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Luckin Coffee's Accounting Scandal: Leaving Investors with a Bitter Taste

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Abstract

Luckin Coffee Inc., the would-be Starbucks of China, landed in hot water when short seller Muddy Water Research exposed the alleged fraud at the company of fabricating its financial and operational data. Luckin initially denied the allegations but its internal investigations came up with a revelation of fabricated 310 millions of dollars in sales. Luckin shares crashed by 80% in U.S. trading and its trading at Nasdaq came to a halt along with a delisting notification. The company's IPO worth $645 million was the 2nd largest in the US by a Chinese firm. The disclosure not only damaged the investors' confidence but also renewed doubts about Chinese corporate governance and financial reporting which may bring a closure to the country's overseas IPOs. Even though Luckin's aggressive growth lured the investors, the sustainability of its business model had always raised many eyebrows. The institutions involved in reporting and IPO due diligence are having questions lurking at their reputations. It is a wake-up call for the investors to be more cautious of Chinese firms, with high growth business models, that plan to go public in the US. Was the Luckin Coffee Inc.'s business model too good to be true? Who is responsible for this accounting debacle-the management, the audit committee, the underwriters or the lax corporate governance? How is this scandal going to impact the investors' perception towards China's overseas IPOs and the future US listings by Chinese companies?

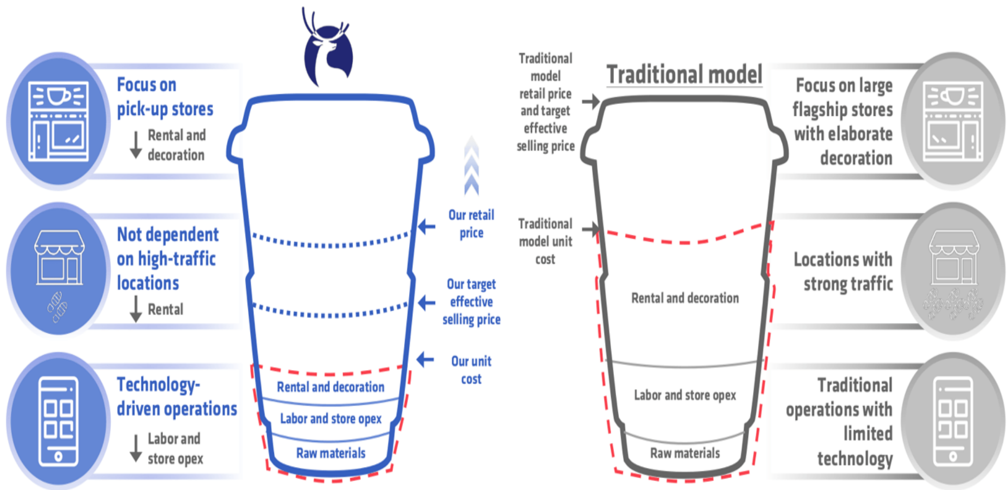
Case Study

Luckin Coffee Inc, a Chinese upstart coffee chain, was founded in October 2017. Co-founded by CEO Qian Zhiya, the former COO of Car Inc, and Charles Zhengayo Lu, the company started its operations in January 2018 by opening its first shops in Beijing and Shanghai. The company was set up to tap in the opportunity of ever growing coffee consumption in the tea drinking nation. The coffee market in China grows at about 40% in sales annually. To exploit this massive growth potential, the Coffee Giant **Starbucks** had entered the mainland China in 1999 and expanded massively with 4300 coffee shops and a goal of opening 5000 outlets by 2021.

Luckin was aiming to contend and share the market leader Starbucks' aggressive optimism on the aspiring and economically empowered young generation of China's coffee market. Luckin Coffee had started offering online first service for people who would order coffee on the go. The focus was to offer cheaper coffee to the young, white-collared and internet savvy population of China. In order to expand its network faster than Starbucks, Luckin started to set up its stores a few meters away from the Starbucks' stores in Tier 1 cities. This approach worked and Luckin Coffee started to gain visibility as a coffee brand in China.

Luckin banked upon the mobile phone technology and connectivity to its advantage and build its strategy around the smartphone. Luckin adopted a "grab-and-go" model where the consumers ordered via its mobile app and shops offered only pick up services. The app directed its consumers to the nearest Luckin Coffee shop from where they collected their coffee and moved on their way.

Luckin tailored its strategy to the flaws of its rival Starbucks. It delivered better coffee at cheaper prices and went light on real estate. As compared to Starbucks' coffee shops, Luckin believed in minimalist shops that were far smaller with little or no seating. Its outlets were tiny shops and cafes which took online orders for pickup and delivery. Also, it offered heavy discounts to its consumers through different types of coupons like buy-one-get-one-free, 50% off, extra coupons for referring friends to sign up etc. It was not rare to see people getting a large latte for only 10 yuan after the heavy discount. In order to give a further boost to customer satisfaction, Luckin had reduced its delivery time by almost half from an average of 30 minutes to 18 minutes. Users had been attracted to Luckin because of its heavy discount promotions like "buy 5 and get 5" and 92% off coupons alongwith its aggressive marketing campaign on WeChat and other social media websites in China. (**Exhibit I**)



Source: Kris, "They Highly Caffeinated Luckin Coffee", https://ipocandy.com/2019/05/luckin-coffee/, May 16th 2019.

