

# Tarena: The School That Relies On Shadow Banking

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**Disclosure:** The author has no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. ([More...](#))

## Summary

- Revenues are strong but are the students solvent?
- Execution, not demographics, matter.
- Rising debt could be a problem.

## **Tarena (NASDAQ:[TEDU](#)) - Execution, Not Demographics, Matter**

The education sector in China is always a headline grabber. Who can resist the lure of a company that claims to reach a market of millions of students a year, young people desperate to grab the brass ring of success in China?

Better yet, education is a fragmented market with few top players. Hence the apparent happy future for China's newest entrant in the education space: Tarena International Inc., which went public in April. The company, which has trained more than 130,000 students, offers distance education, classroom-based tutoring and online learning modules, mainly in IT subjects.

## **IPO [Prospectus](#)**

But, as with most Chinese companies, execution matters more than demographics. Tarena is relying heavily on massive loans from outside firms to fund this expensive education, a relationship that may not be sustainable. We think the market has not priced in the problems caused by student debt. There was only one question on this issue in the Q2 [conference call](#). As student defaults rise, Tarena's business model will be called into question, eventually hurting earnings.

First, the positive side of the story. According to China's National Bureau of Statistics, annual consumption expenditure on education, cultural and recreational services per capita in urban households rose by a CAGR of 8.9% from 2007 to 2014. China has 231

million people between 20 and 29 - a figure that equals 75% of America's total population. According to IDC, the professional education services market grew from US\$8.1 billion in 2010 to US\$11.1 billion in 2013, a CAGR of 11.4%.

Credit Suisse analyst Dick Wei in his initiation report on Tarena said: "This hybrid model allows it to expand rapidly without diluting its teaching quality. Its 76 high-quality instructors were able to reach a total of 46,000 students in 2013. The scalability of the distance-education model allows Tarena to penetrate into new markets more efficiently."

Since its IPO April 3, the stock has doubled and now trades at a hefty 28.9x 2014 consensus estimates. The backing of Goldman Sachs, which owns 29% of the ordinary shares, no doubt helps. (Of course, they were a lead underwriter along with CSFB; and their lockup ends in October.)

On the face of it, the financials look good. Tarena's revenue jumped 61% to \$24.3 million in the first quarter, topping analyst views for \$23.1 million.

Tarena posted a 30% year-over-year surge in student enrollments to nearly 11,000, due to more course offerings and higher tuition fees. Average revenue per student rose 24% from a year ago to \$2,216. Earnings per share of a penny matched the consensus of analysts polled by Thomson Reuters after a 2 cent per-share loss a year earlier.

Operating income of \$581,000 followed an operating loss of \$61,000 a year earlier, and gross margin rose to 64.7% from 60.3%. Q2 earnings weren't bad, either. Revenue rose 53% with operating income up 95%.

So why worry? The story behind the earnings ain't so pretty.

The business model relies heavily on loans from a number of financial companies (notice we didn't say banks). This is partly because Tarena targets modest to no income, young fresh graduates from traditionally low ranked colleges. The IPO prospectus daintily declares:

"To assist our students in paying our tuition fees, we have formed cooperative relationships with the following three credit sources to provide financing services for our students to make one-time, up-front tuition payments" -- and then lists the Bank of

Beijing Consumer Finance Co., CreditEase, and Chuanbang. Perhaps concerned about the blatant conflict of interest as Chuanbang is owned by Shaoyun Han, Tarena's CEO, Tarena stopped doing business with Chuanbang in January 2014. (We notice that change occurred just four months before the IPO).

Tuition runs from \$2,280 to \$2,775 - a pretty hefty nut when the average annual salary even in rich Shanghai is only \$13,000 and much lower elsewhere. As a result, in 2013, 56.9% of the students took out loans arranged by one of the three. Bank of Beijing provided 61.4% of the student financed loans, with CreditEase and Chuanbang handling the rest.

## **Risky Loans**

How does this little loan business work?

In the prospectus, there's not much description about the Bank of Beijing's business except to say that the bank "provides loans" to students. CreditEase is more interesting. They use a "person-to-person lending method to enable qualified students to borrow unsecured loans from unrelated individuals without using a bank as an intermediary."

This is a titillating tidbit. Essentially, CreditEase is functioning as another piece of the mammoth 50 trillion yuan Shadow Banking market. These are loans outside of the banking system. The problem with Shadow Banking loans is:

- a) They are more or less unregulated.
- b) There are few checks on collateral or repayment ability of the borrowers.
- c) They rely heavily on the "moral hazard" theory of lending. In China, this means that the lender assumes someone else will pick up the tab if all else fails.

Tarena doesn't provide any detail on what due diligence CreditEase performs to guarantee the loans will be paid back.

Until last year, even these financial arrangements weren't enough. Tarena guaranteed the loans for the bulk of its students until April 2013 through an arrangement with

Chuanbang. That arrangement has ended, raising questions of how willing the external banks will be to continue lending at the pace that Chuanbang was previously.

On the Q2 conference call, the company admitted bad debt rose 30% to \$1.5 million. But they blamed slower cash collection due to the legacy loan arrangements that ended in 2012. They also mentioned the slow approval process from the banks but called it temporary. We have our doubts.

### **Widespread Dissatisfaction**

We did checked to see if these loans are working. The online complaints suggest a big No. Admittedly, we don't know how representative these online posts are but they appear alarming.

The first batch contain comments soliciting legal advice regarding Tarena's financial contracts:

#### **Shenyang, Liaoning**

The student asked if Credit Ease's loan agreement is linked with Tarena. He wanted to default on his loan as he thought none of the companies Tarena recommended for jobs provided good compensation. He asked the lawyer what are the consequences of default.

