Emerging Markets Investment Theme: Brazilian For-profit Education Companies

By Howard Schwab

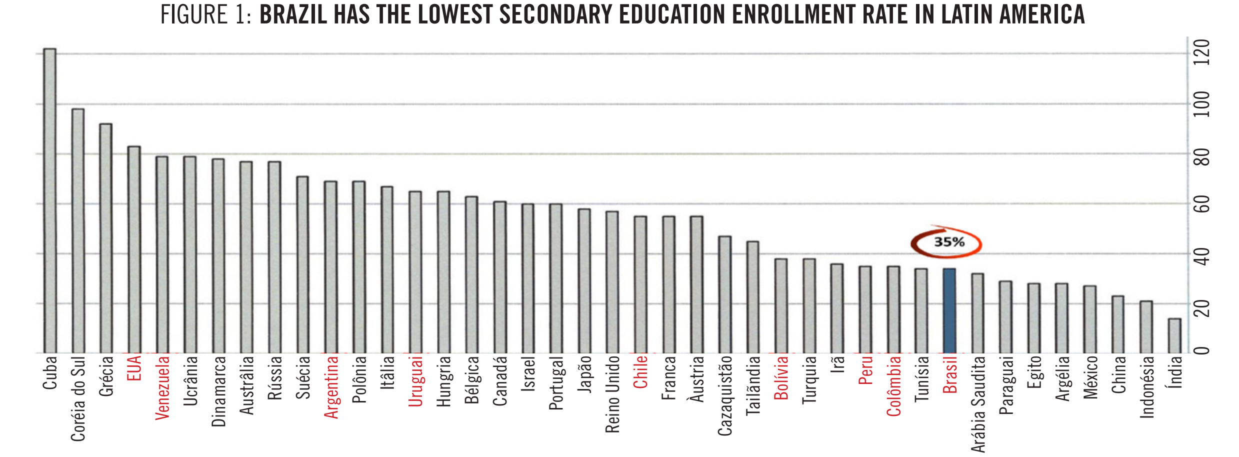
Responding to the needs of its citizens and demands of business owners for more job-ready candidates, Brazilian policymakers have launched an aggressive educational subsidy program known as FIES. The program's goal is to incentivize educational matriculation, especially among the middle- and lower-class populations of Brazil. Notably, within Brazil, only 52% of 15 to 64 year olds had attained secondary-education levels or better as of 2011. In response to this suboptimal level of educational availability, FIES provides significant financing benefits to students and subsequently opens up robust market opportunities for quality providers of secondary education.

Given our stakes and interest in several Brazilian for-profit educators, I recently spent several days in Brazil meeting with management teams and touring educational facilities. During my visit, I sought to assess the potential for market growth and to determine the degree of FIES awareness and utilization among potential students. I was positively surprised by the relatively low market penetration and the obvious economic benefits for potential students. Moreover, whereas many private industries in Brazil have recently suffered from populist policies extolled by the Brazilian government, FIES initiatives require a harmonious partnership between public and private entities to succeed given the heavy reliance on the availability of quality education. The compelling growth opportunities are beginning to factor into expectations for private educational companies. BTG Pactual estimates that during 2013 the free cash flow (FCF) yield of the sector will expand by 80 basis points while return on invested capital (ROIC) should increase by 350 basis points for listed education companies as operating leverage materializes.

FIES and For-profit Education Companies

By 2021, Brazil is projected to have 23.9 million 18 to 24 year olds. The Brazilian government nonetheless has committed itself to the ambitious goal of achieving a post-secondary education enrollment rate of more than 50% by 2020. That would more than double the current enrollment rate of 23%, adding millions of students to school rosters. The FIES program facilitates this goal in two distinct ways. Firstly, it ensures only qualified educational institutions are eligible to accept FIES subsidized students. Secondly, it provides subsidy or financing to improve affordability and availability for eligible students to bolster enrollment rates, which are the lowest among major Latin nations (Figure 1). Over time, the increased adoption of 'distance learning' (online education) will gradually gain prominence in the FIES program as well. This will benefit Kroton, which is the largest provider of distance-learning services in Brazil through its subsidiary Unopar.

