in market segments that feature favorable combinations of curriculum, price point, and geography. They will ensure that their targets and partners have reputable brand names and attractive customer value propositions. Moreover, they will seek scale to unlock cost benefits and proactively safeguard their business models in the event of changes in the market. Investors who do these things will garner handsome returns.

Endnotes

[1] The GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

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