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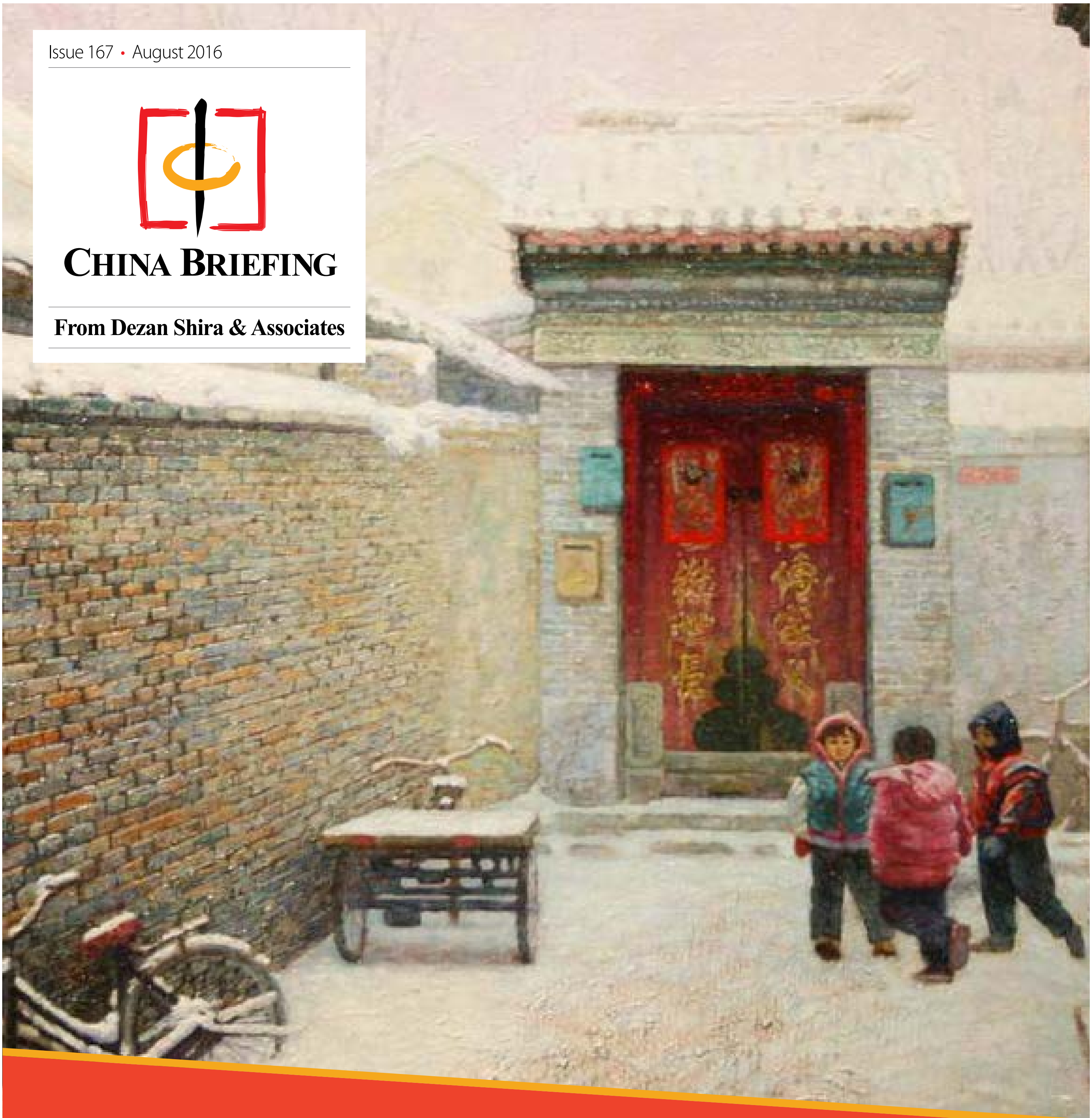
CHINA BRIEFING

From Dezan Shira & Associates



China Investment Roadmap: the Education Sector

Introduction

Alberto Vettoretti
Managing Partner
Dezan Shira & Associates

China's massive education industry has not lacked for publicity in recent years. Spurred by its explosive growth and the strikingly high test scores that come out of the country, education in the Middle Kingdom has both been a model that foreign governments have attempted to emulate, and a sector that foreign companies have been eager to invest in – and with good reason. Although China undeniably has a strong domestic base for education that is the envy of many other countries, there are numerous niche sub-sectors that overseas educators are well placed to tap into and a great appetite for foreign expertise.

