

Research on Financial Strategy Evaluation of Luckin Coffee based on Financial Strategy Matrix

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Abstract

Financial strategy is not only the pillar of the overall business strategy of the enterprise, but also an indispensable part of the overall business strategy of the enterprise. Therefore, if enterprises want to achieve efficient and sustainable development, they should formulate appropriate financial strategies based on their own actual conditions. With the help of the financial strategy matrix model, this paper analyzes the value status and cash status of Luckin Coffee from 2019 to 2022, evaluates the implementation effect of its financial strategy and puts forward practical suggestions to maintain the good development of the enterprise.

Keywords

Financial Strategy; Financial Strategy Matrix; Luckin Coffee; Cash Shortages.

1. Introduction

Luckin Coffee, which once made the Chinese people proud, fell into the vortex of bankruptcy and liquidation after being exposed to financial fraud, and just when people thought that Luckin had become a thing of the past, it was reborn and gradually came out of the shadow of fraud. Even now Luckin Coffee is stronger than ever, with one of the largest coffee chains in China and the fastest growing coffee brand in China. Based on that, this study applies the financial strategy matrix to Luckin Coffee, calculates the corresponding financial indicators of the company, analyzes its value creation ability and sustainable development ability, so as to study the company's development status and provide reference for the formulation of corporate strategy in China.

2. Luckin Coffee Company Profile

Luckin Coffee is headquartered in Xiamen and was officially founded by Qian Zhiya on October 31, 2017. On May 17, 2019, Luckin Coffee, which has been established for 18 months, has 2,370 stores and 16.8 million customers, entered the market with more than 100 million cups sold, and quickly successfully listed on NASDAQ in the United States, setting a record for the fastest. But the good times did not last long, and in the process of catching up with the industry giant Starbucks, he did not hesitate to commit financial fraud. Finally, it was exposed by muddy waters on January 31, 2020[5], and bankruptcy liquidation seemed to have become an inevitable result.

However, after three years since the storm of false accounts in 2020, Luckin has slowly broken out of the darkest moment of financial fraud and regained the public's attention. Luckin Coffee specializes in coffee drinks and offers light meals such as sandwiches and pastries. It adopts "Internet + big data retailer" for C-end users, and most of the stores are mainly fast pick stores. Now, Luckin has not only not been "killed" by this storm, but has grown up healthier. This is a typical heroic nirvana story, and when the hero returns, no one is not curious about what exactly it has gone through.

3. Construction and Analysis of Luckin Coffee's Financial Strategy Matrix

(1) Principles of financial strategy matrix

The Financial Strategy Matrix is a tool used to comprehensively analyze the degree of value growth of enterprises, which emphasizes value creation rather than simple earnings growth. Gabriel Havavini and Claude Vieri linked value status (Return On Invested Capital - Weighted Average Cost of Capital) and cash status (Sales Growth Rate - Sustainable Growth Rate) in a matrix called the financial strategy matrix, which is a commonly used analytical tool for formulating and evaluating strategies[1].As shown in Figure 1:

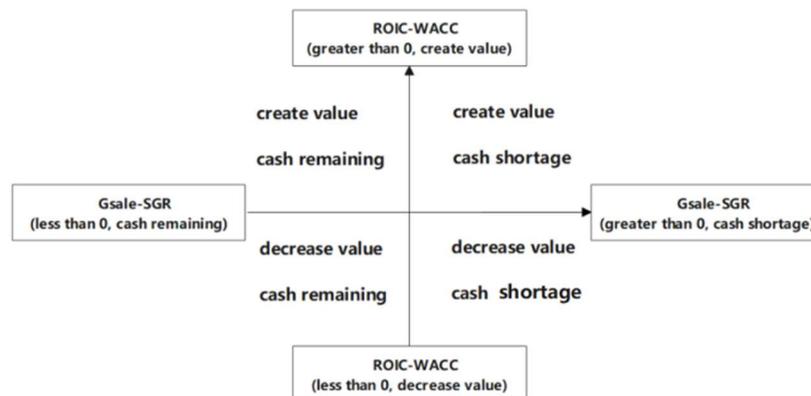


Figure 1. Financial strategy matrix

(2) Luckin Coffee's funding status - horizontal axis

This paper determines Luckin Coffee's funding status by calculating whether the difference between the sales growth rate and the sustainable growth rate (Gsale-SGR) is greater than 0. The specific step is to find the relevant data from Luckin Coffee's annual report, and then calculate the difference between the sales growth rate and the sustainable growth rate and their differences, so as to judge the financial status of Luckin Coffee.

