

Analysis and Research on Short-selling Industry Chain based on Luckin Coffee Incident from the Perspective of Information Disclosure

Huiyu Cong

Qingdao No. 2 Middle School, Qingdao, Shandong, 266061, China

ABSTRACT

With the shorting of Luckin Coffee by Muddy Waters in 2020, the sniping of Chinese stocks by short-sellers has once again aroused widespread social concern. This paper introduces the company background, analysis the whole process of the Luckin Coffee case based on a comprehensive industry chain from the perspective of investment banks, short-sellers, other investment institutions and law firms and gives relevant suggestions based on regulators, limited companies and investors. Three conclusions are drawn: the genuineness, accuracy, integrity and timeliness of information disclosure is the key aspects of short selling; enterprises should improve the quality of information disclosure to cope with the shorting industry chain; a suitable short-selling mechanism could be established to motivate enterprises to improve information disclosure. The significance of this paper is to explore the positive role of short-selling in an active way, in order to fulfill the stable development of China's capital market.

KEYWORDS

Information disclosure; Short-selling; Luckin Coffee

1. INTRODUCTION

With the promulgation and implementation of the new Securities Law, new regulations led by the registration system have taken root in China's capital market, and increasingly inclusive and diversified listing standards have provided enterprises with more opportunities for listing and financing, which improved the efficiency of market allocation of capital. Good information disclosure, as a vital approach to accurately understand the operating performance, financial status, and future development trend of listed companies, is highly valued in the new stage of China's economic development, further escorting the healthy and stable securities market.

However, there are still many problems with information disclosure that need to be solved. The number of listed companies in China is increasing gradually, but the quality of information disclosure is uneven, with issues such as delayed disclosure, misrepresentation, and inflated profits, etc. At the same time, Chinese stocks listed in the US have been shorted for more than 60 times ever since 2016, causing widespread concern over society. In many of these cases, company group that are identified and further locked in by the short-sellers due to information disclosure is not a minority.

This paper analyses the whole industry chain based on the case of Luckin Coffee and derives the different influences of various subjects in the process. Suggestions are given for improvement from the perspectives of regulators, enterprises and investors. The innovation of this paper is to bring about the idea that information disclosure system could be improved by appropriate short-selling [1], which could assist the development of China's capital market.

2. COMPANY BACKGROUND AND CASE INTRODUCTION

As one of China's largest newborn coffee brand, Luckin Coffee has been maintaining a rapid expansion trend since its first store opened in Galaxy Soho in October 2017. In 2018, Luckin Coffee successively launched trial operations in 13 cities, including Shanghai and Tianjin, and its headquarters officially settled in Xiamen. In 2019, Luckin Coffee continued to expand its business map with more than 4,500 stores, surpassing the twenty-year development of Starbucks and becoming the largest coffee chain brand in China. In the same year, it logged in to NASDAQ, with a total revenue that exceeded \$900 million after the initial public offering, 5.9 million new transaction users and \$695 million raising fund. Luckin Coffee then became the fastest company in the world to move from establishment to initial public offering, and its financing scale continued to grow to \$1.1 billion.

Luckin Coffee aspires to "create a world-class coffee brand and make Luckin a part of people's daily life". According to its public information disclosure, the company has three core business operation strategy: Firstly, it pulls closer to its customers through the digital business model. Compared with the traditional "face-to-face" sales, the mobile APP and WeChat mini programs ordering mode adopted by Luckin on a large scale smartly leverages the help of data to understand the different taste tendencies and consumer habits of abundant customers in a clear way, which facilitates targeted sales and enhances the production efficiency and customers' experience. Secondly, it focuses on quick pick-up stores to find the most targeted groups. Compared with self-owned Premium shops and takeaway kitchen shops, quick pick-up stores especially targets young consumers, and are set up mainly in commercial centers, office buildings, and other crowded places, enriching customer resources. For instance, during morning rush hours, "white-collar workers" can set orders and receive coupons through their mobile phones, and later "grab coffee and leave" directly near their companies. In this way, customers not only saves money, but also improves efficiency, so they just naturally become "repeat customers", which is also one of the reasons why Luckin had such a rapid expansion. Thirdly, it sends out various coupons and frequently co-branded to increase popularity. One of the highlights of Luckin Coffee is that it provides a variety of coupon collection channels, such as through UnionPay, bank systems and WeChat groups. The coupons, which are released many times a day, are also rich in categories, such as 55% off, double-cup 50% off, 62% off for the start of the working day, etc. And some of the discounts are very strong, like the famous 9.9 RMB hot-selling coffee coupons. Through this price-lowing operation, Luckin coffee is becoming a brand that a majority of people can afford, without dropping of quality. Luckin Coffee also frequently releases co-branding with a lot of well-known enterprises and images, often together with related products for free, such as the recent co-branding with Dream of Red Mansions, Kweichow Moutai, Maltese, etc. This procedure firmly locks the existing customers, especially the young, and continuously increases its own popularity at the same time.

