MORNINGSTAR®

Australia's Childcare Industry Is too Important to Fail

Appealing value within the childcare sector.

Morningstar Equity Research
23 July 2020

Contents

Gareth James, CFA
Equity Strategist
+61 2 9276 4583
gareth.james@morningstar.com

Childcare Stocks Still Look Undervalued Despite the COVID-19 Surge in Victoria

Investor concerns about the impact of the COVID-19 pandemic on the early childhood education and care, or ECEC, sector have re-emerged following the surge in active cases in Victoria and associated social distancing restrictions. However, we continue to believe childcare stocks are undervalued and that the long-term sector outlook is little changed by recent developments. Capital raisings undertaken by childcare providers earlier in the year also provide appropriate insulation from near-term risks.

The federal government chose not to save ABC Learning from bankruptcy during the global financial crisis, but we believe policymakers' attitude towards the childcare sector has changed significantly since then, partly due to the significant improvements in sector quality and regulation during the past decade. We believe the government support provided during the COVID-19 pandemic sets a precedent for future support of the sector and the temporary provision of free childcare will amplify calls for higher subsidies.

In the short term, childcare centres in Victoria—around 20% of the childcare sector—mostly remain open and ECEC providers will continue to receive the Child Care Subsidy, or CCS, which equates to around 50% of revenue, even if children don't attend centres. In addition, childcare centres nationally will receive Transition Payments from the federal government until Oct. 4, 2020, which account to around 25% of normal revenue. We expect these measures will support the childcare sector through the six-week lockdown in Victoria until Aug. 19, 2020.

Key Takeaways

- We expect the federal government will support the childcare sector through the COVID-19 crisis. We believe this approach will strengthen the perception of the childcare sector as an essential service and reinforce calls for higher childcare subsidies.
- The year 2020 will be tough for childcare operators but we expect unemployment will gradually improve during the second half of 2020 and during 2021, as COVID-19 treatments improve and vaccines become available.
- Childcare landlords are particularly well placed to withstand the childcare sector weakness in 2020 as they are far less exposed to occupancy rate weakness than operators.

Companies Mentioned

Name/Ticker	Economic Moat	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap(Bil)
G8 Education GEM	None	AUD	2.00	0.80	High	★★★★★	0.67
Arena REIT ARF	None	AUD	2.73	2.24	Medium	★★★★	0.67
Charter Hall Social Infra. Trust CQE	None	AUD	3.40	2.43	Medium	★★★★★	0.87

Clouds Are Gathering Over the Australian Childcare Sector Once Again

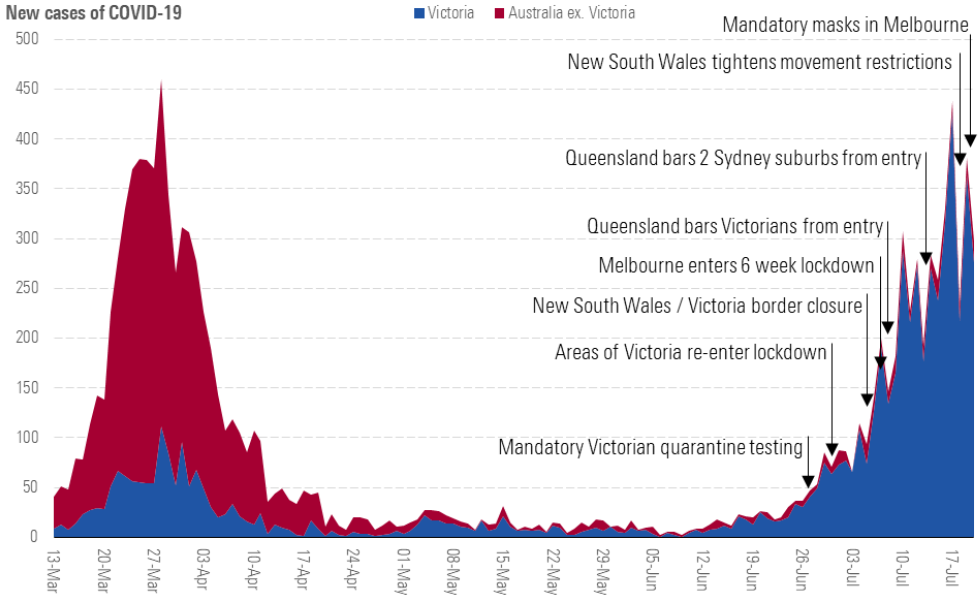
The Current COVID-19 Outbreak May Be Largely Contained Within Victoria

The Australian childcare sector is once again being threatened by the COVID-19 pandemic, with the recent surge in cases in the state of Victoria causing renewed movement restrictions. However, as shown in Exhibit 1, Australia's "second-wave" is still mainly a Victorian issue and the closure of borders with other states and territories could largely contain the outbreak within the state.

To date, Australia's response to the pandemic has been relatively successful, with only around 400 cases per million people, well below the United States at around 10,000 cases per million, or the United Kingdom at around 4,000 cases per million. This success reflects several factors, such as the swift closure of Australia's international border in late March 2020, a requirement of returning nationals to quarantine in hotels, as well as national attributes, such as a relatively low and dispersed population and a lack of foreign land borders.

We don't believe resurgent COVID-19 outbreaks are a foregone conclusion in Australia for several reasons. First, Australia brought the initial wave of COVID-19 cases under control and we believe this is likely to be repeated. Outside of Victoria, the country has maintained COVID-19 cases at negligible levels and the Victorian outbreak appears to have been partly caused by breaches of the state's hotel quarantine system, which is now subject to a judicial enquiry and means previous mistakes are unlikely to be repeated. Returning Australian nationals in quarantine are also now required to undertake COVID-19 tests and face masks are mandatory in Melbourne. Longer-term, we expect a vaccine to become available in 2021, meaning movement restrictions and outbreaks will only be an issue for the next one to two years, if not less.

Exhibit 1 Victoria is the Main Source of new Coronavirus Cases in Australia



Source: Morningstar, Data sourced from https://www.covid19data.com.au

Young Temporary Workers Are Bearing the Brunt of the Economic Slowdown

The COVID-19 pandemic has caused a sharp increase in the Australian unemployment rate. As illustrated in Exhibit 2A, the underutilisation rate has increased as the participation rate has fallen, and around 3.5 million people, or around a third of employed people, are claiming the federal government's JobKeeper subsidy. However, the recent rise in unemployment is unlikely to be permanent and we don't expect a structural decrease in female workforce participation or childcare demand.

Aside from the Victorian outbreak, Australia's economy has been recovering more quickly than previously expected by the federal government's Department of the Treasury, which cut its 2020 peak unemployment projections to 8% from 10% in June 2020. The Australian Financial Review's June 2020 quarterly survey of 28 economists produced an average unemployment rate forecast of 8% by December 2020 and 7.3% by June 2021. The recent extension of JobKeeper to March 2021 will provided significant unemployment support.

