CERCIUS

Insights

The bitter taste of coffee: the case of Luckin Coffee as a case for Chinese start-ups

On April 2, shares of Luckin Coffee 瑞幸咖啡 dropped as much as 81% after the NASDAQ-listed company disclosed that an internal investigation uncovered fabricated sales transactions totaling USD 310 million during the second quarter of 2019. The fraud was reportedly perpetrated by the company's COO, who has had his duties suspended as of December 31, 2019, and an unspecified number of other employees. A day later on April 3, the China Securities Regulatory Commission 中国证券监督管理委员会, the Middle Kingdom's equivalent of the US Securities and Exchange Commission, announced that it had launched a probe into the alleged fraud at Luckin Coffee.

Founded in 2017 as a homegrown attempt to challenge the dominance of Starbucks in the People's Republic, Luckin Coffee has been dubbed by some as the US coffee chain's "rival". So promising was its reputation that Luckin Coffee was able to draw in investments from big players in the finance industry, such as BlackRock and Singaporean sovereign wealth fund GIC. And to top it all off, Luckin Coffee went public on NASDAQ in May 2019, raising USD 561 million in its initial public offering – ultimately closing its first public trading day 20% higher.

Luckin Coffee's corporate strategy was simple: attrition. It would use venture capital funds – and later, funds raised from its initial public offering – to expand rapidly across Mainland China[1] and offer discounts on its food and beverages to undercut Starbucks and consolidate market share. Unfortunately, for Luckin Coffee, its plan was dead in the water from the get-go.

For one, Luckin Coffee resembled much more of a technology start-up than an actual coffee chain. Luckin Coffee rarely had any actual sit-down cafés, and customers were forced to download their mobile application to order any items from the menu. Usually, the order would be prepared at a physical "store" then delivered to the customer via one of China's numerous delivery services (e.g. Eleme 饿了么), or the order would be picked up by the customer at a specified physical location. Even if one found a "store", he or she would be unable to order in person and must use the Luckin Coffee application. What is even more frustrating is that this coffee chain did not accept cash. Sure, given the prevalence of mobile payment platforms in China, it is fair that the preferred option would be Alipay 支付宝 or Wechat Pay 微信支付. However, it is bizarre that a business would refuse a paying customer.

Secondly, Luckin Coffee's adamant pursuit of conquering market share from Starbucks meant that its price war against the latter resulted in tremendous discounts for the consumer. In effect, Luckin Coffee was making a loss on nearly every item it sold. Granted, this was not a boutique café, so the quality of the actual coffee is irrelevant. That said, if one needed a quick caffeine fix, Luckin Coffee has you covered at a fraction of the cost of a Starbucks coffee. Yet, this approach did not bother Luckin Coffee – after all, it was playing with "someone else's" money. And what is even more odd is that the investors did not seem to care that Luckin Coffee was running massive losses quarter after quarter. This is another reason why Luckin Coffee resembled more of a technology start-up than an actual coffee chain – Luckin Coffee was able to convince investors that it would eventually turn a profit and that all the losses should be viewed as "investments". This is essentially the tale of Uber, Lyft, and WeWork. So heavy were its losses that in April 2019, Luckin Coffee pledged its coffee machines as collateral to secure new funding.

Finally, as we mentioned above, the lack of sit-down cafés substantially lowered the appeal and "prestige" of Luckin Coffee versus its US "rival". Coffee in China has always been about the experience of visiting a café, and while sentiments may be slowly changing, the quality of the coffee rarely mattered. On this front, Starbucks was able to win the "heart and mind" of the Chinese consumer by providing the latter with a full café experience, something that Luckin Coffee did not seem to consider

[1] By the end of 2018, which is just a year after its establishment, Luckin Coffee had already expanded to nearly 2 000 stores across the country.

a priority. Furthermore, when we look at Luckin Coffee's long-term plans for automation – the technology start-up image pops up again. Luckin Coffee has been investing heavily in smart robotics in order to automate – to a large extent – its delivery, food and beverage preparation, as well as its ordering and service systems. It is unclear

In any event, Luckin Coffee's corporate strategy of winning market share from Starbucks is a failure – and this recent sales fraud investigation is further proof that Luckin Coffee cannot be seriously deemed as Starbucks' rival. Since Luckin Coffee's establishment and subsequent aggressive national expansion, we have not seen Starbucks' market share take a hit. Starbucks is simply too established in the Chinese market, and barring major reputational issues, the average consumer is going to choose the Starbucks "experience" over Luckin Coffee. It is also puzzling as to why Luckin Coffee attempted to take on Starbucks in such a fashion, especially considering that other coffee chains across China, such as Pacific Coffee and Costa, which have been around for quite some time now cannot even hold a candle to Starbucks.

