More Bad Economic News for Kaiwen Education

The following represents key information that has been drawn from Kaiwen Education's 2018 Semi-annual Report, dated August 7, 2018. The link to the full report can be found in Item 1, below. However, because of the distraction of pop-up ads on that site we have attached the complete report here. Some of the information from that report appears in the AAUP's recent "Claims vs. Reality" memorandum. The page numbers indicated below refer to page numbers in the report.

1. Kaiwen Education's revenue, expenses, and net income are shown in its Income Statement, which reports on company activity over a period of time, in this case the **first six months of 2018**. For this period Kaiwen reports a Net Loss of 51.7 million Yuan on Revenues of 89.4 million Yuan, **a loss of 57.8%** http://finance04.com/sbdm/stock/share,disc,2018-08-08,002659,0000000000000ltho6.shtml – see page 5. **This follows a first-quarter 2018 Net Loss of 74.3%**, based on a Net Loss of 30.1 million Yuan on Revenues of 40.5 million Yuan https://www.barrons.com/quote/stock/cn/xshe/002659/financials/.

2. **The Income Statement for the first six months of 2018 includes income of 595,900 Yuan from a government subsidy, not from company operations. Without that income supplement the reported Net Loss for the first six months of 2018 would have been greater – 58.5%.** (p. 6, 135)

3. **Looking ahead, Kaiwen projects a Net Loss of from 65 to 75 million Yuan for the period, January through September 2018.** (p. 19)

4. **Compared with the same six-month period in 2017 Revenue fell 61.4%,** from 266.9 million Yuan in 2017 to 89.4 million Yuan in 2018. Also of concern is the growth in Net Loss. **Comparing the same two periods, Net Loss grew from 25.3 million Yuan in 2017 to 51.7 million Yuan in 2018** – a growth of 104.2%. Earnings per share declined 100%, from -.05 Yuan per share to -.10 Yuan per share, and return-on-equity fell from -1.14% to -2.37%. (p. 5)

5. **The decline in Kaiwen Revenue from 2017 to 2018 is reported to be due to the cessation of income from Kaiwen's former bridge and steel fabricating business (Jiangsu Zhongtai Bridge Steel Structure Company). That business, which the administration has sought to clearly separate from Kaiwen, accounted for 88.2% of Revenue reported for the first six months of 2017** (204.0 million Yuan) and none of the Revenue reported for the first six months of 2018. (p.13; and Memorandum to the Rider

University community from the Westminster Choir College Acquisition Corporation, August 8, 2018)

Of the 89.4 million Yuan Revenue reported for the first six months of 2018, 91.6% (81.9 million Yuan) was earned from Kaiwen's education business, while 8.4% (7.5 million Yuan) was rental income from apartments leased to Kaiwen faculty and others. (p. 14)

The breakdown of the 81.9 million Yuan revenue from education is as follows: "Tuition and fees", 76.3 million Yuan; and "Training fee income", 5.5 million Yuan – perhaps fees earned from Kaiwen sports camps in China and abroad. (p. 14)

6. Kaiwen's Balance Sheet through June 30, 2018 reports company assets and liabilities and the difference between the two – owner's equity or company net worth – on that particular day, that is, June 30.

Of concern because it indicates the inability to satisfy company debts is that **on June 30 Kaiwen's cash and cash equivalents (e.g., marketable securities) of 165.8 million Yuan were only 19% - about one fifth – of the company's short-term financial liabilities or obligations** (861.9 million Yuan). (p. 38-41) This continues the pattern of very low cash to short-term debt ratios we have seen for this company https://quotes.wsj.com/CN/XSHE/002659/financials.

