

The Path of Luckin Coffee's Performance Turnaround after the Fraud Scandal

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Abstract. The frequent occurrence of financial fraud incidents of public limited companies has disrupted the fairness of the capital market. As one of the offenders, Luckin managed to maintain its profitability despite the severe punishments from the authority. This research analyzes case of Luckin incident, in order to investigate the detailed turnaround strategies taken by Luckin to reverse its image to the public's eyes. The effectiveness of its strategies for other businesses stuck in financial frauds is discussed. A SWOT analysis is applied to identify Luckin's own advantages and limitations, as well as the surrounding opportunities and challenges confronted by Luckin for resurgence.

Keywords: Luckin Coffee; SWOT analysis; Financial fraud incident.

1. Introduction

1.1. Research Background

As key participants in the capital market, the accuracy and reliability of the financial reports of public limited companies are significant to investors, market order and overall economic development pace. The interests of investors and the fairness of the capital market have been significantly compromised as a result of frequent occurrence of financial frauds. Therefore, most companies found guilty to such frauds are expected to face severe punishment, for instance, being forced to cease the business.

1.2. Research Significance

Although financial fraud of Luckin Coffee has passed for 4 years, the uniqueness of this incident requires further study. Distinct from other enterprises, Luckin did not disappear after this incident. By contrast, it still frequently pops up in the public's sights, such as the endorsement of Olympic champion Eileen Gu in 2022 and Maotai-flavoured launched in 2023. What are the strategies that Luckin had employed to achieve such unusual recovery and whether they are useful for other companies with similar conditions? Secrets of Luckin Coffee's turnaround are worthy researching.

1.3. Research Objectives

This paper begins with an overview of the Luckin financial fraud case, including the reports published by Muddy Water Company revealing the illegal behaviors of Luckin, and the serious punishments for Luckin. The main focus of this study is the path of Luckin's performance turnaround after this incident. A business model of SWOT is applied, including study of the internal strength and weakness of Luckin, as well as external opportunity and potential threats for its resurgence path.

2. Overview of the Financial Fraud Scandal and Consequences of Luckin

2.1. Development History of Luckin

Coffee is not native to China. It did not appear in China until the late 19th century when a French missionary visited Yunnan province [1]. However, according to the International Coffee Organization, Chinese government supported coffee production and industry by regenerating the sector in association with the World Bank and the United Nations Development Programme in 1988 [2].

The growing enthusiasm of Chinese dwellers about coffee drives the emergence of coffee retailers in recent years, such as Starbucks and COSTA. Founded in October 2017, Luckin distinguished itself by successfully obtaining multiple rounds of financing within a year and then becoming a well-known coffee-retailing brand in China. Succeeding in opening 2,064 stores in just 20 months, it set a new record for a Chinese company to go public in such a short period [3]. After approximately one year of establishment, Luckin was listed on the National Association of Securities Dealers Automated Quotations, NASDAQ, with a financing scale of 695 million dollars in 2019 [4]. By the end of 2019, the number of stores of Luckin in China had reached 4507, therefore, it became the largest coffee chain brand in China by surpassing other established brands, for instance, Starbucks [5].

2.2. Financial Fraud Incident

Muddy Water, a US investment company, known for successfully targeting companies with poor internal controls, released a short report, which included 5 pieces of smoking gun evidence of data fraud, 6 red flags and 5 business model flaws, exposing a financial fraud incident to the public on January 31, 2020. [6]. 11,260 hours of traffic video and over 25,000 receipts, supported Muddy Water to announce that the financial and daily information of Luckin Coffee had been significantly exaggerated. By artificially manipulating the pick-up code, Luckin had overstated its sales revenue at least 69% per store per day in Q3 2019 and 88% in Q4 2019. Besides, Luckin had falsified the proportion of other goods, like mugs and desserts, to mask the fact of single store losses [7]. Simultaneously, in order to align with its revenue, Luckin exaggerated its advertising costs, rather than fictitious raise of fixed assets, as the purchasing of assets could be detected by auditors. According to the report, there is a false increase in advertising expenses of more than 460 million yuan [8].

