A Failure of Due Diligence: Rider University's Attempt to Sell Westminster Choir College

A White Paper Prepared for the Rider University Chapter of the American Association of University Professors

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Overview

On March 28, 2017, Rider University President Gregory Dell'Omo announced a plan to sell the fully-enrolled, world-renowned Westminster Choir College. Since then Dell'Omo and Rider's Board of Trustees claim to have worked "tirelessly" to select "the best partner, domestic or international, willing to acquire, operate, retain, invest in and grow Westminster in Princeton." To date, they have provided no evidence to support the assertion that the named buyer — Beijing Kaiwen Education Technology Company — a for-profit company with only two years experience in running K-12 schools in China, has the ability to achieve these goals.

In this white paper the authors analyze publicly available data to conclude the buyer's finances are precarious. When this conclusion is combined with the facts that Kaiwen is a for-profit company with no experience in higher education or in preparing young adults for professional careers in music, much less the accreditations necessary to run a choir college, the company's selection by President Dell'Omo and Rider's Board of Trustees represents a failure to perform due diligence and carry out their fiduciary responsibilities.

History of Westminster Sale Efforts

Following its October 2016 meeting Rider's Board of Trustees under the direction of then-Chair Michael Kennedy created a Westminster Special Committee consisting of board members and senior administrative staff. Without soliciting input from Westminster stakeholders — such as faculty, staff, students, and alumni — they met in secret to determine the future of Westminster Choir College. On December 1, 2016, President Dell'Omo announced their decision to close the Westminster campus, sell the property, and move Westminster's programs to the Lawrenceville campus. For many reasons, including the lack of facilities to support Westminster's specialized programs, this decision engendered strong opposition.

On March 28, 2017, Dell'Omo and the Board of Trustees announced Rider University would instead sell Westminster, including its donated assets, for what President Dell'Omo claimed would be $40 to $60 million. The process was to adhere to the following set of "guiding principles."

1. Potential to provide short-term and long-term financial stability for WCC and the University as a whole so both institutions are able to move forward with a high level of quality
2. Commitment to preservation and enhancement of the ongoing integrity of the WCC history, brand, mission, artistic standards and programs
3. Quality of the potential WCC partner, including its mission, reputation, culture and objectives, and, as possible measures thereof, its student outcomes, accreditations, enrollments, tuition and scholarship structure, performance statistics, endowment and giving record, and financial and programmatic resources
4. The likelihood of completion of a transaction with the partner, including financial strength, timing, overall complexity, contingencies and conditions
5. The interests of WCC stakeholders, including administration, faculty, staff, students, Coalition / Westminster Leadership Council, alumni and donors
6. Strong sale proceeds to provide meaningful new program / facility investments in Lawrenceville to grow Rider enrollments
7. Impact on Rider's mission, reputation, culture and objectives

These principles require a buyer to have appropriate accreditations, financial strength, and strong performance statistics and financial resources that will provide both short- and long-term financial stability to Westminster. Rider's Board of Trustees then hired PwC's corporate mergers and acquisitions division, a division of board chair Michael Kennedy's former business firm, to find a buyer for the college. PwC then identified the present buyer (which at that time was trading as the Jiangsu Zhongtai Bridge Steel Structure Co.) as "the best partner, domestic or international, willing to acquire, operate, retain, invest in and grow Westminster in Princeton."

Our analysis will demonstrate that besides no experience in higher education Kaiwen's finances are precarious and thus that it fails to meet four of the first five "guiding principles." Additionally, we provide a simple analysis of the costs of the sale transaction to show that achieving the sixth "guiding principle" — "strong sales proceeds" — is also unlikely.

Financial Analysis of Kaiwen Education

Kaiwen and its previous incarnation, a bridge steel fabrication company, have been money-losing operations. For the past two years Kaiwen has been spending far more than it has been obtaining in revenues. Reflecting this, its net profit after interest and taxes for the past two years are strongly negative as are its calculated cash flows for these years. Both of these bear directly on firm solvency. The respected investor services company Morningstar currently rates the uncertainty surrounding the company and its stock as "High", on a scale whose points are low, medium, high, very high, and extreme. This rating is based on its assessment of the company's cash flow predictability. A purchaser of Kaiwen stock today incurs considerable risk.

