CHILDCARE IN AUSTRALIA

The Changing Dynamics of the Childcare Industry

INTRODUCTION

Over one million children under the age of 12 attend approved/ funded childcare services in Australia. The vast bulk are long day care services but they also include before and after school care. This has been a dramatic increase over the past two decades in line with women's increasing participation in the workforce. This level of growth has seen governments struggle to decide what is the best funding model as they provide the majority of funding to the sector, but they also have a vested interest in keeping women in the workforce. The industry is fragmented and consolidation is an attractive opportunity for those operators who can use economies of scale to profitably grow their market share.

INDUSTRY CHARACTERISTICS

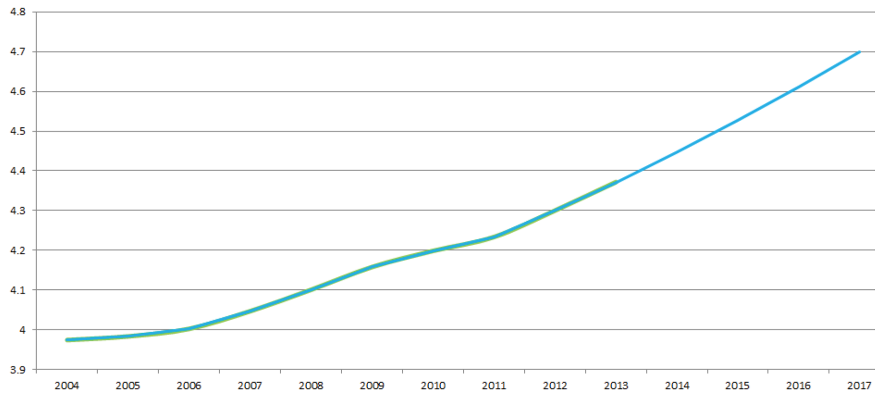
The Australian childcare micro industry is reasonably mature with 3.7% p.a. growth in children attending childcare over the past 10 years[1]. This rate of growth has, according to the Review of Government Services, slowed to 2% p.a. in the last two years, to be in line with overall population growth in the 0-5 year old cohort[1]. Over the last decade, there has been a major upheaval within the industry with the largest operator, ABC Learning, collapsing in 2008. The largest operator is now Goodstart Early Learning (a not-for-profit operator) which purchased 660 of ABC Learning's 1,045 Australian centres[2].

Australian childcare is a A$10 billion micro industry and, according to the Productivity Commission's enquiry into *Childcare and Early Childhood Learning* released in July 2014, the Federal Government contributes some A$7 billion towards the cost of childcare per year[3]. While the government is trying to shift more of the burden onto the user, the importance of the government in subsidising childcare means childcare is sensitive to any change in policy such as means testing. The sector is heavily regulated with high compliance costs, and must conform to national quality framework standards which mandate staffing levels and qualifications. This places a heavy burden on operators since wage costs represent around 60% of total costs[4].

In terms of customer base, just over one million children attend some form of government approved childcare in Australia each year[1]. The focus of the listed childcare operators is on long day care (LDC), the largest component of the childcare market. Approximately 635,000 children attended LDC in 2013[1]. Over 85% of the children in LDC are in the 0-5 year old age group with the average time spent in LDC each week approximately 27 hours[1]. There are over 15,000 childcare centres in Australia, of which almost 6,500 or 40% are LDC[5].

The key drivers of LDC attendance are a function of the birth rate, female workforce participation, employment levels and childcare affordability, though most of these factors are interrelated. These factors have been instrumental in growing childcare attendance 3.7% over the past 10 years, outstripping the 2.1% compound annual ten-year growth in the number of births[5]. The Australian Bureau of Statistics (ABS) is forecasting the number of children aged 0-14 years to increase at a rate of 2.2% per year in the decade to 2023[5] (see Fig.1).