Exhibit 1.Luckin Coffee's Business Model

Luckin expanded and captured the market quickly and saw a significant increase in the demand for its coffee. In a span of just three years, Luckin rose from a nobody to China's biggest coffee chain, with over 4,500 shops, toppling its rival Starbucks from the perch. Despite its glorious expansion and growth, Luckin reported total net revenues for the nine months to 30 September 2019 at US$409.8 million, representing a net loss of US$246.9 million. The situation was even worse than the full year of 2018 where it had reported a net loss of US$74.4 million.

As a start up Luckin was valued at $1 billion and became one of the quickest companies to attain 'unicorn' status in China. In July 2018 it managed to raise $200 million in its maiden fundraising through ‘Series A’ financing. Its investors included Singapore sovereign wealth fund GIC, Chinese investment firms Centurium Capital and Joy Capital.

In the second round of funding in November 2018, Luckin raised another $200 million which increased the company's valuation to $2.2 billion. In April 2019, it was followed by another $150 million raised in a pre-IPO fundraising round from investors including BlackRock Inc, which valued the company at $2.9 billion. In May 2019, Luckin priced its U.S. IPO at $17 per share and raised $645 million through the greenshoe option. It was termed as the second biggest U.S. IPO by a Chinese firm last year.

In early 2020, Luckin completed a follow-on share sale and a convertible bond worth a combined $980 million and ventured into vending machines seeking further expansion by selling freshly brewed hot beverages and snacks.

In February 2020, the famous short-seller Muddy Waters Research shorted the Luckin stock, citing an anonymous report that raised serious questions on the coffee chain’s operations and financials. The anonymous 89 page report claimed that “When Luckin Coffee went public in May 2019, it was a fundamentally broken business that was attempting to instill the culture of drinking coffee into Chinese consumers through cut-throat discounts and free giveaway coffee”. “Right after its $645 million IPO, the company had evolved into a fraud by fabricating financial and operating numbers starting in [third] quarter 2019.” “It delivered a set of results that showcased a dramatic business inflection point and sent its stock price up over 160% in a little over 2 months. Not surprisingly, it wasted no time to successfully raise another USD 1.1 billion (including secondary placement) in January 2020. Luckin knows exactly what investors are looking for, how to position itself as a growth stock with a fantastic story, and what key metrics to manipulate to maximize investor confidence.”

The report insisted that its findings were credible and claimed that the number of items per store was inflated by at least 69 percent in the third quarter and by 88 percent in the fourth quarter of 2019. It also claimed of evidence in the form of over 11,200 hours of videotaping. The report included photos of customers and receipts and several charts to elaborate its findings.

To create an illusion of more business, Luckin had purposely started jumping orders (skipping order numbers). Since the investors and data firms were into tracking the order numbers as part of due diligence, management at Luckin thought of jumping orders as a simple solution. The company had earlier claimed about achieving the store profitability and in order to hold good to this claim, they started overstating their average selling price per order. The company was also exaggerating its advertising expenditure and rerouting the money in order to recognize it as revenue. Although this did not generate any profits but these exponential numbers reflected upon Luckin's growth prospects and instead of profitability, this was what investors cared for. Luckin became the perfect stock for returns-hungry foreign investors desperate to grab a share of China's growth stories.

Luckin had earlier claimed that products like juice, snacks (other than coffee) etc. contributed towards 23% of the revenue. It was noted that Chinese authorities levied a 6% VAT on freshly brewed coffee and juice; snacks carried a VAT of 13%. As per this claim, the VAT bill should have shown much higher amounts than the earlier months. But in reality, the tax statements filed with the govt. showed no increase at all. Initially, Luckin denied all these allegations, called the evidence malicious and claimed contrary to what was said in the report.

On 2nd April, 2020 Luckin Coffee admitted to an internal investigation revealing that its COO Jian Liu and other employees had faked transactions of about US$ 310 million. It submitted a filing with SEC, US confirming the window-dressing of its financials and said the investors shouldn't rely on company's previous financial statements. It fired its CEO and COO and blamed them of gross misconduct. This open admission of accounting scandal led to a fall of Luckin Coffee's shares at NASDAQ by 80% closing at US$ 6.40 leaving the US investors bleeding. The company that was once valued at USD 12.7 billion with its share price touching, in January 2020, an all time high of USD 51, crashed, in May 2020, to a market capitalization of US$ 350 million with its share price trading at USD 2.1. Luckin's ADRs closed at price of $4.39, crashing by 35%, on April 6 before trading was suspended by Nasdaq for six weeks. (**Exhibit II**)

