Why PE Firms, Strategic Investors Must Prepare For Regulatory Changes In Preschool Sector

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In 2023, the size of the Indian preschool market reached $4.2 billion. Market research company, IMARC estimates continuing growth in this sector at a CAGR of 10% by 2032, resulting in a market size of $10.2 billion. Several key factors are driving this growth such as increased awareness on the role of preschool education and a rise in disposable incomes. A lesser talked about but important contributor in this growth is little-to-no regulation so far.

Strategic investors already recognise the opportunity in this sector. In March 2024, Amelio Early Education, an Indian preschool operator, was acquired by the UK-based Kido Education. Many others have announced big plans on their India entry – California-based preschool chain Safari Kids and Norwegian preschool chain Dibber International have been in the news for their India expansion plans. As more large and organised operators enter the segment, private equity firms are also looking to make bets in this space.

The story of regulation in preschools so far has been piecemeal at best, both in formulation and implementation. At the central level, there have been attempts at introducing a legislation, including most recently the Play Schools (Regulations) Bill in 2017.

At the state level, states such as Delhi, Karnataka and Andhra Pradesh treat preschools at par with K-12 and others like Tamil Nadu, Punjab and Jharkhand have standalone regulations for preschools but implementation across all these states is virtually non-existent. More importantly, in most other states, preschools remain outside the regulatory purview.

Regulation follows risk and as risks associated with unregulated growth come to the forefront, the status quo is likely to change soon and in crucial ways. The government is keen to regulate the sector, which would impact businesses as well as M&A and investment activity.

Not-for-profit conundrum

Under Indian education law, only not-for-profit (NFP) companies, such as societies, public trusts or Section 8 companies can establish and sponsor an educational institution.

However, a striking feature in preschools is that most of these are established as for-profits. Companies running such businesses draw comfort from market practices or the notion that the sector is unregulated. Such a view, however, runs contrary to India's National Education Policy, which reinforces the no-profiteering principle and requires all educational institutions including pre-schools to be held to similar standards of audit and disclosure as an NFP.

The main focus of regulatory change is in this direction as well. For example, in Tamil Nadu, although the 2015 code for private preschools allowed management of preschools to vest with companies or partnerships, a new set of regulations was issued in 2023 which require preschools to be sponsored by an NFP. Other states that have enacted specific regulations for preschools, such as Punjab and Jharkhand, also require them to be established and managed by NFPs.

Franchising

A majority of preschool brands in India operate on a franchising model, where an educational institution or operator grants its franchisee the right to use brand name, curriculum and/or teaching methodology in exchange for a fee.

It is important to note that such practices are prohibited at the K-12 and higher education levels. For instance, the Central Board of Secondary Education prohibits franchise arrangements. The University Grants Commission does, too, and has recently made news by issuing several public notices condoning franchise structures prevalent in online higher education.

The franchising restriction goes hand-in-hand with the NFP principle. As more states legislate on the NFP aspect or enforce existing laws, restrictions or a full-fledged prohibition on franchising may not be far behind. When implemented, this will require a reorientation in business strategy, or at the very least, redrawing of the franchising arrangements currently used by preschools.

Right to Education

Reservation requirements for Economically Weaker Sections (EWS) students under the Right of Children to Free and Compulsory Education Act 2009 (RTE Act) is another area of potential regulation for preschools. At present, schools imparting pre-primary education in addition to Class 1 are required to make reservation at both levels.

However, despite challenges before courts, standalone preschools have managed to get away without complying with RTE, likely driven by government's budget constraints. States such as Rajasthan and Maharashtra have been reported to implement the reservation requirement from Class I onwards, even for schools imparting preschool education, citing inability to reimburse schools for their expenditure. It may be a matter of time before regulation follows in this space as well. From an investor's standpoint, it's important to note that compliance with the RTE Act will likely materially impact on and financial condition of a preschool and should be factored early on.

Conclusion

Increased regulatory controls are not new, especially in emerging sectors. This has already been observed in K-12 and higher education, where more regulation through and after Covid has been the dominating story. Such changes always come at a cost, in terms of new compliance burdens but also the opportunity costs as existing business transition to a new framework.

One may argue that such changes could make the sector unattractive. But a deeper look would reveal that sound businesses are based on regulatory alignment and risk management will be easier handled for investor and acquirors once the sector is controlled through regulation.

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