BLOG

Online education: Opportunities and challenges before service providers and investors

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E-education, or online education, has been effective in overcoming time-space limitations and is a relatively new industry in China. However, as its appeal increases, so do the opportunities and challenges inherent in the industry.

The online education market is large and growing fast

China's government and its citizens place a high value on education. Government expenditure on education grew 8.94% y/y to RMB3.4tn in 2017, accounting for over 4% of gross domestic product (source: Ministry of Education of the People's Republic of China); per capita expenditure of urban residents on education almost doubled to RMB1,413 in 2016 from RMB750 in 2011 (source: Deloitte Research).

China's online education market has been growing at an even faster rate. It grew to RMB235.1bn from RMB57.5bn over 2011-18, implying a CAGR of over 20% (source: Deloitte Research). This growth is evidenced by the adoption of massive open online courses (MOOCs; aimed at unlimited participation and open access via the web) and educational mobile applications for preparing for examinations, acquiring vocational skills or learning hobbies.

Potential for enterprises and investors

Lower-tier cities have high growth potential given the lack of high-quality traditional educational resources there. However, such resources are now being made easily accessible through online education. The growth potential is evidenced by the number of users of online education in tier-3 cities and below-tier-3 cities increasing by 1.7% and 2.1%, respectively, from August 2018 to August 2019 (source: Mob Research, Qianzhan Industry Research).

Meanwhile, most online education enterprises are at a stage of early financing. Nearly 70% of investment in the online education industry were Series-A or earlier-stage funding until October 2018 (source: iiMedia Research). We believe that, dominated by start-up companies, the emerging online education space presents considerable opportunities for business development and follow-on investments.

In addition, China's adoption of a two-child policy, high-pressure college entrance examinations, employment pressure and different learning objectives are likely to fuel growth in online education.

But challenges for enterprises and investors

Profitability is not easy to achieve

Most online education enterprises have yet to break even. Only around 5% of them are currently making profits, according to a vice president of the 21st Century Education Research Institute. Of the seven main listed online education enterprises – Koolearn Technology Holding Limited, LAIX Inc., GSX Techedu Inc., China Online Education Group, Sunlands Technology Group, China Distance Education Holdings Limited, and Youdao, Inc. – only GSX Techedu Inc. and China Distance Education Holdings Limited were profitable in the latest fiscal year.

The primary reason for this is high marketing expenses. All the seven enterprises mentioned above reported selling and marketing expenses of more than 70% of the total selling, general, and administrative expenses in the latest fiscal year, **and such a high percentage is not rare in the entire industry.** Online education enterprises are known for their significant expenditure on advertisements and early-payment discounts, as expanding market share and user size is their primary goal. However, the results of such expenditure are usually not very effective, only contributing to making the market more competitive. Small businesses could be affected more, as heavy marketing expenses reduce their budgets to improve services, so few users are willing to pay for the services they currently offer. **Further, in order to expand the market share and user base, these firms require to spend more on marketing. Considering inadequate cash flow to maintain operations, they have to use cash flow from financing activities towards their marketing expenses. Consequently, it creates a vicious cycle. Hence,** a major difficulty in the online education industry is cutting costs of customer acquisition.

Significant regulatory risk

The education industry is sensitive to regulatory risk, and the regulations governing online education are becoming more stringent.

- On 20 November 2018, China's Ministry of Education published a regulation that online schools must register and disclose their curriculum schedules and teachers' qualifications

- On 15 July 2019, an Enforcement Act was released, especially for online schools, specifying rules covering areas such as online class times, teacher qualifications, and limitations on prepaid tuition

Although the online education industry should benefit from a mature administration system in the long term, rising operating costs are a major concern in the short term. Furthermore, regulations governing online education requires more fine-tuning than those governing traditional education, increasing uncertainty.

In conclusion, while the online education market has significant potential, insecure profit margins and regulatory risk are concerns. We believe the key to the success of an online education enterprise is leveraging opportunities and its own strengths.

Acuity Knowledge Partners has a global perspective, with specific insights into the China market. **We have worked with many online businesses in catering to Chinese market and assisted them with market studies, financial modelling, valuation analysis and analysis of various sectoral topics.**

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