Groupon

One of the fastest growing businesses in history, Groupon and its latest daily deals were news the business media could not resist. From the local corner bakery to national retailers such as Gap, sizzling offers were projected to triple Groupon’s 50 million subscribers by the end of the year. But while the limelight remained focused on the headline “feature” deals, Groupon was quietly testing new models to expand this core platform. In late 2010, the company introduced Groupon Stores, a self-service model that equipped stores with the tools to build their own promotions. Sales chief and co-founder Eric Lefkofsky mused that when customers could “go on their own and put up a deal, Groupon would become their commerce strategy,” alluding to yet another new angle of the business, Merchant Services. That said, Lefkofsky quickly cautioned that such lighter-touch models were still very new and represented just one faction of the many tests Groupon was running.

The Groupon Model

Groupon’s initial value proposition was crystal clear: help local merchants introduce people to their businesses. Every day, Groupon subscribers received a daily deal (see exhibit 1), typically from a local business such as a sushi restaurant or spa, though the offerings had also expanded to include some incentives from national entities such as FTD and Gap. The name “Groupon” was a mix of “group” and “coupon.” Users had until midnight on the day the deal was announced to purchase that day’s coupon from Groupon, but the discount only became valid once a certain number of people had signed up for the offer. If the volume threshold was not crossed, neither Groupon nor the business made money. If the tipping point was hit, Groupon made money by commanding a revenue share of the total coupons sold, typically 50% of the revenue generated. That said, as the company had achieved critical mass in the marketplace, it became less about collective buying and more about exposure and discounting. Lee Brown, SVP National Sales for Groupon, commented that by early 2011, achieving the requisite tipping point was nearly a “foregone conclusion;” Groupon reported that less than 5% of all deals purchased in North America failed to reach the required quantity threshold.
At the company’s onset, Andrew Mason, the 30-year-old CEO of Groupon, sought to help local businesses navigate the Internet in a straightforward and comfortable way:

“We help businesses navigate the new world of social media and Internet marketing in an approachable, creative way. An appearance on Groupon validates these businesses as a cool part of their community.” –Andrew Mason (via New York Times).

Groupon delivered value to merchants in several different ways. First, the company provided tremendous exposure to new customers through its daily email alerts; in other words, its power as an online marketing/advertising tool was immense. Second, the company introduced new potential for price discrimination (e.g. Groupon enabled merchants to offer discounts to consumers who valued their products and services less than ordinary/existing customers, whereas typically merchants would normally be working within the confines of their own existing customer base, which was a smaller but substantially more engaged set of consumers). Third, the Groupon platform paved the way for the so-called “buzz” factor in two key ways: Groupon consumers were not only readily sharing their Groupon conquests through social media outlets such as Facebook and Twitter, but they were also likely to spread word about the local merchant—either formally through venues such as Yelp or informally over dinner with friends—after they had used their coupons. The Groupon model was notably pioneering where the social component was concerned: the initial crux of the business, group buying, was instrumental in aiding the company to grow as quickly as it did; word of mouth marketing was no longer a passive phenomenon, but rather an active dialogue that was required in order to gain access to the deal/merchant. At the same time, the Groupon model also delivered obvious benefits to the consumer segment: access to deep discounts for venues and services they may not have otherwise tried, or perhaps may never have even come to learn about.

The Fastest-Growing Business in History

In 2010 alone, Groupon expanded from 1 to 35 countries, launched almost 500 new markets (from a base of 30 in 2009), grew its subscriber base by 2,500% (from 2 million to over 50 million), partnered with 58,000 local businesses to serve over 100,000 deals, and saved consumers over $1.5 billion. By January 2011, the company was estimated to be growing at 50% per month, with a revenue run rate of over $2 billion per year (at its early year run rate). By comparison, when Google filed for its IPO in 2004, it reported growing from under $200 million in revenue to $1.6 billion in less than three years; Groupon accomplished the same feat in just one single year.

How did Groupon achieve this astonishing growth? Most obviously, by providing small- and medium-sized businesses (SMBs) with what they wanted most: more customers. Founder Andrew Mason saw the potential to fundamentally change the way that people buy from local businesses in the same way that e-commerce changed the way that people buy products.
But at a more operational level, this tremendous growth was driven by expertise in telesales and access to capital, driven primarily by co-founders and investors Lefkofsky and Brad Keywell. Indeed, this duo was said to be the true operating force of the business; prior to Groupon, they had extensive experience running big companies and had made a science of bringing human-heavy, sales-dependent, call center type companies onto the Internet. That said, some suggested that they had the resources, relationships, and expertise necessary to fuel the intensely rapid growth of the Groupon sales force. The other side of the business ecosystem, namely user acquisition, was fairly straightforward: through a combination of direct advertising, enticing offers, and basic web social mechanics, Groupon was able to attract a monstrous user base very cost-efficiently. That said, the true effort had to live on the sales side; gaining traction from these large call centers needed to be the bread and butter of Groupon’s model. As far as funding was concerned (and significant funding was needed on both the B2B and B2C sides), Lefkofsky and Keywell had both previously been backed by New Enterprise Associates—one of the largest technology-focused private equity firms in the US, with $8.5 billion of capital under management—which may have also made access to substantial venture capital investments relatively straightforward.

