

## A new class representative: Kroton to acquire Somos for \$1.8bn

**Kroton Educacional SA (BOVESPA: KROT3) – market cap as of 04/05/2018: R\$ 21.75bn**

**Somos Educação SA (BOVESPA: SEDU3) – market cap as of 02/05/2018: R\$ 5.70bn**

**Exchange rate: 1 BRL (R\$) = 0.285 USD (\$)**

### **Introduction**

On April 23, 2018, Kroton Educacional, the largest for-profit education company in Brazil, proceeded to acquire Somos Educação, a leading player in the primary education sector. The transaction which amounted to R\$ 6.3bn (\$1.8bn) is one of the largest in the Brazilian education industry and came after that – in June 2017 – antitrust regulators opposed the merger between Kroton and its rival, Estácio Participações SA, in the university segment. Being restrained in one direction, Kroton is trying to propel its growth in other parts of its business, focusing on elementary and high school education.

### **About Kroton Educacional**

Kroton Educacional is one of the largest private companies, both in Brazil and worldwide, operating in the education sector. It is headquartered in Belo Horizonte and it is listed on the Brazilian stock exchange.

More than 1.2 million students are enrolled in one of its programs, with 290,000 students in basic education. The company directly owns 129 campuses and further operates in 672 affiliate schools, divided into 22 educational brands located in all Brazilian states and, in minor part abroad.

The company was born in 1966, with the setup of the Pitágoras preparatory course for university admission in Belo Horizonte. In the following decades, the curriculum was expanded to cover both primary and secondary school, exploiting the weakness and inefficiency of the public sector. In the 2000s, after a change in the Brazilian regulation, the company was able to offer also undergraduate and graduate courses, completing the education cycle and strengthening its position in the market. The following step was going public, to let investors capitalize on the growth and to raise fresh capital to keep growing. Therefore, in 2007 Pitágoras was listed on the BM&FBovespa (Brazilian stock exchange) under the name of Kroton Educacional SA (KROT3).

It further expanded in the University segment with the acquisition of IUNI (an institution offering postsecondary courses) in 2010 and of several private faculties in 2011. The spree culminated in December 2011 with the then-largest acquisition in the history of education, buying UNOPAR – the country's largest distance-learning education company at the time – for the equivalent of R\$1.3bn (\$700m). In the following years, it kept expanding in the distance education sector through other M&A deals.

The turning point arrived in 2014 when the merger with its main competitor of the time Anhanguera was approved, making the resulting Kroton the largest educational company per market cap and students served. The size of the deal was outstanding for the sector, reaching R\$5bn (\$2.5bn).

In July 2016, the company announced a merger with the next biggest competitor in University education, Estácio S.A., but the General Superintendence of CADE, the Brazilian antitrust agency, blocked the merger as it was believed that the deal would hurt the competitiveness of the industry. After this failure, the focus of the M&A activity shifted toward other age segments.

The company performance is unsteadily increasing, with revenues reaching R\$ 5.56bn (\$1.60bn) in 2017, from R\$ 5.24bn (\$1.5bn) in 2016. The profits are improving as well, although just slightly, showing timidly improving result from 2016's R\$ 1.86bn (about \$500m) to 2017's R\$ 1.88bn (\$537m). However, the overall trend in recent years is clearly upward sloped and the deals concluded seem to have been successful.

## About Somos Educação

It is the largest basic education company in Brazil and operates in a variety of fields including publishing, learning systems, schools, pre-university courses, language courses and educational technology. It is based in São Paulo, the economic capital of Brazil.

Everything started in 2010, when Ática and Scipione publishing and SER learning system, members of Grupo Abril, were split from SER to create Abril Educação, the initial core of the company.

In October 2011, Abril Educação was listed on the Novo Mercado, a section of BM&FBOVESPA, raising R\$371m to finance further expansion. In the following years, it mainly focused on organic growth with just some minor publishing brand acquisitions maintaining its focus on its core business.

Its growth potential attracted some private equity funds and in February 2015, Tarpon Investimentos took over the company, owning 44.9% of the shares. Soon after the company underwent a period of transition, losing as much as R\$331m (\$95m), caused by the load of debt used for the acquisition. Nevertheless, the company was solid enough and already in 2016 it was making profits, recording R\$48m (\$13m), out of R\$287m in revenues (\$82m). Together with the ownership shift, there was a profound rebranding of the firm, thus Somos Educação was born.

## Industry Overview

The development of the education industry of a country is usually well linked with the political agendas of its governments. Even for the Brazilian educational system, the story remains the same. For a decade, starting in 2002, governments put forward the goal to increase the share of university students from 17% to 33%. What followed was an incredible symbiosis between the public and the private sector. Even if public universities are still considered the country's best for their prestige and quality of research, there the cost per student is three and a half times higher than at private colleges. Thus, because of budget-meeting purposes, “the government has had no choice but to work with the private sector. It cannot meet the demand on its own, [...]” claimed in 2014 Mr. Iunes – at the time he was the global head of investment banking for Brazil's Itaú BBA.