As can be seen from Table 1, the sales growth rate in 2019 is much higher than in other years, exceeding 2, more than doubling year-on-year. This is related to Luckin's successful listing on NASDAQ in 2019, attracting a large amount of capital to enter, expanding stores in a large area, and entering the consumer's field of vision with high cost performance. The sales growth rate in 2020 has fallen sharply compared to 2019, but the overall situation is also considerable. This is inseparable from the full-scale outbreak of the new crown epidemic and Luckin Coffee's financial fraud scandal. After the financial fraud turmoil, Luckin Coffee actively reorganized, adjusted strategic measures, and slowed down the growth rate of self-operated stores. In 2021, the business situation has rebounded, and the revenue growth rate is rapid, far exceeding that of other offline catering brands. Although the sales growth rate in 2022 is not as strong as in 2021, the overall situation is very impressive and has achieved very good results.

Table 1. Luckin's sales growth rate from 2019 to 2022

project	In 2019	In 2020	In 2021	In 2022
Operating income (1,000 yuan)	3,024,934.00	4,033,418.00	7,965,323.00	1,329,2982.00
Sales growth rate (%)	259.81	33.34	97.48	66.89

Source: Calculated based on Luckin Coffee's annual report.

Table 2 shows that the sustainable growth rate in 2019 and 2020 fell below 0 or even achieved negative growth. The main reason is that Luckin Coffee has been in a loss state from 2019 to 2020, and although the operating income is considerable, the cost of raw materials and store leasing remains high. In addition, it fell into the financial fraud storm and faced huge fines, which made the net operating profit margin in the past two years negative. In 2021, the operating conditions returned to the right track, the operating net profit margin returned to positive for the first time, and the sustainable growth rate exceeded twice the sustainable growth rate in 2022, which was reflected in the continuous narrowing of losses and the reduction of average customer acquisition costs. This largely depends on the strategic focus transformation of Luckin Coffee after the new management takes over, that is, the transformation of product positioning, store opening strategy, marketing methods, etc. In 2022, compared with 2021, the operating income increased, but the operating net profit margin decreased, which is related to the successful fulfillment of the settlement fee of 180 million yuan in 2022.

Table 2. Luckin's sustainable growth rate from 2019 to 2022

project	In 2019	In 2020	In 2021	In 2022
Net operating margin(%)	-104.48	-138.91	7.26	3.67
Total Asset Turnover(%)	45.67	42.27	73.63	116.64
Equity multiplier	1.90	3.42	3.39	2.08
Profit Retention Rate (%)	114.44	100	100	100
quadruple product	-1.04	-2.01	0.18	0.09
1-quadruple product	2.04	3.01	0.82	0.91
Sustainable growth rate (%)	-50.90	-66.76	22.06	9.76

Source: Calculated based on Luckin Coffee's annual report.

Calculation formula:

$$\text{quadruple product} = \text{net operating margin} * \text{total asset turnover} * \text{equity multiplier} * \text{profit retention rate}$$

$$\text{Sustainable growth rate} = \text{quadruple product} / (1 - \text{quadruple product})$$

According to Table 3, the difference between Luckin Coffee's sales growth rate and sustainable growth rate in 2019-2022 is positive, indicating that it has been in a state of cash shortage. In 2019, Luckin Coffee's cash shortage is the most serious, mainly for two reasons: First, the operating costs remain high, Luckin Coffee has expanded its stores in a large area, and although the location is not a high-priced prime location, but the operating costs such as store rent and employee salaries cannot be ignored. Second, the marketing expenses were too large, and Luckin Coffee seized the market by implementing "money-burning" subsidies and large-scale advertising, resulting in a serious shortage of funds. The cash shortage in 2020 is still serious, mainly because it fell into a financial fraud storm in 2020, and although its operating income increased, it was undergoing debt restructuring that year and needed to pay a lot of compensation. From 2021 to 2022, the cash shortage has eased, and the difference between sales growth and sustainable growth has decreased year by year. This was mainly due to the reorganization of Luckin Coffee, the new management refocused its strategy and achieved a

significant increase in operating income. First, slow down the growth rate of self-operated stores and expand franchised stores to achieve cost reduction and efficiency increase; Second, reduce the range of "money-burning" subsidies and use the "horse racing mechanism" to launch explosive products; Third, the marketing model has changed from the previous fission marketing to the retention of refined community operations to enhance consumer loyalty. But overall, the capital status of enterprises is still not optimistic.