What is notable is that Kaiwen clearly lacks the cash resources to simply complete the purchase of Westminster. The further improvement of the Westminster campus, and perhaps even the continued operation of the Westminster campus under Kaiwen ownership, would also require on an infusion of funds from other sources. Any further debt is likely to require periodic interest payments and eventual repayment. Because Kaiwen's stock is trading so low, the issuance of additional shares to raise new money is certain to be resisted by current shareholders. Not clear at the present time are the sources of the new funds required to complete the purchase transaction and potentially improve and operate the campus. Neither is it clear from published financial statements what outside entity, in what form, provided Kaiwen with a considerable cash infusion in 2016 - 1.69 billion Yuan - which was likely used to fund considerable capital improvements at Kaiwen that year (829.3 million Yuan).

Additionally, the source of the Kaiwen's cash infusion in 2016 and the source(s) of any future outside funds that Kaiwen requires are of concern. For some some time, the Chinese government has been worried about the excessive use of debt funding construction and speculation; the proliferation and purchase of high-risk securities that eventually would have little or no value; and its unregulated and unmonitored shadow banking industry. This shadow industry attracts Chinese depositors seeking higher returns, and highly-leveraged and other lenders unable to secure loans from the regulated banking sector. Without access to detailed financial statements, with thorough notes prepared by licensed and certified public accountants, or access to a document like the SEC-required 10K filed by all publicly-traded U.S. firms, it is not possible to ascertain if Kaiwen faces risks because of the quality of its own investments (e.g., new company investments in 2016 was 416.0 million Yuan), nor is it possible to ascertain the quality of its investors, creditors, and current and future customers.

Kaiwen: a Chinese Penny Stock

Very likely because of the ongoing and important negative business results, the per-share price for Kaiwen stock has shown a steady decline for the past twelve months. On Friday, March 23 the closing per-share price of 11.83 Yuan ($1.88) was 31% below the closing price of 17.12 Yuan a year ago (03/28/2017) despite the dramatic rise in the stock market in this period and the widespread dissemination of news concerning Rider's discussions with Kaiwen. Such a low share price is a reflection of investor concern over Kaiwen. The stock is clearly considered a risky investment, and given its converted share price in U.S. dollars, U.S. equity investors would refer to this company as a “penny stock” (currently any stock trading below $5 per share).

Additionally, Kaiwen continues to demonstrate negative per-share earnings. An important indicator for investors is the total return percentage - calculated for all stocks - which shows the actual rate of return of an investment over a given period of time, and includes all interest and dividends received, capital gains (stock appreciation) and losses, and distribution of additional shares. The one-year total return percentage for Kaiwen is -30.33% and the year-to-date percentage is -6.04%. In contrast, the average one-year total return percentage for Morningstar China, an index of stocks that Morningstar tracks, is +20.87%, fully 51 percentage points better than Kaiwen's percentage return. For an investor, there are many better places for his/her money in China than Kaiwen.

Other data reported for Kaiwen for 2016 also raises significant concerns. In 2016 Kaiwen had an extremely high level of debt relative to its equity, a ratio of 37.50, whereas a debt-to-equity ratio of .50 or .60 is prudent for most firms, and one site indicates that it should be no higher than 2.0 (see Chart 1).

