

February 12, 2020

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Company Note

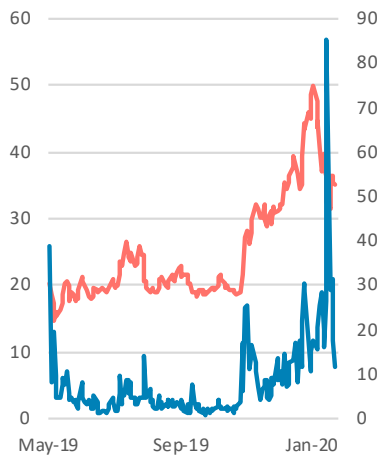
Anne Stevenson-Yang
anne@jcapitalresearch.com

+1 860 391 6094

Luckin Coffee (LK) One Year Price Chart and Volume

Price	\$38.79
Market Cap (USD)	\$9,767.20 mln

Luckin Coffee (LK) last share price in USD (left, pink) and volume in 100k shares (right, blue)



Source: Bloomberg February 10, 2020

Luckin Coffee (LK) The Long and Short of It



Closed Luckin store in Shijiazhuang February 7. | Source: J Capital

On January 31, Citron Research tweeted out a response to a detailed [short report](#) alleging fraud in Luckin Coffee's (LK) sales numbers.



Citron cited data from "Biz Con China," referring to [Business Connect China \(BCC\)](#), a Shanghai-based expert-network company that also sells data on listed, Chinese-domiciled companies. We managed to see a copy of BCC's report, and right there in the first paragraph is written: "Based on BCC's tracking, we are skeptical about some of Luckin's reported figures." The next paragraph begins: "Luckin's reported figure of 444 items sold per day in 3Q19 is likely to be higher than their actual sales." Citron seems to have missed this.

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“A good intention, with a bad approach, often leads to a poor result.”
Thomas Edison

We know BCC to operate with a high degree of integrity but think the methodology used to collect the data was flawed. BCC itself warns clients that “we believe BCC’s tracking results portray the optimal situation that Luckin can reach.” Notably, BCC’s tracking results show lower numbers than LK management reports.

BCC tracked only 10 physical stores (0.3% of total physical stores) versus the 620 physical stores (18.1% of total physical stores) tracked in the Anonymous report. Further to this, 50% of the stores that BCC visited were “Relax stores” which make up only 4% of Luckin’s total store count as of September 30, 2019. Relax stores on average have a 23% higher order volume than do other types of stores, according to BCC.

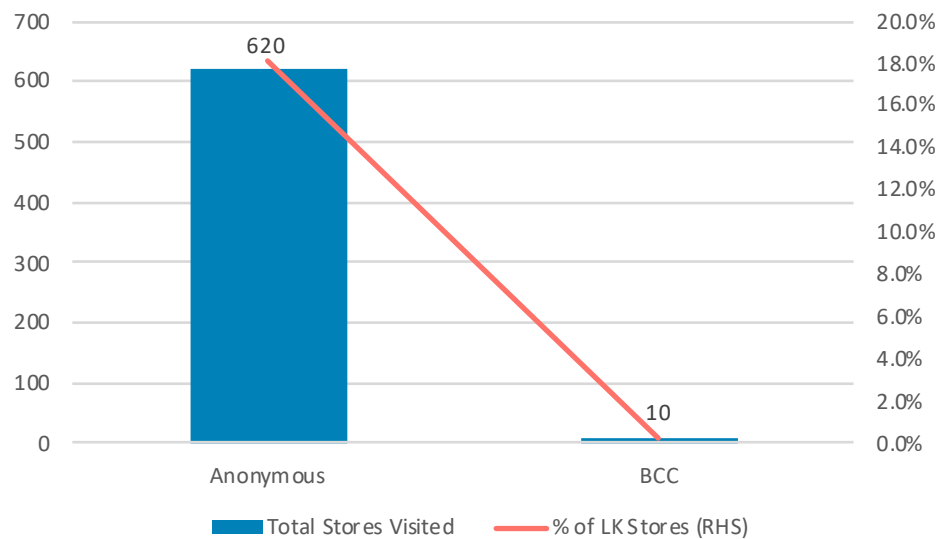
It’s not all bad news. In several areas, BCC’s data backed up the data in the Anonymous report. Citron conveniently forgot to mention that in the tweet.

Luckin has so far issued a blanket denial without providing confirmatory evidence. We are short Luckin and believe that the work of the anonymous short sellers was credible and complementary to our own analysis of the company’s reports.

Problems with the sample methodology

BCC’s overall sample size of physical stores pales in comparison with the Anonymous report.

Chart 1. Total Stores Visited: BCC vs Anonymous



Source: Anonymous report, BCC data

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BCC visited only 10 stores across Tier 1 and Tier 2 cities. In Tier 1 cities BCC visited four "Pick up" and four "Relax" stores. When compared with the 620 stores visited by the Anonymous report the coverage is underwhelming.