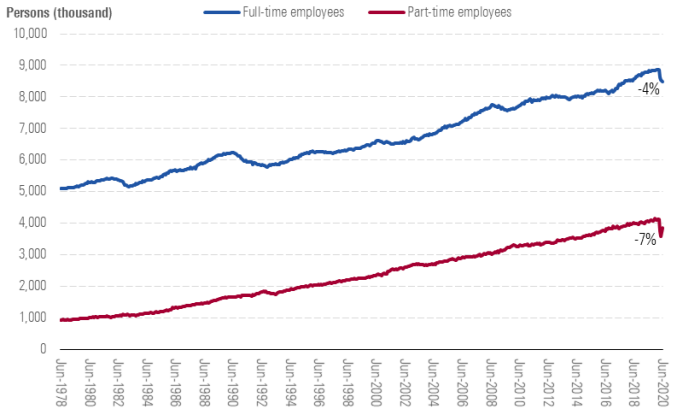
Notably, the increase in unemployment appears to have primarily impacted young temporary employees, such as retail store assistants and hospitality workers. Exhibit 2B shows the split between full-time and part-time jobs and that around half of the 630,000 jobs lost in 2020 were part-time, despite the part-time sector comprising only 30% of all jobs. In addition, young people appear to have been disproportionately impacted, with around a third of jobs lost occurring in the 15 to 24 age group, despite this age group comprising only 14% of all jobs. Importantly, there doesn't appear to be a material disproportionate impact on female employees, which is a positive sign for the childcare sector.

The seemingly disproportionate unemployment impact on young and part-time employees could be relatively beneficial for the childcare sector for two reasons. First, we expect temporary jobs to rebound relatively quickly as the economy recovers, and second, we expect the childcare sector has relatively low exposure to youth and temporary unemployment considering around 10% of all mothers are aged under 24 years.

Exhibit 2A Unemployment is High but Distorted by JobKeeper

Source: Australian Bureau of Statistics, Labour Force June 2020

Exhibit 2B Young Part-Time Employees Bearing the Brunt of the Downturn



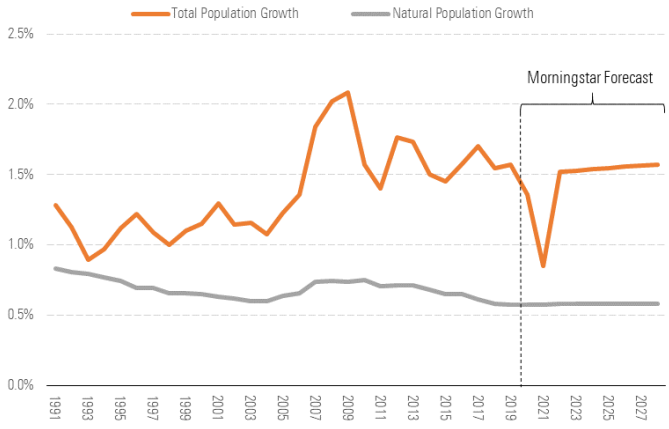
Source: Australian Bureau of Statistics, Labour Force June 2020

Childcare Is Unlikely to Be Materially Impacted by Lower Immigration

The 2020 closure of Australia's international borders will have a material short-term impact on immigration and Australia's population growth rate, as illustrated in Exhibit 3A. Aside from the short-term impact on nominal GDP growth, and potential associated impact on childcare demand, childcare demand may also be impacted by an associated fall in births. However, the birth rate is a function of both population and the fertility rate and an increase in fertility could easily offset the decline in population. It's also possible immigration may exceed normal levels following the crisis, in order to boost economic growth. We also expect other factors, such as the unemployment rate, the status of lockdowns, the supply of new childcare centres, and government subsidies, to have a much bigger impact on the childcare market than immigration.

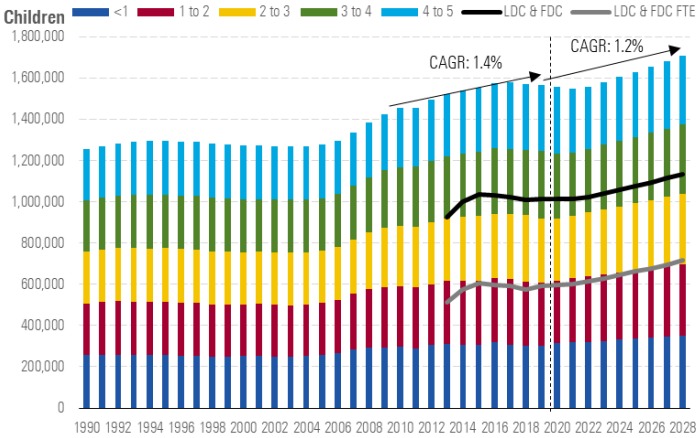
The coloured bars in Exhibit 3B represent the number of children in each age bracket and combined represent the approximate addressable market, in terms of number of children, for childcare services. The black line shows the number of children registered to attend long daycare, or LDC, and family daycare, or FDC, services. The grey line is our estimate of the full-time equivalent attendance of LDC and FDC services, considering children tend to spend around three, out of five days each week, in childcare on average.

Exhibit 3A Australia's Population Growth Is Dependent on Immigration



Source: Morningstar, Data from Australian Bureau of Statistics

Exhibit 3B Weak Immigration Will Only Impact a Small Part of Childcare Demand



Source: Morningstar, Australian Bureau of Statistics. Note: FTE means full-time equivalent

The Federal Government Seems Determined to Save the Childcare Sector

The Australian ECEC sector provides education and care services to children aged from birth to around 5 years old, before they enter the school system and comprises three main types including: LDC, FDC, and pre-school, or PSK. A description of each segment can be found in the appendix.

The ECEC sector is highly dependent on both federal and state government subsidies, which comprise around 60% of industry revenue. The main subsidy is the federal government's Child Care Subsidy, or CCS. The cost difference between the price of the childcare provided and the CCS is borne by parents and is known as the "gap fee."

The initial COVID-19 outbreak and associated movement restrictions caused a fall in ECEC occupancy rates in March 2020 which threatened a significant fall in ECEC sector revenue and profits. If sustained, this could have caused widespread bankruptcies in the ECEC sector but was avoided thanks to a range of federal government support measures including:

- **March 30, 2020 - JobKeeper Wage Subsidy:** On March 30, 2020, the federal government announced the JobKeeper wage subsidy, which would be available to all sectors of the economy between March 30, 2020 and Sept. 27, 2020. Businesses which meet the criteria are eligible for wage subsidies worth AUD 1,500 per fortnight per employee. The JobKeeper subsidy has since been extended to March 2021 but ended for the ECEC sector on July 20, 2020.

- **April 2, 2020 - Early Childhood Education and Care Relief Package, or ECECRP/"Free" Childcare:** The federal government's ECECRP was announced on April 2, 2020 and was paid to ECEC providers between April 6, 2020 and July 12, 2020. The ECECRP paid ECEC providers 50% of the revenue they were generating before the crisis began, as at March 2, 2020. The ECECRP required participating ECEC providers to provide childcare to the general public for free.

- **April 3, 2020 - Rental Code of Conduct and Moratorium on Rental Evictions:** On April 3, 2020 the federal government announced a mandatory code of conduct for landlords and small business tenants and a six-month moratorium on rental evictions, which was subsequently legislated by

Australian states and territories. These initiatives enabled tenants to claim rental deferrals and waivers from landlords.

- **June 8, 2020 - Transition Payments:** On June 8, 2020, the federal government announced its plan to transition the ECEC sector back to the CCS. This included an ending of the ECECRP on July 12, an ending of JobKeeper for the ECEC sector on July 20 and the establishment of Transition Payments for the ECEC sector between July 13, 2020 and Sept. 27, 2020. Transition Payments make up 25% of the ECEC service provider's revenue prior to the crisis, as at March 2, 2020.

- **June 8, 2020 - Reduced Activity Tests:** CCS eligibility requires parents to undertake a certain level of "activity" such as paid employment, study, or job searching. On June 8, 2020, the federal government announced it would reduce activity tests for the childcare sector between July 13, 2020 and Oct, 4 2020.

- **July 13, 2020 - Additional Absence Days:** From July 13, 2020 families became entitled to 42 absence days per child per financial year, whereby the ECEC provider continues to receive CCS when the child is absent, and potentially additional absence days in certain circumstances.