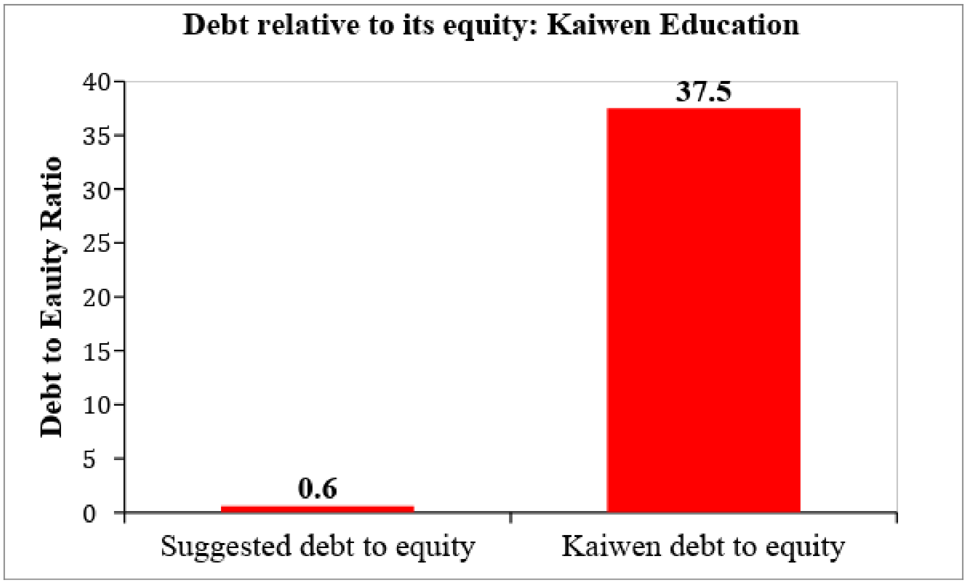

Chart 1: Debt to Equity Ratios

Most of the debt was short to medium-term debt, requiring "service" (payments and retirement) in the near term. This is surmised from the long-term debt-to-equity ratio for 2016, which itself was very high at 6.87, as was the total debt-to-assets ratio, 22.07.

For 2016 as well, Kaiwen's cash ratio of .68 is also a concern. An acceptable cash ratio is considered to be in the range of 1.5 to 2. This ratio is calculated by dividing cash on hand plus marketable securities, like bonds, by current liabilities/debts. It is an important measure of liquidity and the ability to cover current obligations. A ratio of 1 or greater - actually much greater - is desirable here (see Chart 2). Related to this, for the first three quarters of 2017, Kaiwen's cash, cash equivalents, and accounts receivable are only 25% of Current Liabilities - a very precarious situation.

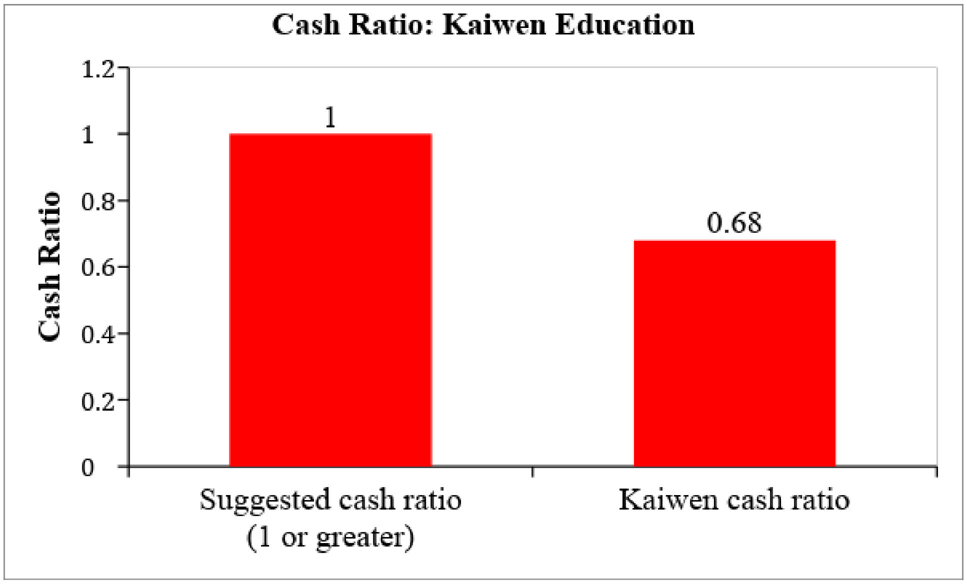

Chart 2: Cash Ratio

The commonly used interest coverage statistic for Kaiwen is also revealing of a company having earnings difficulty. This is a measure of how easily a company can pay its annual interest expense on outstanding debt without adding more debt or marketing additional company shares. This ratio is calculated by dividing company earnings before interest and taxes by its annual interest payments. A ratio of +2 is considered the minimum acceptable. At Kaiwen in 2016, the ratio was -2.76, with the negative earnings that year of -99.8 million Yuan unable to cover the annual interest owed. Firms in this position, operating with high debt and a record of negative earnings, will invariably find acquiring additional financing difficult and will borrow at elevated rates of interest because lenders face greater risk.

