



Case Study Analysis

Luckin: From Brewing
Coffee to Brewing Fraud



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The background of the slide is a blurred image of a financial market data display. It features various numbers in red and green, indicating price changes, and directional arrows such as 'Buy', 'Strong Buy', and 'Sell'. The text is overlaid on this background.

What is Luckin's business?

How does it differ from Starbucks? What are the value propositions for each firm?

Business Model

Luckin's business model: **“Previously, you had to look for coffee, but now coffee comes to you”.**

Quality

Superior Arabian coffee beans
World Barista Best teams

Price

design
20 – 30% less than that
of Starbucks

Accessibility

30 minutes delivery or free drink

There are 3 store types: **relax stores**, **pickup stores**, and **delivery kitchens**.

	2Q2018	3Q2018	4Q2018	1Q2019	2Q2019	3Q2019
Relax Stores	22	45	86	109	123	138
Pickup Stores	356	903	1811	2163	2741	3433
Delivery Kitchens	246	241	176	98	99	109

% Pickup Stores	57%	76%	87%	91%	93%	93%
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Mobile app enables:

- Customer may order at any time in a cashless manner.
- AI technologies and data analytics

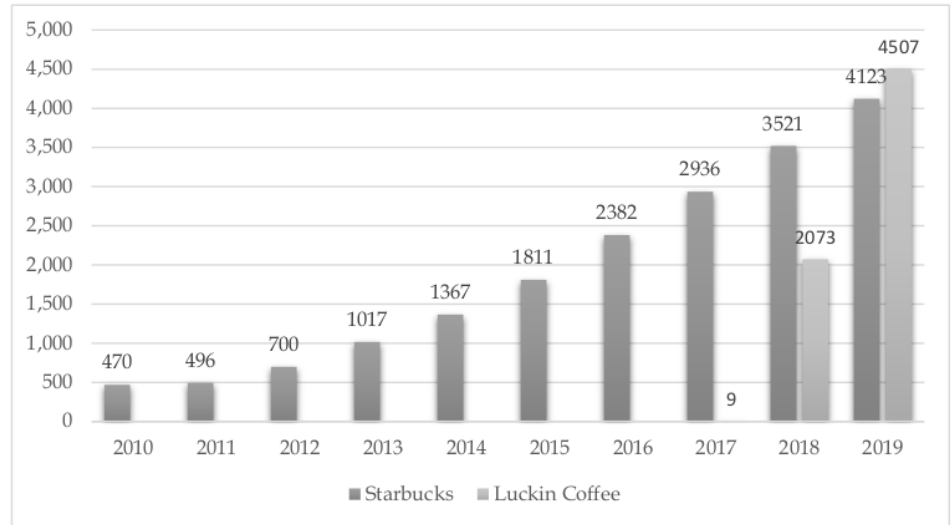
Luckin's Strategy

Luckin's Strategy: Extreme Growth..

Luckin bets all cards in having the most brutal and exponential growth - **high risk high reward** strategy

The company is not anywhere near net profit for the first years for the sake of making the most profit later.

Exhibit 6 – Store Growth of Starbucks vs. Luckin in China



Source: Company Annual Reports, Prospectus and Quarterly Statements



Strategy - How?

1. Aggressive expansion through construction of new establishments
2. Lower prices for the same quality of the competition
3. Highly convenient model for the client

Also important to note: for this to work, **Luckin required great initial funding.**

Luckin vs Starbucks

3 types. Focus on delivery quickness and simplicity	Stores	Social space. Comfortable and well-decorated.
High	Quality	High
~30% cheaper	Price	Higher than Luckin
Mobile app and standard procedures. Data analytics, AI, supply chain management	Technology	Used for standard procedures, such as orders and payments
Many promotions. Buy X coffees and receive Y free.	Loyalty	Loyalty program with points. Occasional promotions.
Young people. 'White collars'.	Market	Middle to high-end customers. Young people.