- **July 7, 2020 - Additional support for Victoria:** The federal government announced on July 7, 2020 that ECEC centres in Victoria could claim CCS in cases where families are unable to attend centres due to the lockdown.

We have illustrated the main components of the changing subsidy environment in Exhibit 4. Although the ECECRP and JobKeeper broadly ensured the survival of the ECEC sector, they weren't without issues. First, the ECECRP was based on revenue generated in early March, which is typically a relatively low point for occupancy for the seasonal ECEC sector. Second, the imposition of "free childcare," caused higher occupancy rates for many LDC operators but without an associated increase in revenue. This resulted in some ECEC providers turning away families on "health grounds" and calls to reinstate the CCS once the economy was showing signs of recovery in June 2020.

Exhibit 4 Subsidies Have Changed With the Evolving COVID-19 Situation

	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20
Child Care Subsidy	Operated until 5 April 2020			Suspended until 12 July 2020			Operating from 13 July 2020					
Parent gap payment	Operated until 5 April 2020			Suspended until 12 July 2020			Operating from 13 July 2020					
Reduced activity test	Operated until 5 April 2020			Suspended until 12 July 2020			Operating until 4 October 2020			Not applicable		
Jobkeeper for the childcare sector (~40% of 'normal' revenue)	Implemented on 30 March 2020			Operates until 20 July 2020			Not applicable					
Early Childhood Education & Care relief Package (50% of 'normal' revenue)	Implemented on 6 April 2020			Operated until 28 June 2020			Not applicable					
Transition Payment for the childcare sector (25% of 'normal' revenue)	Not applicable			Implemented on 13 Jul 2020			Operates until 27 September 2020			Not applicable		

Source: Morningstar, Australian Government Announcements

The Victorian COVID-19 Outbreak Will Have a Mixed Short-Term Impact

Victorian and New South Wales Childcare Centres Remain Open

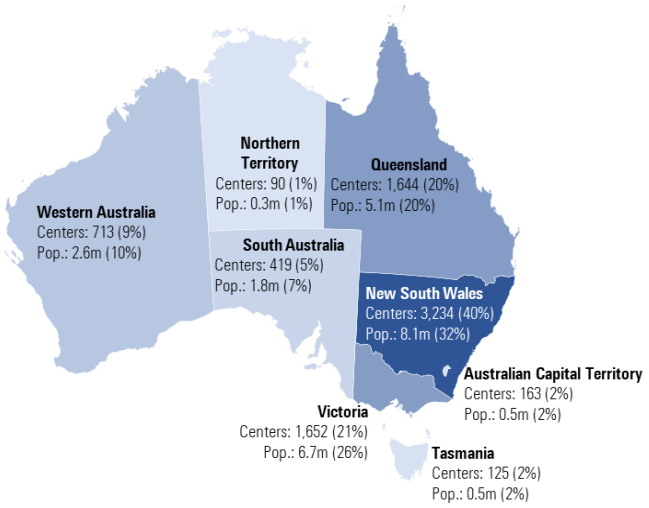
The LDC sector dominates ECEC services and makes up around 8,000 centres throughout Australia, as illustrated in Exhibit 5A, with around 20% of all LDC centres, and around 25% of the national population located in Victoria. ECEC providers may have higher or lower exposures to Victoria, depending on their portfolio mix, as shown in Exhibit 5B.

Despite the current movement restrictions, LDCs have remained open in Victoria and the federal government will continue to pay the CCS to LDCs, even if parents keep children away from the centre due to COVID-19 concerns. This is important for two reasons. First, it means centres continue to generate revenue, and second, it maintains the customer relationship between the centre and the child's family.

Although more recent LDC occupancy data is not available, the initial wave of the COVID-19 outbreak in March 2020 caused G8 Education's occupancy rate to fall to around 60%, or around 10 percentage points below its normal rate. However, the impact from the current outbreak in Victoria is likely to be less because the outbreak is largely limited to one state and a range of government economic stimulus schemes are already in place, both for the broader economy and for the childcare sector specifically.

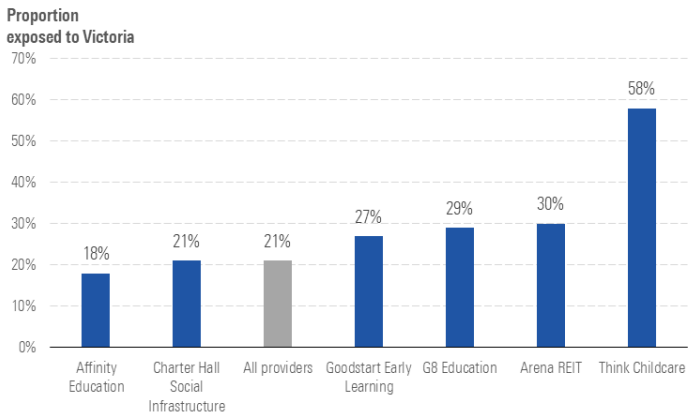
Victoria is likely to remain in Stage 3 lockdown until Aug. 19, 2020, however, centres can still claim the CCS even if children stop attending the centre, which amounts to around 60% of centre fees. ECEC providers will also receive transition payments until Sept. 27, 2020, which are worth around 25% of a centre's "normal" revenue, meaning LDC providers should be in a reasonable position until October 2020 at least. However, we expect the federal government to increase subsidies if required and depending on the progression of COVID-19 outbreaks.

Exhibit 5A LDCs Are Mainly on Australia's Eastern Seaboard



Source: Australian Children's Education and Care Quality Authority (ACECQA)

Exhibit 5B Proportion of Long Daycare Centres in Victoria



Source: Morningstar, company filings.

LDC Operators Are far More Exposed to Childcare Weakness than Landlords

LDC operators are far more exposed to childcare sector weakness than LDC landlords because operators are more exposed to volatile childcare centre occupancy rates, which are the key determinant of LDC profitability. In contrast, LDC landlords generate rental income from their LDC operator tenants largely irrespective of the occupancy rate of the childcare centre. Generally speaking, landlords are only impacted if the operator becomes bankrupt.

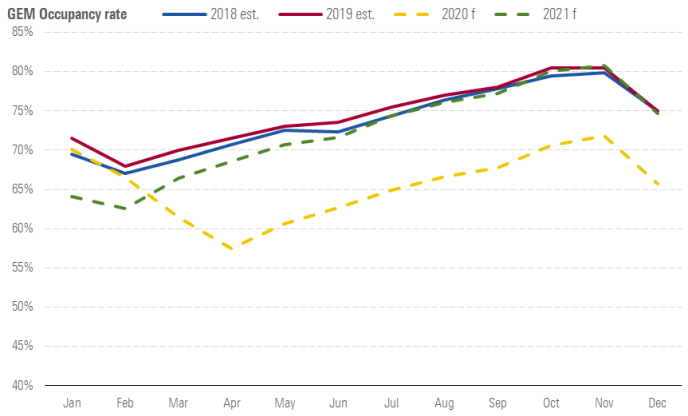
We consider bankruptcies to be unlikely in the LDC sector, particularly for large landlords such as Arena REIT, or ARF, and Charter Hall Social Infrastructure Trust, or CQE, for three reasons. First, the federal government appears determined to support the sector during the COVID-19 pandemic and particularly to avoid bankruptcies. Second, ARF and CQE have a high exposure to Goodstart Early Learning, which is the largest operator of childcare centres in the country, is owned by a consortium of charities, and very conservatively financed. And third, because ARF and CQE are exposed to relatively large and high-quality ECEC operators.