But while there are various gaps in China's education market that foreign education providers could fill, the industry has consistently remained one of the country's most restrictive for foreign direct investment (FDI) since its opening up period in the late 1970s. In China's Catalogue for Foreign Investment, FDI into education can alternately be defined as encouraged, restricted, or prohibited depending on the area of investment, highlighting how sensitive the industry is still considered by the Chinese Communist Party.

In this issue of China Briefing, we navigate through China's regulatory framework for investment into education, presenting a roadmap for best practices in the industry. We examine the key market information that has driven the industry's growth, analyze the different investment models that are available for foreign companies, and finally discuss the effect that China's recently released NGO law will have on foreign investment into education.

There are an abundance of opportunities for foreign involvement in China's education industry, but a return on investment can only be realized with a firm prior understanding of the market environment and the selection of an appropriate investment vehicle. We hope that this issue of China Briefing will help put your company on the right path.

With kind regards,

Alberto Vettoretti

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Knowledge is Power: Understanding the Education Market in China

By Dezan Shira & Associates
Editor: Alexander Chipman Koty

China's already immense education industry is poised to further expand in the coming years as Chinese parents prepare their children to compete in an economy far different than the one they grew up in. After decades of relentless growth facilitated by an abundance of low cost workers, China is transitioning to a more mature development model reliant on services and skilled labor – and increasingly affluent Chinese families are investing in education to meet these needs. Already worth RMB 1.6 trillion (US$240 billion) in 2015, China's education market is projected to nearly double to RMB 3 trillion (US$450 billion) by 2020.

The growth of China's education industry is striking. Investment cases grew from 190 in 2014 to 270 in 2015 – an increase of 42 percent – and the amount of mergers and acquisitions and IPOs rose by 165 percent and 76 percent, respectively. All told, investment catapulted from RMB 6.1 billion ($913.4 million) to RMB 15.9 billion (US$2.4 billion) year-on-year.

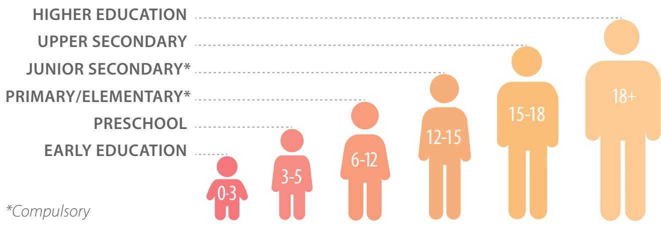
Although China is experiencing a long-term aging population, the size of its current youthful population remains significant. Of China's 1.37 billion citizens, 17 percent are between the age of 0 and 14 – approximately 233 million in need of education. The parents of this nearly quarter billion contingent of children are wealthier than previous generations and prepared to pay a premium for education. In addition to China's longstanding cultural emphasis on education, the country's one child policy gave parents strong incentives to invest heavily in their children, as parents and grandparents are often dependent on a single child for support as they age. The relaxation of the one child policy in recent years, however, may lead to an increase in newborns at a time when many Chinese families are prosperous enough to comfortably raise more than one child.

Surveys consistently show that Chinese families prioritize spending on education ahead of any other area, including real estate and retirement savings. Spending habits support this statement, as the McKinsey Global Institute projects the country to spend 12.5 percent of its overall consumption growth on education for those under 30 over the next 15 years, the most in the world aside from Sweden. Further, according to ICEF Monitor, almost half of a Chinese 20 year old's per capita consumption is spent on education, in contrast to less than a quarter for an American. These expenditures are significant and set to rise, as the working age urban middle class is forecasted to increase to over 50 percent in 2030 compared to just four percent in 2010.

Despite the willingness of Chinese consumers to spend on education, foreign investors face several challenges entering the market. The Chinese government is often suspicious of foreign involvement in education, and holds strict control over curricula. Foreign participation is prohibited in compulsory education spanning ages 6-15, and most types of educational facilities require establishing a joint venture with a Chinese partner.

