

Analysis of Short Selling – Based on the Luckin Coffee Scandals

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ABSTRACT

Luckin Coffee is a high-profile coffee corporation known by individuals due to its aggressive expansion and the sign of replacing the Starbucks in China. However, only 9 months after its IPO on NASDAQ, Luckin was accused of financial problems and huge flaws in its business model. Based on this scandal, through analysing the whole issue and some relative information, the key point of a successful short selling and the role that short selling plays in the capital market are considered. The result comes up that a clear evidence of the financial fraud or possible flaws is the key point during the process. Also, the short trades can be positive in the market's perspective.

Keyword: financial fraud, short-selling process, Luckin coffee, The Muddy Water Research.

1. INTRODUCTION

Nowadays, despite many fraudulent cases, the US capital market is still attractive to investors and capital-thirst enterprises. Companies incorporated in China are subject to stricter listing standards and have to wait longer for IPO approval. Therefore, listing in a liquid foreign exchange market and reaching out to long-term investors is therefore an ideal option. But exposure to more liquid markets also comes at a cost. If a scandal breaks out at a US listed company, the bad news could undermine investor confidence in all the Chinese companies involved[1]. The short institution is able to expose the fraud of certain corporates, so the key point of the short selling and whether short trade is a more effective supervision way to restrain financial fraud of listed companies by using short selling mechanism is going to be analyzed in this essay. Based on the analysis of the case of Muddy Waters shorting Luckin Coffee, this paper concludes that shorting plays a positive role in restraining financial fraud of listed companies in China. The reason

is that uncovering and exposing evidence of financial fraud is key to short trades.

2. BASIC INFORMATION ABOUT THE LUCKIN COFFEE SCANDAL

In April 2020, the Luckin Coffee, was plagued in a financial scandal. Founded in October 2017, the high-profile coffee maker advertised itself as a challenger to Starbucks in China and quickly attracted a flood of venture capital. By the end of 2019, Luckin expanded rapidly to outnumber Starbucks in China. According to related press releases and Luckin's own public data (figure 1), it took only 20 months for the number of stores to jump from an initial 290 in Q1 2018 to 4507 in Q4 2019. Along with the rapid growth is a high cash rate, which threatens the sustainable development of the company. Though it announced a net loss of \$82 million for 2018, Luckin made its IPO on NASDAQ. This series of action quickly caught the eyes of aggressive short sellers[7].