This 165 million Yuan of cash was recently cited specifically by the administration to show that Kaiwen had access to ample funding sources. However, it is obvious that there are many current claims on these funds. (Memorandum to the Rider University community from the Westminster Choir College Acquisition Corporation, August 8, 2018)

The most significant short-term liabilities were (1) a short-term loan of 249.5 million Yuan, with the source of the loan not identified; (2) bills and accounts payable of 377.5 million Yuan; and (3) other payables of 234.9 million Yuan – **which included a sizable payment of 193.1 million Yuan to Kaiwen's controlling company, Badachu Holdings Group**. **A short-term loan of 280 million Yuan, with the lender not identified, is also reported for the first six months of 2017.** (p. 15, 39-40, 127)

7. Among Kaiwen's listed assets two are worthwhile noting here. **One listed asset is simply described as a "prepayment" of US $1 million to Rider University, which may constitute a down-payment on the purchase of Westminster, evidence of "consideration" in contract law, or a partial or the full fee paid to Rider for managing Westminster in the coming academic year.** (p. 38) No further explanation of the prepayment is provided in the report.

A second listed and very sizable asset – it's an incredible one third of all Kaiwen assets - is "Intangible assets". The listing of this asset and especially its size continues a Kaiwen practice that raised concerns in previous analyses of its balance sheets. **In the current report Intangible Assets are valued at 946.4 million Yuan, similar to their value at the end of 2017. This asset does not include the asset Goodwill, which Kaiwen lists separately and is valued at 214.7 million Yuan.** (p. 39) (The Goodwill associated with two of Kaiwen's listed subsidiaries, Kevin Zhixin (Goodwill of 186.1 million Yuan) and Kevin Ruixin (Goodwill of 27.6 million Yuan), should reflect, according to U.S. accounting standards, only the amount paid for those units above their company or book values. That this accounting standard was followed at Kaiwen cannot be determined from the report.) (p. 96)

In practice, intangible assets, exclusive of Goodwill, arise from brand recognition, patents, trademarks, and copyrights. **Because Kaiwen is both a new and struggling company and offers no objective and compelling evidence in this report, on its website, or elsewhere to support its claim of achieving a prominent position in the international K-12 education market, one is prone to conclude that the value assigned to "Intangible assets" is unreasonable and reflects an overinflated view of the company's brand.** A cryptic, inadequate description of this balance sheet item in supplementary notes to the financial statements fails to establish its validity. (p. 94)

From an investor's perspective this potential account inflation, and any inflation of Goodwill or any other asset as well, is consequential, as it/they can materially influence key metrics – e.g., earnings to book ratio, price to book ratio – that investors routinely use to determine a company's soundness and to determine whether to purchase its stock.

8. **Also reported is Kaiwen Board approval of a 1.3 billion Yuan line of credit for "wholly-owned subsidiaries" from the Industrial and Commercial Bank of China Co., Ltd. Beijing, Haidian Sub-branch. The subsidiaries identified are the Beijing Wenhua Xuexin Education Investment Co., Ltd.,** and the Beijing Wenkaixing Education

Investment Co., Ltd. **A "100% equity interest in the company" seems to be the collateral for this line of credit.** What is meant by "the company" is not specified. (p. 29) **The Wenhua Xuexin company, one of the two subsidiaries mentioned here, signed the Acquisition and Sale Agreement with Rider – see below. (p. 30) So, it may be possible that someday the Bank of China could have a legal claim on Westminster's property and assets.**

The precarious financial condition of Kaiwen requires a loan guarantor, another entity willing to pay this potential creditor if Kaiwen defaults on its borrowings. The guarantor for this line of credit is Badachu Holdings Group, Kaiwen's controlling company, and the start and end date for this guarantee is 6/29/2018 and 6/29/2035. Currently, Badachu Holdings Group is also a guarantor for four other Kaiwen loans or lines of credit – two other Badachu guarantees ended earlier in 2018. The amounts and the ending dates for the four guarantees are: 100 million Yuan, 11/6/2018; 100 million Yuan, 11/6/2018; 200 million Yuan, 12/31/2018; 200 million Yuan, 3/26/2020. Another Kaiwen guarantor is Southern Heavy Industries and the amount of the guarantee and its ending date are 120 million Yuan and 4/11/2019, respectively. (p. 126)

9. **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 the distribution of additional shares. **Morningstar reports that the one-year total return percentage for Kaiwen is -30.06% and the year-to-date percentage is -12.23%. In contrast, the similar figures for Morningstar China, an index of stocks that Morningstar tracks, are +8.48% and -1.84%, respectively (08/24/2018).** As we have indicated before, for an investor there clearly are many better places for her/his money in China than Kaiwen.
https://www.morningstar.com/stocks/XSHE/002659/quote.html

