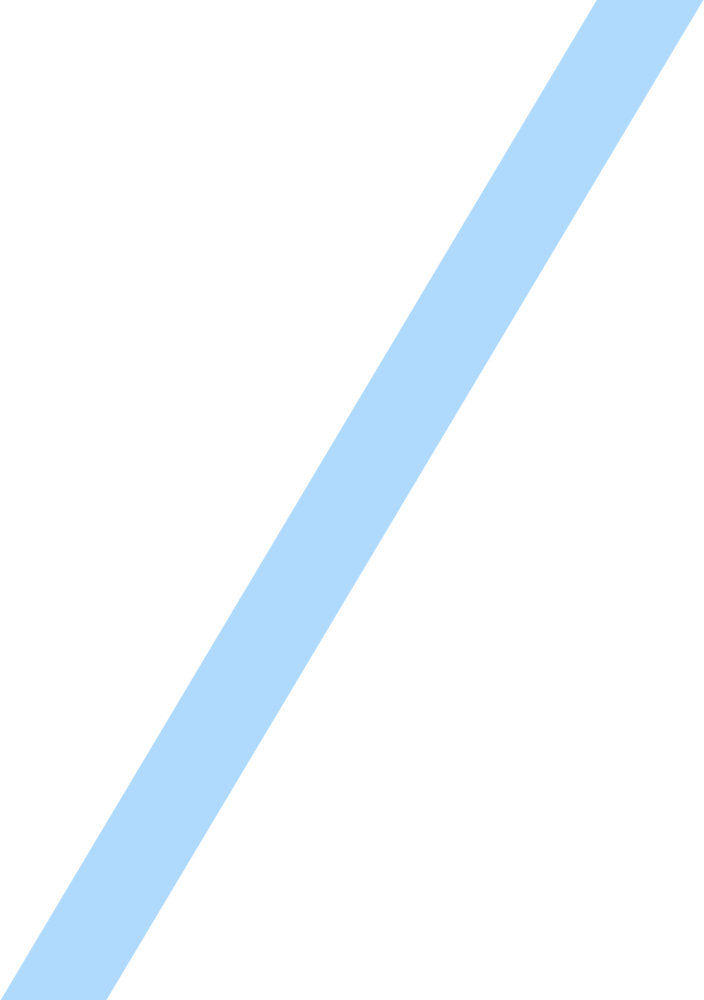
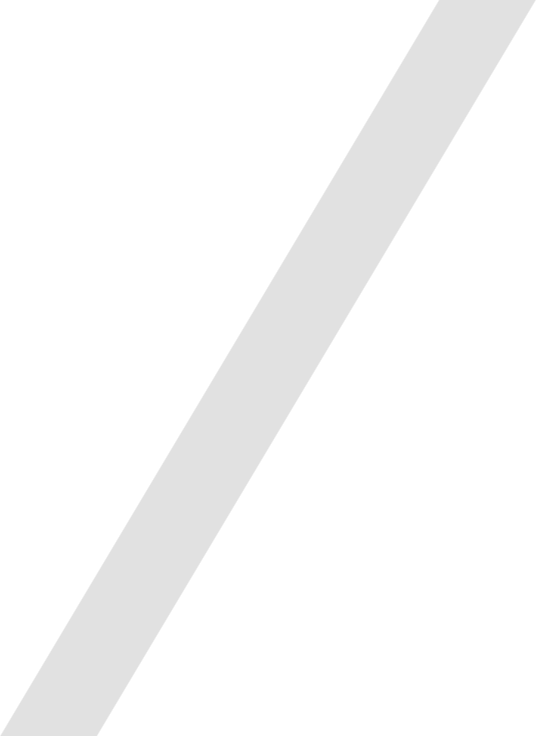
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| Luckin Coffee  Website: https://lkcoffee.com/ |

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| CONTROVERSY  REPORT |

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Luckin Coffee 2019 and 2020 Annual Report Analysis