Unfortunately, the Luckin Coffee story is emblematic of the wider start-up sector in China and of the global venture capital/private equity industry. There is simply way too much undeployed funds from venture capital and private equity firms, which means that such firms are willing jump on board any start-up that may offer even a small return on investment. These global firms and their respective capital have recently found their way into the People's Republic – in the second quarter of 2018, China surpassed North America in attracting global venture capital funding. Yet, the presence of a large amount of venture capital ready to be deployed does not guarantee that there will be any "good" start-up firms to invest in, especially in the People's Republic, where innovation often takes a backseat to making quick money.

In fact, the Chinese technology and start-up sector is quite adept at taking already-tested concepts in North America or Europe, and retrofitting it to be compatible with the Chinese market. More often than not, when the concept provides a service that is absent in the Chinese market, the start-up can easily scale-up the concept and make a decent return. We need to look no further than Uber and Didi Chuxing 滴滴出行, the latter being a near replica of the former. However, we run into major problems when venture capital begins flowing into non-sensical start-ups.

To keen observers of the Chinese market and of the country's wider socio-economic environment, Luckin Coffee's plan seemed fantastical. Similarly, we can recall the bike-sharing 共享单车 bubble. It more or less started with ofo, a Beijing-headquartered bike-sharing firm founded in 2014. For those unfamiliar with bike-sharing, these "start-ups" allow customers to rent bikes, which can usually be found across a city, via the firm's own mobile application – hence why they can be considered "technology" start-ups. While each firm differed slightly, the general concept was that a user would pay initial subscription fee – usually very cheap – or put up a deposit before he or she can unlock and ride a bike. Some firms will then charge based on the time spent on the bike, or the fee would be calculated based on distance traveled. In any case, the overall cost of riding one of these bikes was minimal, which suited big Chinese cities like Beijing where one would usually have to travel large distances across the city.

The problem began when a large number of similar start-ups began copying ofo. And as you can imagine, the supply of bikes began to outstrip demand, which meant that these firms began engaging in a price war. To be fair, ofo was simply too aggressive in its expansion – not content with simply expanding across the People's Republic, the bike sharing company soon launched an international division. By 2017, ofo had 10 million bikes deployed in 250 cities across 20 countries. At this point, the company was valued at a ludicrous USD 2 billion. The beginning of ofo's end began in 2018 when it failed to merge with its largest competitor – Mobike – and subsequently failed to get acquired by Didi Chuxing. From then on, ofo began exiting overseas jurisdictions. Unsurprisingly, its overly aggressive expansion resulted in major liquidity issues for the company.

The worst came in October 2018, when customers began demanding refunds on their deposits en masse, which effectively created a "bank run" on ofo. By January 2019, ofo had dissolved its international division and gave the latter's 50 employees the option of either quitting or taking a 50% pay cut to join the company's Mainland business. Now, when one visits Beijing, ofo bikes can still be seen strewn across the city, usually piled up near bus and subway stations.

This "flash in the pan" type of start-up is far too common in China, and the abundance of global venture capital only fuels the problem. And yet, as we previously mentioned, those who understand the

Chinese market and the wider socio-economic environment in China would have saw ofo's inevitable crash the moment it became overly ambitious with regards to corporate expansion. To be fair, ofo was indeed quite useful for Beijing residents when it first launched, but the company's dreams of becoming a globally recognized brand was simply that – a dream. Bike-sharing, and in this case – ofo, thrived in Beijing, and other major Mainland Chinese cities because of limitations on automobile permits and the fact that traffic is wildly congested, but these conditions are not universal. And the fact of reality is that there demand for bike-sharing services in China – let alone the world – has a hard ceiling, and ofo's success which led to the spawning of multiple copycat firms, along with multiple strategic errors, ultimately resulted in its own demise.

Subscribe for more more articles