10. In the report Kaiwen provides some quantitative figures to indicate the number, and thus the popularity of, private international schools in China. However, its presentation here is poorly organized and inadequate, and therefore neither illuminating nor persuasive. Kaiwen does say its offerings in China "are aimed at the middle class" and "high net worth families", and its goal in relation to this market is to identify "profit points". (p. 7-8, 10) In this market Kaiwen desires to "increase market share and brand influence", and, "to do this quickly, (it) will use merger (with) and acquisition of quality educational resources" at home and abroad. (p. 9)

In sections of the semi-annual report Kaiwen discusses at great length its emphasis on sports training in its schools and through sports camps. Its focus on the arts receives almost no attention or mention. Cited by Kaiwen as important in developing its business model focused on physical education and training are the reports, plans, and goals of several government organizations, including the State Council, the Beijing Municipal People's Government, and the Ministry of Education. (p. 7-8)

The report mentions the June 21, 2018 "Acquisition and Sale Agreement" signed by Wenhua Xuexin, "a wholly-owned subsidiary of (Kaiwen Education), and Rider University". Another's translation from the Chinese provides the following title for this section: "Acquiring overseas famous schools to build a high-end art education platform". Here, **the acquisition of Westminster is described as "the beginning and key of the global layout of the business", and indicates the acquisition will play "an important role in enhancing the company's ability to enhance (sic) cross-cultural operations, enhance brand value and competitiveness".** (p. 12)

Kaiwen also reports the following: "Although the market demand in the international education industry is gradually increasing, the number of competitors is also increasing". (p. 10) **Of concern here, of course, is the word, "gradually".** Kaiwen's precarious financial situation requires strong market demand in the present, especially in relation to greater competition.

11. In its semi-annual report Kaiwen is required to identify risks faced by the company including market competition risk, and to identify countermeasures it will take. A brief attempt to describe these risks using statistics from various sources quickly dissolves into incoherence. Kaiwen turns to a very familiar approach, utilizing blovation and hyperbole. Here, for example, we learn that "the company's international schools are the first-echelon in the industry" and "(its) teaching system…has a strong competitive advantage in the international education market". (p. 19-20)

12. **Reported in the semi-annual document is the recent approval by Kaiwen's Board of a new, non-public issuance of "no more than 20%" of its outstanding shares, or "99 million shares", to raise 1.0 billion Yuan. The proceeds "will be used for the 'Adolescent High Quality Education Platform Project'". It is assumed these funds will be used to improve Kaiwen's K-12 programs in the middle and upper grades.** No additional description of this project is provided. (p. 27)

The intention of a recent communication from the administration was to suggest that the proceeds from this offering would be available to meet Westminster needs. That does not

seem to be the case at all. (Memorandum to the Rider University community from the Westminster Choir College Acquisition Corporation, August 8, 2018)

13. **The Badachu Holding Group Co., Ltd., is the controlling shareholder of Kaiwen Education, with 32.6% of Kaiwen's shares. The State-owned Assets Supervision and Administration Division Commission of the Haidian People's Government of Beijing holds 51% of the equity of the Badachu Holdings Group. (p. 123-124)**

14. Under the section title in the report, "Acquisition and disposal of subsidiaries during the reporting period", the following, which is 100% verbatim, is reported. These entities may have relevance in the future for Westminster:

"Kevin Education US Co., Ltd. New establishment. No actual operation.
Princeton Westminster International LLC has not been established.
Kevin School, Chaoyang District, Beijing, newly established is mainly engaged in academic education.
Hunan Kaiwen Xingyi Education Technology Co., Ltd. New establishment. No actual operation." (p. 19)

On page 30, the following appears: "Huaxue intends to set up a subsidiary, Princeton Westminster International Co., Ltd., in New Jersey, USA, and acquire the company's subsidiary of Reed (Rider) University…Westminster Choir College, Westminster Conservatory of Music, and Westminster Continuing Education…The transaction price is 40 million US dollars." We find no other or fuller reference made to "Huaxue" in the report.

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