While its sales operations were at the crux of its success, Groupon had also benefited from inherent features of its business model, particularly negative working capital. A negative working capital metric, measured as the differential between current assets and current liabilities on the balance sheet and more practically understood to be the funds required to keep a company in business, implies that a company is effectively being financed by its customers. In other words, because Groupon charged its users upfront, took a cut of the revenue generated and then paid merchants back later, it quickly recovered its upfront costs surrounding promotion design and distribution. This strategy had proven critical for the Groupon’s profitability, especially in light of the robust costs associated with company’s sales operations.

That all said, Mason, Lefkofsky, and Keywell faced an important question: what was the right level of touch with B2B customers? While Lefkofsky asserted that the “vast majority [of Groupon merchants] require some level of hand-holding,” Groupon was feverishly testing less intensive models. Should the Groupon model be a mechanism for buzz, or an end-to-end solution for the partner merchants? As the company planned for its continued path ahead, it became evident that they would need to understand not only which models would work best in the long run, but also which models would be most viable where scale was concerned.

**Local Advertising on the Internet**

Prior to 1999, banner advertisements sold on a CPM (cost per thousand impressions) basis were the dominant method of Internet advertising. By late 1999, however, Google piloted a test program focused on unobtrusive text ads. And rather than running those advertisements blindly to all corners of the Internet, the company targeted those text ads based on user queries in its search engine. Indeed, by January 2000 Google sales representatives were deep in the throes of selling CPM-based text ads to a variety of retailers, but they failed to generate material revenue for Google – at least initially. Ultimately, the burst of the dot-com bubble
in the spring of 2000 changed everything, as it marked the crash of the online banner ad market.

In the wake of the bust, namely October 2000, Google introduced a self-service platform called AdWords for buying online text ads, an idea they borrowed from a company called GoTo.com, which ultimately became Overture and later, Yahoo! Search Marketing. By the next year, Google’s ad revenue was on pace to hit $85 million, but still trailed behind Overture, which banked $288 million in ad revenue by selling ads on a pay-per-click (PPC) basis through an auction marketplace; Google was still selling its ads on the CPM basis at the time.

In February 2002, Google deployed a new version of AdWords; this new product iteration adopted Overture’s PPC auction model, but was not a simple clone of the competition. While Overture’s PPC auction allowed advertisers to buy their way to the top of the ad listings, Google realized the issues with this approach; specifically, the company recognized the power of relevance. Indeed, if an advertiser bid its way to the top of the rankings with an irrelevant ad (meaning Google users were unlikely to click on it), then no one would make money from the arrangement. Embracing the importance of relevance, Google introduced clickthrough rate to measure the ad’s relevance; if an ad with a lower bid had a higher clickthrough rate, it could feasibly rank higher than an ad with a higher bid. In other words, a lower bid ad with more clicks generated more revenue for Google (and more interest for the advertiser) than a higher bid ad with fewer clicks; it was a win-win situation. Moreover, the auction model empowered the advertisers with the ability to (implicitly) state their value for any given ad placement, and to pay out accordingly.

What differentiated the PPC model of advertising from the CPM model was that it mitigated the risk for advertisers by pushing the cost structure one step further down the conversion funnel. Whereas the CPM model forced advertisers to pay for simple exposure, the PPC model enabled them to only pay once web browsers indicated some kind of interest by actually clicking on the advertisement. That said, as leading Internet journalist and expert John Battelle explained, what is notable about Google is that it did not invent search or auction-based PPC advertising, but rather, it demonstrated innovation by perfecting the business model.

In 2010, paid search (comprised of both Google and its competitors) accounted for more than half of online ad spending among SMBs, but traditional search advertising was still not working for the smallest local businesses, namely because of challenges managing downstream attribution as well as the fact that successful search marketing required more analytical sophistication than most SMBs had in house. A wave of companies such as Yodle and Yext had entered the market to try to merge online advertising with offline lead generation and customer relationship management, but none had transformed the local advertising landscape. Enter Groupon. Beginning in November 2008, local advertising evolved one step further with Groupon’s entry into the market, namely to the cost per acquisition (CPA) model. While Google had beta tested pay-per-conversion models in the past, the company had trouble scaling this model for true revenue-generating transactions rather than just for simple sign-up or lead completions. Groupon, however, managed to bridge the gap between the online and brick-and-mortar worlds and effectively allowed small
businesses to pay out for advertising only once consumers had actually generated revenue for the merchant. Whereas prior models asked advertisers to pay up front and hope for the best on the back end, the Groupon model only commanded payment once the merchant saw real, tangible results.