China's Education Industry at a Glance

Educational stages



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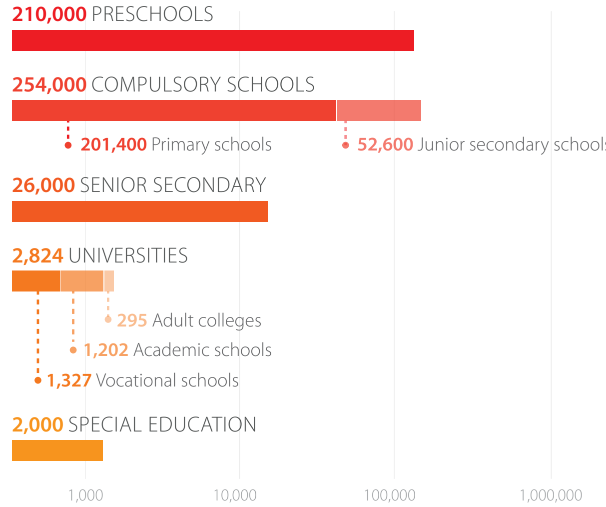
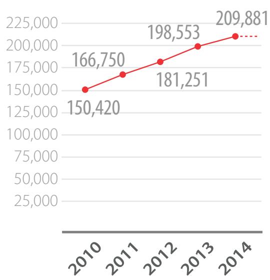
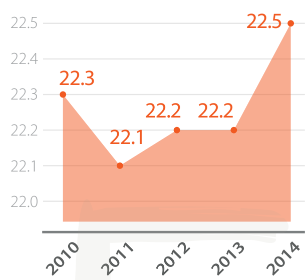
Education in China 2014



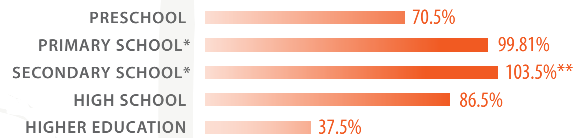
Number of preschools



Child dependency ratio

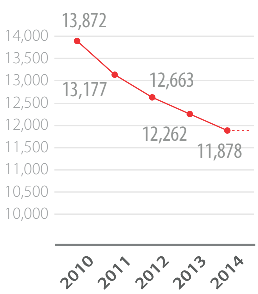


Gross enrollment

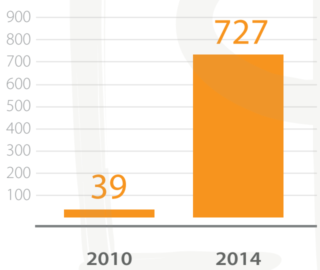


*Compulsory
**The gross enrolment ratio refers to the age group officially associated with a given level of education; the gross enrolment ratio can therefore exceed 100% due to grade repetition or students beginning their education at an atypical a

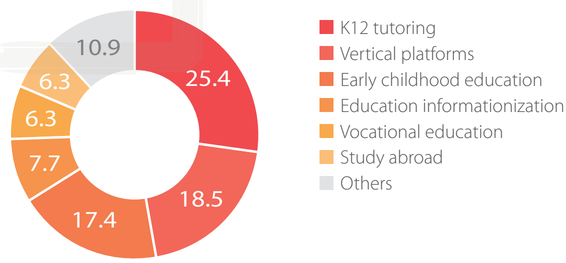
Number of vocational secondary schools



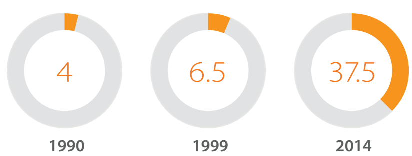
Number of private higher education institutions



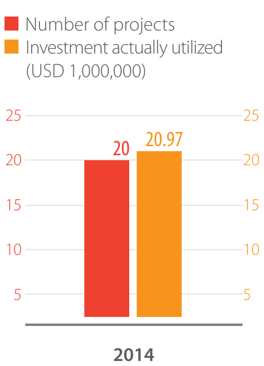
Breakdown of Overall Investment in China's Education Industry (% of investment)



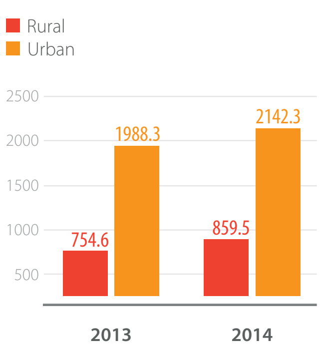
Percentage of 18-22 year olds in higher education