Fig. 1: Population of Children in Australia Aged 0-14 (Millions)

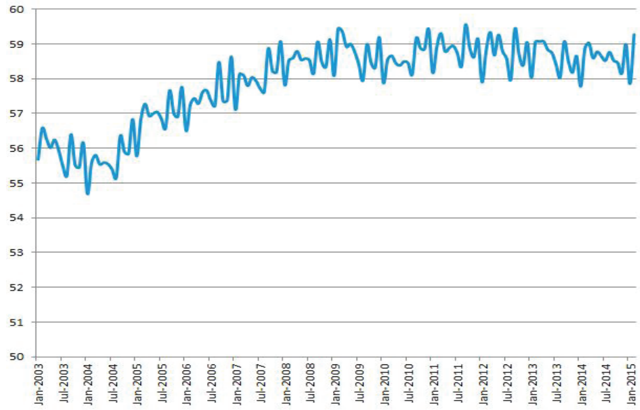


Source: ABS, Arnhem

[1] Australian Government - Department of Education, Employment and Workplace Relations (DEEWR) - Child Care in Australia - August 2013
[2] "GoodStart - a social investment story". Prepared by Social Ventures Australia for the Australian Government Department of Education, Employment and Workplace Relations, http://socialventures.com.au/work/goodstart-a-social-investment-story/
[3] Australian Government - Productivity Commission - Childcare and early Childhood Learning - July 2014
[4] GoodStart Submission to Productivity Commission Inquiry into Childcare and Early Childhood Learning; G8 Education and Affinity IPO documents - 20th November 2013
[5] ABS 3235.0 Population by Age and Sex, Regions of Australia 2013

The increase in female participation in the workforce is a global trend. According to the ABS, since 2003, the Australian workforce participation of women aged 20-74 years old has risen from 61% to 65% where it remains steady (see Fig.2)[6]. This lags men at 79%, with working women also three times more likely to work part-time than men[7]. Australian female workforce participation rates are above the OECD average, but below many of the northern European countries where childcare is much more affordable and 6% below Canada[8].

Fig. 2: Female Workforce Participation 20-74 Years (%)

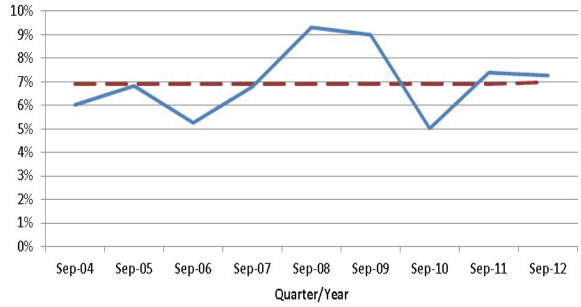


Source: ABS

While increasing workforce participation over the past decade drove an increase in the number of children in childcare and hence government childcare expenditure, Melbourne's Grattan Institute has estimated that if women in Australia had the same workforce participation rate as women in Canada our GDP would be about A$25 billion higher by 2022[9]. As a result of these economic benefits, it appears unlikely that the government would jeopardise female workforce participation with radical funding reform.

While the government has a vested interest in keeping women in the workforce, the out of pocket costs of childcare have been rising (see Fig.3). Growth in childcare fees has averaged 7% over the 10 years ending December 2012, while the means-tested Childcare Benefit has only been indexed at CPI and the Childcare Rebate fixed at A$7,500 since 2011 (though expiring next year)[10]. The expense of childcare may have led to the plateau in female workforce participation and could limit growth in LDC demand making future price increases harder to push through. In addition, a significant portion of the industry is comprised of not-for-profit operators, including industry number one, Goodstart. Larger not-for-profits may operate a cross subsidised model, where successful profitable centres support loss-making centres in other areas. At times this could make it difficult for commercial operators to price according to supply and demand dynamics.