Occupancy Rates Will Be Impacted in 2020 but Should Recover

Although LDC occupancy rates will be impacted in 2020, we expect a recovery to begin in the second half of 2020 and continue during 2021, based on our estimates of G8 Education's monthly occupancy rates, as illustrated in Exhibit 6A. Before the main outbreak of COVID-19 in Australia in February 2020, G8 claimed its occupancy rate, which is the proportion of their centre capacity for which they are receiving fees, was slightly below the previous corresponding period. However, by April 2020 occupancy had fallen to around 60%, around 10 percentage points below the normal occupancy rate at that time of year, and attendance, which is the proportion of their centre capacity who actually turn up for childcare, was around 30%.

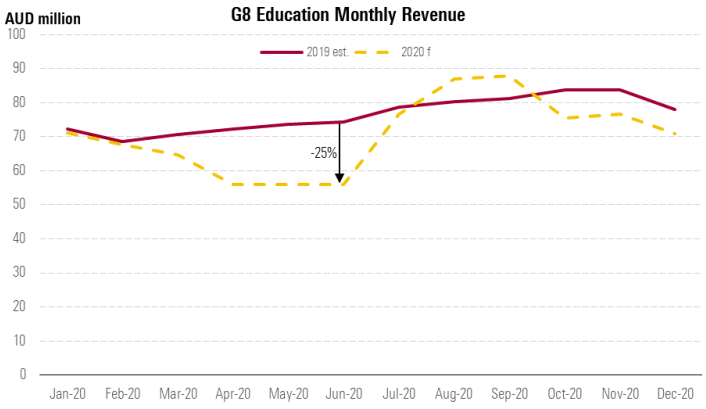
G8 does not provide regular occupancy updates but said in mid-June 2020 that occupancy was 65% and the attendance rate was 53%. Our forecasts assume occupancy gradually improves and returns to "normal" levels by early 2022; however, our forecasts are materially above G8's assumptions for an occupancy rate of 50% for the second half of 2020 which we consider to be overly conservative.

Exhibit 6A We Expect a Gradual Recovery in Occupancy Rates



Source: Morningstar, G8 Education

Exhibit 6B G8's Revenue Will Be Weak but not Catastrophic in 2020



Source: Morningstar, G8 Education

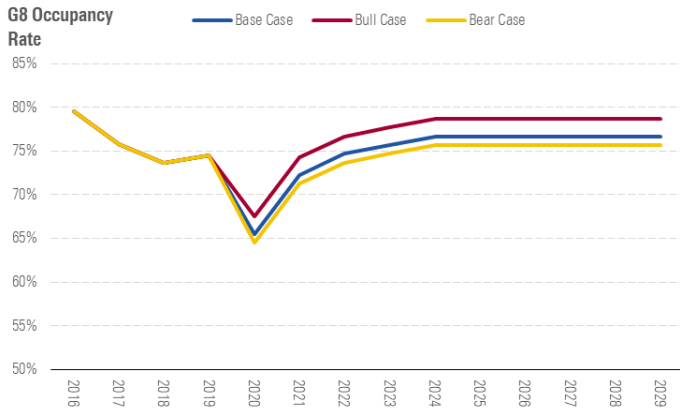
Our forecasts assume a recovery in occupancy rates from April 2020 and a gradual narrowing of the occupancy shortfall, although we don't envisage a recovery to normal occupancy rates until late 2021. Our corresponding revenue forecasts are shown in Exhibit 6B, although these forecasts assume JobKeeper payments are counted as revenue rather than a cost reduction. It looks feasible revenue could exceed normal revenue in the third quarter due to the overlap of subsidies in addition to the recovery in occupancy rates in all states except Victoria.

The Current G8 Share Price Is our Bear-Case Scenario

We have illustrated the main assumptions underlying our earnings forecast in Exhibits 7A to 7D below, including our base-, bull- and bear-case scenarios. Our base case fair value is AUD 2.00 per share, but our bear and bull cases are AUD 1.00 and 2.80, respectively. The key assumption underlying all scenarios is the federal government will continue to subsidise the sector for the foreseeable future and provide additional short-term support during the COVID-19 crisis.

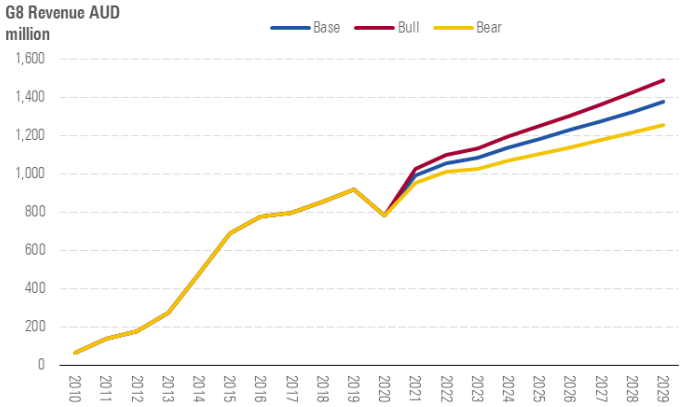
The current G8 share price is similar to our bear-case scenario which assumes a long-term EBIT margin of 12%, versus 20% in our base case. Although G8 generated an EBIT margin of 15% in 2019, this figure was distorted by new centre openings, and established centres generated an EBIT margin of 22% before head office costs which are typically about 4% of revenue. However, we expect G8 to improve occupancy rates over recent "normal" levels in the long term, due to the relatively new focus on quality by the firm, such as hiring a head of early learning from the Australian Children's Education and Care Quality Authority to develop early learning programs.

