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Analysis



EduInfra – Emergence of a new asset class

Key Takeaways

- EduInfra offers a promising 10 – 11% entry cap rate for annuity investors with rental escalations in the region of 3 – 5%
- Infrastructure classification allows for tax optimal exit through InvITs
- Seller awareness needed – operators slowly moving towards asset light models; depth, but potential untapped
- Significant international investor interest in annuities from EduInfra

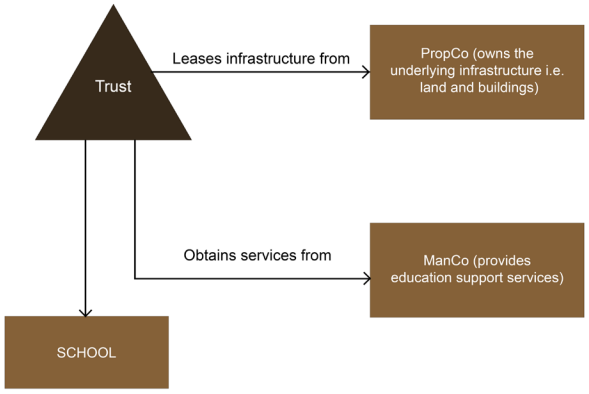
Emergence of Educational Infrastructure as a new asset class

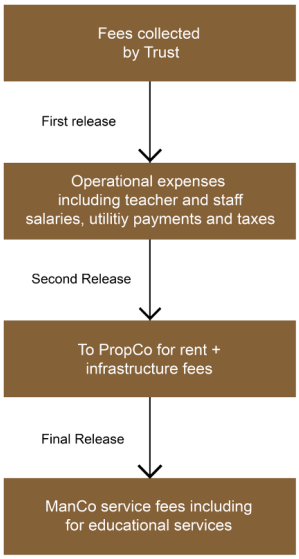
In recent times an emerging sub-set of infrastructure is garnering increasing amounts of interest from global private equity and pension funds – Educational Infrastructure or '*EduInfra*'. EduInfra refers to the infrastructure, building and land used to deliver social services like education. India especially has a growing education sector, with the 2nd largest schooling system in the world, and the K-12 sub-segment constituting more than 50% of the overall size of the education industry in India.[1]

EduInfra is attractive to annuity investors looking for stabilized yield plays. The sector has an edge over other similar asset classes due to its non-GDP linked and rather recession proof character with significant potential for capital appreciation. Conventionally, deals in the education sector have involved private equity players investing in the asset heavy model with very few school operators choosing to hive-off the underlying assets due to the impact on P&L.

From a buy side perspective, EduInfra offers the best of both worlds – higher than commercial real estate yield coupled with security of underlying real estate with minimal vacancy risks, and a cash rich tenant that could operate at an EBITDA margin of up to even 50% (where the asset is not leased).

A typical structure in this sector is illustrated below. Generally, there will be a public trust (or society or section 8 company) holding the educational institution. All school fees comes into this public trust, and the public trust incurs the operational expenses. Trust may outsource rendering of educational services and other operational matters to a management company ("**ManCo**") for a certain service fee. Infrastructure investors will typically come in and acquire the real asset (land and building) and enter into a lease arrangement with the public trust. Lease rentals are often backstopped by the ManCo.





[1] Source: Investcorp: India Education Infrastructure Opportunity Whitepaper (*https://www.investcorp.com/wp-content/uploads/2022/04/India-Education-Infrastructure-Opportunity.pdf*)

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What is the commercial story for EduInfra?

The education sector offers great opportunities for growth with a burgeoning middle class and the high value ascribed to education. The sector also enjoys tremendous pricing power, seeing relatively low elasticity of demand.

School operators who have been hobbled by the lack of growth capital can now turn to monetizing their underlying infra for their growth needs. This structure offers an asset light operations model allowing for rapid expansion. This is similar to the sale and leaseback model widely deployed by airlines allowing for efficient capital deployment and significantly lower capital requirements.

For annuity investors, these assets could offer an entry cap rate of 10% + on a net-operating basis with local leverage at around 8.5 – 9.5%. The leases are long-term (usually 25 years +) and generally on a triple net basis (NNN), which essentially means that property tax, insurance and common area maintenance costs are paid for by the operator, thus minimizing operating expenses for the infrastructure investor. The cap rate could further be compressed by about 300 – 500 basis points. Ajay Kumar from Investcorp, a large global sponsor which is making EduInfra its central investment strategy said "*The asset class has stable long-term yields and an attractive and resilient underlying sector creating a meaningful opportunity set for international investors with an attractive risk adjusted return profile. Also subsequent potential listing of an Infrastructure InvIT under Indian regulations can provide a favorable and efficient path to exit for investors*."

EduInfra - Real estate or Infrastructure?

Regulatory uncertainty around (a) the commercialization of social infrastructure, and (b) the categorization of social infrastructure as 'real estate' or 'infrastructure' contributed to a certain degree of regulatory morbidity. Both positions now stand clarified.

Thanks to the overall push for development of social infrastructure, land and building of schools now qualify as ‚infrastructure' and have been added accordingly in the harmonised list of infrastructure assets. Infrastructure qualification has several advantages.

1. *Access to prioritized infrastructure funding:* First, access to lower-cost bank loans due to EduInfra being a "priority sector" and access to certain infrastructure specific domestic institutions that offer credit at competitive rates.

2. *Tax exemptions for patient capital:* The potential to seek complete tax exemptions on income from interest and capital gains for sovereign wealth funds and pension funds. The list of infrastructure sectors to which the exemption currently applies doesn't include social infrastructure. However, the list has been expanding basis industry representations and we are hopeful that social infrastructure could soon be included basis industry representations.