#### **Dongguan, Guangdong**

The student claimed that he had wasted four months watching Tarena's training video while there were no high-paying job as Tarena had previously promised. He asked what his [legal](#) options were.

#### **Shanghai**

He called Tarena a [fraud](#) and said he couldn't get a job placement following graduation. He complained that he wasn't able to pay off his loan from CreditEase and called CreditEase a fraud too.

#### **Shanghai**

He claimed Tarena made false statements and promises. He and his classmates believe the Tarena course was a [waste](#) of time. He is soliciting legal advice on how to demand punitive payment.

### **Zhejiang**

Tarena claimed after borrowing money and taking the course, he couldn't find a job. Tarena is threatening to [sue](#) him for non-payment.

### **Kunming, Yunnan**

The student didn't understand Tarena's business model. He claimed he didn't receive any money from Tarena after four months of useless tuition. Now Tarena wants him to make payment for the tuition loan and interest accrued during 20 months, accounting for one-third of tuition. (Link NA).

Here are complaints filed with China's consumer protection bureau:

**Chongqing.** Tarena refused to [refund](#) tuition when a student wanted to quit after four days study.

**Hangzhou.** The student was solicited to study with Tarena from a job fair. He claims Tarena told him they would arrange job for him after he completed training. The student paid a tuition fee for a supposed "famous tutors" master class. But he wanted his [money](#) back after finding out it was actually a distance videoconferencing course. Tarena refused to do so.

**Chengdu.** The student wanted to withdraw from the course after only 4 days. Tarena delayed the [payment](#) of the refund for weeks.

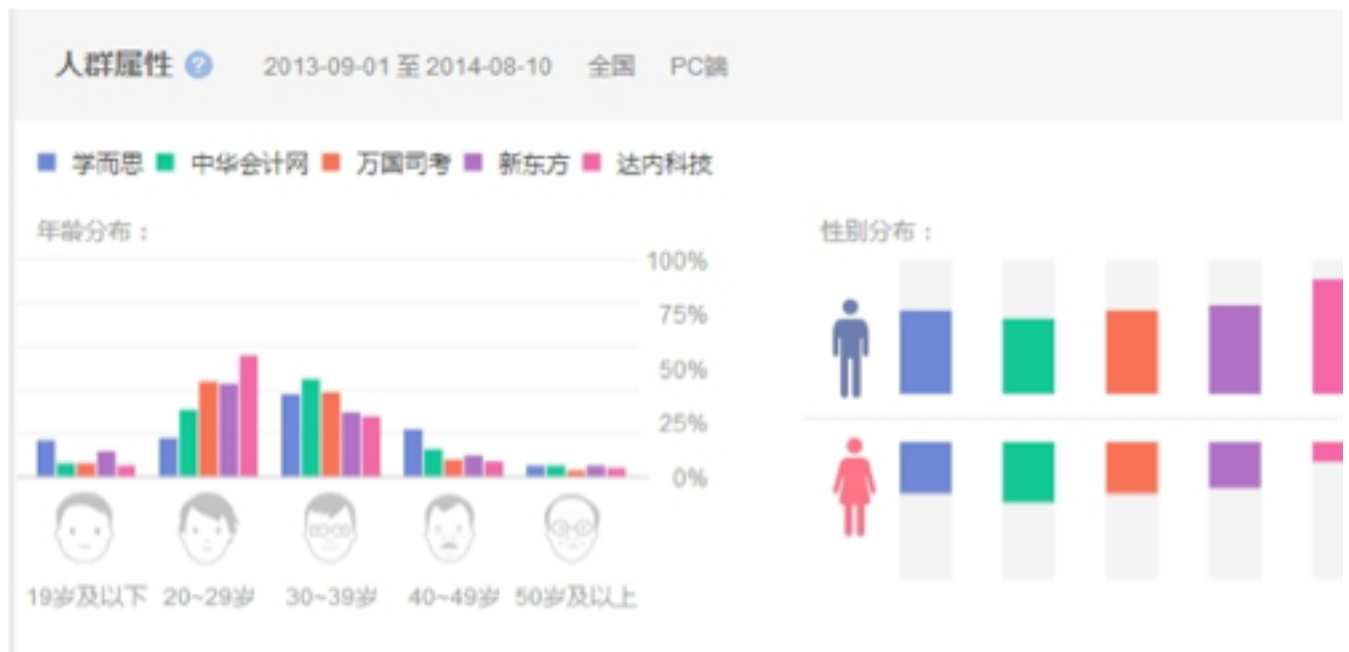
**Chengdu.** The student completed his course with Tarena and wanted to get his housing deposit back, but Tarena delayed the return of the deposit until this [complaint](#). Of course, it's easy for the company to argue that there are always bad apples in the group. But it didn't take us very much time to dig up these complaints. How many more are there?

### **Poor Reputation**

We did a search on Baidu (the Google of China) for the top five words associated with the four leading education companies. The results for Tarena were startling.

Top Five Keywords on Baidu for Major Chinese Schools	
XRS	After school, tuition, Shanghai, Interactive, Teach
Wanguo (Private Company)	Question Bank, Tianxing (a rival), Houda, (a rival), enrollment, official website
EDU	Email System, Tianjin New Oriental, Wuhan New Oriental Overseas University Application A
TEDU	Kunming, <b>Fraud</b> , Salary, Shenyang Tarena, IPC

We also used Baidu to compare the makeup of the students in the different schools. Tarena (in pink), clearly skews much younger. That's a much riskier group to be lending to. As the chart notes, there is a much higher proportion of students in the 20 to 29 age range than among its competitors. This group is likely to be harder to employ due to their lack of experience.



Notice the \$1 trillion in student debt in America due to predatory lending. The funding arrangements are similar to the massive student debt owed in the U.S, much of which was generated by for profit schools. Are we seeing the same thing in China?