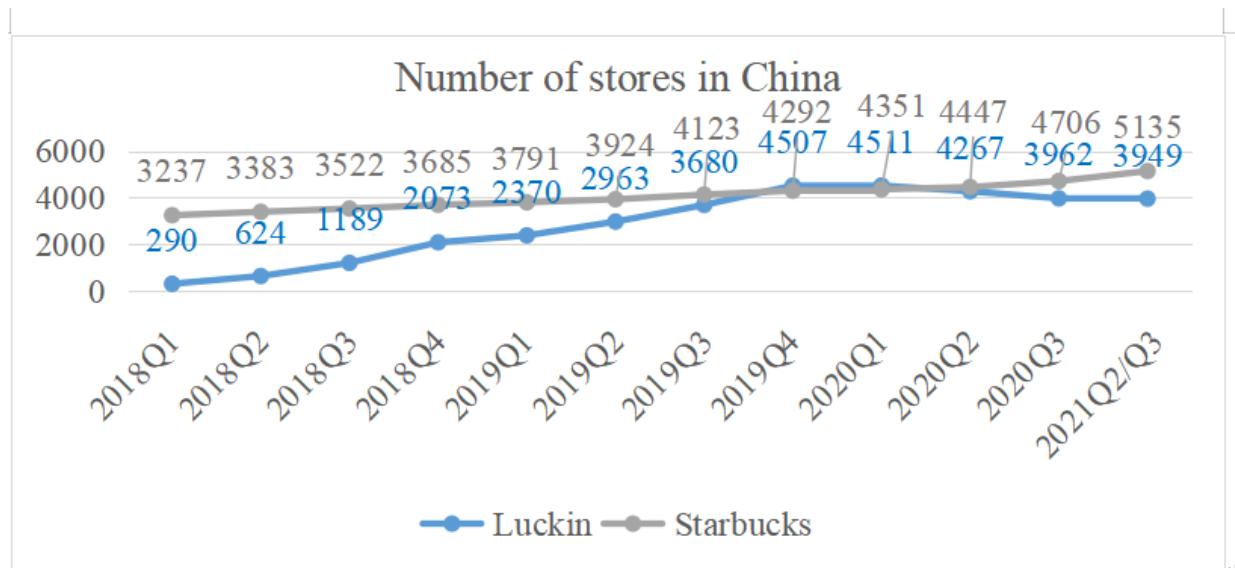


Figure 1 Number of stores of Luckin Coffee and Starbucks in China

(From its establishment, Luckin always flaunts its intention to become “the Starbucks in China” and replace the position of Starbucks in China. Therefore, the data of

Starbucks in the same period of time is used here for comparison to show the rapid development of Luckin)

Table1 Important events in Luckin Coffee Scandal

Time (Eastern time)	Event	Effect on Stock price
10-Oct-17	Luckin opened its first store in Beijing,China	
17-May-19	Luckin IPO on NASDAQ	
7-Jan-20	Luckin announced its pricing of follow-on offering of ADRs	
14-Jan-20	Luckin announced its completion of follow-on offering of ADRs	
31-Jan-20	Muddy Water Research released on 89-page "unattributed" report and declared it planned to short sell Luckin	Sudden drop Reached daily low of \$26.75 at 14:13, went up to \$32.47 at 16:00
2-Apr-20	Luckin admits it oversated its profits by 2.2 billion RMB	Eight trading halts Opening price decreased by 81.6%
15-May-20	Luckin received the 1st delisting notcie from NASDAQ	
19-May-20	Luckin released news about the 1st delisting notcie from NASDAQ	
20-May-20	Luckin resumed trading	
23-Jun-20	Luckin received the 2nd delisting notice from NASDAQ	
26-Jun-20	Luckin announced a trading halt on June 29th and would delist soon	Six trading halts a maximum price drop of 60%
29-Jun-20	Luckin delisted from NASDAQ and trades at the OTC Pink market (OTC:LKNY)	

Above is the timeline of the process of the whole issue. Before the release of the report, the stock price of the Luckin can reach to \$36[2]. It can be seen from the graph that, in Jan 31, 2020, the Muddy Water Research released on 89-page “unattributed” report and declared it planned to short sell Luckin. After the report was published, the stock price drop sharply, reaching the lowest point of \$26.75 in the day. Though it went up to \$32.47 later at that day, there was still a gap between the original price. This can draw a conclusion that the information about the possible or actual financial fraud is a key point in the process of short selling.

3.THE ROLE OF SHORT SELLERS

The means of short selling institutions is to find the

company with problems, take it as the target of short selling, through a lot of investigations, find the evidence of financial fraud and other evidence, and then borrow its shares and release short selling report, so as to profit from it[4].

In the Luckin’s scandal, the Muddy Water Research became a well-known investigative. The Muddy Water Research was founded in Hong Kong, China in June 2010 and listed in the US in July in the same year. After it is listed, more than 15 of 35 companies shorted by Muddy Waters Research are Chinese stocks, including Good Future, “Oriental Paper” and Huishan Dairy etc. Among them, several companies shorted suffer from lower stock prices, debt crisis and even delisting.

Once a listed company is shorted, even if there is no

material financial fraud, the stock price will fall sharply in the short term. For instance, after “New Oriental” was shorted by Muddy Waters Research in 2012, the stock price dropped 35.02% on the day. After paying a high investigation fee to prove innocence, the stock can recover within a year. Companies that disclose false information face delisting.