Exhibit 7A Occupancy Should Normalise by 2022



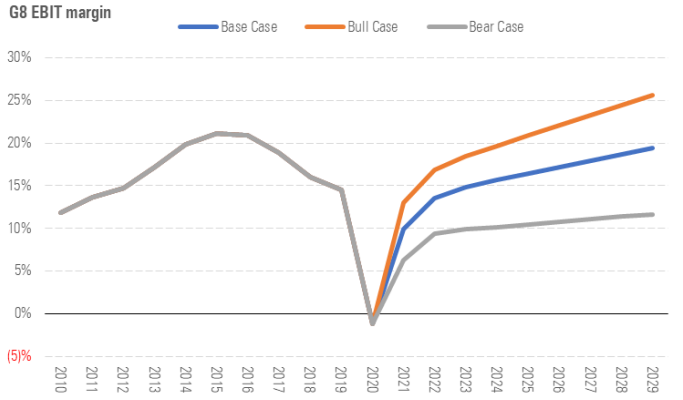
Source: Morningstar, G8 Education

Exhibit 7B Occupancy and Fee Growth Should Drive Long-Term Revenue Growth



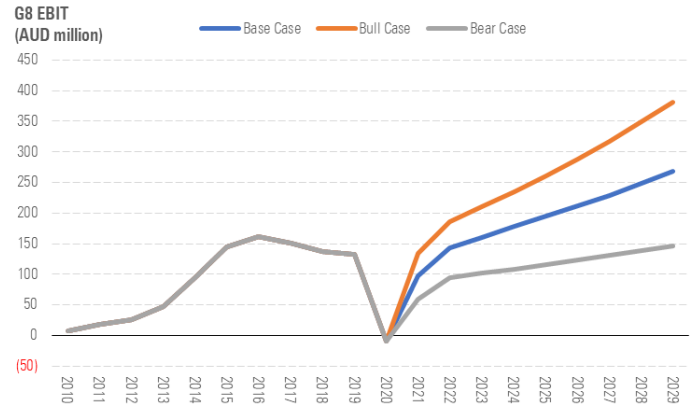
Source: Morningstar, G8 Education

Exhibit 7C Occupancy Should Drive Margin Rebound



Source: Morningstar, G8 Education

Exhibit 7D EBIT Can Return to Growth in the Long Term

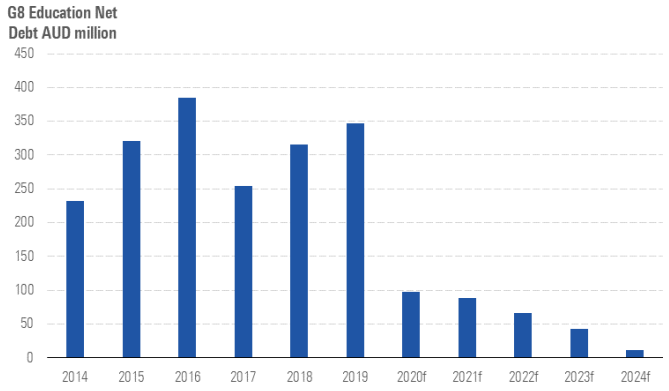


Source: Morningstar, G8 Education

Strengthened Balance Sheets May Drive M&A Activity

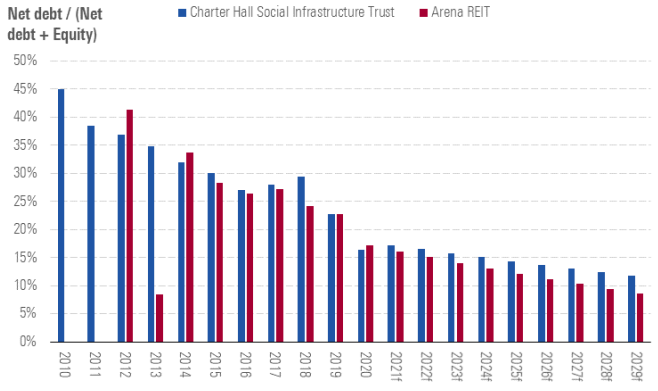
G8 Education's decision to raise AUD 301 million in new equity in April 2020 significantly strengthened the company's balance sheet as illustrated in Exhibit 8A. However, the decision to maintain cash and debt facilities means the company has flexibility to both manage a protracted downturn and pursue opportunistic acquisitions. ARENA REIT and Charter Hall also raised AUD 85 million and AUD 123 million, respectively, in June 2020. In the short term, this additional capital has deleveraged already conservatively geared balance sheets, but in the long term we expect the new capital to be used for real estate developments and acquisitions of real estate assets.

Exhibit 8A G8 Has Significantly Derisked Its Balance Sheet



Source: Morningstar, G8 Education

Exhibit 8B Landlord Gearing Is Conservative



Source: Morningstar, ARENA REIT, Charter Hall Social Infrastructure Trust

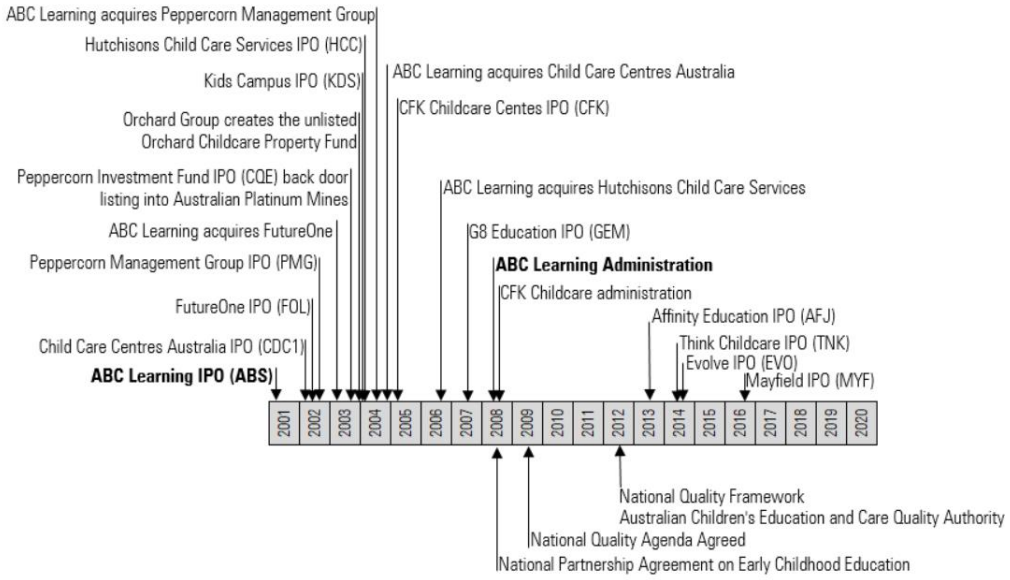
Investors Can Benefit From the Childcare Moral Hazard

The "Wild West" Days of ABC Learning Are Over

The highly successful initial public offering, or IPO, of ABC Learning in 2001 triggered a wave of copycat IPOs in the following years, as illustrated in Exhibit 9. However, since the collapse of ABC Learning and the associated reputational damage to the childcare sector during the GFC, the quality of the ECEC sector has improved. As also illustrated in Exhibit 9, the national quality agenda was agreed between the state and federal governments in 2009, and the National Quality Framework, or NQF, National Quality Standard, and National Quality Ratings were established in 2012. The Australian Children's Education and Care Quality Authority, or ACECQA, was also created in 2012 and there has been a significant improvement in the educational qualifications of childcare workers.

We expect the increased regulation, quality, and government funding of the childcare sector in recent years have been significant factors in the government's decision to support the sector, and deem childcare to be an essential service, during the COVID-19 crisis. The federal government's actions also set a precedent for the future and we expect the childcare sector will now always be considered "too important to fail." The provision of "free" childcare during the recent crisis also sets a precedent which is likely to support calls for further long-term government support of the childcare sector.

Exhibit 9 Standards Within the Australian Childcare Sector Have Improved During the Past Decade



Source: Morningstar

Access to Childcare Is Considered a Human Right in Western Countries

The ECEC sector is an unusual sector of the economy in that it sits at the border between the private sector and publicly provided services. In most countries, childcare was historically considered to be primarily the responsibility of women. However, as women gained equal rights

and workplace equality, access to childcare became perceived as a human right and childcare was recently deemed to be an essential service by the Australian government.

The ECEC sector has also increasingly been perceived part of the education system, access to which is also generally considered to be a human right. Access to childcare is also increasingly required to incentivise women to have children and support practically stagnant natural population growth in western countries, which has broader economic growth implications.

It's therefore understandable that western governments heavily subsidise childcare. However, since the 1980s, many western countries have also sought to privatise state-owned industries, on the basis that the private sector is a more efficient allocator of capital and lacks the political interference and bureaucracy of state-owned organisations.

The consequence for the Australian childcare sector has been a largely privately-operated sector but with significant government funding and regulation. While this arguably creates a moral hazard for the federal government whereby it effectively underwrites private risk capital, we expect this structure to continue.

Parents Can't Afford Childcare Without Government Subsidies

The fundamental challenge of the ECEC sector is that ECEC services are labour-intensive and lack economies of scale. Government regulations control the way in which childcare is provided and mean childcare would be prohibitively expensive for most parents without subsidies, despite childcare workers being among the lowest paid employees in the country.

ECEC services provide a simple solution to childcare demand in that they simply transfer the task from the parent to an employee. However, additional costs are created in the process, such as rental costs, operating costs, and a need to generate profits, which wouldn't be incurred if the parent looked after the children themselves at their own home. The logistical and emotional challenges of juggling paid employment and putting a young child into long daycare also has nonmonetary costs which are borne by parents.