How is Luckin's operational and financial performance?

Is there any relationship between operational and financial performance? Are they consistent?

Luckin's Financial/Operational Performance

- One key aspect of Luckin's operational performance was the use of technology to drive customer engagement and loyalty
- The mobile app the company developed along with the extensive distribution network that included a combination of self-operated stores, partner locations, and delivery services, allowed for Luckin to have an exponential growth!

Exhibit 2 - Operational Data of Luckin

	1Q2018	2Q2018	3Q2018	4Q2018	1Q2019	2Q2019	3Q2019
<i>Number of stores</i>	290	624	1,189	2,073	2,370	2,963	3,680
<i>Cumulative no. of transacting customers (in thousands)</i>	485	2,918	5,984	12,530	16,872	22,777	30,724
<i>Average monthly items sold (in thousands)</i>	488	4,001	7,760	17,645	16,276	27,593	44,245
<i>Percentage of delivery orders</i>	61.7%	62.2%	51.4%	40.8%	27.7%	19.8%	12.8%

Source: Luckin Earnings Highlights

Luckin's Financial/Operational Performance

- Another aspect of Luckin Coffee's operational strategy was its focus on affordability. The company offered lower prices than its competitors.
- This strategy makes for great and fast growth, yet no profitability. In opposition to the immense growth in customers, Luckin repeatedly presented, much higher Expenses than Revenues. However this was part of its strategy.

Exhibit 4 – Financial Statements of Luckin

Exhibit 4.1 – INCOME STATEMENTS (in millions of ¥, except per share data)

	Fis. Yr Ended	Three Months Ended					
	31-Dec- 2017	Mar- 2018	Jun- 2018	Sep- 2018	Dec- 2018	Mar- 2019	Sep- 2019
Freshly brewed drinks	0.2	9.6	100.5	192.7	346.9	361.1	1,145.4
Other products	0.0	1.4	8.4	34.4	91.4	84.0	210.8
Others	0.0	2.0	12.5	13.7	27.2	33.4	39.1
Total Revenue	0.3	13.0	121.5	240.8	465.4	478.5	1,541.6
Cost of materials	0.8	9.4	75.8	151.6	295.4	275.8	721.1
Store rental & other op. costs	1.6	20.2	99.9	172.5	283.5	282.4	371.5
Depreciation expenses	0.9	4.0	15.0	28.9	58.9	84.0	88.5
Sales and marketing expenses	25.5	54.4	178.0	225.3	288.4	168.0	390.1
Gen and admin expenses	22.0	39.0	74.9	118.3	147.5	173.0	265.8
Store preopening and other expenses	5.7	11.1	21.3	29.8	35.6	22.4	21.8
Total Operating Expense	56.5	138.1	465.0	726.4	1,109.2	1,005.6	1,598.8

Relationship Between Them

- The company's initial strong operational performance, including its rapid expansion and customer acquisition, helped it grow its market share and customer base.
- However, Luckin Coffee's financial performance was further damaged by accounting fraud, which highly impacted investor confidence in the company and its ability to raise capital. This, in turn, has had a negative impact on the company's operational performance, as it has had to scale back its expansion plans and implement cost-cutting measures to preserve



Relationship Between Them


- The accounting fraud was also a big factor that called into question the effectiveness of Luckin Coffee's operational strategy.
- The company's focus on rapid expansion and customer acquisition, coupled with low prices to drive affordability, may have contributed to the company's fraudulent activities.
- Concluding the relationship between them has been quite dynamic and complex being the financial performance impacted by the operational successes and failures of the company



Are they consistent?

- The company was quite consistent in the beginning since they were constantly selling products with discounts in order to attract customers, even though it meant not to have any profit.
- The company forged results in order to maintain this consistency and keep growing.
- This consistency was progressively lost due to the changes the company did in the business model and approach.





Why did Luckin commit the financial fraud?

Were there any red flags consistent with the information from the anonymous report? Could Luckin's fraud have been prevented?