2.3. Consequences of Financial Fraud Incident

When faced with these allegations, Luckin denied its financial misconduct. Surprisingly, Luckin Coffee actively admitted its illegal behaviour on April 2, 2020. The impact of financial fraud on the its share price on stock market was quite immediate and devastating. Luckin coffee stock price fell dramatically and triggered the circuit breaker mechanism [9]. After its admission, the closing price fell by more than 75%. On May 15, 2020, Luckin Coffee was informed to be delisted from the U.S. Securities and Exchange Commission. Consequently, Luckin Coffee announced its delisting in NASDAQ on June 29, 2020 [6]. In September 2020, the State Administration for Market Regulation imposed an administrative penalty on Luckin Coffee (China) Co., Ltd, fining the company 2 million yuan for its illegal behaviors [10].

3. Analysis of Luckin's Performance Turnaround after the Fraud Incident

3.1. Performance Representing Resurgence

Even though it experienced the financial fraud scandal, Luckin Coffee is still an indispensable part of daily lives of youngsters in recent years. "China City Chain Coffee Consumption Report 2021" indicated among consumers aged 18-24 in domestic new first-tier and second-tier cities, Luckin's market share had exceeded 25%. Simultaneously, Luckin has reached 16% in the proportion of students in these regions [11].

The operating profit margin of Luckin Coffee had continued to rise from -25.87% in 2020 to 12.10% in 2023, according to its published financial statements, as Figure 1 shows. Additionally, in the first quarter of 2024, the revenue of self-operated stores was 4.58 billion yuan, an increase of 45.8% compared to 3.14 billion yuan in the same period of 2023. The profit and profit margin of the self-operated stores were 321 million yuan and 7.0%. respectively. The revenue of the affiliated stores was 1.508 billion yuan, an increase of 32.8% compared to 1.135 billion yuan in 2023 [12].

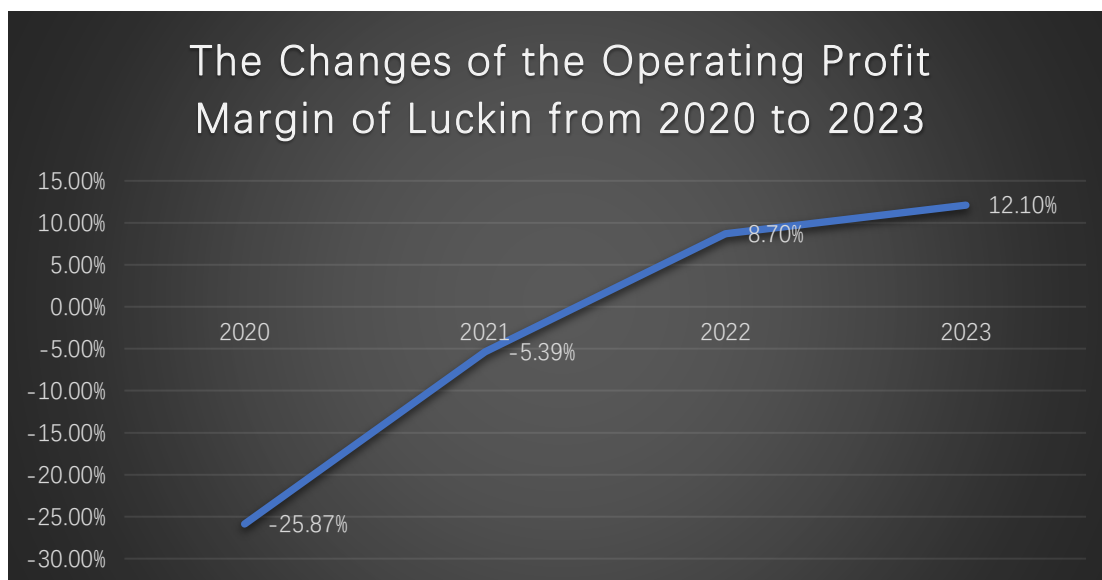


Figure 1. the operating profit margin for Luckin from 2020 to 2023

3.2. The Ways of Turnarounds

In order to make clear how Luckin has turned around, one needs to understand its own strengths and weaknesses, the opportunities and threats around the company, and how the company has made full use of its strengths to seize external opportunities