Higher Regulation Limits Wage Growth

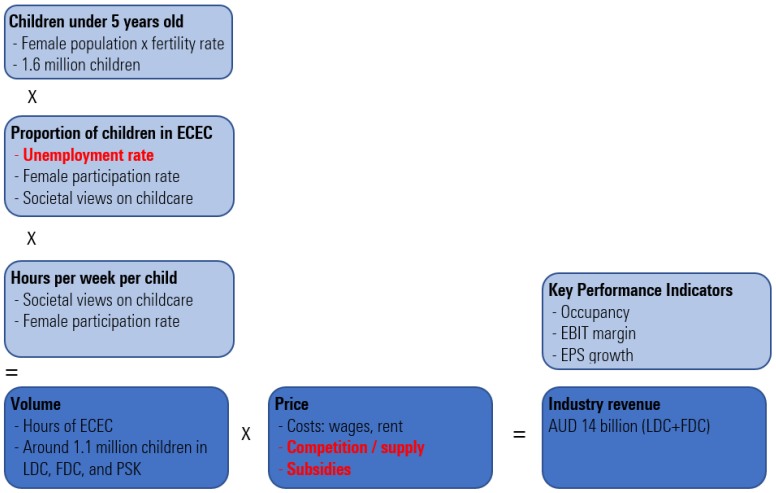
Higher wages for childcare teachers are a key risk for the childcare sector because wages usually comprise around 60% of a childcare operator's revenue. However, despite the fact that childcare workers are relatively low paid, and unions regularly campaign for much higher wages, we believe low wages are largely a function of the structure of the industry and unlikely to increase significantly. For example, regulation limits the number of children that can be cared for by a teacher; for children under 3 years old, as an example, the ratio is four children per teacher. This creates extremely challenging economics whereby significantly increasing the wages of over 100,000 childcare teachers would require a significant increase in government subsidies. However, we expect childcare subsidy growth to primarily support more, rather than more expensive, LDCs.

Oversupply Is a Bigger Threat to Childcare Than COVID-19

Unemployment, Subsidies and Supply Are Key Market Drivers

We consider the main drivers of the childcare sector to be unemployment, government subsidies, and the supply of new LDCs. In the short term, the unemployment rate and subsidies are likely to be the most important factors, as discussed above. However, we expect a gradual improvement in unemployment in the second half of 2020 and further government financial support. In 2021, we expect COVID-19 treatments and a vaccine to support economic recovery. In the long term, we expect the main driver of the sector to once again become the new supply of childcare centres and we expect new supply growth to slow towards demand growth. We illustrate the drivers of the Australian childcare market in Exhibit 10.

Exhibit 10 Unemployment Is the Key Short-Term Risk, but Supply More Important Over the Long Run



Source: Morningstar

The Childcare Market Has Significant Growth Potential

Generally speaking, we consider the addressable market for ECEC services in Australia to be around 1.6 million children. This is the number of children aged under 5 years old, which is roughly the age at which children start entering the national school system. However, the rate of ECEC participation for children aged under 1 year old is only around 10% meaning the addressable market is arguably closer to 1.2 million, as illustrated in Exhibit 11A. The ECEC participation rate for children aged under 1 is low because parental leave is a legal requirement in the first year of a child's life and parents typically want to care for their new child themselves, particularly if the mother is breast feeding.

Exhibit 11A also shows our estimate of the number of children in each of the main ECEC sectors. Notably, the FDC sector has been shrinking in recent years, which we attribute to increased regulation, a trend which we expect to continue. Also, of note is that the PSK sector, which almost entirely comprises not-for-profit providers, has not grown for many years. In contrast, the LDC sector, which is the sector in which GEM, ARF, and CQE operate, has grown strongly in recent

years, a trend which has been obscured by the declining and stable FDC and PSK sectors, respectively.

Although the use of ECEC services appears to be high based on our estimates of the number of 1- to 4-years olds who use LDC, FDC, and PSK services, the data is somewhat misleading. This is because children use ECEC services for only part of the week on average, or around 3 days, and Exhibit 11B shows our estimate of full-time equivalent, or FTE, use of ECEC services. This means that on a full-time equivalent basis, there is much greater potential for increased ECEC use, namely by increasing hours per child.

However, as with ECEC use by children aged under 1 year old, we estimate there are natural limits to usage because we expect it's unlikely that children aged under 5 will ever reach full-time attendance of ECEC services due to societal views that babies and toddlers shouldn't participate in full-time education.

Exhibit 11A Most Eligible Children Appear to Be Registered for Some ECEC

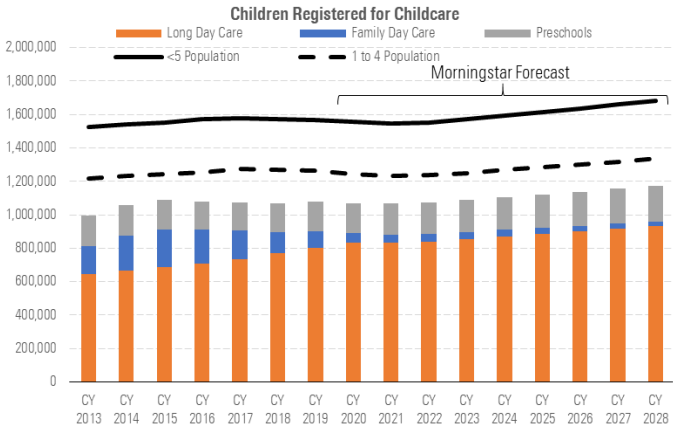
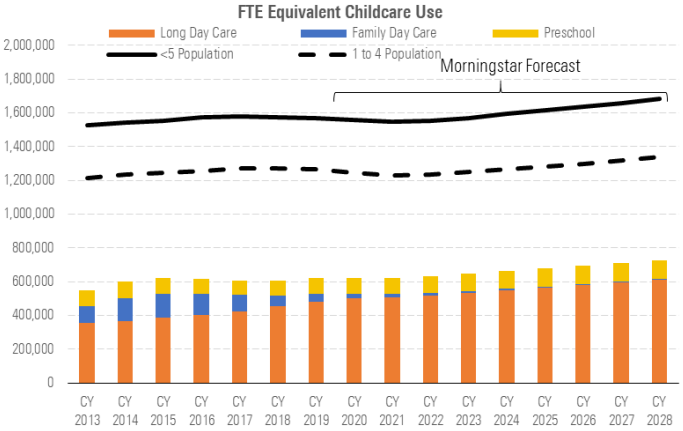


Exhibit 11B FTE Usage of ECEC Services Is Far Lower Than Registered Use



Source: Morningstar, Australian Federal Government Department of Education, Australian Bureau of Statistics data

Childcare Market Growth Will Slow Without New Subsidies

Exhibit 12A shows that the ECEC industry, excluding pre-schools which do not fall under the childcare subsidy and are almost entirely not-for-profit, has grown at mid-single-digit annual rates in recent years. However, this rate disguises two contrasting trends, including a decline in the FDC market and stronger growth in the LDC market. We attribute the decline in FDC due to an increase in regulatory scrutiny and we expect this trend to continue to shrink this market segment. Ultimately, we expect regulators would prefer the market to comprise LDCs only due to the ease with which they can be regulated.

In Exhibit 12B, we've attempted to deconstruct LDC sector revenue growth into component drivers, including growth in the number of children, hours used per week, and fees. This indicates the number of children has been growing at around 4% per year, hours used per week has been growing at around 1.5% per year, and that fees have been growing at around 5% per year.

However, we expect that over the long term, fee growth will be harder to achieve due to downward pressure on inflation unless subsidies are increased. However, the read though is this will also limit wage growth for already relatively low paid childcare employees despite the constant increase in regulation and bureaucracy and we doubt operators would absorb wage growth without fee growth.