FIGURE 1: **BRAZIL HAS THE LOWEST SECONDARY EDUCATION ENROLLMENT RATE IN LATIN AMERICA**



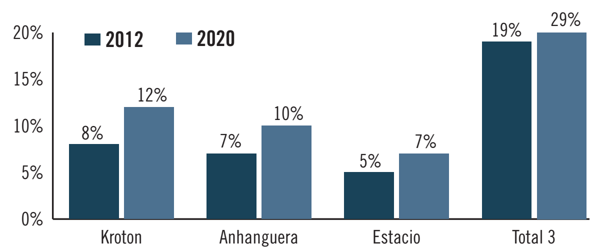
Sources: Kroton, Unesco

In our opinion, leading companies in the private education space will receive several benefits from the implementation of FIES, including:

- Enhanced margins and ROIC benefits
- Improved retention rates as students are more incentivized and economically inclined to stay in school
- An increased concentration of market share among those educational providers most able to offer quality service and educational brand identity (Figure 2)

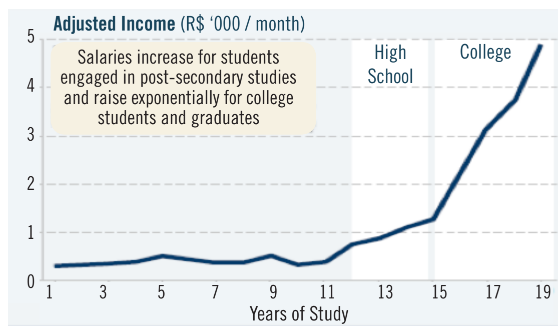
Making the FIES program exceedingly compelling to prospective students is the economic benefit of obtaining a secondary degree in Brazil, as illustrated in Figures 3 and 4. The government recognizes that the aspirational youth of Brazil can best succeed economically if equipped with higher levels of education. Similarly, corporations can more efficiently generate value-added services and products as well as improved productivity from new recruits if furnished with a more developed labor pool. Hence, the urgency and commitment behind FIES appears to have meaningful long-term government support as the program helps the key constituents of youthful citizens as well as private enterprise.