On 31 January 2020, Muddy Waters Research, a well-known short-seller, claimed to have received an 89-page anonymous short-selling report which directly accused Luckin Coffee of financial fraud, especially for inflated revenues. The stock price of Luckin closed down 10.74% that day, with a maximum drop of 26.51%.

On 3 February, Luckin Coffee denied all the allegations.

On 4 February, CICC, one of the main underwriters of Luckin Coffee, argued that the allegations in the report were lack of valid evidence. On the same day, Haitong International, another underwriter, expressed a similar point of view. Combined with the previous disapproval of the report by Citron, another short-seller, the share price witnessed a slightly increase of 15.6%.

In March, the short-selling position of Luckin zoomed exponentially, with a huge number of put options traded.

On 2 April, a number of US law firms released a statement reminding investors that the class action lawsuit regarding Luckin Coffee was approaching the deadline. On the same day, Luckin officially

announced that a preliminary investigation by the Special Committee found that the total sales amount related to false trading from the second to the fourth quarter of 2019 was approximately 2.2 billion RMB. Share price plummeted 80% and trading was suspended several times during the session.

On 7 April, Luckin declared suspension of trading until the additional information requested by Nasdaq was fully satisfied.

On 19 April, Luckin was accused of omitting significant information and producing misleading statements, and was embroiled into at least four class-action lawsuits, facing considerable litigation payouts.

On 18 September, the State Administration for Market Regulation made an administrative penalty decision against Luckin, with a total penalty 61 million RMB.

On 22 December, Luckin agreed to pay a \$180 million fine and compromise with SEC.

3. ANALYSIS OF THE CAUSES AND RELATED SUGGESTIONS

From previous analysis, it can be concluded that information disclosure is a vital breakthrough point for short-sellers, which is also the root of the "avalanche" reaction of Luckin. According to the efficient market hypothesis [2], in a stock market with sound laws, good functioning, high transparency and full competition, all valuable information has been timely, accurately and fully reflected in the stock price. Combined with the information commodity theory [3], enterprises assist investors to make rational decisions by continuously disclosing relevant information, which in turn makes the share price more accurately reflected by their true value, and thus improves the efficiency of the market. However, the interests of the agent and the clients are not fully aligned, and in the case that clients are at an information disadvantage and not capable of supervising the agent, the agents, who are accessible to more information, have the incentive to act on behalf of its own interest and damage the interest of clients, which is known as the principal-agent problem. The information asymmetry between managers and investors, and between majority and minority shareholders, have led to some share prices being either "inflated" or undervalued, which restricts the development of the market. Therefore, the key to enhancing information disclosure is to reduce the degree of information asymmetry. At the same time, the act of one side of using its information advantage to satisfy its own interests will also trigger the vigilance of short-sellers and become the handle of being shorted. Thus, information disclosure is not only the source of short selling, but also one of the most effective means to deal with short selling.

In this case, if the management of Luckin had discovered the problem in time and disclosed it to the market right away, the short sellers would not have been able to make profits easily as they receive information at the same time as investors do, without apparent time difference. Meanwhile, given that the company has actively made relevant disclosures and responses to problems, law firms can't file class action lawsuits against it on the grounds of inaccurate or misleading statements. However, it is precisely due to the postponed disclosure, most investors do not understand the real situation, and that is how Muddy Waters took the opportunity to achieve "fishing in troubled waters" through a series of methods such as on-site evidence collection and inverse process of data. The full requirements of information disclosure are genuineness, accuracy, integrity and timeliness, the negligence in any of which would increase the risk of being shorted [4].