Exhibit 12A The LDC Sector Is Engulfing the FDC Sector

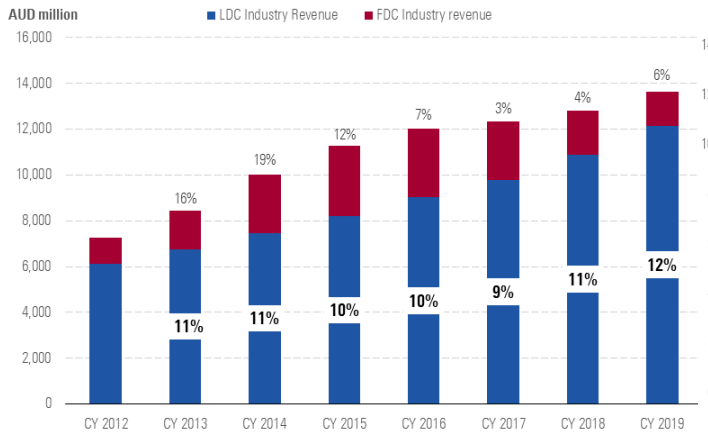
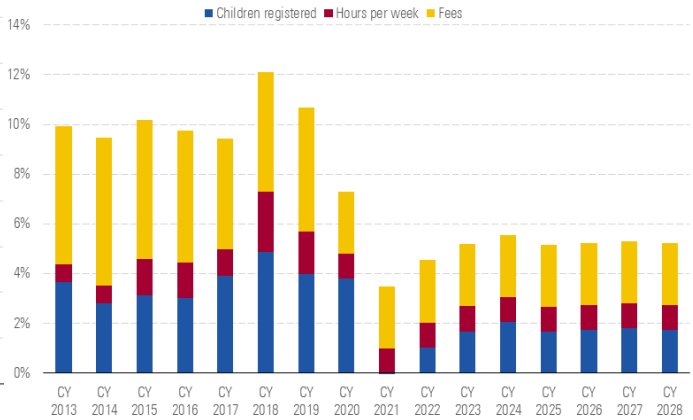


Exhibit 12B Fee Growth Has Been the Main Driver of LDC Revenue Growth

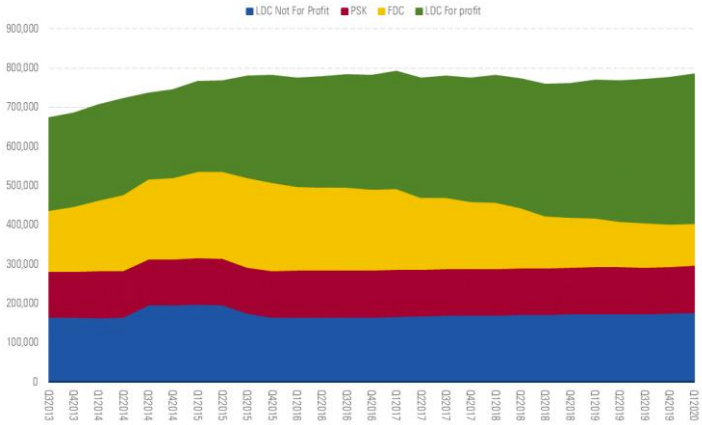


Source: Morningstar, Australian Government Data

Supply Needs to Slow to Support Occupancy Rates

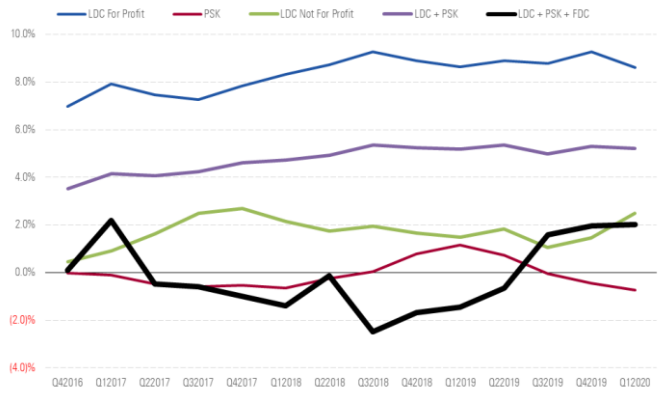
As illustrated in Exhibit 13A, the for-profit LDC sector is increasingly dominating the ECEC industry and we expect this trend to continue. However, Exhibit 13B shows that the growth of the for-profit LDC sector is well above that of the ECEC industry but has been obscured by the declining FDC sector and lack of growth from the not-for-profit LDC and PSK sectors. The benefit from declines in the FDC sector will be less in future, meaning LDC for-profit growth needs to sharply slow to avoid an oversupply of the industry. We expect operators to act rationally and slow new supply to avoid profit margin deterioration.

Exhibit 13A For Profit LDC Dominates Industry Growth



Source: Morningstar, ACECQA, Australian Government Data

Exhibit 13B For Profit LDC Growth Needs to Slow



Source: Morningstar, ACECQA, Australian Government Data

G8 Strategy Should Be to Strengthen its Competitive Position via Its Brand

The ECEC sector is a reasonably commoditised sector with little differentiation between operators other than centre location, centre presentation and layout, and employee quality. This means providers usually lack material competitive advantages, particularly at a national level, or pricing power, beyond location, and are particularly vulnerable to new childcare centre supply.

Historically, the strategy of listed childcare operators was to attempt to create short-term EPS accretion by acquiring childcare centres with relatively cheap debt and listed equity. However, this strategy is hugely problematic for a range of reasons and doesn't really create long-term shareholder value.

We believe a far better strategy for childcare operators such as G8 Education is to strengthen their competitive position, which we believe they can achieve by investing in their brand, as explained in Exhibit 14. Although cost advantage is the most likely source of competitive advantage for ECEC service providers, we believe this is largely beyond the control of operators such as G8 Education. Similarly, efficient scale may be an advantage for a well-positioned childcare centre but it's hard to achieve at a national level and operators are unlikely to secure well-positioned locations for less than a fair price.

In contrast, an operator's brand is within its control and can be primarily built in childcare by ensuring high standards and providing a high-quality service. However, we expect this will only be monetisable if consumers can associate the high-quality service with a nationally recognisable brand which is promoted and advertised. This is the strategy often employed by organisations like Starbucks, in the café sector, Hilton in the hotel, and used in the fitness and retail sectors, all of which are otherwise capital-light with low barriers to entry other than a good location. Notably, Goodstart has a national brand and high-quality reputation, although this appears to be causing superior occupancy rates rather than pricing power.

Exhibit 14 Childcare Operators Should Invest in Building Their Brand

Economic Moat Source	Likelihood	Evidence
Cost Advantage	Most Likely	- As illustrated in Exhibit 14, some ECEC providers have cost advantages. For example, not-for-profit operators do not pay corporate tax, and family daycare operators have a range of cost advantages.
Efficient Scale		- Although efficient scale advantages do not exist at a national level, it's possible that providers could have an efficient scale advantage at a local level, whereby new entrants will avoid entering a local market which is already well served.
Intangible Assets		- The tendancy towards consolidation within the for-profit sector has created groups with multiple brands and therefore little brand value. However, Goodstart Early Learning has created a national not-for-profit brand which likeley acts as an advantage.
Switching Costs		- Although switching costs likely exist once a child is enrolled in a centre, children tend to stay for 2 or 3 years meaning the benefit isn't significant. Although a family may use the same centre for multiple children and therefore extend the relationship over a number of years, we still don't think this is sufficient to warrant a switching cost advantage for a group such as G8 Education.
Network Effect	Least Likely	- Network effects occur when additional customers increase the appeal of the service for existing customers. However, we expect it's more likely that the opposite is true, in that parents would prefer a more intimate rather than crowded environment for their children to attend.