FIGURE 2: **FORECASTED MARKET SHARE SUPPORTS THE CONCENTRATION OF BENEFITS FROM FIES**



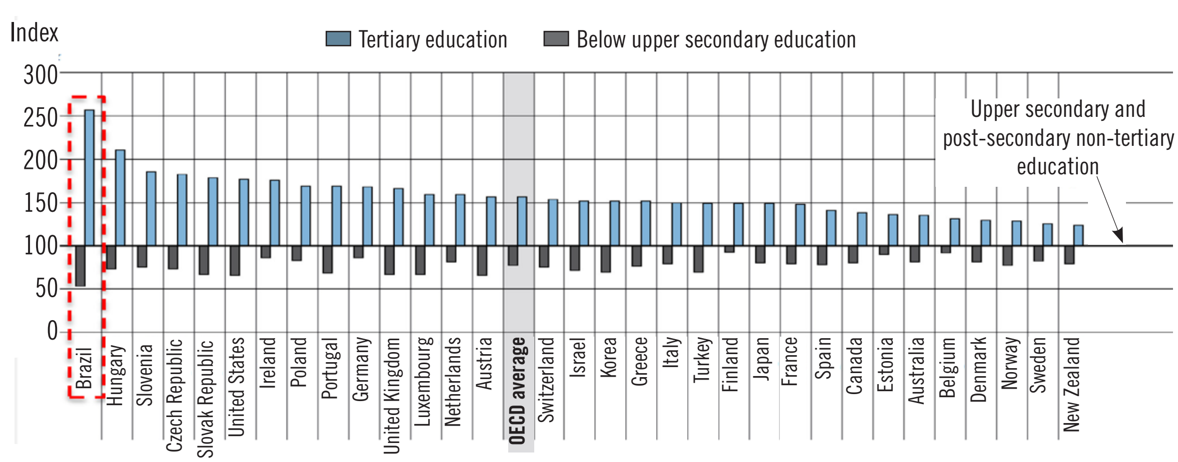
Source: BTG Pactual

FIGURE 3: **RETURNS BY EDUCATION LEVEL INCREASE EXPONENTIALLY**



Source: BTG Pactual

FIGURE 4: **IN BRAZIL, A POSTSECONDARY EDUCATION PROVIDES 2.6 TIMES THE EARNINGS OF THOSE BELOW THAT LEVEL**

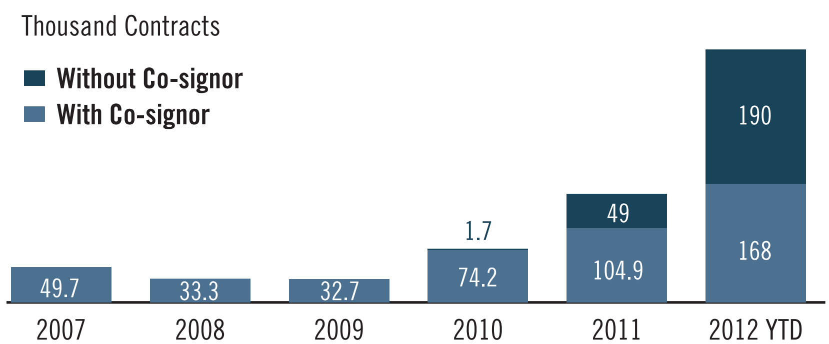


Source: Kroton

Investment Opportunities

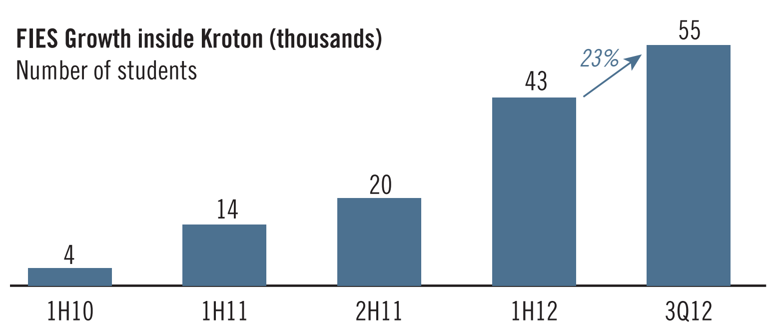
From an investment standpoint, we find the oligopolistic nature of for-profit education to be attractive. Government officials in Brazil remain steadfast in their belief that the quality and availability of education must improve, and the success of FIES and other educational measures will be judged accordingly. As a result, the entrenched participants—including Kroton, Estacio and Anhanguera—benefit directly through their existing economies of scale, higher overall margin potential, and strong governmental relationships. New entrants are faced with high upfront capital costs as well as stringent certification benchmarks that often require extended periods of evaluation time. In other words, payback periods on upfront investment can be uncertain. Thus, the already dramatic growth in FIES (Figure 5 & 6) has flowed disproportionately to the existing players as opposed to new entrants. We suspect this will remain the case.

FIGURE 5: **PARTICIPATION IN FIES HAS INCREASED 10-FOLD SINCE 2009**



Source: Credit Suisse
Data as of November 2012

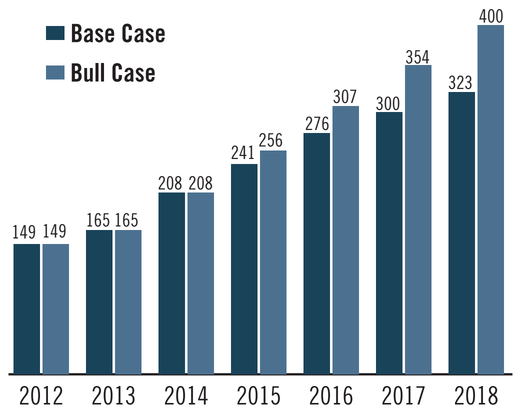
FIGURE 6: **KROTON IS ALREADY REAPING FINANCIAL BENEFITS OF FIES, SEEING STRONGER NOMINAL GROWTH AND MORE SUSTAINABLE STUDENT CLASSES AS RETENTION AND RENEWALS HAVE RISEN**