Foreign Direct Investment

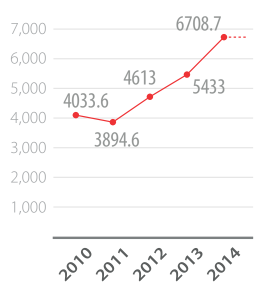


Per Capita Household Expenditure on Education and Arts (RMB)



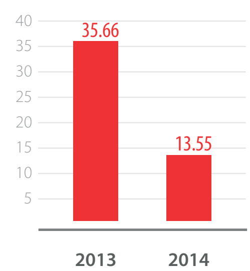
Total Investment in Fixed Assets (Education)

Unit: 100 million



Net Overseas Direct Investment

Unit: USD 1,000,000



The Chinese education system's rigid fixation on standardized examinations further restrict what forms of education are in demand for students below the tertiary level. Despite these limitations, there is robust demand for foreign education services as highly competitive consumers value the quality of overseas expertise.

While certain sectors of China's education market are highly saturated and extremely competitive, such as English language training (ELT) schools and preparatory schools for the Zhongkao, Gaokao, and SAT exams, demand for other more specialized education institutions is rising. Some of these are specifically promoted by the government and benefit from favorable policies, while others are emerging due to the growing awareness and spending power of Chinese consumers.

Vocational Education

The Chinese government recently pledged RMB 10 billion for the development of infrastructure for new vocational schools, with local governments supplying even more. There were 29.3 million Chinese studying applied skills, such as technical IT training and other trades, at vocational schools and colleges in 2014, comprising 6.3 percent of the education market. By 2020, the Chinese government aims to have 38 million students in vocational schools, but these schools are often looked down upon in China, and the majority of teachers are unqualified. As the government pursues a growth model increasingly demanding skilled labor, the development of vocational schools into trustworthy sources of applicable skills and knowledge is key. Such institutions are the only form of education explicitly listed as encouraged for investment, reflecting the need to attract services in this area.

Early Childhood Education

Early childhood education, which covers education for children below the age of three, is a promising growth sector benefiting from rising disposable income levels. Since 2009, China's baby care industry has grown by 55 percent per year, demonstrating the willingness of Chinese families to spend heavily on young children. While the Chinese government is still focusing on increasing enrollment in preschools and kindergartens, the education market for children too young for these institutions is growing. Due to the youth of these children, such facilities must act as nurseries in addition to providing early education. However, China's early childhood education sector suffers from a lack of regulations and oversight. About 60 percent of early childhood education schools are registered as consulting companies or educational training centers and are not connected to the local government's education department. Some overly ambitious schools promise to teach advanced topics such as English and mathematics in early preparation for future examinations despite the fact that students are aged three or younger, and only about 10 percent of teachers in early childhood education institutions actually have teaching certificates. These issues point to the need for more formalized and higher quality education in this sector.

Special Education

Special education is another field that is largely absent in China. It is generally quite difficult for students with physical and learning disabilities to receive individualized education services tailored to the unique challenges they face. Even accessing general education services is often problematic, as only about 72 percent of children with disabilities enroll in school, compared to 99.6 percent of their able-bodied peers. Special needs students who participate in general education institutions are often discriminated against or have their needs misunderstood, and schools usually lack the resources to care for them. Indeed, many children with learning disabilities do not even have their conditions recognized to begin with. Those with speech and communication disorders, for example, suffer from a lack of resources and qualified care. In 2010 there were only about 1,000 speech-language pathologists (SLPs) in all of China, many of which were trained for under six months and sometimes only two weeks. Support for students with physical disabilities such as deafness is slightly better, though the type of education they can pursue is often limited and facilities lack accessibility. As awareness of students' special needs grows, there will be increasing demand for specialized education that cannot be provided by mainstream institutions.

Investing in China's Education Industry

By Dezan Shira & Associates
Editor: Zhou Qian

Despite China's promise to gradually open up its education sector to the world following its accession to the WTO in 2001, the country's education industry is still a highly sensitive area for foreign investment. This is mainly due to how closely intertwined it is with Chinese ideology and identity and its propensity to influence children's beliefs, resulting in foreign investors engaging in education in China usually being faced with closer scrutiny.