3.2.1. Targeting at psychological thoughts of customers

Luckin launched coffees at rational and affordable prices, offering various benefits during economic recession caused by Covid-19.

The external economic conditions facilitate the preferential policies of Luckin. Covid-19 is one of the most serious humanitarian crises in recent years due to its serious symptoms and high death rates. The number of foreign enterprises that withdrew was more than double the number established in the same period. The number of newly established foreign-invested enterprises was approximately 39,000 in 2020, while a total of 102,000 foreign-invested enterprises exited China in the same period. The withdrawal of foreign companies and closure of domestic enterprises contributed to social unemployment problem, thus increasing the financial burdens of residents. Urban unemployment rate continued to rise from below 5% to 6.2%. China's surveyed urban unemployment rate remained around 5.5% by the end of 2022 [13]. As a result, individuals tend to think twice before spending every penny due to the dramatically reduced salaries and increased unemployment rates. To address the issue of people being reluctant to spend lavishly on food and drink, Luckin placed WeChat QR codes in various locations, such as offline stores and online Wechat official accounts, attracting residents to scan by providing numerous coupons. For instance, new users who download its App for the first time are able to enjoy their first cup of coffee for free, therefore, the first wave of consumers is quickly acquired consequently because customers enjoy discounts while taking pleasure in a nice cup of coffee [14].

Meanwhile, "9.9-yuan coffee policy" launched enables Luckin to maintain a high level of customer loyalty. Luckin not only quickly established a huge private domain traffic group, but also receives popularity among Chinese citizens. According to Luckin's financial statements, monthly customers in the fourth quarter were 62.4 million on average in the fourth quarter of 2023, which was an increase of 154.2% compared with the figure for the same period in 2022 [15].

3.2.2. Precise marketing positioning

Targeting at growing lower-tier cities and towns in China is one of the resurgence plans of Luckin. The coffee market in high-tier cities is nearly saturated, but instead still has great growth potential in the lower-tier regions. The desire for coffee with high quality among residents in lower-tier cities and

towns is growing evident, supporting Luckin Coffee started to expand into the third and fourth tiers [16]. Therefore, Luckin concentrated on expanding in underdeveloped regions and adopted a popular franchise model. In order to attract franchisees, Luckin announced a plan, called "zero franchise fee, stepped profit-sharing" in January 2021 [17]. This means that Luckin's franchisees are only required to pay for refurbishments, equipment and deposits, excluding franchise fees and thus reducing their financial burdens. Compared with other brands whose franchise fees are hundreds of thousands of dollars, acceptable franchise threshold provided allowed Luckin to expanded dramatically in under-privileged areas.

3.3.3. Proper application of technology

After "death sentence" from NASDAQ being delisted, Luckin Coffee aimed to automate the operation through application of technology. Luckin promoted the repurchase rate by ensuring the activity level of the community. Once a customer joins the WeChat group, Luckin Coffee automatically sends a welcome message with coupons, making the customers feel valued and respected by Luckin.

In addition, personalized operation also helped revive Luckin. Based on historic consumption recordings, big data assists Luckin accurately to judge individuals' tastes. Therefore, Luckin will be able to develop new coffee products that satisfy most people's appetites according to the previous sales of each coffee drink. Besides developing new products, customers can be recommended coffee coupons or similar new coffees that meet their existing personal preferences via Luckin's wonderful application of technology [18]. For instance, if 7 out of the past ten orders were Coconut Milk Latte, then the customer will receive a coupon for Coconut Milk Latte instead of an Americano. Consequently, Luckin maintained a high level of customer loyalty as customers are allowed to enjoy their favourite coffee with low prices.

