



FROM THE ANALYSTS: EQUITIES

PRIVATE SCHOOLING IN SOUTH AFRICA—DIFFERENCE IN COST, DIFFERENCE IN QUALITY

By Andrew Randles (Analyst)

Primary school and high school education in South Africa is primarily performed by the government, which spent R267.5 billion or 15.9% of the budget in 2018/19 on “Basic Education,” or approximately 5.5% of 2018 GDP. Despite this investment, our education system remains one of the worst performing in the world.

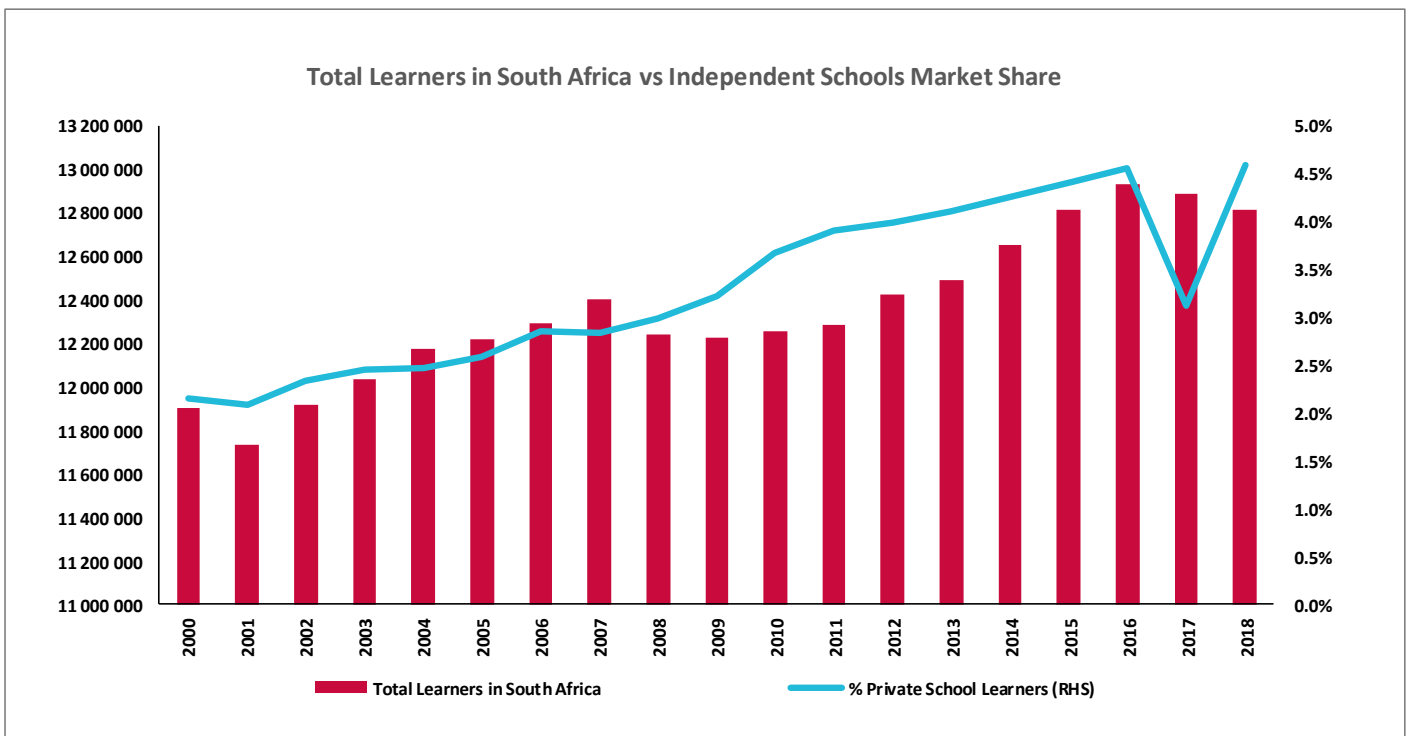
Research by the Institute of Race Relations shows that schools are critically under-resourced, with just 29% of government schools having a library and only 18% a science laboratory. The results of this are clear in statistics such as that only 13% of the 2006 Grade-1 class achieved a university entry qualification when they wrote matric in 2017. The report also showed that South Africa only boasts a 38% matric pass rate if one takes into account students who dropped out before sitting the final exams.