Potential Risks in Early 2019

Although the Muddy Waters analysis indicated that Luckin Coffee's fabrication began in the second quarter of 2019, several potential risks were already apparent in early 2019. Zhiya Qian, Luckin Coffee's CEO at the time, conducted a strategic communication conference with investors on January 1st, 2019. She forecasted that Luckin would overtake Starbucks as China's top coffee brand in 2019. In that year, they set a goal of opening 2,500 additional stores, bringing its overall store count to 4,500 . The crucial thing to remember is that Luckin has only been around for a little over two years. Starbucks took 20 years to develop 4,000 outlets in China; Luckin's expansion strategy was far too aggressive, making it nearly impossible to achieve. Furthermore, the majority of Luckin Coffee's board members, including CEO Qian, as well as their initial funding, came from Car Inc., a Chinese car rental company. In 2012, Car Inc. attempted to list on the Nasdaq but was unable to do so due to a lack of interest. One of the main reasons is that investors questioned Car Inc.'s over-aggressive expansion strategy at the time, as they did with Luckin Coffee; also, Car Inc.'s loss had expanded year over year from 2017 to 2019 . The troubles at Car Inc helped to explain why Luckin Coffee went public only 18 months after its founding. These possible threats might have been easily recognized using publicly available information in early 2019, but few individuals paid attention to these abnormalities.

Looking Backward to the 2019 Report

The current Luckin Coffee's 2019 Annual Report was filed after The Muddy Waters' report, meaning that the fraud was corrected. Fortunately, the original reporting numbers were retained in the company's Third Quarter 2019 Earnings Presentation. Looking back to the Q3 2019 report, the total number of stores and transacting consumers both increased in a correlated ratio, but the average monthly item sold did not. In Q1 2019, the number of retailers more than doubled compared to Q3 2018, and item sales nearly doubled. Before Q1 2019, the growth of items sold still matched the growth of stores and customers; nevertheless, the numbers began to become irrational in Q2 2019, which is when Luckin Coffee admitted they began the fraud. The number of items sold climbed by 70% in Q2 2019 and 60% in Q3 2019, even though the number of stores expanded by just about 24% in both quarters . Because Chinese consumers prefer to get their caffeine from tea, it's difficult for the coffee market to expand quickly in a short period of time. The sudden increase in the quantity of items sold by Luckin was suspicious. As a result, when we go back at the fabricated report today, investors should be concerned about the abnormal increase in items sold in the 2019 report.

Comparing 2019 and 2020 Annual Report

Luckin Coffee has undergone a lot of adjustments since the turbulence of 2019, as evidenced by their 2020 Annual Report. Luckin suffered a significant loss of litigant settlements and SEC settlements in 2020 as a result of the fraud in 2019. These settlement losses were a major blow to the corporation, accounting for up to 41% of total net losses that year . The good news is that the fraud, and the pandemic, which began in 2020, had no serious impact on Luckin's operations. Because of the shutdown, most franchise companies closed a large network of branches; Luckin's number of stores actually increased by 14. On the other hand, year-over-year revenue growth was also up 33 % in 2020 . Except for losses from settlements with litigants and SEC, Luckin Coffee actually has seen a decline in net loss in 2020 compared to the previous year.

Actions Taken to Rebuild Trust

The preceding section demonstrated that Luckin Coffee's efforts to rebuild its reputation since 2019 had yielded some impressive outcomes. To regain investor faith, the corporation primarily pursued two paths: settlement and reorganization. Luckin achieved an agreement with the SEC to end the investigation in early 2021, which could significantly assist the firm amortize the settlement costs outlined before. In terms of reorganization, Luckin began by reorganizing key positions immediately following the 2020 fraud. The majority of the Car Inc. board members were dismissed. Following that, the company reorganized its equity with its major creditors.The Car Inc. was out. Centurium Capital and Joy Capital, two of their shareholders, agreed to a $250 million dollar financing agreement with Luckin . This agreement helped them to mitigate the credit and liquidation risk at a time of need. Luckin Coffee appears to have come back to life.

Press Statements

According to Wolfe (2021), the main purpose of a press release is to:

* To notify the media about an event in hopes that they will spread the word.
* To share something about your business, hoping a reporter will see a story in your press release and write an actual news article about it.
* To promote your business' appearance on the internet via blogs, websites, and social networks.