Moreover, Luckin is keen on advertising its brand on popular social media, including Weibo and Tiktok. Luckin always posts information related to the introduction of its brand and new products developed on Tiktok. Luckin had 2,555,000 Tiktok fans, and accumulated 6,237,000 products were sold during its broadcast room by January 2023 [19]. This indicates Luckin has received a large number of profits via social media, thus promoting its resurgence.

3.3.4. Frequent co-brands

Luckin collaborated with popular celebrities and other well-known businesses in order to advertise its brand in a larger scale.

The "Star Effect" is a popular marketing strategy applied by different companies across the world. Invitation of household celebrities for endorsement allows Luckin to recover its brand image quickly. Star chasers, particularly those youngsters, always pursue spiritual quality related to their idols, thus recognizing Luckin Coffee's brand subconsciously. Through this strategy, Luckin Coffee formed its "Fans circle culture" and "social group", which refer to the organized networks of fans passionate about promoting and supporting their favourite sport or entertainment idols [17]. Therefore, it seems rational that Luckin achieved resurgence after "death sentence" by capturing hearts of fans. During the 2022 Beijing Winter Olympics, Luckin Coffee invited Eileen Gu to be the spokesperson. Residents were familiar with Eileen Gu, who was the first freestyle skier to win three medals at a single Olympics. Luckin not only launched Gu Ailing cup sleeves, straw standees, and human-shaped standees in its physical stores [19], but also delivered congratulatory posters online and offline as soon as she achieved the championship, demonstrating the brand's rapid response ability, which is worthy learning for other companies.

Another collaboration of Luckin is the Maotai-flavoured jointly launched with Kweichow Moutai Company, a company specializing in production and sales of liquor, on 4 September, 2023, created a craze on platforms nationally [20]. The red slogan with description "Love this cup of wine and coffee" not only attracts a large number of consumers, but also preserves the traditional characteristics of both co-branding brands. On September 5, Luckin announced that the first-day sales of the "Maotai-flavoured Latte" exceeded 100 million yuan [20]. On March 21, 2024, Luckin Coffee announced that

Maotai-flavoured Latte product had more than 25 million customers. Luckin exploits the nature of curiosity of customers properly in terms of trying something new or unknown [21]. Therefore, the special combination of liquor and coffee received unprecedented success and allowed 2 companies to reap considerable profits.

To celebrate the third anniversary of its representative Coconut Milk Latte coffee, Luckin collaborated with the cartoon character of Pop Mart in the trendy toy industry. The rich themed peripherals, cold-changing cups, and THE MONSTERS figures effectively promoted citizens' purchasing desires, and further expanded the targeted audience group of the "Luckin Coconut Milk Birthday Season" [22].

3.3.5. Strong bargaining power, lower selling prices

Direct cooperation with coffee origins, self-owning supply chain and production factories, have reduced costs and maintained price competitiveness of Luckin, making it the preferred brand for consumers' daily coffee consumption.

In 2021, Luckin announced that it is going to purchase 1,000-2,000 tons of high-quality coffee beans in Ethiopia each year for the next few decades [23]. The origin of Luckin is clearly stated and is a well-known coffee bean-producing area. Therefore, customers tend to trust its brand as well as qualities. The bulk purchases of coffee beans will assist Luckin to bargain the purchasing price down with its suppliers.

Consequently, Luckin is given an opportunity to resurgence after the financial fraud incident, as it is able to charge lower prices to residents while maintaining profitability. Luckin Coffee has captured hearts of thousands of consumers by providing them with cost-effective freshly ground coffee products, which are particularly attractive for students and new entrants to the workplace. Concurrently, Luckin Coffee is continuously providing discounts to attract customers, thus allowing the middle-class to afford to consume their everyday coffee. In a study researched in 2018 by Jennifer Ferreira and Carlos Ferreira, the growth of income for Chinese middle-class people and the willingness to improve life quality were mentioned [24]. Compared with Starbucks, whose single items exceed 30 yuan, Luckin Coffee, which is within 20 yuan, is more price-competitive. Luckin can offer customers a better taste than instant coffee below 15 yuan. Therefore, Luckin Coffee enjoys a high customer loyalty [19].