The USA capital market has formed a well-developed shorting system, which is generated by the collusion and cooperation of investment banks, investment institutions, law firms and short-sellers, and will eventually put the company involved in a passive situation. The following is a further analysis of the case from different perspectives, focusing on the short-selling and information disclosure.

3.1. Investment Bank

Investment banks play an auxiliary role in the process of Chinese companies going public overseas. For Chinese companies, due to the lack of the knowledge of overseas listing specifics in the early stages, they tend to look to experienced investment banks for help. Of course, during this process, investment banks will ask for high commissions from companies. And it is exactly because commissions are directly proportional to the amount of money raised by the listed companies, investment banks are likely to exaggerate key ratios such as P/E ratios in order to maximize their own returns. However, when a company is successfully listed and the investment bank is gradually stepping out, overly "perfect" statements and the lack of familiarity with the details of overseas disclosure systems will attract short-sellers' attention, carrying a foreshadowing for their next move.

Luckin did not fall into this trap, which may take credit to the long-term cooperation between its management and investors together with its experienced team.

3.2. Short-seller

Muddy Waters is the main short-seller in this case, which has rich experience in shorting Chinese concept stocks, such as Oriental Paper Company Limited, Sino-Forest-Corporation, Focus Media and China Huishan Dairy Holdings Company Limited, etc. The traditional profit model for short-sellers is very fixed: First, lock target through data analysis, often focusing on sudden changes in financial figures or frequent changes in management. Next, form a shorting report through online investigation, offline evidence collection or other means to obtain key internal information of the company. Then, establish short selling positions and publish the shorting report. Finally, wait for the stock price to fall and reap huge profits from closing position. In addition to this traditional route, the shorting techniques have been constantly updated with the increasing number of short-sellers in recent years,. For example, not only those short-sellers, corporate competitors, insiders with unequal distribution of benefits or other individuals with conflicts against the company, etc. can be exposed to the enterprise's internal scandals. The shorting report against Luckin actually did not come from Muddy Waters, but was submitted anonymously. Another way is that short-sellers can gang up to achieve a joint shorting of the business, doubling profits.

As can be seen in most shorting reports, short-sellers tend to question the genuineness and integrity of information disclosure. Muddy Waters' allegations on Luckin mainly focus on the genuineness of revenue and profit, which contains the following two points: First, inflate the number of transactions by jumping orders, overstating the daily transaction volume by 72% on average. Second, exaggerate the real unit price of goods through a large number of coupons. Muddy Waters claims that for every 100RMB of operating income, only 46% of which is real, less than half of the total. Other relevant news also indicate that Muddy Waters has been aware of Luckin's financial fraud before the release of the shorting report, but chose not to make it public immediately, so that the timeliness of the information is also a key factor that put Luckin in an extremely passive situation.

3.3. Other Investment Institutions

Instead of releasing the short report instantaneously, short-sellers could choose to sell it to their 'allies' -investment institutions, to establish short-selling positions and jointly increase returns afterward.

3.4. Law Firms

At the final position in the shorting industry chain, law firms often contact investors who have suffered losses due to shorting and help them appeal against the company involved. This often tends to be joint appeals, because law firms are under the lure of high returns. In this case, law firms including GPM, Gross, Faruqi and Pomerantz filed a joint lawsuit against Luckin.

Up to now, the main participants in the short-selling industry chain have been analyzed fully. Under the meticulous corporation of investment banks, short-sellers, other investment institutions and law firms, a series of shortselling process not only pushes the involved company into the ‘abyss’, but may also affect their accounting firms and insurance companies. Since short-sellers mainly focus on the genuineness, accuracy, integrity and timeliness of information disclosure, shorting can also be considered as a way to motivate companies to improve and standardize their information disclosure. However, it is certainly undeniable that shorting still causes enterprises and most investors to suffer huge losses.

Through the case of Luckin Coffee, we should learn a lesson to improve the development of China's capital market. The following are corresponding suggestions from three perspectives: regulators, listed companies, and investors.