Kaiwen's Losses

The results for 2016 included a loss of -99.8 million Yuan on revenues of 322.6 million Yuan, a loss of 31%. Gross Margin/Profit (revenues less direct costs - costs directly associated with instruction) was -15.7 million Yuan and Operating Margin/Profit (gross margin less sales, general, and administrative expenses) was -115.5 million Yuan.

Kaiwen forecast that it would return to profitability in 2017 but this is clearly not the case. Kaiwen showed a loss for the twelve month period ending September 29, 2017, which includes the last quarter of 2016, of -116.3 million Yuan on revenues of 523.9 million Yuan, a loss of 22%. Gross Margin/Profit was 19.0 million Yuan, and Operating Margin/Profit was -127.6 million Yuan. The business showed a loss for the third quarter of 2017 of -38.4 million Yuan on revenues of 217.8 million

Yuan, and has forecast a loss of -25 to -35 million Yuan for the first quarter of 2018.

Kaiwen's Cash Problems

Cash flow, an important measure of company solvency, refers to the net amount of cash and cash equivalents (e.g., securities) that flow in and out of a business. A positive cash flow indicates that a company's liquid assets have increased over a period of time, permitting it to settle debts, re-invest in its business, pay expenses, additionally compensate employees and shareholders, and provide a buffer against future financial challenges.

Net cash flow and net income are different. Certain items that are deducted from a company's Sales/Revenues for a particular period of time to obtain Net Income are not cash outflows, such as depreciation. These deductions from company income, in fact, are cash available to a firm.

There are four cash flow statements that collectively provide an important picture of a business and the acquisition and flows of cash: an Operating Cash Flow Statement; an Investing Cash Flow Statement; a Financing Cash Flow Statement; and a Free Cash Flow Statement. The following sections describe each of these and report 2016 and 2017 data for Kaiwen from two sources: the Wall Street Journal and Morningstar. As these sites are awaiting the publication of Kaiwen annual results for 2017, only selected cash flow figures are available for 2017. For 2016 there are only slight differences between the two sites in the data reported.

As Free Cash Flow represents an overall picture of where a firm stands in terms of available cash, we will start with that cash flow statement.

Free Cash Flow

Free cash flow is money available to a firm that can be used to pay dividends to shareholders, pay off debt, buy back stock, and improve and expand the business. Free cash flow for 2016 was negative, -1.14 billion Yuan. For the most recent twelve-month period, including the last three quarters of 2017, free cash flow was negative, -1.10 billion Yuan (see Chart 3).