Strategy - What for?

Recall Luckin's strategy: **aggressive growth** and **low prices**.

This combination is designed to draw the **most clients possible**, aiming to create a solid, active and loyal customer base.

Having a **huge active customer base**, when the company **decided to stop the growth and become profitable**, the **profits** would supposedly be **enormous**.

Why Fraud?

Luckin's strategy **aimed to**:

Generate huge profits by quickly becoming the biggest in the Chinese coffee industry

and **needed**:

- Investors
- Huge active customer base

Investors only come if the strategy seems to be working. Therefore, everything depended in the active customer base.

So... if there weren't enough sales, they had to fake them to maintain the investors

Redflags

- Luckin did not have a **clear strategy** to **maintain their customer** base when their **prices were to rise** in the future
- Luckin's Chief Marketing Officer and co-founder was once **imprisoned** for 18 months for **illegal business operations**
- Luckin was **not following its initial strategy** of enabling the client to have a **very convenient** experience and be delivered coffee to wherever he wanted (Exhibit 2 and 1 shows diminishes in delivery sales and kitchens)

Exhibit 1 - Shop Formats in Luckin

	Description	Number of Shops					
		2Q2018	3Q2018	4Q2018	1Q2019	2Q2019	3Q2019
Pickup stores	Typically located in high traffic areas such as office buildings, commercial areas, and university campuses. These small-size stores (20-60 sq meters) have limited seating and inexpensive furnishings. They are designed for order pickup or delivered to customers.	356	903	1811	2163	2741	3433
Relax stores	Spacious and large stores (> 120 sq meters) for branding purposes.	22	45	86	109	123	138
Delivery kitchens	Small sites to make coffee for delivery orders. Delivery kitchens enable Luckin to increase its customer base. They might be turned into pickup stores if the customer demand in that area is sufficiently high to justify such conversion.	246	241	176	98	99	109

Source: Company Prospectus and Quarterly Earnings Release Reports

Exhibit 2 - Operational Data of Luckin

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Source: Luckin Earnings Highlights



Could it have been avoided?

- Less aggressive strategy - more time to analyze the impact of decisions
- Better market study
- **More:** attention to the viability of the business model and to its profitability
- **Less:** attention to shareholders, memberships and trends

The background of the slide is a blurred image of a financial market data screen. It features various numerical values in red and green, along with directional arrows and text labels such as 'Buy', 'Strong Buy', and 'Sell'. The text is slightly out of focus, creating a sense of depth and context related to the financial market.

How did the market react to Luckin's announcement on April 2, 2020?

Why did the market react this way?

Luckin's announcement on April 2, 2020

- Luckin announced the involvement of its Chief Operating Officer (COO), a director, and several employees in fabricating sales transactions. The fabrication was estimated to be US\$310 million for the 2nd to 4th quarters of 2019.
- Some costs and expenses were also inflated through forged transactions.



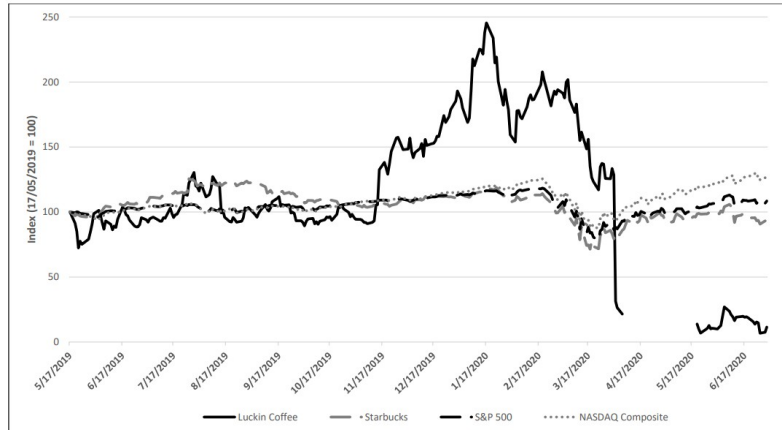
Procedures after the announcement

- The company formed a committee comprising independent directors, along with independent legal and accounting professionals.
- Suspended the COO and the employees associated. **The director involved in the fraud continued in the company.**

How did the market react?