Market Entry Policies

According to China's Catalogue of Industries for Guiding Foreign Investment (2015) (外商投资产业指导目录), the education industry is divided into three separate categories. While compulsory education institutions (primary and middle schools) and special training institutions (such as military, police, political, and Chinese Communist Party schools) are still considered prohibited areas, foreign investors are allowed to invest in pre-school educational institutions, high schools, and tertiary educational institutions in the form of Sino-foreign joint ventures, in which foreign majority ownership is allowed but only when the Chinese party is in a leading position. That is to say, the principal or key administration officer in such institutions is required to be a Chinese national and the council, the board of directors, or joint administration committee of the school must be majority Chinese.

In contrast to these restrictions, foreign investors are encouraged to invest in sports training and non-academic vocational training institutes (such as IT, accounting, English, etc.), primarily because these industries are considered to have talent shortages.

The only way for foreign investors to circumvent the restrictions listed in the Catalogue is to establish international schools for the children of foreigners. According to the Interim Provisions on Set-up of Schools for Children of Foreign Nationals in China (关于开办外籍人员子女学校的暂行管理办法), qualified foreign organizations, enterprises, and individuals legally residing in China are allowed to establish wholly foreign owned and controlled pre-schools and K12 schools that are only open to the children of foreign nationals. However, it's important to note that this kind of international school is forbidden to have any branches – it can only be a single school.

Non-profit or For-profit

Another acute consideration for foreign investment in China's education industry is whether foreign parties can profit from their investment. In China, education is traditionally regarded as a public cause, and the government has therefore been reluctant to privatize the sector. As such, China's laws and regulations usually require education institutions to be non-profit organizations, but there are several holes and contradictions across different pieces of legislation. Article 28 of the Implementation Measures on Establishment and Operation of Sino-Foreign Cooperative Educational Institutions (中外合作办学条例实施办法) specifies that all Sino-foreign cooperative educational institutions are prohibited from for-profit activities.

Typical VIE Structure

This also applies to the aforementioned international schools for children of foreigners. Correspondingly, education institutions are usually required to be registered as "private non-enterprise units" in the civil affairs department, rather than registered as "limited liability companies" in the Administration of Industry and Commerce (AIC).

Although the Private Education Promotion Law (民办教育促进法) stipulates that investors could get a "reasonable return" of up to 75 percent of the net margin from a private education institutions, it is still significantly different from regular dividends distribution. In practice, "reasonable return" is rarely added into the institution's Articles of Association because this concept is never clearly defined, making pre-establishment approval even more difficult as a result.

Nevertheless, the recent revision of China's national education laws in 2015 – together with some local level regulations and practices – sheds some light on the feasibility of for-profit education. The revised PRC Education Law (教育法) abolished the previous provision "No organization or individual may establish or run a school or any other educational institution for profit-making purposes", pointing towards a more relaxed attitude from the government regarding for-profit education. At the local level, Shanghai released two provisional regulations on commercial training institutions in 2013, making Sino-foreign for-profit education explicitly operable in the Pilot Free Trade Zone (FTZ). Similar practices are also observed in Beijing, Guangzhou, Shenzhen, and Hangzhou, amongst others, though these cities have not released formal regulations as Shanghai has. Conversely, however, the vote on the proposed amendment to the "Private Education Promotion Law", which emphasizes the legitimacy of for-profit education and specifies the transfer method of non-profit education institutions to for-profit institutions, was temporarily suspended. There are also further contradictions in China's recently released NGO law, which is discussed in detail in this magazine's final article. Consequently, it is still too early to say that the barriers to for-profit education have been eliminated, both legally and in practice.

Common Investment Models

In view of the abovementioned restrictions and market entry barriers, foreign investors sometimes use the "variable interest entities (VIE)" model to access China's education industry. Under this model, foreign investors retain control over entities operating domestically in China through a series of contractual arrangements rather than direct shareholding. Typical examples include TAL Education Group, New Oriental, and Maple Leaf Educational System, the structure of which is summarized in the graph in the upper left.

However, considering the increasing legal risks embedded in the VIE structure, such as contract invalidity, fighting of control rights, and transfer pricing reviews, investors may instead choose one of several direct investment models, including:

- **Model 1:** Set up self-owned pre- and K12 international schools for children of foreigners or vocational training centers, e.g. Wellington College International Shanghai, Wall Street English, etc.
- **Model 2:** Set up Sino-foreign cooperative educational institutes, such as a university-level cooperation (e.g. NYU Shanghai), department-level cooperation (e.g. China-EU School of Law), and program-level cooperation (MDS Program between Peking University and Hong Kong University)

- **Model 3:** Franchising, focusing on pre-school and English training, e.g. EF Education and My Gym (early childhood development programs)
- **Model 4:** M&A—such as Sequoia Capital's investment in Universal Education Group

Due to the limited scope of this magazine, we mainly focus on the first two of these models in the following paragraphs.