Earlier this year, The Economist reported that in 47% of South African high schools not a single pupil meets a commonly accepted international standard for maths.

The private school system performs well but at an exorbitant cost. Private schools in 2017 saw a 98.8% pass rate for the 11 500 students who sat the Independent Examinations Board (IEB) exams, but the average private high school costs R136 000 compared to R35 000 for the average public fee-paying high school.

New “for-profit” private school networks bridge the gap between quality and costs

Private school network operators such as Curro aim to service the gap in the market, supplying a spectrum of quality education options from R22 800 per annum to R103 800 per annum, with a 99.7% IEB and 93% National Senior Certificate (NSC) pass rate. They also achieved an 88.1% and 81.1% IEB and NSC university exemption pass rate compared to South Africa’s average university exemption rate of 22% for the last five years. Independent private schools have a market share of 4.6% of students attending school in South Africa (Figure 9), leaving plenty of room for consolidation and growth. Given general discontent with state schools and assuming an improvement in the economy, we can expect the growth in private school students compared to public school students to continue in line with the 18-year compound annual growth rate of 4.3% since 2000. Of that 4.6%, Curro has about 10% of the market, Advtech 5% and Spark 2%, with the rest being made up of other independent schools.



Note: 2017 shows an aberration due to a misclassification of independent schools in Gauteng in the National Master List

Figure 9. Total learners in SA vs Independent schools Market share. Source: School Realities Report. Department of Basic Education..