We believe there are several reasons why Luckin chose to hold the Press Release Statements. Luckin wanted to let investors know about certain major events related to the company as soon as possible. For example, the Responses to Anonymous Report Containing Misleading and False Allegations was intended to stabilize and reassure investors, as well as to give confidence to the market. However, it later admitted itself that there was indeed a huge data falsification in the 2019 annual report, thus also making the previous response look a bit ridiculous. As for Luckin Coffee's Announces Formation of Independent Special Committee and Provides Certain Information Related to Ongoing Internal Investigation released on April 2, 2020, it was an attempt to undo as much as possible the mistakes made by the company and the large number of disappointed investors.

Company Actions

According to the information published on the Luckin Coffee’s official website we know that company’s Board of Directors (the “Board”) has formed a special committee (the “Special Committee”) to oversee an internal investigation into certain issues raised to the Board’s attention during the audit of the consolidated financial statements for the fiscal year ended December 31, 2019. The Special Committee has retained independent advisors, including independent legal advisors and forensic accountants, in connection with the Internal Investigation. The Special Committee recommended certain interim remedial measures, including the suspension of the chief operating officer - Mr. Jian Liu and those employees suspected of misconduct, and the suspension and termination of contracts and transactions with the parties involved in the identified fabricated transactions. The Audit Committee accepted the Special Committee's recommendations and implemented them with respect to the individuals and parties currently identified as being involved in the fabricated transactions. The Company will take all appropriate action, including legal action, against the individuals responsible for the misconduct. The action taken by the company is to restore the true operating conditions of last year as much as possible and to get out of the quagmire of falsification as soon as possible, because as a U.S. listed company, falsifying the data in the annual report is an extremely bad behavior.

Possible management actions

Although the result was to put the blame on Mr. Jian Liu (COO) and a director of the Company, and several employees reporting to him. However, since there was such a major problem, several other executives were more or less responsible, especially the CRO and the CEO. If the CRO and the CEO were more or less aware, then they acquiesced to the data fraud; if they were not aware, then they were not competent and the company had huge loopholes that needed a series of improvements.

I think this situation could certainly have been avoided. In fact, it is a rather outrageous situation. Generally speaking, there can be some degree of manipulation of statements, such as understate and overstate certain items, but outright fabrication of data to the extent that Luckin Coffee does is very rare. Clearly the accounting firm responsible for the annual report at the time didn't do its job as well as it should have.

Credit ratings

Credit Rating agency reactions

There are three major credit rating agencies, S&P, Moody’s, and Fitch. They are playing an important role in keeping the information transparent. Their job and responsibility is to detect accounting controversy, so the investors will not have information bias. The accounting controversy imposes severe costs on the investors. The credit rating agencies will first access non-public information to verify what goes wrong. Next, the credit ratings agencies will state clearly in their rating framework about the fraud and how that is going to affect the companies credit rating. At last, the credit rating agencies have reputational incentives to ensure that their ratings are accurate and they will scrutinize4 firm financial reports. This is the reason why the barrier to entry in this industry is so high.

Latest rating for Luckin Coffee’s senior unsecured debt

Credit rating agencies provide investors with information about whether or not the bond or debt issuers can pay for its obligations. It also provides information about countries’ sovereign debt. It is very important to look at the rating score before you make any investment. In the global credit rating market, Moody’s, Standard & Poor’s, and Fitch monopolize the whole industry. S&P is the rating agency rate for Luckin Coffee. S&P Global Market intelligence ‘s Fundamental Probability of Default showed the company having a 1 year default risk of 11.98%. Luckin Coffee received a score of ccc+ from S&P. This score evaluates credit risk of financial instruments. On April 2, 2020, Luckin Coffee’s preliminary internal investigation report showed that the sales had increased by 2.2 billion Yuan. This exposure to a company was fraudulent, the latest rating for Luckin Coffee senior unsecured debt decreased from ccc+ to ccc-. A score of ccc+ and ccc- are “below investment grade (Junk)”. The score shows that Luckin is vulnerable to default.

Latest rating outlooks

The latest rating score decreased from ccc+ to ccc-, which is almost the lowest score. Ccc+ is a score that the credit rating agencies do not recommend to invest in. However, after Luckin Coffee engaged into the accounting controversy, the rating went further downgraded to ccc-. It is clear that rating agencies are bearish to Luckin’s outlooks. The rating agencies focus on nine factors, business profile, operating segment and industry standing, business risk, historical performance analysis, scale and margins compared to its peers, revenue and margin drives in the past, and their sustainability, cash flow generation capability, balance sheet analysis and liquidity profile, financial ratios and peer analysis. In this case, Luckin Coffee was involved in an accounting fraud that sales increased by 2.2 billion yuan from the second to the fourth quarter of 2019. This led to further downgrade and is in the category of balance sheet analysis and liquidity profile.