Set-up Procedures

Set-up of an international school for the children of foreigners

Theoretically, all foreign organizations, enterprises, and individuals legally established or residing in China can apply to set up an international school as long as it satisfies the following requirements:

- Has adequate demand
- Has teaching expertise
- Has necessary facilities, equipment, and other teaching resources
- Has stable sources of funding
- The main setup procedures include:
  1. Submit the application and other documents to the provincial level educational administrative departments
  2. Upon review and preliminary approval of the provincial level government, the application shall be delivered to the state-level Ministry of Education for final approval
  3. Register with the civil affairs department

This type of school is allowed to enroll children of foreigners legally residing in China, can choose the curricula, textbooks, and teaching programs by itself, and can hire foreign staff according to relevant laws and regulations. However, it is forbidden from enrolling Chinese nationals, opening additional branches, or conducting any for-profit activities.

Set-up of Sino-foreign cooperative educational institutes

For Sino-foreign cooperative education, both the foreign and Chinese parties are required to be educational institutions with a legal presence in China. That is to say, no individual investors are allowed to engage in this type of educational institution.

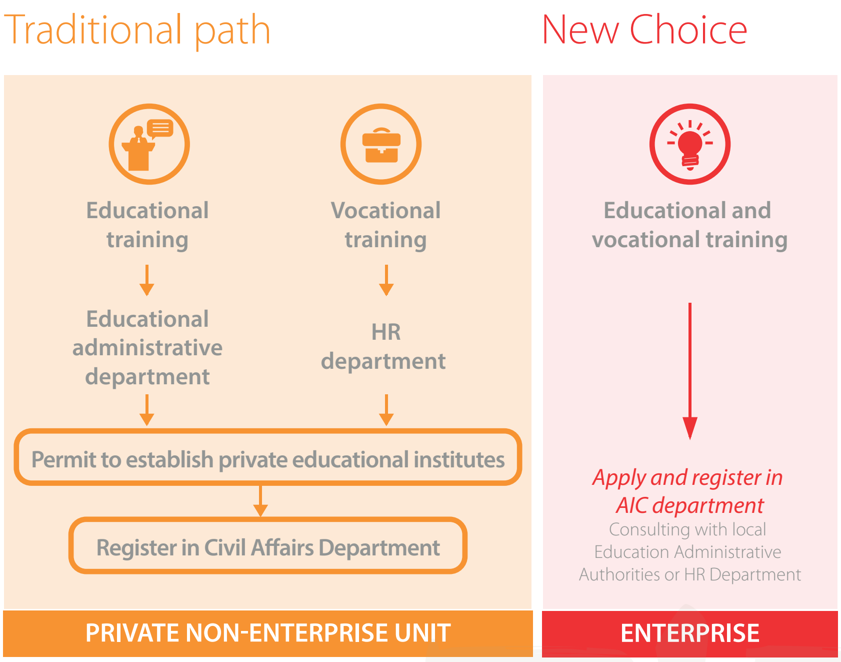
Both parties may make capital contributions in the form of cash, land use rights, intellectual property (IP), and other types of property. However, except for foreign institutions invited by either the state or the provincial level government to participate in cooperative educational undertakings in China, the IP contribution ratio generally cannot exceed one-third of each party's total contribution.

Investors seeking to set up Sino-foreign cooperative educational institutions are required to obtain pre-approval from the corresponding level of government depending on the specific category:

Generally, the set-up process for Sino-foreign cooperative educational institutions includes two stages: the preparatory stage and the official establishment stage. Applications satisfying all establishment requirements and standards can be submitted for official establishment directly.

During the preparatory stage, certain documents specifying the key information of the cooperative programs are required by the bureau in charge, including a certificate showing that a minimum of 15 percent capital contribution for the startup has been made. Upon receiving the application, the bureau in charge will approve or reject it within 45 working days. If approved, an approval certificate for preparatory establishment will be issued, which is valid for three years. No enrolment will be carried out during this preparatory period.