3.5. Regulators

Firstly, view short-selling in a rational way. Given that short-sellers are profit-oriented and do not act out of ‘justice’, short-selling is actually a process of wealth transfer. We do not lack of examples of malicious shorting, such as the shorting of 360 Security Browser, New Oriental Education & Technology Group , China Evergrande Group and other Chinese stocks. Short selling is in fact a " rapier ", and we should prevent malicious short selling to protect the legal rights and interests of enterprises and investors while letting it play its role in monitoring at the same time.

Secondly, further promote the development of information disclosure in a more executive manner. From the previous analysis, we draw a conclusion that information disclosure is the clue that connects the whole case, so enterprises should pay special attention to genuineness, accuracy, integrity and timeliness parts of it. And the most important part is to let these four standards be implemented in practice, instead of just being a slogan.

Thirdly, supervision and penalty should be increased. Before short selling, laws should serve as a deterrent to enterprises. After short selling, government is expected to promote sterner punishment against involved companies and their associated accounting firms, using laws to strictly constrain enterprises and inhibiting the occurrence of such events from the source.

Fourthly, establish a long-term strengthening mechanism. Since the establishment of China's capital market started relatively late and the relevant system is still in a period of developing, it is not wise to just copy the corresponding mechanisms of short-selling from European countries or the United States directly. We should respect the objective laws of market development and build a short-selling mechanism that meets China's unique conditions step by step.

3.6. Listed Companies

Firstly, improve internal governance and information disclosure mechanisms. As the main body of short-selling cases, the behavior of listed companies is crucial. Listed companies should attach great significance to information disclosure, focusing on aspects such as revenues, profits, and fundraising. They are also expected to familiarize themselves with corresponding policies and regulations, in order to take preventive measures if needed.

Secondly, upgrade risk-warning system and establish a coping mechanism. As the number of shorted companies has been rising recently, listed companies should establish a coping mechanism to deal with shorting problems in advance. And most importantly, making an official response right after the release of the shorting report can assist to cut losses as much as possible.

3.7. Investors

It is important for investors to establish an investment philosophy that matches their own economic level. The proportion of retail investors in China's stock market is not small, so severe stock fluctuations caused by short-selling are likely to cause social problems. Individual investors are expected to fully understand the risk of investment, respect the market and invest in a rational way. However, it is of a greater importance to gradually reduce the number of retail investors and avoid direct confrontation between individuals and short-sellers.

4. CONCLUSIONS AND PROSPECT

4.1. Conclusions of the Study

After analyzing the whole process and industry chain of Muddy Waters' shorting of Luckin Coffee, following conclusions are drawn: Information disclosure is often the key breakthrough point of shorting, the genuineness, accuracy, integrity and timeliness of which are the aspects that enterprises should pay attention to; A developed shorting chain exists in the overseas capital market, which can carry out a joint strangulation of companies involved, and enterprises should improve the quality of their information disclosure in order to cope with the risk of overseas listing; Under the background of the continuous development of China's capital market, a suitable short-selling mechanism could be established to motivate enterprises to improve information disclosure, while regulators and investors should also make self-improvement.

4.2. Research Prospects

The short-selling mechanism in China's capital market is still immature and carries certain risks. However, in face of the complex and volatile global capital market environment, avoiding short-selling cannot solve the problem. The only way is to confront the challenges and risks, and explore the positive role of short-selling in an active way, in order to fulfill the stable development of China's capital market.

REFERENCES

- [1] Qin, Z. M., Yu, P. F. (2021). Research on Financial Fraud Suppression of Luckin Coffee Based on Short Selling Mechanism. *Accounting and Control Review*, 02: 224-245
- [2] Fama, E. F. (1965) The Behaviour of Stock-Market Prices. *The Journal of Business*, 1: 34-105.
- [3] Jensen M. C., Meckling W. H. (1976) Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure. *Journal of Financial Economics*, 4:305-360.
- [4] Han, H. L., Liu, S. Y., Lu, W. C. (2020). Short selling Industry Chain Analysis Based on Luckin Event - From the Perspective of Information Disclosure. *Finance and Accounting Monthly*, 08: 3-8