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3. *Exit through InvITs:* Infrastructure investment trusts (InvITs) are increasingly becoming popular, attracting some of the world's largest annuity and growth investors. InvITs are tax optimized vehicles with light touch regulation by SEBI. Investors of an InvIT are subject to a reduced interest tax of 5% (as against 40% generally and say 10% for investors investing from the Netherlands, 15% for Singapore etc.), and exempt from tax on dividends (10% in the Netherlands). Importantly, InvITs are not subject to thin capitalization norms (unlike a company) making distributions to foreign shareholders tax optimal. Roll-over of assets to an InvIT in exchange of InvIT units is also tax neutral. Unlike REITs, which can only be public listed, InvITs could be public listed or private listed as well - a unique classification which allows for listing with just 5 investors. Hence, InvITs can act as an efficient platform for housing such infrastructure assets, and also benefit from cheaper leverage. Today, InvITs have attracted SWFs and PFs and leading global financial sponsors. A private listed InvIT can easily tap into public funds and convert into a public listed InvIT for optimal value unleashing at the appropriate time.

What are the key challenges?

1. *Sophisticated counterparties, though not deal-makers:* Founders, usually sophisticated academics and educationists, may not be quite keen to part with the real estate asset. Rakesh Gupta, Managing Partner at LoEstro, an investment banking and strategic advisory firm active in the EduInfra space said, *"Most promoters tend to look at the business in entirety – as an asset heavy business. Considering the way in which real estate has historically appreciated in India, promoters are conservative in their approach and the idea of an asset light model doesn't sink in easily. A combination of hand-holding and promoter education discussing the merits of an asset light model is therefore required."* With many schools being run as family businesses, there is a fair bit of effort required in the initial stages as the promoters may not be as growth oriented. With the sector remaining largely unorganized, it is primed for platforms to aggregate – ideally a platform with an operator, a growth investor and a yield investor with a different monetization story for the growth and the yield assets.

2. *GST Hit:* GST of 18% on lease rentals tends to eat into the annuities, and there is a need for policy advocacy measures to reduce the rates. Currently, education services provided by educational institutes are charged a nil rate while a large part of their expenses (rent and infrastructure fees) are charged at 18%. This could defeat the purpose of exempting education services from GST as the costs are likely to be factored included in computing the education services fees payable by students. Rationalization of this structure will have the benefit of reducing fees of students and further increasing access to education.

3. *Swelled up P&L:* School operators may not be keen on sale and leaseback structures as the lease rental payments could swell-up the P&L. So, the demand side could appear weak.

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4. *Operator risk:* Heavy reliance on the school operator delivering the high dividend yield often discounts the comfort from the ownership of the real estate due to perceived challenges in evicting the operator. Eviction of school management could no doubt be tricky. However, with newer operator chains coming in play, replacing the operator in the existing premises is not as difficult as it used to be. In fact, some EduInfra owners have also set up their operator platforms to ensure seamless transition of management in case of operator default. The private fund may also require the lease rentals to be secured by the operator or by a parent/ affiliate of the operator – which can add a significant layer of comfort.

5. *Cash traps and regulatory approvals:* The underlying infrastructure assets may be held privately or through a trust. Where the assets are held by a public trust, transfer may require regulatory approval, which could be time consuming depending from state to state. Even where such approval is procured, unless there is a growth play planned or there is existing debt to retire, the sale proceeds tend to be trapped in the public trust since withdrawals from the public trust could be under close scrutiny. Hence, the end-use of the proceeds should be carefully structured before.

Conclusion

While the market has significant depth, it is largely fragmented and hence challenging to deploy large cheque sizes. On the operator side, with the entry of global super aggregators of schools like Nord Anglia (Oakridge), ISP (Sancta Maria), Cognita (CHIREC), and funds like KKR (Lighthouse Learning), Sofina & Sequoia (K-12 Techno), Foundation Holdings (Ryan International), Morgan Stanley (Narayana Group) the landscape is evolving. On the asset side, players like Investcorp and Cerestra Ventures are actively building a portfolio of educational infrastructure assets – with Cerestra setting up an InvIT to monetize their asset portfolio.

Traditionally, assets like transmissions, telecom and other non-GDP linked assets were preferred by investors as against GDP-linked assets like roads or airports. Social infrastructure, while offering substantial cap rate compressions also provides access to an operating income that is better protected during economic downturns, while offering alpha during periods of GDP growth. In an inflationary market where risk-free securities are trading at close to 7%, investors are recalibrating strategies to look for higher annuities. Opportunities are limited, especially when seen on a risk-adjusted basis. EduInfra, relatively less understood, appears to fit the bill.

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Infrastructure Investment Trusts (“InvITs“) and infrastructure is a core specialism of the firm. In 2019 alone, members of the team have advised some of the world’s largest sovereign wealth funds, pension funds, and leading global financial sponsors, on some of the largest and pioneering transactions in the space with overall deal values exceeding USD 5 billion. With an overwhelming majority of select international clients, we take immense pride in our ability to offer well rounded advice right from fund formation and setting up of investment platforms to making tax optimized downstream investments with an in-depth, on the ground knowledge of the written and sometimes unwritten Indian legal, tax and regulatory landscape....*read more*

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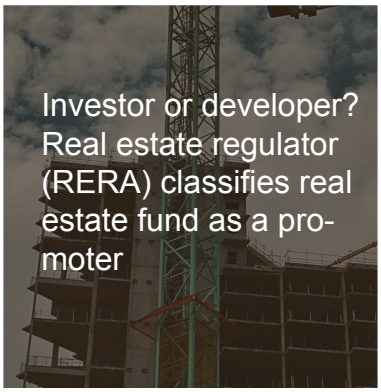





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