Fig.3: Average Annual % Change to Long Day Care Hourly Fees



Source: DEEWR, CBA

REGULATION

Regulation has increased significantly since 2009 under the National Quality Framework (NQF) system and the subsequent National Quality Standards (NQS). The two requirements that are most onerous, are minimum caregiver qualifications and staff to child ratios. Typically, occupancy rates of 60-65% are required for a centre to break even with occupancy averaging 70-80% nationwide[11]. The biggest expense for any childcare centre is staff wages which equate to approximately 60% of revenues, with rent next at approximately 13% of revenues[11]. Interestingly, cost escalation in the sector has far outstripped general CPI and meant that most of the benefits of fee increases have not flowed to operators but to their staff. Increasing compliance is unlikely to see this change.

The draft report of Productivity Commission's enquiry into *Childcare and Early Childhood Learning*, released in July 2014, proposed that that the Childcare Benefit (CCB) and the Childcare Rebate (CCR) should be replaced by a single subsidy called the Early Care and Learning Subsidy (ECLS). This ECLS would be means tested and uncapped, but linearly taper in reverse proportion to income from 90% to 30% of the deemed cost for all approved centre or home based early childcare services. The new payment is based on a deemed cost of provision of childcare services not an actual cost, so parents choosing higher quality services would have to make up the difference between the actual and deemed cost.

The terms of reference for the Productivity Commission have suggested that any reforms to the funding model must remain within the existing funding structure. The Federal Government

[6] ABS Labour Force Participation Rate - Labour Force Survey; ABS Data available on request - June 2013
[7] OECD (2012) OECD.Stat
[8] Babies & Bosses - Reconciling Work and Family Life: A Synthesis of Findings for OECD Countries 2007
[9] Gratton Institute - Submission to the Productivity Commission Inquiry into Childcare and Early Childhood Learning - March 2014
[10] DEEWR - Childcare in Australia - August 2013
[11] G8 Education and Affinity Prospectus documents - June and November 2013 and 2014 Half Year and Full Year results presentations
[12] National Commission of Audit - table 4.2 - Large and Fast Growing Programmes - February and March 2014 http://www.ncoa.gov.au/report/phase-one/part-a/4-3-fiscal-projections.html

expects childcare sector spending of $6.5 billion in FY14 and with spending expected to increase to A$7.6 billion by FY16[13], the conversion to a "deemed cost" approach is unlikely to change the total amount of funding provided to the childcare industry.

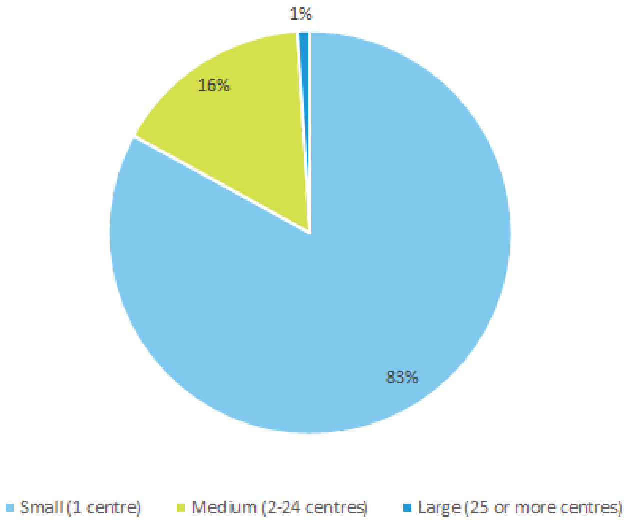
The Productivity Commission's Final Report into proposed changes to the childcare sector was handed down to the government on 31 October 2014, but has not yet been made public. By law, the government has 25 sitting days to table the report in Parliament, which could push out a more formalised response to the second quarter of 2015, which would lead into the Federal Budget, the most likely time to announce any reforms.