4.MEANS OF SHORT-SELLING AND THE INVESTIGATION METHODS

4.1.Means of short selling

First thing to do in the short selling is to find out a targeted company. However, it is not a easy process to target a company. Steps like referring to financial statements, gathering the temporary announcement, media reports, and website information, forming the information-chain and finding logical node are all need to be concerned.

As can be seen from the short selling of the Chinese stocks done by Muddy Waters Research and other investigation institutions, the success of short selling is mainly because they have already obtained detailed evidence of the financial fraud of the target corporates. The main method of short selling is to question the accuracy of corporates’ information disclosure and disclose the fact of financial fraud of listed companies through sufficient evidence collection[5].

4.1.1.Pointed out that the company’s information disclosure is not true

Some listed companies with poor operating conditions rely heavily on external financing. In order to obtain more external financing to maintain their normal business activities, enterprises took illegal actions to beautify their financial statements, in order to show investors the potential for future earnings, so as to attract additional investments. . The enterprise fraud is manifested in the virtual increase of income and profit, virtual reduction of expense and other aspects in order to improve their own net profit. In this way, the company can create a good business condition of the illusion. The short selling institutions just seize this point. Along with the experience of the internal professional staff and the evidence gained during the investigation process, the short selling companies lay the foundation for the success of the short selling. The release of the short selling reports mainly attack and question the income, profits, taxes and fees of the corporate.

4.1.2.Point out that the company’s information disclosure is incomplete

Due to investors’ judgment on the corporates’ financial situation on their own, enterprises will not only

inflate their income and profits, but also conceal important information, such as corporate debts, related party transactions, and hidden costs and expenses. Therefore, questioning the incomplete disclosure of corporate information is also an important means of attack by short sellers.

In the report exposed of the Luckin Coffee, Muddy Waters mainly focused on Luckin's fraudulent behaviour and problems in its business model. It announced that the financial and operation data of Luckin Coffee had been falsified. Muddy Water Research believed that Luckin had committed fraud by overstating the number of items sold per day, by at least 69% per store per day in Q3 2019 and by 88% in Q4 2019, which was supported by 11,260 hours of store traffic video. Besides, Luckin falsify the proportion of other goods except coffee to cover up the fact of single store loss. There are 5 smoking gun evidence of data fraud, 6 red flags and 5 business model flaws.

4.2.Investigation methods

In order to accurately find the problem companies, ensure the success of final short selling and achieve the purpose of obtaining high profit, the short selling company needs to have a complete and rigorous short-selling process. For example, in the early stage, it is necessary to search for problem companies, conducting a large number of investigations to obtain evidence of financial fraud, cooperated with intermediary companies and play games with listed companies. Among all the steps, accurate access to evidence of financial fraud is a crucial part in the short-selling process, and there are various ways to obtain information. Specifically, the investigation methods of short selling institutions can be summarized as follows:

4.2.1.Field survey

Through the field investigation to the target company, the company’s production line condition and number of employees are evaluated, and then the state of its business activities are generally judged[9].

In this case, the researcher questioned Luckin’s sales data and demonstrated the falsification of its data from the aspects of Luckin’s products, the number of customers, the number of goods picked up and the number of orders. It comes up with the conclusion. For example, it proved that Luckin has inflated its own APP online order volumes, by average of 72%[8].

4.2.2.Investigate suppliers

The investigation of suppliers can help short sellers to check the authenticity of the target company’ s data and confirm whether there is any discrepancy between the actual and disclosed data, including whether the supplier’

s production capacity can support the receiving company' s huge production, and whether there is a gap between the supplier' s supply price and quantity and the data disclosed by the target company[9].

In this scandal, the researcher found out that there are some potential risks. There is a people who has financial connection with Luckin' s chairman has established a new coffee supplier just adjacent to Luckin' s headquarters. In addition, the researchers found that perishable food and cold-chain foods usually sold out before the noon, which is really rare in this industry. Also, for cold-chain food, most of Luckin' s store are not equipped with heating equipment. All of this information leaves wonders about Luckin' s actual sales[8].