Table 1. Store Types Visited

LK Stores Sep 30, 2019	LK Store %	BCC Sample	Anonymous
Pick Up	3,433	93%	50%
Relax	138	4%	50%
Delivery Kitchen	109	3%	
Total	3,680		620

Source: Anonymous report, BCC data

BCC selected physical LK stores to observe based on highest popularity (measured by number of comments and views) on Meituan Dianping. These stores were located in the downtown CBD area of each sampled city. Random sampling would have likely produced a more representative sample. The anonymous report sampled physical stores in 53 cities.

The BCC sampling chose to emphasize geographies rather than cities where order volume is representative of the whole, sampling eight of 10 stores in Tier 1 cities, where coffee consumption is higher, although less than 25% of Luckin stores are in Tier 1 cities.

BCC observed traffic for one day per month on a weekday, recognizing that for most stores located in the CBD area, the weekend traffic is significantly lower than on weekdays. Anonymous data indicates a 9% difference between weighted average orders and weekday orders.

BCC's sanity check strategy no longer holds. That check consisted of having field staff place orders when they arrived and departed, then check the receipt by order number. But as of November, LK no longer used sequential numbering on receipts. The anonymous team, by contrast, made video recordings of full opening hours of the stores they monitored and then checked the videos, tossing out any that were missing 10 minutes or more out of the average 11.5-hour days.

Most problematic, BCC designed a large portion of its survey around Luckin's app. The integrity of app data in China is debatable at best. The anonymous report provided clear evidence of number skipping online that the

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team estimated led to order inflation of 72%. Anonymous compared data from their visits to 151 offline stores with app data for the same day.

Apples to apples

There are numerous instances where BCC's data confirms the findings in the anonymous survey.

At the single store that BCC and Anonymous both monitored, the China Shine Plaza (耀中广场店) Relax Store in Guangzhou, data is almost identical, indicating that the store bias likely affected the survey.

Table 2. China Shine Store, Guangzhou

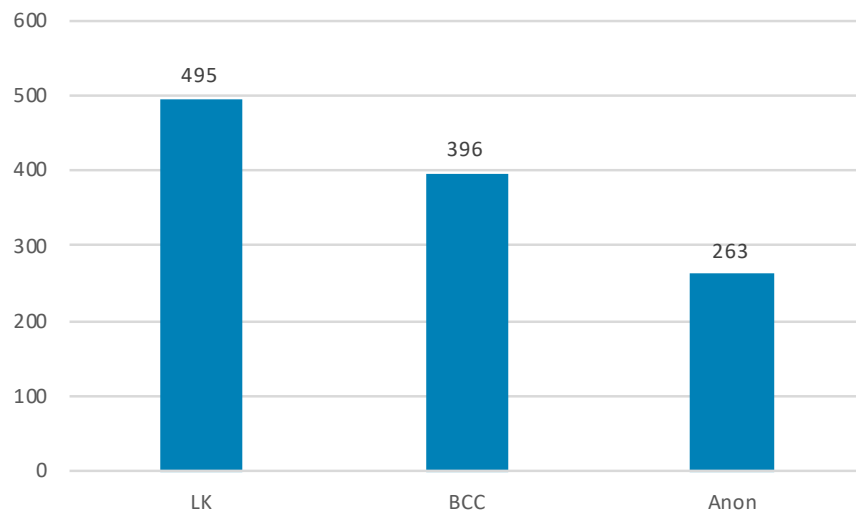
	Average Orders Per Day
Anonymous	853
BCC (Dec 2019)	860

Source: Anonymous report, BCC data

BCC estimated that "other products" were 5% of pick-up orders in Q4 2019. The Anon survey reported 6.2% for Q4. Meanwhile, Luckin claims "Other Products" is driving revenue growth and rose from 7% Q1 2018 to 22% Q3 2019.

BCC reported counting 396 orders per store per day in Q4 2019, while LK reported 483-506 orders per day in that quarter.

Chart 2. Items per Day: LK vs. BCC



Source: LK data, Anonymous report, BCC data

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Anonymous receipts show that the net selling price is 12% lower than claimed. The BCC survey indicates that the December 2019 revenue increase was driven by heavy discounting (eg, 45% off lattes).

Most significantly, even with its strong bias, BCC clearly showed that the number of items sold per day is far below what the company claims.

Converting shares

On February 10, the chairman’s sister, Wong Sunying, filed an SC13G form to indicate that she had converted 95.4 mln, or nearly half, of her B class shares in Luckin to A class shares, indicating a change of control. Wong’s 9.7% share in the company was 100% pledged for loans as of the last filing, on January 21, so this likely indicates a margin call or other prompt for a sale.

The virus

The general shutdown of the Chinese economy in response to the nCoV virus has been extraordinary, forcing all Luckin outlets in the four cities we checked to be closed at through February 9. On the 11th, the company was no longer posting a general shutdown notice, but over 90% of the outlets we checked in Beijing, Shanghai, Haikou, and Shijiazhuang remained closed. We believe Q1 revenue will be very severely impacted.



Screenshot from the Luckin app showing six of seven stores in Beijing’s Haidian District reporting that they were closed on February 11.

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