However, before analyzing the impacts of the public policies, it is important to draw a distinction between the market of primary education and that of secondary education. In the former, the presence of public schools is widespread and even private institutions in this segment are mostly small and local. Regarding secondary education, even if Brazil education system can boast prestigious public universities which concentrate basically all the scientific production and are the only ones which appear in international rankings, this segment is dominated by big private companies. They represent 88% of the total number of higher-education institutions and hold 75% of the number of enrollments (making Brazil the home for some of the largest for-profit education operators in the world).

On top of that, the economic growth experienced by Brazil significantly increased the demand for skilled workers. This created an environment of opportunities for investing in education consuming the attention of foreign investors which turned their eyes to Brazil. Since foreign, private capital started to flow in, big deals have been closed, such as the sale of Grupo Multi (owner of English language schools) to Pearson (owner of the Financial Times, by then). Besides that, the government also provided big incentives to the industry: two stimulus programs were created, FIES and ProUni. The first was a low-interest loan scheme which allowed low-income students to finance 100% of their education, and the second was a tax exemption program that benefited institutions which made places available for students who could not afford a higher education. The rationale behind those measures was that paying to keep a student in a private institution was cheaper than increasing the number of places in public universities. In that way, politicians found a way to achieve their target of increasing university enrollments and benefited from a market dominated by private institutions. By 2014, R\$14bn (\$4bn) were spent in FIES alone

and 40% of undergraduate places were funded by the program. This represented 25% of the revenues of private universities and ProUni accounted for 10% of cost cuts every year.

The scenario changed dramatically with Brazil's biggest recession started in 2014. The new government, with an austere agenda, cut the generous incentives and completely changed the structure of FIES. As the economy worsened, the average household expenditure for education also dropped significantly. This triggered a big consolidation wave in the sector. Nonetheless, the biggest players – Kroton and Estacio – lost close to a third of their market capitalization after 2014. This signaled the end of a period of great prosperity in the education business in Brazil. Companies now look for new ways to regain revenues and start a new positive cycle.

## **Deal Structure**

On April 23, Kroton Educacional announced it will buy 73.35% of the total capital of Somos Educação. The Brazilian companies agreed on an upfront payment equal to R\$ 23.75 (\$6.78) for each Somos' share, adding up to R\$4.5bn (\$1.28bn), a 66% premium on the closing value of Somos shares on Friday (April 20). The contract has been signed between Saber Serviços Educacionais Ltd. (indirectly controlled by Kroton) and the investment funds managed by Tarpon Gestora de Recursos S.A., which is the controlling shareholder of Somos. For what concerns the financing of the operation, Kroton is expected to raise more than a \$1bn from the local and cross-border bond markets in order to pay the all-cash consideration.

The acquisition contract is binding, but subject to the approval of the Brazilian antitrust authority, CADE. If the operation is not concluded by October 23, 2018, the price will be daily adjusted using the CDI rate (the Brazilian inter-bank deposit rate), starting from October 24. Finally, within 30 days from the closing of the deal, Kroton intends to file a tender offer with CVM and B3 S.A. to purchase the remaining shares of the company in order to delist Somos.

## **Deal rationale**

The deal is part of Kroton's growth plan – announced last December – to invest into Brazilian basic education highly-segmented sector, after that regulators blocked its original plan to strengthen its presence in the higher education segment.

All things considered, Kroton's move into early education seems timely and just a part of a massive investment plan – which has begun with last month's purchase of Leonardo da Vinci school – which consists in opening and acquiring 30 new education units and 150 partnerships just for this year.

The acquisition of Somos is predicted to boost Kroton's revenue by 30% and to provide a good level of diversification to the acquirer's market positioning, as the 27% of revenue's base will be originated from elementary and high school education, compared to the current 3%.

Other relevant synergies for Kroton will come from around R\$300m cost reduction expected in 4 years through the unification of academic and administrative activities, the creation of economies of scale in providing education services and platform and the potential revenue increase from the enhancement of commercial capillarity and market penetration and the delivery of complementary education services.

Upon deal completion, Kroton will manage a network of 3,600 among owned and partner schools and will serve more than 85,000 professors and 1.2m students. According to the 2017 two companies' results, the post-acquisition EBITDA will amount to R\$3.01bn (\$860m) with total net revenues of R\$7.43bn (\$2.12bn).

## **Market reaction**

Upon deal announcement on Monday, April 23, markets reacted extremely positively as Kroton share price raised by 5% to R\$14.20. Somos gained with a massive 49% increase to R\$21.35, while Tarpon (the current owner of Somos) jumped 29%.

## Financial advisors

Somos's shareholders were advised by two local investment banks, Banco Itau-BBA and Riza Capital Consultoria, while the advisors of the buyer have not been disclosed yet.