COMPETITIVE LANDSCAPE

The ownership structure of the childcare sector has changed significantly over the past decade. This period was characterised by the rapid consolidation of the industry by ABC Learning Centres from 2001-2009, with ABC having over 1,000 childcare centres in Australia at its peak[14]. Unfortunately, this peak coincided with ABC going into administration. Of ABC's 1045 Australian centres, around 660 of these centres were sold by the administrator to Goodstart Early Learning, a not-for-profit (NFP) operator formed by four NFPs/charities for the purpose of taking over the ABC centres[14]. Fifty ABC centres were closed and the remainder sold to other providers (NFPs and private). Goodstart owns around 641 centres and services over 73,000 children, giving it a market share of just over 10%. While much smaller, KU Children's Services is also a significant not-for-profit operator with over 150 childcare centres providing services to 14,000 children. Currently around 40% of all approved childcare facilities in Australia are operated as not-for-profit organisations, however corporate participants are again increasing their presence through the likes of G8, Affinity, Guardian and more recently, through the soon to be listed Think Childcare and Education[15].

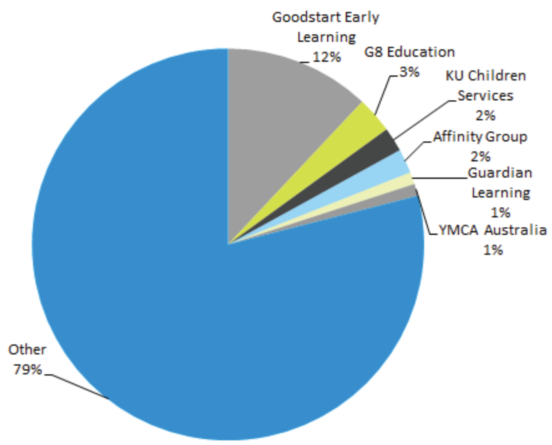
Around 83% of providers manage only one centre, so there is a strong capacity for consolidation (see Fig.4). Prior to its collapse, ABC Learning had a target of acquiring four new centres a week and the lack of price discipline in these acquisitions was a contributing factor to its collapse[16]. With the gradual creep in market share (see Fig.5), operators must show price discipline. Industry number two, the listed G8 (GEM) targets paying no more than four times earnings before interest and taxes (EBIT), though GEM paid 5.2 times EBIT for its opportunistic Sterling acquisition[17]. GEM aims to acquire 100-120 centres in the next 12 months. Affinity (AFJ), also listed, has also been actively acquiring as well. In April it bought 51 centres, which increased its number of licensed places by 83%. It paid an average multiple of 5.2 times EBIT[17].

Fig. 4: Spread of Ownership of Approved Childcare Operators



Source: Department of Education Administrative Data, February 2014

Fig. 5: Main Industry Players



Source: G8 Education and Affinity Prospectus Documents and Investor Presentations

Price competition is a key differentiator in the market with the Productivity Commission publishing numbers showing that approximately 50% of all LDC centres set fees within 5% of average fees for a three-year-old in that area[17]. The report cited anecdotal evidence of providers assessing competitors' pricing before pricing themselves and price convergence increasing with an increase in the number of childcare centres found with in 5km.

A survey by the Australian Childcare Alliance found 66% of providers compete on hours of operation, inclusion of food and nappies, health and educational factors, age and condition of facility and other intangible factors[18]. Many of these factors are

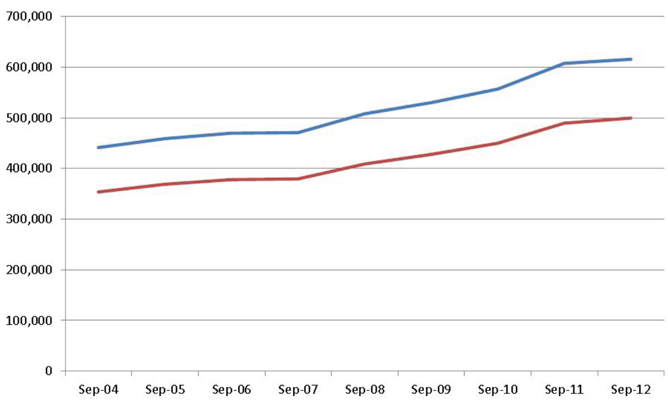
[13] National Commission of Audit - table 4.2 - Large and Fast Growing Programmes - February and March 2014
[14] DEEWR - State of Childcare in Australia - April 2010
[15] Department of Education administrative data - 2013 and 2014
[16] G8 Education - IBISWorld Industry Report 08710 - Childcare Services in Australia - April 2011
[17] G8 Education and Affinity Prospectus documents and investor presentations - June and November 2013 and 2014 Half Year and Full Year results presentations
[18] Australian Government - Productivity Commission Childcare and Early Childhood Learning - Issues Paper - December 2013