Table 3. Luckin's funding status from 2019 to 2022

project	In 2019	In 2020	In 2021	In 2022
Sales growth rate (%)	259.81	33.34	97.48	66.89
Sustainable growth rate (%)	-50.90	-66.71	22.06	9.04
Gsale-SGR(%)	310.71	100.05	75.42	57.85
Cash Status	Cash Shortage	Cash Shortage	Cash Shortage	Cash Shortage

Source: Calculated based on Luckin Coffee's annual report.

(3) Luckin Coffee value status - vertical axis

In this paper, the value status of Luckin Coffee is judged by calculating whether the difference between the return on invested capital and the weighted average cost of capital is greater than 0. The difference is greater than 0, indicating that the company's business creates value; If the difference is less than 0, the value of the company has been impaired. Table 4 shows that the difference between the return on invested capital and the weighted average cost of capital ratio from 2019 to 2022 is large, but it shows a downward trend year by year. The company has been in a state of value impairment from 2019 to 2021, and the company's value creation in 2019-2021 is not optimistic, mainly because the company has been in a loss state in the past three years, while the capital invested in store expansion, advertising and marketing has increased year by year. In 2022, Luckin Coffee was in a state of value creation, and the new management implemented the strategic focus transformation that year, and the profitability of Luckin Coffee increased and increased year by year, indicating that Luckin Coffee's existing business strategy and financial strategy are the right choice. In 2022, the return on invested capital returned to positive for the first time, which indicates that the company is in an upward stage or reflects the company's strong management ability[4].

Table 4. Luckin's value status from 2019 to 2022

project	In 2019	In 2020	In 2021	In 2022
ROIC(%)	-141.03	-58.20	-3.54	8.90
WACC(%)	7.93	7.24	6.93	-1.09
ROIC-WACC(%)	-148.96	-65.44	-10.47	9.99
Value Status	Decrease Value	Decrease Value	Decrease Value	Decrease Value

Source: Calculated based on Luckin Coffee's annual report.

(4) Construction and analysis of financial strategy matrix

By analyzing the relevant financial indicators calculated above, Luckin Coffee's financial strategy matrix for 2019-2022 was constructed. The specific analysis is shown in Table 5:

Table 5. Luckin Coffee's 2019-2022 financial strategy matrix

Project	In 2019	In 2020	In 2021	In 2022
Gsale-SGR (%)	310.71	100.05	75.42	57.85
ROIC-WACC (%)	-148.96	-65.44	-10.47	9.99
Financial strategy matrix quadrant	Quadrant IV	Quadrant IV	Quadrant IV	Quadrant I

Source: Calculated based on Luckin Coffee's annual report.

As can be seen from Table 5, Luckin Coffee is in a detracted cash shortage in 2019-2021 and a value-added cash shortage in 2022.

From 2019 to 2021, Luckin Coffee's abscissa value is greater than 0 and ordinate value is less than 0, which is in the fourth quadrant of the financial strategy matrix. This shows that Luckin Coffee's business can not only bring the added value of the enterprise, but also due to its low sustainable growth rate, that is, the company itself can provide less funds, can not reach the funds needed for its own development, resulting in a shortage of funds[3].

In 2022, Luckin Coffee has a abscissa value greater than 0 and an ordinate value greater than 0, which is in the I. quadrant of the financial strategy matrix. This shows that on the one hand, Luckin Coffee's business can bring enterprise value appreciation and good development prospects, but on the other hand, the cash flow generated by it is not enough to support business growth, and it will encounter cash shortage problems[2]. This tends to be typical of growing businesses, and the faster the business grows, the worse the cash shortage.

The 2019-2021 period and 2022 are located in different quadrants of the financial strategy matrix, and in addition to the impact of the new crown epidemic, they are largely inseparable from Luckin Coffee's "exchange blood restructuring" and "strategic focus transformation". In general, Luckin Coffee has a large funding gap, which will have a big impact on its value creation ability, and needs to pay attention to the funding issue.