4.2.3. *Investigate customer*

Through the survey of customers, the short-seller can determine whether the data released by the target company is true. For example, knowing the purchase quantity, purchase price, customer's evaluation of its products, future expectation and other information can help the survey institution understand the business situation of the listed company[9].

The researcher also did some research on the state of the coffee industry. It is showed from the report that the actual state of this industry nowadays or the analysis of the consumer behaviours reflected by similar companies is not match the data published by Luckin[8].

4.2.4. *Hire a professional*

To ensure the accuracy of the attack, short sellers will hire professionals to analyse the data during the investigation of the target company and provide strong evidence for the release of the short report[9].

However, though the report was released by the Muddy Water Research, the report is not written by them. This report was done by another research company who hired groups of professor in this field to do this deep research of Luckin[8].

4.2.5. *Key point of short selling*

It is no hard to find out that the key point in the short selling is the detailed evidence of the financial fraud. With the evidence, the price of the stock will fall down, creating a gap for short sellers to profit. Pointed out that the company' s information disclosure is not true or incomplete can both lead to the essential step of the short selling.

Not only in this case, also the well-known short selling of the pound done by the Quantum Fund which is instructed by George Soros is based on the possible flaws that Soros found in the British pound. At that time, Britain

s monetary policy was trapped the ERM (The European Exchange Rate Mechanism) due to the economy it suffered is contrast to another country, Germany[6]. Normally, according to the impossible Trilemma, it is impossible to have all three of the factors in the following at the same time: an independent monetary policy, a fixed foreign exchange rate and free capital movement (absence of capital controls). All the country can only maintain a maximum of two outcomes, but UK wanted to achieve them all. Due to ERM, the UK needs to maintain high-interest rates while keeping the exchange rate stable and free capital flows. This is impossible to be sustainable[10]. Soros found this possible flaw and bet that the UK can not sustain these three points for long. This is how Soros smelled blood and started to prepare for the attack on the British pound. After the success from this action, he kept doing short selling among various country' s currency such as the Thai baht based on the same investing concept.

Actually, the existence of Luckin have been curious by individuals for a long time. People are all curious about how Luckin can still survive with the huge loss after all the financing. (In fact, Luckin Coffee finished three rounds of financing, along with the accumulated financing amount of more than \$500 million, before it started its IPO on NASDAQ.) It is these doubts in the market that attract the interest of the short sellers and some investigator.

5. CHARACTERS OF THE SHORT SELLING MECHANISM IN THE MARKET

Short selling is a common phenomenon in the mature capital market, and the active short-selling force has played a role in curbing bad behaviours to a certain extent. Even though there is no lack of malicious short selling events due to the huge profits, and it might exacerbate market panic or even reverse the market in the depression time in the market, short selling institutions still have value.

Short selling mechanism can be used to adjust the market price, accurating the price. It is a kind of pricing mechanism. If a product does not meet the market expectations and the quality concept can not support the high price, the chance of short selling will increase. Also, short selling mechanism is the self-purification of the trading market. It will expose the illegal issue and related operation of listed companies to a highly monitoring level of the trading market through various ways, which is of great significance for curbing illegal activities[3].

6. CONCLUSION

In the Luckin scandal, there is a big defect of the business model, a positioning risk, of the Luckin Coffee. Under the condition of imperfect internal control, this kind of risk will further turn into the risk of material

misstatement (RMM) and management risk. It is obvious that having a clear evidence of the financial fraud of the targeted corporation is a key point during the short-selling process. With a clear evidence, the possibility of profiting in short trades will increase hugely. Besides, the listed companies should be aware of the serious consequences of financial fraud, strengthen the enterprise internal control system, do a good job in information disclosure, detailed disclosure of merger and acquisition information, actively respond to the market test. It is essential for the listed company to remember that don't take any chances.

In addition, short selling can be not only a pricing mechanism but also a self-purification mechanism. Though it may sometimes be used by some malicious purposes and hurt or ruin the market severely, it still has its own significance for existence.

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