Source: Morningstar

We have created an industry "cost curve" as shown in Exhibit 15 to compare the competitive positions of different providers based on cost alone. We consider FDC providers to be the lowest-cost providers of childcare because they operate services from their own home and do not need to generate a profit beyond their wages. We have assumed wages are effectively profit which implies wage costs are effectively zero. We expect FDC operators also have relatively low tax rates because the personal tax rate of the operator is likely to be low and the blurring of lines between business and personal costs creates the potential to reduce tax. However, we expect the FDC sector to continue to shrink due to regulatory concerns and don't consider it a material threat to for-profit LDC operators like G8 Education.

We consider owner-operator for-profit centres to be the second most cost-advantaged childcare providers. Like FDCs, these providers benefit from working in their business, which means the need to generate a profit is less likely and owners may also employ family members in the business. We also expect these operators to have a tax advantage, by not having to pay payroll tax and also because they may have opportunity for an aggressive approach to expensing. As owner-operators, we expect these businesses also have relatively strong local networks and reputations which support the business via lower marketing costs.

Exhibit 15 G8 Education Has a Cost Disadvantage Versus Some Providers

	FDC[1]	Own. Op. FP[2] LDC[3]	Lge. NFP[4] LDC	Sm. NFP LDC	Lge. FP LDC	Sm. FP LDC	Med. FP LDC
Revenue	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Percentage of revenue							
Wages	0%	40%	60%	60%	60%	60%	60%
Rent	0%	13%	13%	13%	13%	13%	13%
Operating costs inc. utilities	3%	5%	5%	5%	5%	5%	5%
Corporate costs	2%	2%	4%	5%	4%	5%	7%
Cross subsidising	0%	0%	2%	2%	0%	0%	0%
Total costs	**5%**	**60%**	**84%**	**85%**	**82%**	**83%**	**85%**
EBIT margin	**95%**	**40%**	**16%**	**15%**	**18%**	**17%**	**15%**
Tax Rate	5%	15%	0%	0%	30%	30%	30%
Tax as percentage of revenue	5%	6%	0%	0%	5%	5%	5%
NPAT margin	**90%**	**34%**	**16%**	**15%**	**13%**	**12%**	**11%**
Not-for-profit advantage			16%	15%			
Costs as a percentage of revenue	10%	66%	68%	70%	87%	88%	90%

Source: Morningstar. Notes: 1. family daycare, 2. for-profit, 3. long daycare, 4. not for profit.

We expect large and small not-for-profit providers are the third- and fourth-most-advantaged providers respectively for two main reasons. First, the lack of need to create a profit creates a cost advantage, and second, these providers do not pay corporate or payroll tax. However, not-for-profit operators also tend to cross-subsidise lossmaking centres, which is an additional cost, and tend not to expand their networks particularly aggressively.

We expect large for-profit providers have an advantage over small and medium corporate providers. While the larger operators have similar economics at the centre level, they likely have an advantage from economies of scale across multiple locations, particularly with regards to their head office costs.

Landlords Offer Relatively Low-Risk Exposure to Childcare

Cap Rate Expansion Is an Over-reaction to Short-Term Risks

The prices of CQE and ARF tend to perform like bonds to some degree in that they typically trade at a spread over the Australian 10-year government bond yield. As shown in Exhibit 16B, these securities have tended to trade at a spread of around 3% over the Australian 10-year government bond yield, which reflects investor's perceived risk relative to the government bond. Although the COVID-19 crisis caused a blowout in the spread, based on fears of widespread bankruptcies of ECEC providers, we think this was unjustified and our fair value implies a return to around 4%.

Exhibit 16A Cap Rates Have Steadily Declined in Recent years

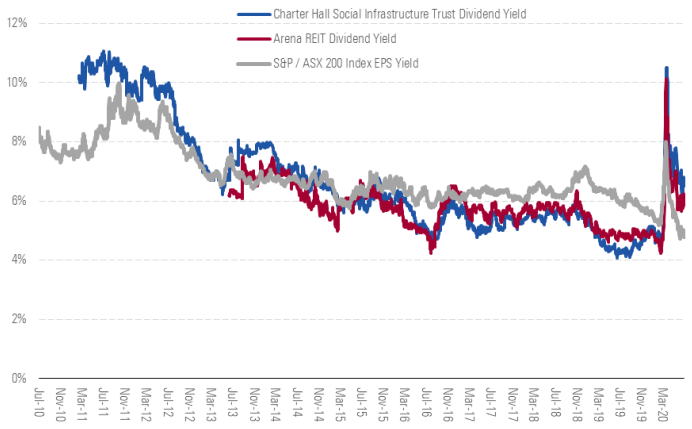
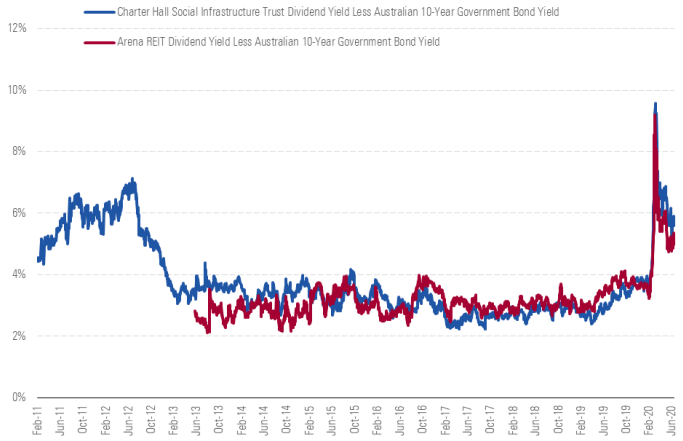


Exhibit 16B Cap Rate Spread Expansion Looks Unwarranted



Source: Morningstar, CapIQ data

Appendix

Australian Childcare Industry Provider types

The Australian early childhood education and care, or ECEC, sector provides care services for children, typically from birth to 5 years old, before they enter the school system, and for school aged children outside of school hours. There are four main types of provider in the ECEC sector, although other providers such as nannies, au-pairs, and babysitters also service the sector:

- **Long Daycare Centres (LDC)**: Long day care centres comprise the largest component of the ECEC sector and provide part-time or full day care for children under school age. Long day care centres are critical for working parents. Centres are regulated and must comply with the national quality framework, or NQF, including minimum internal and external floorspace per child and child/carer ratios of around 1:4 for children under 3 years old and 1:11 for children aged 3-5 years. LDCs may also provide preschool programs.

- **Family Daycare (FDC)**: Family day care services are provided by qualified individuals from within their own homes for children under school age and are limited to four paying children per provider. Providers must be affiliated with a Family Day Care Scheme, which provides administrative and regulatory oversight. Providers, known as "educators" must either have a Certificate 3 in childcare or be working towards this qualification.

- **Preschool (PSK)**: The delivery of preschool is complex—services are delivered in a variety of settings by a range of providers. Of the more than 8,600 preschools in Australia, half are dedicated preschools provided by governments or non-government groups, and half are LDCs with preschool programs. Preschool services that deliver early childhood education programs provided by a qualified teacher are aimed at children in the year before they commence full-time schooling, although there are different starting ages for children across jurisdictions.

More Information

If you wish to obtain further information regarding this report, licensing and our services, please contact us on:

Morningstar.com.au subscribers	**Advisers/Institutions/Others**
Tel: 1800 03 44 55	Tel: +61 2 9276 4446
Email: help.au@morningstar.com	Email: helpdesk.au@morningstar.com

For further information on our analysts and research methodologies, we recommend you visit www.global.morningstar.com/au/researchdocuments.