4. Luckin Coffee's Financial Strategic Choice

Since Luckin Luckin has been caught in the aftermath of the financial fraud turmoil until the beginning of 2022, the financial fraud incident ended with a fine of 1.18 billion. Luckin Coffee's shareholding structure and management level have been comprehensively "changed", and the strategic focus is also very different. Therefore, this article makes reasonable analysis and suggestions for the financial strategy selection of Luckin Coffee in view of the cash shortage and value creation of Luckin Coffee in 2022.

(1) Funding aspects

Luckin Coffee is in the growth period of the enterprise, full of momentum and good development prospects. For a company in the growth stage, the cash flow of the enterprise will not be very good. Because the company is trying every possible way to grow rapidly, it has been in a state of lack of money and the asset-liability ratio at this stage is also very high. From the above financial strategy matrix constructed from 2019 to 2022, it is known that Luckin Coffee has been in a state of cash shortage, which is a long-term high-speed growth capital problem. Such funding problems can generally be solved by increasing the proportion of borrowing, increasing the share capital, and merging mature enterprises. The asset-liability ratio of healthy companies is usually 40%-60%, and the current ratio is usually between 1-3. According to the financial report data, the asset-liability ratio of Luckin Coffee in 2022 is 51.82%, and the current ratio is 2.13, which meets the level of healthy enterprises and has a good financing strategy. On

this basis, the borrowing ratio can be further increased to maintain around 60%, while broadening investment channels and further optimizing the capital structure. When the sales growth rate declines, the company will have excess cash to return the loan.

(2) Investment aspects

According to Luckin's four quarterly reports in 2022, the company has a large investment demand, which is mainly reflected in the continuous emphasis on R&D investment and the establishment of supply chain strategic cooperation. In terms of research and development, Luckin Coffee adopts the "horse racing mechanism" to carry out product innovation and research and development, and implements the "new fighting" strategy, that is, constantly launching new products, and pushing an average of 12 new products to promote products. In addition, Luckin also pays special attention to strengthening the development of unmanned retail technology and the resource investment of coffee professionals to lay a good sales foundation for product upgrades. In its reports for the four quarters of 2022, Luckin Coffee indicated that it will continue to deepen strategic cooperation in the supply chain. In September 2022, Luckin Coffee entered into a strategic partnership with the world's leading companies to source Brazilian coffee beans. Meanwhile, Luckin's second roastery plant is expected to be completed in 2024.

For growing companies, a large amount of capital is generally allocated to meet investment needs. Luckin Coffee is also investing in vertical integration and research and development. At the same time, Luckin Coffee can further diversify investment and effectively reduce investment risks. In addition to the first time, Luckin can carry out capital expenditure budget planning and improve investment management.

(3) Operation aspects

For companies in value-added cash shortages, sustainable growth rates can be improved by improving operational efficiency. On the one hand, it is necessary to improve after-tax operating profit, and on the other hand, it is necessary to improve asset turnover. Improving tax operating profits is reflected in both cost reduction and price improvement. Improving asset turnover can often be achieved by reducing working capital, divesting some assets, and changing supply channels. According to the four quarterly reports in 2022, Luckin Coffee is slowing down the growth rate of its own stores, while closing stores with poor efficiency to achieve cost reduction and efficiency increase. In addition, Luckin Coffee optimized the previous "money-burning" coupon subsidy securities and adopted a penetrating pricing strategy, and the average price of coffee for old users increased by 2-3 yuan. In response to the long-term high-speed growth of capital problems, Luckin Coffee can establish JIT (just-in-time production system) to improve asset turnover. At the same time, reduce unnecessary expenses, such as cutting ineffective advertising, and reduce working capital.

5. Conclusion

After being hit hard by the financial fraud turmoil, Luckin Coffee is now "reborn". Its means of bringing the dead back to life deserve our repeated consideration. This article analyzes the capital status and value status of Luckin Coffee from 2019 to 2022 (before and after the fraud), and only explains the financial strategy and strategic selection suggestions of Luckin Coffee in 2022. After sorting and calculating, it is found that Luckin Coffee's cash shortage is more serious, and the ability to use funds is lacking. Therefore, Luckin Coffee should expand its financing channels, diversify its investment and construction, and improve its operating efficiency to alleviate the cash shortage.

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