

# China's Education market around COVID-19.

## Is there an opportunity?

March 27, 2020

### Executive Summary

The epidemic that began in January 2020 delayed the start of the academic year in China and closed all offline education and training activities. Judging from the current situation, since most K-12 schools have not yet officially reopened the DAU<sup>1</sup> of online education products is still high. The online class has become an essential model due to its scalability. In this context, the reason why education companies have launched free courses is not only to contribute to public welfare but also to get brand exposure and attract more users during the outbreak. Given the lower cost of attracting new students when all schools are closed, online companies can do more things to improve user stickiness.

This situation will not, however, benefit all online players in the Chinese market. There are internal and external factors that should be taken into consideration. On the one hand, the crisis has exacerbated the shortcomings of the industry (large, unbalanced teams; exorbitant customer acquisition costs; competition based on low price models; poor accountability of learning outcomes). On the other hand, the measures that the educational authorities will introduce (extending the academic year to the summer months) may well have a significant financial impact on the P&L of many incumbents. Last but not least, investment funds are expected to take a back seat and play safer, concentrating their activity on secondary markets. The latter would only benefit the large players in the market, and could well bring about mergers and acquisitions.

(Sources: CNA; e27; Crunchbase; Reuters; corporate websites; EDT Partners' market intelligence)

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<sup>1</sup> Daily Active Users

## Predictions about the end of the pandemic

The exact date of the end of the COVID-19 in China hasn't so far been determined. However, Chinese experts stated on February 27 that they were confident of basically controlling the epidemic by the end of April. According to the medical authorities, we need to see a period of 28 days with no cases registered before the outbreak can be declared officially over.

## The impact of COVID-19 on exams and schools

### 1. The postponement of Gaokao is still under evaluation

There is no official news that the formal national Gaokao will be delayed. However, some regions have made adjustments to the arrangements for Gaokao and other examinations. The measures can be roughly divided into three types:

- Postpone the time of Gaokao and some other examination arrangements. For example, Beijing announced the postponement of the second English listening computer test for Gaokao in 2020.
- Unify postponement of "special admissions" exams for colleges and universities.
- Change the mock exams delivery methodology. For example, Beijing changed the mock exams of the Gaokao from offline to online. The follow-up Mock exams will also be rescheduled according to the specific time of the school.

### 2. IELTS and TOEFL will not be entirely replaced by Duolingo for the time being.

Although there are more than 200 schools worldwide that accept it, most colleges still do not accept DET. Some universities only consider DET as an alternative to the language test during the epidemic, and they limit the date on which their grades are recognised.

Some schools have lowered their requirements for the IELTS and TOEFL test. Just like some schools in the UK accept non-UKVI test scores to apply for language classes, some schools in China will relax the validity of TOEFL and IELTS for up to 3 years.

It is expected that once the epidemic is over, TOEFL and IELTS will increase the number of test positions for the computer-based test, bringing more convenience to candidates who are anxious to score.

### 3. The gradual reopening of K-12 Schools

According to the rules for school opening issued by the MoE, students will return to their classrooms in batches.

- Students in the final year of Junior High and High School
- The remaining K-12 school students
- University students

Currently, the first batch (advanced grades) is expected to go back around the end of March or early April. As of March 22, a total of 13 areas nationwide have established a back-to-school date. Among them, Yunnan, Ningxia, and Shanxi, where school starts in the first week in April. In those areas where a starting date has been specified, schools will begin on April 7 at the latest.

## Online Education

### 1. Online Edtech companies took advantage of COVID opportunities to increase the number of users.

During the epidemic, all online educational companies opted for launching free live tutoring. Yuanfudao, Zuoyebang, Xueersi, Koolearn, Genshuixue, and Youdao kick-started free live-course services. During this period, the number of users of online education Apps and platforms skyrocketed. Take Koolearn as an example. On January 27, when Koolearn announced the launch of one million free live courses for K-12 students across

the country, the ranking of the App rose from 556th to 7th in the iPhone education free Apps ranking.

The staff of most EdTech companies is gradually returning to work as planned.

## 2. The use of technology has increased dramatically.

Here are some examples.

- Classin's App climbed to #8 in the iPhone Education App category in just three days – before January 24, it was not even ranked among the top 100. It remained in the top 10 for weeks after that.
- Users of Huijiang CCTalk platform have increased more than tenfold compared to the previous year, and now hosts millions of teachers and students online.
- DingTalk became the most-downloaded free App in February. Millions of teachers and students are still using the video and messaging platform for free.
- Zuoyebang's free live broadcast registrations exceeded 28 million on February 15.
- Between January and mid-March, Yuanfudao ranked first in in-app purchases.
- Yuanfudao opened free live lessons on February 3, setting an industry record of 5 million K-12 students nationwide attending online lectures on the same day. What's more, more than 10 million people registered for free live lessons on February 6.

## Offline Education

The outlook for offline education companies is not optimistic.

As expected, some educational companies have closed down because of cash-flow disruptions. The current fee refund solution is mainly to transfer students to similar companies, allowing learners to choose online courses of similar institutions to continue to ensure class progress.

## Predictions for the education industry

At this point, we dare to outline some initial predictions as to how the industry will develop further.

1. Online and offline models will eventually merge; education companies are more likely to move towards the OMO model<sup>2</sup>.

The online education industry has significantly benefited during the COVID-19 crisis. During this time, however, the shortcomings of the industry are also being exposed:

- Excessive number of players
- Lack of product and service differentiation
- Extremely high customer acquisition costs
- Imbalanced teams and over-staffed companies
- Difficulties in connecting with customers
- Lack of tools to monitor the effectiveness of teaching

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<sup>2</sup> OMO — Online Merging with Offline model

Industry players do not have much time to address these problems given the current circumstances. Therefore, when the epidemic is over, the industry will need to face some hard decisions. One possible way forward would be seeking a deeper integration between online and offline operations.