**Competition**

By March 2011, Groupon faced three significant competitors in the daily deals landscape: LivingSocial, Bloomspot, and Buywithme. With the exception of LivingSocial, Groupon was rumored to be ten times the size of other competitors in the space; Exhibit 3 provides more details about market share. Though a host of other “flash sale” models such as Gilt Groupe and RueLaLa had also emerged and could be loosely construed as competitors, most companies in this bucket were more focused on clearing inventory for well-known national brands rather than on helping SMBs to improve their revenues through buzz, so they were not direct competitors, though they were certainly competing for the attention of consumers in their email inboxes.

**LivingSocial**

From a consumer vantage point, Groupon and its largest competitor, LivingSocial, were fundamentally very similar products; they key difference between the products was that LivingSocial did not have any required tipping points for deals to become active. Indeed, whereas Groupon was about group/social buying, LivingSocial was more about social discovery. From a B2B vantage point, while Groupon leveraged large call centers to reach many of its merchant customers, LivingSocial fielded a local sales force in every city in which it was operating. Clearly this “hyper-local” model was capital intensive, and some wondered if the cost structure really translated into customer dedication. Regardless, the company had proven financially sound and had attracted investments from well-regarded industry figures such as Steve Case (founder of AOL) as well as a $175 million infusion from Amazon.com.

**Bloomspot**

Bloomspot’s core model, the daily email and flash sale, was similar to Groupon’s, but the company focused on the notion of “attainable luxury,” so it had a slightly different target market than Groupon. Moreover, Bloomspot had demonstrated a marked interest in the health of their merchant partners; indeed, the company had launched a host of programs to increase incremental sales to merchants. One such program awarded consumers with reward points for every $1 they spent above and beyond the baseline value of the deal; so if the offer were for $25 for a $50 service, the consumer would earn points for every dollar spent beyond that $50 mark. Emily Smith, a marketing and business development manager for the company, noted that companies like Bloomspot were beginning to think that that “Groupon had become so big, that [focusing on the implications for the end client, namely the merchants] didn’t even really matter anymore.”
Buywithme
As the name implied, Buywithme leveraged the same concept of group buying that had made Groupon so successful. The key difference between the two models was that Buywithme deals were live/available for a full week rather than for just 24 hours. Because new deals were introduced each day, a consumer had multiple deals to peruse at any one point in time. From the B2B perspective, Buywithme was similar to LivingSocial in that the personal interaction element of the sales process was immensely important; for instance, BuyWithMe sales representatives personally visited each merchant that ran a deal. The company was well-poised for growth; in July 2010 it closed a $16 million Series B funding round from Bain Capital, and by early 2011 it was continuing to expand its offerings to a host of new geographic markets.

Limitations of the Groupon Model?
Certainly, analysts had pointed to limitations in the Groupon model and there were stories of marked failures. For example, hours before Valentine’s Day in February 2011, customer service representatives at Groupon’s corporate headquarters in Chicago, Illinois were inundated with complaints following a nationwide offer for $20 off a flower purchase of $40 or more with FTD Group Inc. Specifically, Groupon consumers reported that they found the flowers they bought through Groupon were priced lower as sales items on FTD’s own website than they were via the Groupon entry point; in other words, it seemed as though FTD was compensating for the Groupon discount by inflating the prices of the products for which the Groupon could be applied. FTD President Rob Apataoff insisted that FTD made no such price hikes and that the issue stemmed from a misunderstanding about the terms of use for the Groupon offer, and ultimately did issue credits to unsatisfied customers.

Traditional marketing frameworks advocate that merchants consider a few key factors when contemplating a sales promotion such as Groupon: awareness, product trial, repeat purchases or visits, average basket or check size, and (where appropriate) party size (e.g. at restaurants). Critics pointed out that while Groupon nailed the awareness and trial elements, it was less clear they had built a model that encouraged repeat visits. While Groupon touted that 97% of its merchants indicated they would be interested in being featured on Groupon again, a 2010 Rice University research study implied otherwise. That study surveyed 150 local businesses in 19 American cities and 13 product categories that ran a Groupon promotion between June 2009 and August 2010. Indeed, the results were very different from Groupon’s 97% internal figure: 42% of the businesses said they would never use Groupon again. Merchants reported that Groupon redeemers were so extremely price sensitive that they barely spent beyond a discounted product’s face value (again, if the offer was $25 for $50 worth of sushi, the table sought to net out as close to $50 worth of sushi as possible). The study also examined the issue of repeat purchases, and suggested that of those Groupon deals that proved profitable to the merchant, less than 31% of consumers returned to the product or service, and for unprofitable deals, that figure was only 13%. Obviously the study and the press surrounding it spurred some degree of merchant concern, as using discounts to attract new customers would surely only boost profits when those customers actually returned on their own and pay full price later down the line.
“I really wanted {Groupon} to work... It didn’t drive in new people, and the people that were coming in didn’t spend even our average sale. It was just sad.” – Jonathan Freiden, Co-CEO of U.S. Toy Co. (via Wall Street Journal)