Category	Bureau(s) in Charge
• Tertiary educational institutions for undergraduate or higher degrees	• Ministry of Education
• Tertiary technical education • Non-academic tertiary education	• Provincial level People's Government
• High school • Self-study examination assisting institution • Extracurricular tutoring • Early learning/pre-school education	• Provincial level education administrative department
• Vocational training	• Provincial level human resources department



During the official establishment stage, another application for official set-up must be submitted with the following documents:

- Application form for official establishment
- Approval certificate for preparatory establishment
- Status report for preparatory establishment
- Articles of association
- Certificates of capital and assets of the Sino-foreign cooperative educational institution
- Personnel list of the first board of directors, board of trustees, or joint management committee (to satisfy the requirement of "led by Chinese party")
- Proof of qualifications of the principal, chief administrative officer, teachers, and financial staff

The bureaus in charge will review and decide whether to approve within three months of receiving the application for non-academic education and six months for academic education. Upon approval, a permit for Sino-foreign cooperative education with a standard format and serial number will be issued.

The last step for establishment is to register in the civil affairs department. After that, the educational institution will be legally formed and allowed to conduct corresponding enrolment and teaching activities. However, it is important to note that it is, once again, forbidden to open additional branches or conduct any for-profit activities.

Set-up of for-profit training centers in certain cities

For-profit training centers are now possible in limited cities, as mentioned above, though the specific procedures vary from city to city. Here we look at Shanghai as an example.

In Shanghai, qualified investors who can provide international advanced management experience, a service model, training subjects, qualified teachers, or teaching facilities are allowed to invest in Sino-foreign cooperative for-profit training centers in the Free Trade Zone (FTZ). There are a number of set-up requirements for a for-profit training center, the most important of which being that the institution must have appropriate school-running funds of no less than RMB 1 million, with one half monetary contributions. Additionally, the for-profit training center must be registered as a company rather than a private non-enterprise unit, subject to the following process:

1. Step 1: Make company name pre-approval and registration in the FTZ AIC department and submit required documents
2. Step 2: The AIC department must deliver the application to the FTZ Administration Commission. Within 10 days of receiving the application, the Commission will make a decision. Upon approval, a preparatory establishment business license will be issued
3. Step 3: Within six months of receiving the preparatory establishment business license, the applicant should apply to the FTZ AIC department for official establishment registration, otherwise it must change the business scope or de-register the business license

For-profit training centers are allowed to have branches, but no less than a RMB 0.5 million capital increase should be made for each branch.

China's New NGO Law and its Impact on FDI into the Higher Education Industry

By Dezan Shira & Associates
Editors: Samuel Wrest and Mia Yiqiao Jing

China's long-anticipated Non-governmental Organization (NGO) Law was released in April 2016. Widely reported in mainstream Western media and commented on by foreign governments, the law, set to come into effect in January 2017, is widely seen as part of President Xi Jinping's efforts to restrict and control organizations whose interests aren't in line with those of the Chinese Communist Party. The law places various constraints on foreign NGOs in the name of protecting China's national security, but the ripples resulting from its implementation will not be limited to NGO activities as traditionally defined in the West. Indeed, the broad and at times vague language contained in the law mean that its provisions can quite easily be applied to China's private education industry.

This is most starkly exemplified in the law's blanket ban on all "for-profit" foreign schools, the makeup and activities of which are not clearly defined. Due to its loose definition of "non-governmental" and "non-profit", there is also a risk that the marketing and funding activities of education providers that aren't for-profit will also be affected.

One of the other defining characteristics of the NGO law is its requirement that foreign NGOs be reviewed by the Public Security Bureau rather than the Ministry of Civil Affairs, illustrating how the Chinese government might view NGOs as potentially hostile. This will extend to foreign education providers, with activities such as registration, licensing, recruitment, operations, and education programs needing to be disclosed.

Complying with the NGO Law

As mentioned in the second article of this magazine, the NGO law is one of several contradictory pieces of Chinese legislation concerning for-profit education activities. Because the law doesn't clearly indicate which practices are considered "for profit", it is likely that it will be used as a means for local governments to shut down foreign education institutions that they do not approve of. It is therefore essential that foreign investors regularly communicate with local governments in order to understand their area-specific development strategies, targets, and how education programs can boost local economic development.