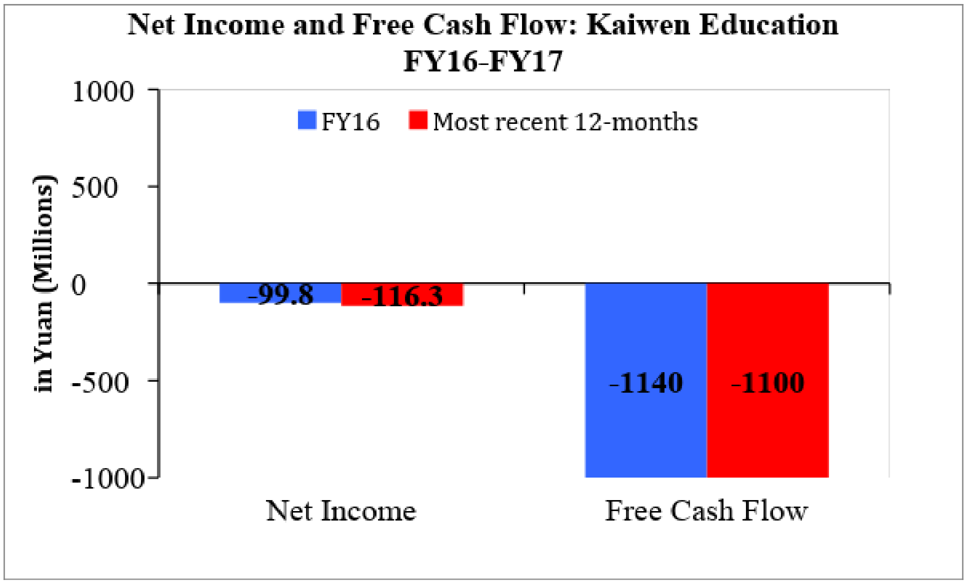

Chart 3: Free Cash Flow

Operating Cash Flow

An operating cash flow statement reveals the cash generated by its basic business. Net operating cash flow for 2016 was negative, -294.3 million Yuan, primarily caused by net income (loss) for the year of -99.8 million Yuan, an increase in accounts receivable (a decrease in cash received) of 196.3 million Yuan, and a decrease in accounts payable (an increase in cash paid for goods and services) of 328.5 million Yuan. For the most recent twelve month period, which includes the last three quarters of 2017, net operating cash flow was negative, as well, and was -310.6 million Yuan.

Investing Cash Flow Statement

An investing cash flow statement reveals the cash going out of the firm to purchase securities as investments, acquire other businesses or new equipment, or fund new construction.

Investing cash flow for 2016 was negative, -1.30 billion Yuan, primarily influenced by an outflow of cash - sourced from new investment in Kaiwen and/or loans - for capital expenditures (829.3 million Yuan), and the purchase of new company investments (476.0 million Yuan). For the most recent twelve month period, Kaiwen capital expenditures, a cash outflow, was -1.01 billion Yuan. No additional data pertinent to the 2017 investing cash flow statement is currently available.

Financing Cash Flow Statement

A financing cash flow statement deals with a company's investors and creditors, and tracks cash coming into a business from the sale of new stock and bonds, or from loans; and tracks cash leaving the business through the payment of interest, the retirement of debt, and dividends paid to shareholders.

Financing cash flow for 2016 was positive, 1.52 billion Yuan, and primarily a function of an inflow of new funds from sources not identified (1.69 billion Yuan) and new long-term debt (43.0 million Yuan), and a cash outflow from the retirement of existing long-term debt of 607.0 million Yuan.

The Net Result of the Potential Transaction

Should the sale of Westminster Choir College to Kaiwen Education take place, the net result of the transaction would at best be negligible, or in the more likely case, it would represent a net loss for Rider University.

If the deal is completed with the maximum value identified on the current term sheet being used in negotiations, $40 million, Rider must relinquish to the buyer approximately $20 million, which is the value of Westminster's endowment. Additionally, as the lawsuit by the Princeton Theological Seminary contends, Rider would need to relinquish approximately $8 million of any sale proceeds to the Princeton Theological Seminary and repay the $8 million it has borrowed using the Princeton property as collateral. In addition to these costs, based on our calculations Rider's administration has already paid almost $1 million to previous Board of Trustees chair Michael Kennedy's former firm, PwC, to negotiate the deal. Additional legal costs to defend lawsuits from the Princeton Theological Seminary and from Rider students, parents and alumni, members of the Rider community who are suing the school for fraud and malfeasance, have no doubt already run into the hundreds of thousands.

So, should the sale be completed at the current $40 million ask price and Rider is forced to pay the Princeton Seminary and the bank the $16 million being demanded, then Rider would only be left with $3 million in proceeds from the transaction (40 - 20 - 16 - 1), an amount which could be substantially reduced by a settlement agreement with the other plaintiffs suing Rider over the sale. If in the end Kaiwen negotiates the sale price 20% to 40% below the ask price (a common occurrence in business transactions) then Rider would realize a net loss of between $5 million and $13 million.