S&P’s Fundamental Probability of Default

Management and Governance Credit Factors is a component of assessment of an enterprise’s creditworthiness. It is one of the most qualitative aspects of rating methodology. This method encompasses the broad range of oversight and direction conducted by enterprise‘s owner, board representatives, executives, and functional managers. If an enterprise has the ability to manage important strategic and operational risk, then it plays a positive role in credit rating. On the other hand, weak management with a flawed operating strategy or an inability to execute business plans effectively is likely to lower the enterprise’s credit rating. The analysis of management and governance includes management, strategic positioning, risk management/financial management, organizational effectiveness, and Governance. In March 2019, before the fraud was found. The management and governance of Luckin Coffee have huge problems. The audits of the company did not provide cautious and careful monitoring. Luckin Coffee has an incapability ERM team, which did not capture the risk early and drew up a plan to mitigate/prevent the risk from happening. The brief Management and Governance Credit Factors table is shown below.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Strong | satisfactory | fair | weak |
| Management |  |  |  | √ |
| Strategic positioning |  |  | √ |  |
| Risk/Financial management |  |  |  | √ |
| Organizational effectiveness |  |  | √ |  |
| Governance |  |  | √ |  |

Three lines of Defense

Basis the Anonymous report published, it was understood that Luckin Coffee’s Three lines of defence failed miserably or rather was not present at all. Since it is understood that Luckin had falsely represented it financials by inflating orders and order data with the sole intention to maximize investor confidence.

* 1st LOD: Lies with the business, which makes sure the integrity and accuracy of data. However, in case of Luckin both integrity and accuracy of data were comprised since it was understood that actual numbers were manipulated to show dramatic business and stock growth.
* 2nd LOD: Lies with internal management, which performs an assessment of financial statements and internal controls to avoid unauthorized changes to data, additionally provide an oversight to 1st LOD. Clearly, this was a failure for Luckin since business was involved with inflating revenues and profits. 2nd LOD either accidentally or intentionally failed to test and challenge these fabricated financial and operating numbers.
* 3rd LOD: Lies with internal audit, which independently has to perform an assessment of financial statements and internal controls and report the same to board of directors to align with assessments done by 2nd LOD. However, no issues were raised by internal audit on practices followed in the firm, neither it could identify any of the accusations stated in the anonymous report.

Inherent Risks

As understood from 2019 SEC filings, Luckin coffee’s material weakness included:

* Lack of sufficient entity level control policies and procedures, including failure to demonstrate commitment to integrity and ethical values and lack of appropriate segregation of functions and duties
* Lack of control procedures to monitor the accesses granted to and activities conducted within the information databases for the purpose of financial reporting
* Lack of sufficient accounting and financial reporting personnel with requisite knowledge and experience in application of U.S. GAAP and the Securities and Exchange Commission, or the SEC, rules

Additionally, basis the anonymous report it was understood Luckin coffee had flawed business model since:

* Luckin’s idea to target China for a coffee market even though Tea dominates 95% of the caffeine market. Luckin desired coffee to be dominate Tea market even though China has been a major producer and consumer of tea for over hundreds of years.
* Luckin attracted consumers by giving off generous discounts to increase sales however customers saw this as a one time opportunity and not as recurring customers. Additionally, as Luckin inflated product prices they started loosing customers. Failure on their part was that Luckin had not anticipated such behaviour and continued to carry same activities.

Stock Performance

* Technology doesn’t guarantee success: Luckin used ordering through app, data analytics and artificial intelligence to improve operations. It even used vending machines, however at the end of the day people need a product which should resonate with their needs and budget.

Stock performance compared to overall U.S. stock market

Apparently, prior to fraud accusations (January 31st, 2020) Luckin stock performed great compared to its IPO in the secondary market. Once the accusations were published, the stock price didn’t deviate out of the expected (or usual) range. The stock performed similarly till April 1st, 2020.

