

### How the fraud investigation unfolded

The Luckin Coffee (Luckin) coffeehouse chain was founded in 2017 on an innovative “grab and go” business model that allows its customers to order coffee and other convenience products via an app. After raising USD 645 million through an IPO in the US in May 2019, the company rapidly expanded the number of its retail outlets in China and announced plans to expand into the Middle East and India. According to the Wall Street Journal, by the end of 2019 Luckin was operating more than 4,500 stores throughout China. On January 10, 2020, Bloomberg reported that Luckin’s share price had tripled since its IPO and that the company had increased its stock value by 26 percent by announcing a sale of additional shares and a convertible bond for a combined amount of USD 778 million. In mid-January 2020, the company’s share price reached USD 50.02.

On January 31, 2020, the short-selling firm Muddy Waters Research posted an anonymous report stating that Luckin misrepresented its financial statements in 2019. The report asserted that Luckin had inflated the number of products sold in its stores by 69 percent in Q3 2019, and 88 percent in Q4 2019, and that it had overstated its advertising expenses and store-level operating profit by CNY 336 million (approx. USD 48 million) and CNY 397 million (approx. USD 57 million), respectively, in Q3 2019.

Initially, Luckin categorically denied the allegations and warned that the company would be taking appropriate action to defend itself against what it referred to as unsubstantiated, ungrounded, and flawed allegations.

On April 2, 2020, Luckin announced that it had suspended its Chief Operating Officer and several other staff members following suspicions that they had fabricated some transactions between Q3 and Q4 2019. The company said it would be conducting an internal investigation and warned investors to disregard previous financial statements. Luckin’s share price fell to USD 6.40 following the announcement.

The Chinese and international media widely covered the company’s April 2 disclosure, with Forbes reporting that the fraudulent transactions totaled approximately CNY 2.2 billion (USD 316 million).

Legal experts interviewed by Pengpai News estimated that Luckin could face an estimated CNY 75.4 billion (USD 10.8 billion) in legal liabilities for financial misrepresentation and warned that the company could also face a substantial fine if it was found to have violated China’s newly amended Securities Law.

Several US law firms filed class actions on behalf of Luckin investors alleging that the company had made false and/or misleading statements to investors.

On April 7, Nasdaq suspended trading in Luckin’s shares.

On April 22, a court in Xiamen, China, was asked to approve the first class-action lawsuit filed by investors in China, who seek to cover losses caused by Luckin Coffee’s alleged fraud.

### Case study timeline

#### 2020

##### January 31

RepRisk picks up short-seller report stating that Luckin Coffee had misrepresented its financial statements in 2019 and identifies company as potentially exposed to ESG risk (RRI value increases by 25). Company’s share price closes at USD 32.49.

##### April 2

Luckin Coffee suspends COO and other staff members, announces internal investigation into possible financial fraud, and warns investors to disregard previous financial statements. Company’s share price drops to USD 6.40.

RepRisk categorizes Luckin Coffee as very high risk (Peak RRI 73 in April 2020).

##### April 5

Luckin Coffee share price decreases further to USD 4.39.

##### April 7

Nasdaq suspends trading in Luckin Coffee shares.

##### April 22

First investor lawsuit seeking compensation for losses caused by financial fraud filed against Luckin Coffee in China.

##### April 28

The Chinese State Administration for Market Regulation raids offices of Luckin Coffee. BBC reports that China’s Securities Regulatory Commission has also launched an investigation into the company’s financial position.

##### April 29

Markets Insider reports that the US Securities and Exchange Commission investigating Luckin Coffee’s accounting practices.

##### May 19

Luckin Coffee receives a delisting notice from Nasdaq.

RepRisk has published a series of Case Studies that demonstrate the materiality of environmental, social, and governance (ESG) issues – and how RepRisk can serve as an early warning system before these issues translate into reputational, compliance, and financial risks. For more Cases, please visit [www.reprisk.com/news-research](http://www.reprisk.com/news-research) or contact us at [media@reprisk.com](mailto:media@reprisk.com).

Six days later, on April 28, the Chinese State Administration for Market Regulation raided the offices of Luckin Coffee as part of an investigation into the company. On the same day, the BBC reported that the China Securities Regulatory Commission was already carrying out its own probe into the company.

On May 19, Luckin Coffee received a delisting notice from Nasdaq, which cited investors' concerns about the company's fabricated sales.

Three other US-listed Chinese companies, TAL Education, GSX Techedu, and iQiyi, have also faced allegations of false accounting in 2020, which prompted the Chinese media to use the term "Luckin effect" to refer to a chain reaction allegedly triggered by the Luckin Coffee fraud investigation. These recent events have prompted the Chinese Financial Stability and Development Committee of the State Council to pledge "zero tolerance" with regard to financial fraud.

### Were there prior indicators of risk?

RepRisk's unique research approach and methodology picked up warning signals on the environmental, social, and governance (ESG) risks associated with Luckin Coffee. The company had a significant jump in its RRI as early as January, over two months before Nasdaq suspended trading in the company, and reached a Peak RRI of 73 in April – just short of RepRisk's extremely high-risk threshold of 75. Their high values resulted from a series of risk incidents that raised serious concerns about Luckin's business conduct despite the company's laudable mission statement, included below.

### Conclusion

Our aim is to illustrate the viability of identifying warning signs of reputational risk exposure.

The analysis of a company's ESG risk exposure over a period of time allows stakeholders to receive warning of risk incidents and enables them to take steps to mitigate their exposure to such risks.

### Luckin Coffee's Code of Business Conduct and Ethics

"We are strongly committed to conducting our business affairs with honesty and integrity and in full compliance with all applicable laws, rules, and regulations. No employee, officer, or director of the Company shall commit an illegal or unethical act, or instruct others to do so, for any reason."

The analysis of a company's ESG risk exposure over a period of time allows stakeholders to receive warning of risk incidents and enables them to take steps to mitigate their exposure to such risks.



RepRisk Index (RRI) trend of Luckin Coffee



Luckin Coffee share price trend. Source: Nasdaq

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