Sources

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http://quotes.wsj.com/CN/XSHE/002659/financials/annual/cash-flow
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ADDENDUM - 5/1/2018

Preliminary financial statements for 2017 for Kaiwen Education Technology Co. Ltd. are now available online. Overall, what they reveal does not change our assessment of the company nor alter our belief that Rider University's administration and Board of Trustees failed to perform due diligence and carry out their fiduciary responsibilities. (source: https://quotes.wsj.com/CN/XSHE/002659/financials)

Because of Kaiwen's projection of a loss of 25 to 35 million Yuan for the first quarter of 2018, a posted loss of -116.3 million Yuan for the twelve-month period ending September 29, 2017, and a loss of -38.4 million Yuan for the third quarter of 2017, it was a surprise to see Kaiwen report a positive Net Income of 23 million Yuan for 2017. (source: https://quotes.wsj.com/CN/XSHE/002659/financials/annual/income-statement)

However, financial results for 2017 also reveal large negative cash flows in two very significant areas. Operating cash flow for 2017 – the cash flow from Kaiwen's basic business or operations that the company would rely on to, for example, create and staff a new high school in the United States and cover all of Westminster's expenses and improvements – is -161.5 million Yuan. Free cash flow for 2017 is -1.032 billion Yuan. (source: https://quotes.wsj.com/CN/XSHE/002659/financials/annual/cash-flow)

Kaiwen liquidity – its ability to cover current financial obligations – remains a very significant concern. Its balance sheet for 2017 reports Kaiwen cash and cash equivalents of 178.0 million Yuan and current liabilities that are three times larger at 934.0 million Yuan. (source: https://quotes.wsj.com/CN/XSHE/002659/financials/annual/balance-sheet)

The *cash ratio* reported for the company for 2017 – cash and cash equivalents divided by current liabilities – has fallen to .19, from .68 in 2016. An acceptable cash ratio is considered to be in the range of 1.5 to 2.0. Two other liquidity ratios reported for 2017, the *quick ratio* and *current ratio*, have fallen from 2016, and are each .33 when they should be at least 1.0. Kaiwen's *interest coverage ratio*, a measure that reveals how easily a company can pay its annual interest expense on outstanding debt, remains a negative, at -1.10 when +2 is considered the minimum acceptable. (source: https://quotes.wsj.com/CN/XSHE/002659/financials)

Other balance sheet items raise significant questions. On the asset side, something called "Other Intangibles" - this does not include "Goodwill", which is valued at 215 million - is almost a billion Yuan (956 million Yuan). These "Other Intangibles" are fully a third of all Kaiwen assets, and most unusual. There is no explanation of what these are. (source: https://quotes.wsj.com/CN/XSHE/002659/financials/annual/balance-sheet)

On the liability side of the 2017 balance sheet long term debt is shown as zero. However, the 2017 financing cash flow statement clearly shows that 309 million Yuan in new long-term debt was acquired by Kaiwen in 2017. Both cannot be true, of course. (sources: https://quotes.wsj.com/CN/XSHE/002659/financials/annual/balance-sheet AND https://quotes.wsj.com/CN/XSHE/002659/financials/annual/cash-flow)

This same cash flow statement shows a flow into the company of something titled "Funds from Other Sources", in the amount of 1 billion Yuan. In 2016 we saw and report an almost identical flow like this – 1.69 billion Yuan - into Kaiwen that used the same label. Kaiwen remains a company requiring ongoing cash inflows from unknown sources in order to continue to operate.

Author Biographies

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Gerald D. Klein is professor of organizational behavior and management emeritus at Rider University. Dr. Klein received his Ph.D. from Case Western Reserve University and his M.B.A. from Harvard. In the College of Business he taught at the undergraduate and graduate levels. He is a co-author of two books and has published in such journals as the California Management Review, Organizational Dynamics, National Productivity Review, Compensation and Benefits Review, and Personnel.

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Arthur Taylor is a professor of information systems at Rider University. Dr. Taylor received is Ph.D. from Rutgers University, and his M.S. from George Mason University. Prior to joining Rider, he worked for 17 years primarily as a consultant in information systems working with database systems and accounting software. He has published several books and has published articles in a number of information systems and educational policy journals.

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Michael Brogan is an an associate professor of political science at Rider University. Dr. Brogan received a Ph.D. from City University of New York, and a Masters of Public Administration from Rutgers. He has extensive experience in public budgeting, higher education budgeting and public policy analysis including being the Budget Officer for Academic Affairs at Rider University. He has published extensively, authoring book chapters and numerous articles in public policy journals.