## 2. Market concentration will accelerate

It is early days to determine whether online giants will vie with large companies adopting an OMO model. What seems clear to experts is that concentration in the industry will accelerate. Before the crisis, some industry incumbents referred to the race for securing rounds of investment as the game of the fittest, a scenario in which the companies with the deeper pockets would eventually prevail. Leaving aside the likely over-valuation of some of the players, it seemed apparent to all concerned that the market would eventually adjust. In this pre-crisis scenario, many expected that smaller companies without a unique value proposition and the necessary financial muscle would wear out the patience of investors and fold. The gradual removal of smaller players would allow mid-sized and large companies to increase their paid user base, which would in turn give way to a more balanced, profitable market landscape.

This scenario has been radically affected by the recent medical emergency. Online players have made their resources and technology available for free. They now must strive to retain their old user base and turn new users into a paying customer base. It remains to be seen whether companies will be able to push on with their growth plans amid a market landscape that has been dramatically disrupted, or else if we will witness the first M&A of companies with complementary target audiences.

## 3. Economic consequences of COVID-19

- Short-term (Q1): The economy is facing a big shock, and it's hard for companies to resume work; especially those in the tertiary industry. Only essential services will go back to normal during this first phase of recovery.

- Mid-term (Q2 and Q3): Although the situation in China is improving, the outlook in the rest of the world is far from optimistic. China may well be affected by a surge of imported cases (as it is currently the case in Singapore and the SAR of Hong Kong). According to the estimates of local experts, it is highly unlikely that the pandemic will be under control before the summer. This means that most industries will need several months to return to normal. No signs of robust recovery are expected before Q4.
- Long-term: experts agree that economic recovery will depend to a large extent on the trends and policy measures undertaken by governments in the medium term. The total loss attributed to COVID-19 is expected to exceed that of SARS.

Measures are being introduced to lower rental costs at government properties. To date, however, no further economic or fiscal measures have been announced to support the private education industry. It is expected that many small players will disappear.

#### 4. The impact in Q1 will not be fully digested until October.

Linked to the above, operators also need to take into consideration the measures introduced by the government. At this point, it is unclear whether the MoE will decide to shorten the summer vacation, or else extend the learning week to include Saturdays and Sundays. Whichever the case, the decision will have a negative effect on online companies, which may need to reimburse fees to parents for those lectures that will not take place. This measure could unequivocally bring about layoffs, with the subsequent loss of talent, and other measures to mitigate losses.

As a consequence, it is expected that the hidden impact in this first quarter will not be fully felt until October 2020 at the earliest. Some companies may experience rough times towards the end of the year.

#### 5. Estimated recovery time

As the pandemic extends to Europe and the Americas and its effects start denting the world economy, experts call for measures to restore public and private activity to what it was before the outburst. In China, complete recovery will come to educational companies only when their enrollment levels and teaching activity goes back to that in early January 2020.

A gradual return to school, paired with decisions to extend the academic year, may well mean that the recovery time for the education industry does not mirror that of the economy at large.

## 6. Investment opportunities

The world has realised the importance of learning continuation plans sustained by digital tools. The importance of embracing a hybrid or blended approach; the relevance of an analog-digital-analog strategy for mainstream, K-12 education; the value of technology and flipped-classroom methodology... COVID-19 will surely have a profound effect on the education industry; it will accelerate change and contribute to transforming the way we teach and learn.

Recent historical events indicate that, in times of recession, startup investment tends to drop significantly.

Some voices indicate that this may well not apply to EdTech and online learning. This view is supported by the critical role EdTech tools and companies are playing in learning continuation strategies. The situation in China, however, could prove an exception.

The funding of young companies and mature startups could well be affected. Our sources indicate that this could well be the time that investment funds introduce a note of caution and become more conservative, moving their funding to secondary markets. Those still willing to take risks are expected to exact very high discounts. In this context, it is the more consolidated companies that will benefit from the impact on the industry caused by COVID-19.

In this respect, Reuters announced on March 20 that Tencent-backed Yuanfudao was near to close a new round of investment that will bring its valuation to \$7.5 billion. The round started before the outbreak and aimed at raising \$1 billion. Given the circumstances, Yuanfudao decided to close the round sooner.

## Recommendations

The Chinese market will continue to offer excellent opportunities for EdTech and educational companies. The crisis has put online learning at the core of the social debate. Both parents and educators are more aware than ever before of the benefits of digital and blended learning.

The context should, however, be read with caution. Not every company will be able to turn the crisis into opportunity. Cashflow tensions will emerge from the fact that tuition was offered for free for a considerable time. It is unlikely that the government will produce a stimulus plan to help operators. Besides, the academic year will intensify, and classes will eat into the summer months, with a consequent loss of income to the private sector.

From a product and services perspective, online Chinese companies need to address differentiation (one of the big elephants in the room) to consolidate their market share. In this respect, foreign companies operating in China should concentrate on making their USPs visible. Local operators will favour products that enhance the quality of their offering and, very especially, allow agents to monitor learning effectiveness.

At this point, we suggest that companies operating in China should exercise due diligence before entering contractual obligations and concentrate on market leaders and consolidated companies. Although it is still worth exploring commercial avenues with smaller companies, it seems reasonable to assume that, as far as these companies are concerned, no firm action should be taken until Q3 at the earliest.

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