- Luckin's stock trading halted 5 times within an hour after the US market opened.
- Luckin's stock price plummeted 80% on the same day: closed at US\$6.4 from a previous close of US\$26.2
- Luckin's value shrank by US\$5 billion in 1 day.

Exhibit 9 – Historical Stock Price Pattern of Luckin Relative to Starbucks, S&P 500, and NASDAQ Composite



Data: Thomson Reuters Eikon

- Starbucks stock price curve follows S&P 500 and NASDAQ composite indexes.
- Luckin's stock price curve follows the indexes until they fabricated sales transactions. After the forged transactions (around November 2019), the stock price increased a lot and surpasses Starbucks.
- After the announcement, Luckin's stock price plummeted.
- At the beginning of the pandemic, the stock price and the indexes of both companies decreased.

Luckin's sales were not up to level with their expansion, which could indicate that their strategy was failing

Exhibit 10 – Analyst Recommendations

Period	# Analysts	Buy	Hold	Sell
Jul-2019	7	85.7%	14.3%	0.0%
Aug-2019	7	85.7%	14.3%	0.0%
Sep-2019	7	85.7%	14.3%	0.0%
Oct-2019	7	85.7%	14.3%	0.0%
Nov-2019	7	85.7%	14.3%	0.0%
Dec-2019	7	85.7%	14.3%	0.0%
Jan-2020	7	85.7%	14.3%	0.0%
Feb-2020	7	85.7%	14.3%	0.0%
Mar-2020	7	85.7%	14.3%	0.0%
Apr-2020	4	75.0%	25.0%	0.0%
May-2020	3	66.7%	33.3%	0.0%

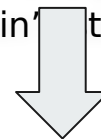
Source: Thomson Reuters Eikon

Before the announcement:

- 85.7% of the analysts recommend the buying of Luckin's stocks

After the announcement:

- 66.7% of the analysts recommend the buying of Luckin's stocks



- Lower percentage of analysts recommending the buying of Luckin's stocks.
- Higher percentage of them recommending the hold of their stocks.

Why?

As before, after the announcement there's no analysts recommending the sale of Luckin stocks. Despite this fact, the value of the company shrank. **Why??**

Vicious Cycle of Sales



1. Start of the pandemic + fraud increases shareholders' uncertainty and decreases willingness to take risks
2. Some shareholders decide it is too much risk and sell, which drives the stocks down
3. Other shareholders, seeing the trend, become more afraid and sell their stocks too

If you were a shareholder, what would you do upon Luckin's announcement in April?

Would you buy more of Luckin's shares, hold or sell your shares?



First Approach: Follow the trend and sell

Pros:

- Minimizes the losses in the case of further stock devaluation
- Risk free

Cons:

- Will incur losses as the stock were probably bought at a higher price
- Must be done quickly before stocks lower even more

Second Approach: Buy low and expect a bounce back

Pros:

- Can lead to much higher payoffs later on if the company's value bounces back due to the low price
- May raise their value by showing that some investors still trust in the company

Cons:

- Much riskier as the company may collapse even further, be shut down by authorities or file for bankruptcy.



Veredict

- Company has had consecutive negative results in terms of profit.
- Sustained by continuous investments from investors moved by the hype of seemingly exponential growth
- This speculation inflated Luckin's value and made it valuable but unstable

Given this instability, once the fraud was revealed, the most likely scenario would be a total collapse, so we would choose to sell the remaining shares while they still have value, to minimize the losses, since Luckin's situation doesn't give good prospects.

In the future, there's the possibility things can change, however, the most wise option is to try to save part of the investment.