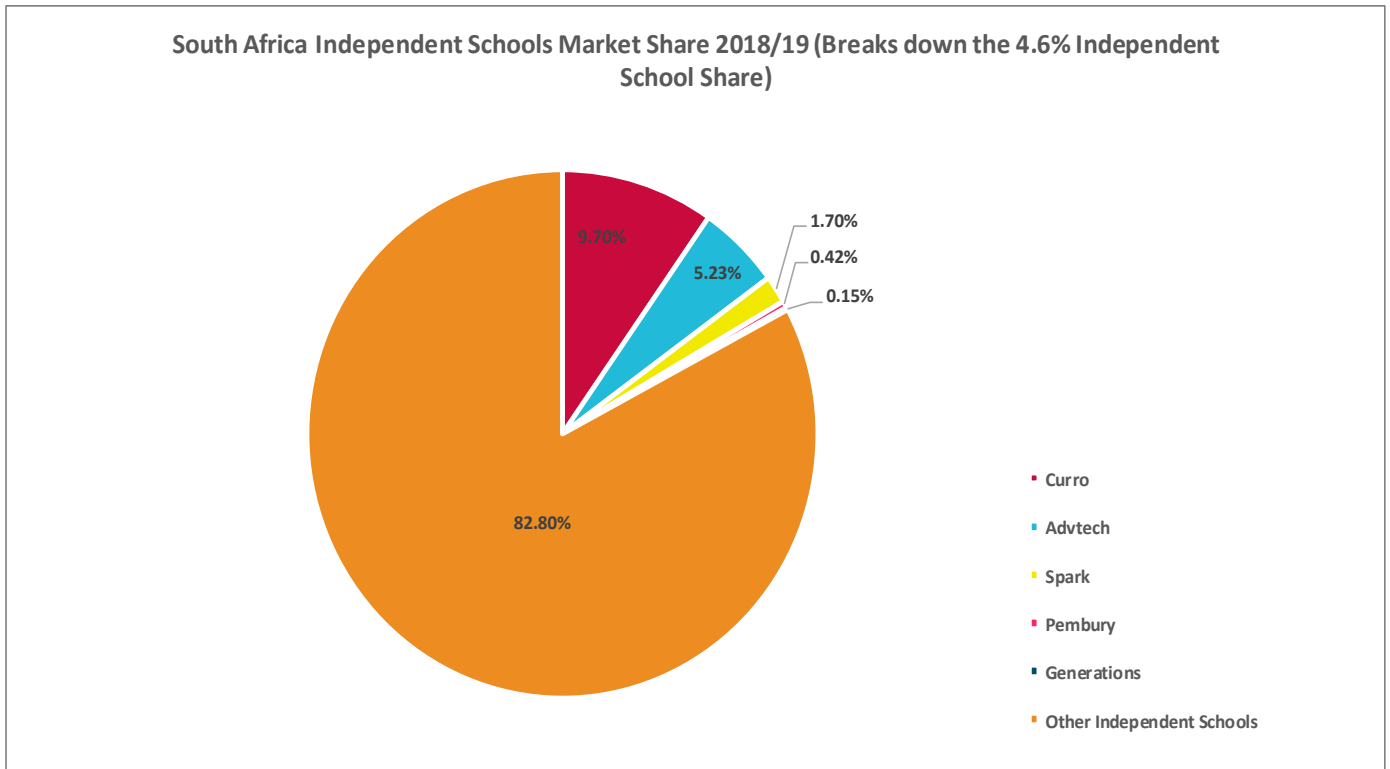


Figure 10. South African Independent Schools Market Share 2018/2019. Source: School Realities Report. Department of Basic Education..

Schools as an investment

Schools can make for good investments as they have the potential for a strong brand leading to student retention and stable profitability. The potential to develop a strong brand/intangible asset is driven by a number of factors, but primarily by the school's curriculum, its performance over time, culture and physical location.

Pricing power for successful schools is high as parent demand for quality education is price inelastic up to the limits of affordability. Once established, capital requirements to maintain schools are low and can lead to high and stable cash flows, albeit capped by the number of students the school can accommodate.

Growth potential (target market)

Clearly, there is a demand for quality schooling, but most South Africans are constrained by cost. We estimate that the target market of students that could afford this 'more reasonably priced' education is approximately 1.2 million learners, which means total independent learners could increase by 97.4%.

Strong growth is capital intensive early on

Setting up a school requires significant up-front capital to buy land in densely populated areas and fit out facilities. Once built, schools have a high fixed cost base with teachers' salaries accounting for approximately 70% of operating costs, educational expenses (books, materials, departmental expenses) 10%, administration 10%, ground and maintenance expenses 7%, with 3% remaining as a surplus. We estimate that approximately 60% of school costs are fixed.

This means that short- to medium-term risk is elevated by upfront costs, high fixed costs and the potential for slow student inflows as a school proves its value. Schools generally make substantial losses in their first year as the fixed costs are not met by the initial revenue generated from the first intake of students. A new school will take at least seven years to reach a capacity utilisation of more than 80%, where it reaches full potential operating margins and creates large shareholder returns.

At the moment there is a land-grab happening between the private school networks in South Africa. This large up-front capital investment combined with delayed profitability causes strain on short-term cash flow and a potential deluge of cash for investors willing to take the risk of funding these investments. For example, in 2018 Curro made R388 million in operating cash but shelled out R739 million to buy more land, build more schools and add to old ones.

Figure 11 shows Curro's use of cash over the last decade.

Risks to the model

Although we model for ongoing growth in private education, the South African middle class is stagnating, predominantly a function of a stagnant economy. This creates risks to a model that needs volume due to high fixed costs.