Credit Suisse group led the IPO for Luckin and was amongst the lead underwriters and the biggest creditors on loans to Luckin founder Lu Zhengyao. The bank had provided to Luckin about $100 million in margin loans, garnering 60 per cent of the banking fees, estimated at US$30 million for two deals valued at US$1.2 billion. The bank also led a US$460 million convertible bond sale in January and was on the hook for a portion of the US$518 million in the defaulted margin loans to Lu. The firm had been working with the Luckin founder for about six years. Luckin's downfall had hit Credit Suisse harder than Morgan Stanley, Barclays, Goldman Sachs and China International Capital Corp. Due to the scandal, Credit Suisse was dropped from a US$500 million IPO in Hong Kong for a health care start-up. All the major lenders were at a risk of having to book losses on margin loans given to Luckin's founder Lu. The banks stood to lose more than $100 million from the loans given. Hong

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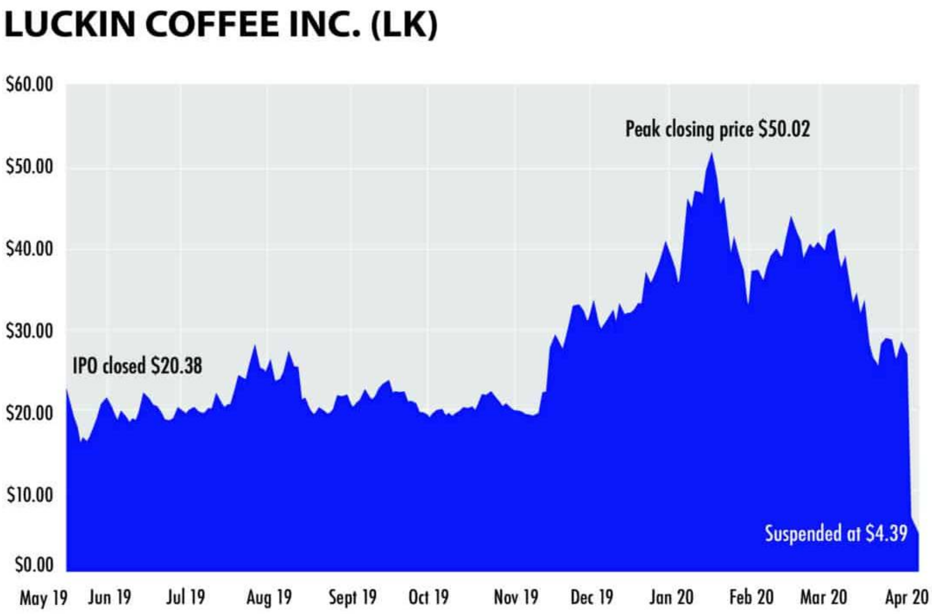
Kong-based law firm King & Wood Mallesons and Beijing-based Jingtian & Gongcheng had provided legal due diligence and reviewed the prospectus.



Source: Binder Eli, "The Big China Short", https://www.thewirechina.com/2020/04/26/the-epic-collapse-of-luckin-coffee/, April 26th 2020

Exhibit 2.Luckin Coffee's Stock Price since its May 2019 IPO

Many questions had been raised on the role of Luckin's independent auditor Ernst & Young Hua Ming LLP. The company said in a filing with SEC that the issues were raised to the board's attention during the audit of consolidated financial statements for 2019 and the fraud took place from the second to the fourth quarter of 2019. According to a company statement E &Y didn't issue any audit opinion for the period of the fraud. The speculations were rife that the anonymous report had raised alarms at Ernst & Young after which an anti-fraud team was made to intervene. The team discovered the fraud and then urged the company to conduct an internal investigation.

Nasdaq had issued a delisting recommendation notice to Luckin on grounds of "public interest concerns" related to accounting discrepancies. Nasdaq also proposed stricter norms and guidelines to restrict the ability, of companies from foreign markets, to remain listed. The coffee group was being investigated by the SEC, US but it cited difficulty in obtaining necessary information because China got in place a new law that required firms to first take approval from Chinese regulators before cooperating with any investigation conducted by international authorities. On 20th May 2020 US lawmakers and govt. took steps to restrict Chinese firms' access to American capital markets. The US Senate had passed a bill that would not permit companies that refuse to disclose information from listing on Wall Street. The bill also barred foreign companies from listing on US exchanges if they failed to adhere with US auditors for three straight years.

The scandal has reignited concern among investors over sloppy corporate governance but the problem of fraud isn't new. “What’s playing out here is not a new fraud, it’s just an issue for a new, well-known company,” said Drew Bernstein, co-chairman of MarcumBP, a leader in U.S. audit and advisory work for Chinese pre-IPO and publicly traded companies. “The essence of the fraud is somewhat predictable. A question that always arises in the wake of any high-profile fraud: How could this have happened? Followed quickly by: Who is responsible? The responses are equally predictable,” he said.

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