Traditionally, foreign universities have targeted China's more affluent coastal cities. However, the Chinese government is now putting more emphasis on providing high-quality education services to children in Central and Western China. With China targeting 20 percent of its energy mix to be clean before 2030, the government is also working to promote expertise in atmospheric science, disaster management, ecology and environmental engineering.

While the NGO Law stands to further impede FDI into China's higher education market, the Sino-foreign education industry is still expected to expand overall. In order to ensure that investment is worthwhile, foreign education providers will have to look closely at a number of influencing factors, including the location of their institution or program and the subjects that it teaches.

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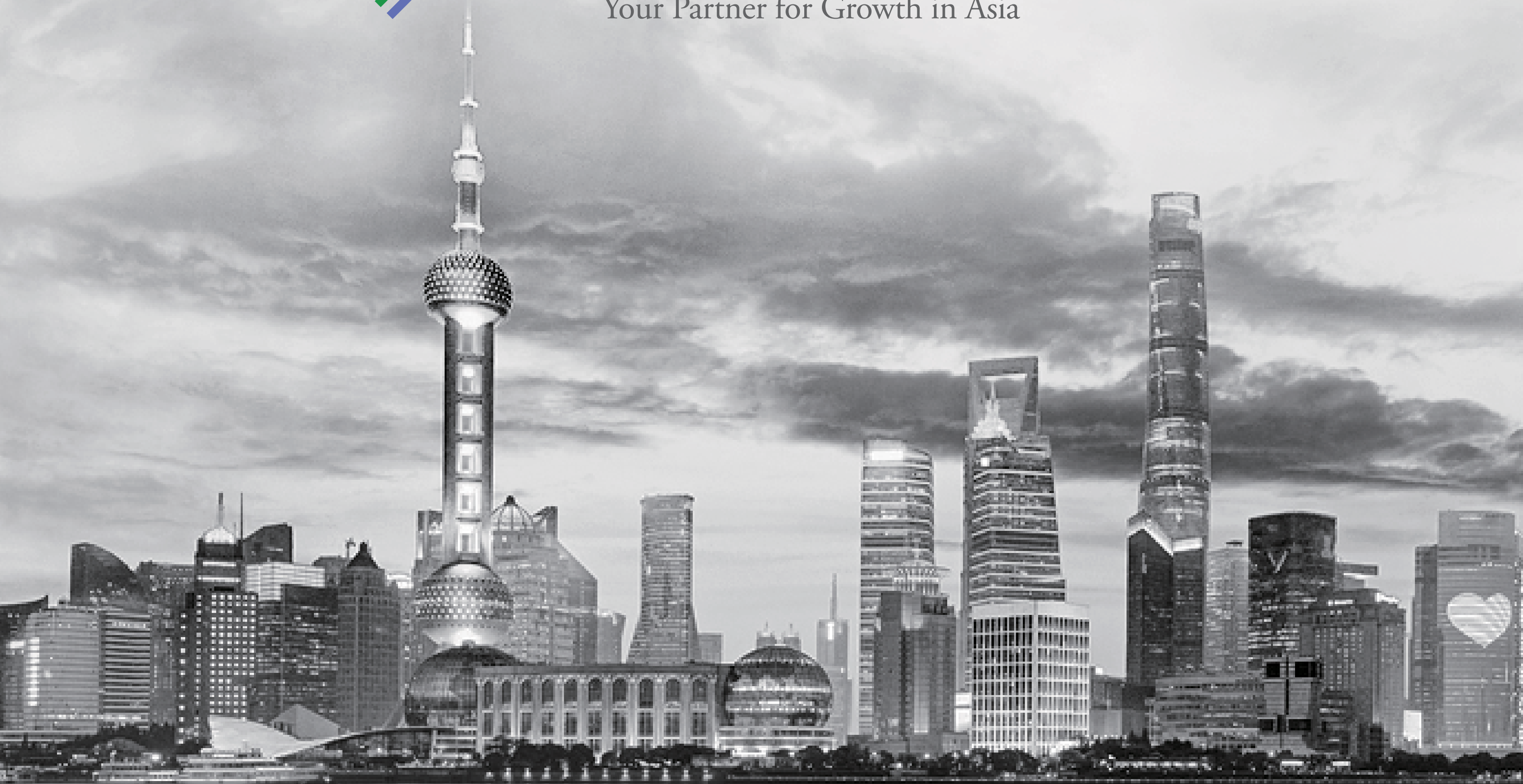

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