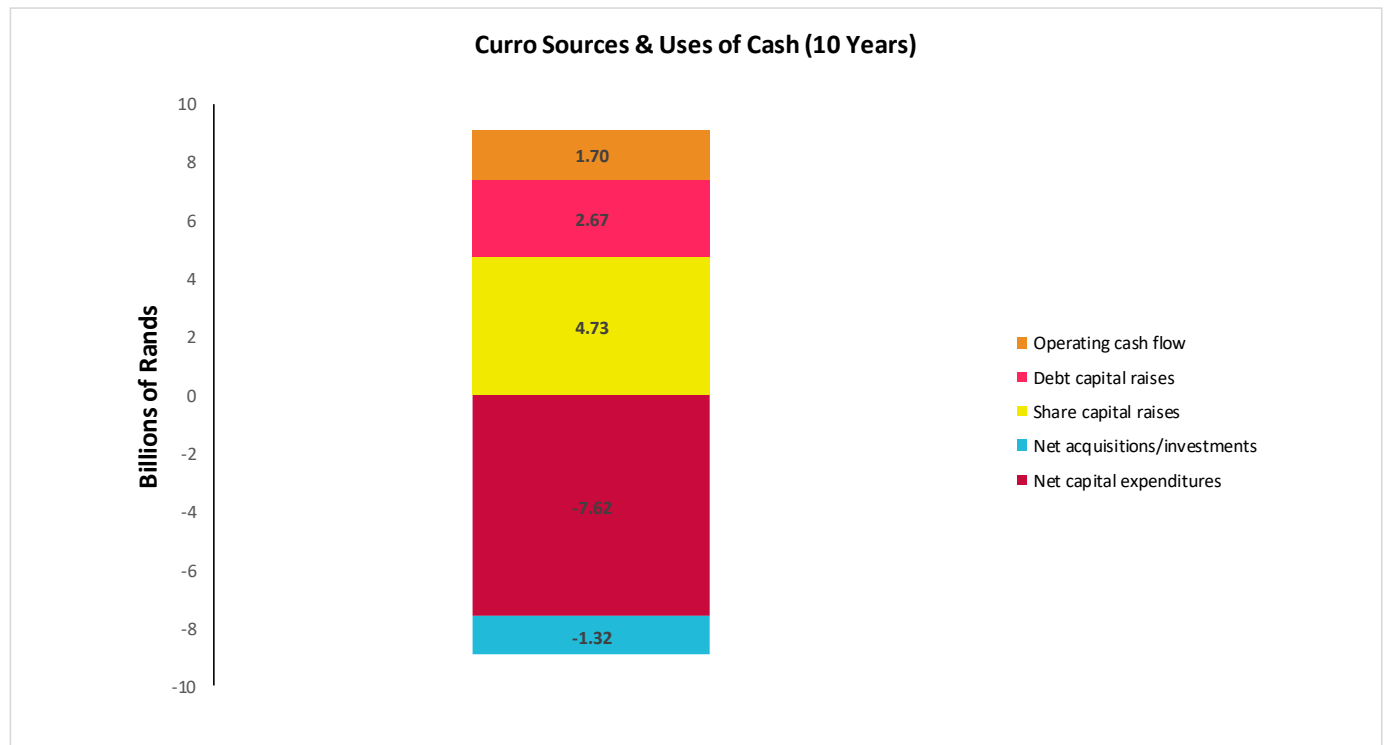


Figure 11. Curro Ten year Sources and Use of cash. Source: School Realities Report. Department of Basic Education..

Northstar's investment position

We believe that an opportunity will arise where the market underappreciates the potential for JSE-listed education companies to deliver outstanding shareholder returns. Presently however, our work indicates that the opposite thesis applies and these businesses are trading above what we deem to be fair valuations.

¹ <https://irr.org.za/media/media-releases/35-22-may-press-release-freefacts-22-05-18.pdf/view>

² <https://www.economist.com/special-report/2019/04/25/south-africas-youngsters-are-let-down-by-a-lousy-education-system>

³ <https://businesstech.co.za/news/lifestyle/258621/top-private-and-public-schools-in-south-africa-cost-vs-performance/>; <https://businesstech.co.za/news/lifestyle/244513/south-african-private-schools-that-are-cheaper-than-public-schools-in-2018/>

⁴ Independent Schools Association of South Africa: <https://www.isasa.org/download/establishing-a-new-school/>



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