% Student Base	**4.4%**	**18.2%**	**21.1%**	**33.9%**	**43.2%**

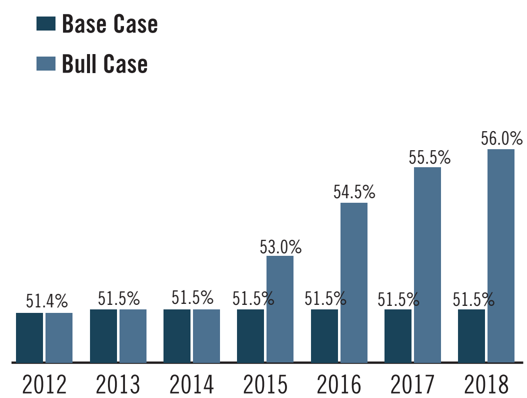
Source: Kroton

FIGURE 7: **THE OPENING OF 200 NEW LEARNING CENTERS COULD INCREASE THE NUMBER OF STUDENTS BY ABOUT 75,000 BY 2018**



Source: BTG Pactual

FIGURE 8: **INCREASED STUDENT SIZE SHOULD IMPROVE GROSS MARGINS DUE TO HIGHER OPERATING LEVERAGE**



Source: BTG Pactual

Leading private education providers such as Kroton and Anhanguera have further cemented the benefits of scale by developing elaborate "learning systems," which essentially represent easily replicable curriculums for standard usage across new and existing campuses. Progress with distance-learning offerings should exploit the brand recognition of leading players even further. A study conducted by BTG Pactual illustrates how gross margins for Anhanguera may benefit during the next five years (Figures 7 and 8).

Investment Risks

As with all strong growth stories, risks must be thoroughly understood and monitored. In the education space, direct competition remains limited as meaningful players predominately operate in different geographic regions. However, over time it is likely that competitors will begin to encroach on each other's markets—similar to developments in the U.S. for-profit educational space nearly two decades ago. Increases in competition could raise marketing and other administrative expenses, threatening margin progression for leading providers. Additionally, while distance learning represents an opportunity, this more mobile form of learning also poses a legitimate threat to incumbents as the relatively lower set-up costs and high associated returns make it a significant area of focus for new and existing competition.

Payer concentration also remains a pervasive risk for the sector given its extremely high reliance on government and associated funding. That said, we see a strong alignment of interests between the private segment and the regulator for two reasons. The government wants to meet its stated targets by 2020 and regulators require that the quality of education remain as much of a priority as its availability, at least in the near term. Over time, however, the policy could limit sector returns and potentially impede overall economic profit for private educational players. We shall continue to monitor these risks.

Conclusion

Identifying outstanding and underappreciated growth opportunities such as the Brazilian educational sector remains the hallmark of the Driehaus investment philosophy. Based on our analysis, the environment for growth appears sustainable for Brazilian private education providers. With FIES serving as a tailwind, the largest provider, Anhanguera, is estimated to generate earnings growth of about 40% per annum over the next two years with a 24.4% ROIC. Furthermore, the relatively negligible representation of Brazilian for-profit education in the MSCI Emerging Markets Index reinforces our view that many of the strongest growth themes within emerging markets remain underrepresented by broader conventional indices. Given the rather heady moves in some of these stocks during the past year, we continue to weigh the associated risks carefully. However, Driehaus continues to believe in the superior growth potential within the Brazilian education space and that relative alpha opportunities exist over the coming business cycle.

ABOUT THE AUTHOR

Howard Schwab is the lead portfolio manager for the Driehaus Emerging Markets Growth strategy and co-portfolio manager for the Driehaus Emerging Markets Small Cap Growth and Driehaus International Small Cap Growth strategies. In addition to his portfolio construction responsibilities, he oversees the emerging markets research team and analyzes macro-level trends and associated market risk. He joined Driehaus Capital Management in 2001.

DISCLOSURES

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