3.3.6. Challenges confronted

Although Luckin has leveraged its strengths to seize external opportunities and reverse its business image, its turnaround has not been without challenge.

The popularity of bubble tea in China threatens the survival of coffee industry to some extent, as milk tea is a fantastic drinking substitute for Chinese residents. Simultaneously, layout advantages and strategies adopted by competitors, such as Starbucks and Cotti, are swaying customer loyalty of Luckin .

Chinese youth have growing enthusiasm for milk tea recently. By the end of 2019, milk tea has expanded its market quickly and dramatically in major cities, with an increase of 59% in first-tier cities and 120% in second-tier cities in terms of store numbers. The rise of 138% of third-tier cities indicates the great potential of the milk tea industry [25]. Ingredients, such as pearls and puddings in milk tea, have attracted customers attention. In the same article [25], it was found that 88% of milk tea customers were between 19-34 years old, indicating the enthusiasm of the youths. After purchasing milk tea, it is unlikely for customers to buy a cup of coffee again as their tastes and functions are similar. Coffee, as an alternative to milk tea, may be confronted with challenges of decreasing sales due the prevalence of bubble drinks.

The layout of physical stores is a weakness for Luckin compared with its competitors. If customers place an order during the peak period, for instance, in the morning, they are always forced to stand outside the store and wait as a result of a small construction area, which leads to poor customer experience. By contrast, the layout of Starbucks allows customers to be seated while waiting their

drinks. As a result, for Luckin, customer loyalty is difficult to maintain in the long term, which is detrimental to its brand reputation and profitability [26].

Starbucks and Cotti coffee are strong opponents for Luckin. The collaboration between Starbucks and a Chinese online delivery business, Eleme, puts Luckin under a great pressure. Customers can order meals made by companies cooperating with Eleme, so they are able to select their favourite drinks and order Starbucks online, weakening Luckin Coffee's advantage of online business to some extent [27]. Unlike Luckin, 9.9 yuan per cup of coffee is no longer the bottom line for Cotti coffee, which once again launched a price war in 2023. To illustrate, new users can receive six coupons surprisingly, including "1-yuan free drink coupon," "6.6-yuan free drink coupon," and "8.8-yuan free drink coupon". Similarly, Cotti adopted similar promotion strategy, such as inviting online influencers on social media, and posing videos of new products to advertise its brand in a large scale [28].

The coffee market is highly competitive. Not only established brands but also several independent coffee shops put Luckin under considerable pressure. Personal coffee shops are not chain operation, but growing rapidly in the recent years. The positioning of targeted groups for coffee in China is not explicit and young consumers are passionate about having their unique memories of coffee. Therefore, the profitability of Luckin is threatened [27].

4. Conclusion

4.1. Summary

Although Luckin was confronted with several challenges from its competitors, it has made great efforts for its resurgence. The failure in the capital market did not affect the daily operation of its business. Actions, such as psychological targeting, precise market positioning, application of technology, frequent co-brands and strong bargaining power have paved the way for its turnaround. The attention paid to reversing its brand image was significant in maintaining its profitability. Generally, Luckin's turnaround was successful, indicated by its financial performance in the recent years.

4.2. Limitations and Expectations

This thesis only discusses resurgence plan adopted by Luckin in China. Measures taken by Luckin in other nations to restore its image may be different but are not discussed in this study. Therefore, future researches may include the analysis of advertising and marketing strategies of Luckin in other nations. In the future, further studies will be done to provide more suggestions for companies stuck in running dilemma.

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