captured in the National Quality Standards (NQS), which the Productivity Commission has recommended further defining and evaluating with a greater focus on quantitative methods to aid comparison. There appears to be a link emerging as the NQS gains traction (currently only one third of long day care centres have been assessed): not-for-profits are enjoying the highest NQS scores and are also attracting the highest fees.

While there is significant competition, customers tend to be very sticky. Parents face high switching costs when confronted with a competing offer as significant value is placed on stability of the child. This results in competition between centres being focused around new clients, somewhat decreasing the variability of occupancy.

Historically, supply and demand for LDC has been tightly related. The Productivity Commission forecasts this trend to continue, with government policy controlling over supply. When the Childcare Rebate (CCR) was increased from 30% to 50% in 2008, supply growth ticked up[19] (see Fig.6). Recently, supply has weakened as operators wait for the Productivity Commission's findings. The increase in supply of childcare has been almost entirely by for-profits, with their market share increasing by 48% to 70% from 1991-2012[20].

Fig. 6: Supply and Demand of Long Day Care



Source: DEEWR

Barriers to entry are modest. There is the financial commitment in the lease agreement and fixtures and fittings as well as bearing the losses incurred as occupancy ramps up.

The government licensing process has not been a barrier to entry in the past with an 86% approval rate for 2009-2012[21]. The biggest potential barriers to entry are an increase in regulatory commitments and education requirements.

CONCLUSION

Despite a modest growth outlook, we are attracted to the Australian childcare micro industry based on the sustainability of this growth given an above-trend birth rate fuelling an increase in the number of children aged five years and younger. Evidence suggests there are powerful economic incentives for the government to encourage women to remain in or return to the workplace, which, in our view, reduces the risk of dramatic negative reform to the childcare funding status quo. Notwithstanding the relatively low barriers to entry, consolidation of centres should allow better management of staff across centres and hence cost containment while still adhering to the NQF framework guidelines. This, along with bulk procurement and economies in marketing and head office costs, will enable larger competitors to grow margins even in the absence of continuous healthy fee increases.

[19] Australian Childcare Alliance - ACA Childcare Reality (CCR) for Parents Survey - February 2014 http://www.pc.gov.au/inquiries/completed/childcare/submissions/initial/submission-counter/sub310-childcare.pdf
[20] Australian Government - Productivity Commission Childcare and Early Childhood Learning - Issues Paper - December 2013
[21] Australian Government - DEEWR - Child Care in Australia - August 2013

ABOUT ARNHEM INVESTMENT MANAGEMENT

Arnhem Investment Management is a boutique Sydney based Australian Equity Fund Manager. Arnhem manages approximately AU$3.7 billion of institutional and retail funds.*

The founding members of the investment team, George Clapham, Neil Boyd-Clark and Mark Nathan were instrumental in the establishment of the Australian equity funds for ABN AMRO Asset Management in 2000.

In 2008 they formed the boutique manager, Fortis Investment Partners which was renamed Arnhem Investment Management in 2010. Arnhem is majority owned by the investment team with BNP Paribas Investment Partners having a 40% holding.

*As at 31 December 2014

ABOUT BNP PARIBAS INVESTMENT PARTNERS

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* Source: BNP Paribas Investment Partners as at 31 December 2014

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