However, the stock price took a dive on April 2nd, 2020 significantly even though U.S. markets performed the usual during these periods. Henceforth, Luckin stock gradually decreased.

The following events possibly influenced the stock prices for Luckin, shown additionally is the US market performance.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| No. | Event/News | Date | LCKNY | SPY |
| a | Anonymous Report published | January 31, 2020 | $ 32.49 | $ 321.73 |
| b | - | April 1, 2020 | $ 26.20 | $ 246.15 |
| c | Luckin Coffee announces special committee to investigate | April 2, 2020 | $ 6.40 | $ 251.83 |
| d | Luckin Coffee asked to delist from Nasdaq | May 19, 2020 | $ 4.39 | $ 291.97 |
| e | Lucking Coffee officially suspended trading and is delisted | June 29, 2020 | $ 1.54 | $ 304.46 |

The following charts show overview of Luckin stock in comparison to S&P index for the period of December 30th, 2019 – April 11th, 2022.

* The blue line represents S&P index.
* The 1st chart shows actual price changes to stock and the index. (1)
* The 2nd chart shows movement of stock and index over the said time. (2)
* The violet frame highlights the significant changes.

Chart

Description automatically generated

(1)

A picture containing text, indoor

Description automatically generated

(2)

It is quite evident that Luckin stock moved independently of the actual market. It was influenced mainly by the fraudulent accusations in addition to Covid-19 effecting the markets.

Luckin’s stock dropped from $26.20 to $6.4 in a day, while the index moved rom $246.15 to $251.83.That is almost a 75% drop in price of Luckin stock while the market didn’t observe much difference.

Stock performance compared to competitors/sector

Moving on next we will compare how Luckin performed in comparison to similar business or sector.The following shows a trend of stock prices for the period of December 30th, 2019 – April 11th, 2022.

Chart

Description automatically generated

The colours represent following:

Blue: Starbucks Corporation (SBUX)

Red: Luckin Coffee Inc. (LKNCY)

Yellow: Baristas Coffee Company, Inc. (BCCI)

The following table shows the Luckin stock prices in comparison with competitor firm Starbucks Corporation for the same dates as we priorly compared it with S&P index:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| No. | Event/News | Date | LCKNY | SBUX |
| a | Anonymous Report published | January 31, 2020 | $ 32.49 | $ 84.83 |
| b | - | April 1, 2020 | $ 26.20 | $ 62.62 |
| c | Luckin Coffee announces special committee to investigate | April 2, 2020 | $ 6.40 | $ 65.00 |
| d | Luckin Coffee asked to delist from Nasdaq | May 19, 2020 | $ 4.39 | $ 75.86 |
| e | Lucking Coffee officially suspended trading and is delisted | June 29, 2020 | $ 1.54 | $ 73.48 |

It is understood that Starbucks stock growed during the period of the drop in Luckin’s stock.

The growth was not significant, however elimination of a competitor might have benefited Starbucks in the long run.

Lucking coffee faces following key risks:

* First and foremost, major risk which Luckin Coffee was facing is adequate accounting and financial reporting procedures.
* Secondly, Luckin faces is lack of adequate controls, and policies to monitor accesses to data for financial reporting.
* Next, it faces operational human resources risk since priorly employed personnel have been accused and faced legal actions for the fraud committed against firm and investors.
* Next, it faces Reputational Risk since it has been already involved in a fraudulent case of inflating prices to fabricate financial statements.

Next, Luckin Coffee settled the accounting fraud charges by paying fine of $180 million to U.S. Securities and Exchange Commission.

We believe it might be hard for management to win back faith from investors and regulators on integrity of its operations and financials.

However, it is understood that its revenues had grown by $370 million for 3rd quarter of 2021.

Additionally, Luckin reported a net loss of approximately $859 million for 2020 year end.

Furthermore, it reported losses of $3.6 million for first 3 quarters of 2021.

Considering the above factors we would recommend not to invest in Luckin Coffee right now.

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Please note:

The comparisons made for stock’s have been procured from Yahoo finance of the following:

* SPDR S&P 500 ETF Trust (SPY)
* Luckin Coffee Inc. (LKNCY)
* Starbucks Corporation (SBUX)