A January 2011 exposé in The Wall Street Journal showcased some alleged limitations of Groupon when it uncovered the story of U.S. Toy Co., a family-owned toy retailer with eight stores across the US. One of its stores near Kansas City, Kansas drew 2,800 customers from a Groupon promotion offering $20 worth of U.S. Toy merchandise for $10; this 2,800 figure initially seemed impressive given the store typically attracted only a few thousand customers in any given week, but the aftermath was a different tale. Most Groupon shoppers bought only the minimum $20 worth of merchandise at U.S. Toy, and moreover, about 90% of the Groupon takers were existing customers of the store.

Looking beyond the traditional frameworks, Groupon critics began to assert that these promotions were often cannibalizing existing revenues and profits, as many long-time customers were beginning to rely on discounts for products/services for which they had previously paid full price. Moreover, some merchants claimed negative brand implications from using Groupon—as one merchant explained, “places that before signing up with Groupon had good reviews [on Yelp] are starting to get 3-star reviews that say things like ‘The food wasn’t that great but we had a Groupon so we didn’t expect much.” Lee Brown countered, arguing that while using cannibalization tools was a novel idea for acquisition, merchants “have long been cannibalizing in their CRM.” In other words, once a consumer signed up for a merchant’s mailing list, he was often inundated with special deals and promotions that did not always make sense financially for the merchant. Indeed, business developers like Brown wondered why merchants would not leverage the discounting tactic for user acquisition if such deals really brought in materially higher volumes of customers. These issues surrounding the viability of acquiring a consumer on promotion were further complicated by the fact that local businesses did not always have the resources to fully assess and understand the comprehensive economics of the promotions they offered.

Indeed, the industry debate surrounding the merits and the viability of the Groupon economics reaffirmed an important question: what was the appropriate degree of “hand-holding” with the merchants and what, if anything at all, was Groupon doing to inspire longer-term relationships with its merchants? How could the company effectively work with merchants to optimize Groupon’s rapid growth as well as the efficacy of its value proposition where the merchants were concerned?

These questions were important as Groupon prioritized its growth levers for the company. By early 2011, the company was leveraging four key forces to propel its growth: geographic expansion of the existing product, international expansion (mostly through acquisition, but the company had recently launched in China), buzz (in terms of generating even more user signups), and finally, innovative new marketing models. With lower barriers to entry for competitors on three of the four drivers, Groupon sought to make bold and effective decisions where the development of new models was concerned.
High-Touch or Self-Serve?

The SMB segment was one that spent little energy seeking out new online advertising options. Rather, they were aggressively pursued by traditional SMB advertising providers such as the Yellow Pages. Lefkofsky observed that most small businesses required help and hand-holding in the promotion process. In other words, to be effective and to gain scale, the Groupon model required a large and widespread sales force. Though this reality was capital-intensive, Lefkofsky explained that Groupon went about its expansion wisely; it leveraged massive centralized call centers to fuel the city expansion strategy and to ensure that new geo launches were off the ground as quickly as possible. Focusing on “testing as a process,” Groupon sought to continue its creativity in launching new markets. Specifically, it looked at not only key population centers and Internet usage patterns, but also explored opportunities such as pairing zip codes to reach consumers outside of the major metropolitan markets.

That said, these new markets still required new sales hires; in other words, under the original business model, the more small businesses Groupon wanted to work with, the more sales and service people it needed to hire. Ironically, the success of most other Internet business models had been about building businesses that actually reduced employee overhead. Indeed, the so-called legends of most dot-com phenomena had been the engineers behind the core product, but at Groupon, the superstars lived in the sales force.

While Groupon’s role was primarily seen as a sales intermediary that promoted standalone feature offers for merchants, the company had leveraged its process of testing to develop alternatives to the first-generation Groupon model and to begin to further explore the question faced by the executive team.

The original model—the standalone feature email for merchants—provided the heaviest degree of marketing help from Groupon, but it also carried the highest costs (e.g. commission fees). At the other side of the spectrum, Groupon introduced a concept called “Groupon Stores” (see Exhibit 2); this approach sought to introduce a degree of self-service to the merchants. Essentially, consumers would sign up for a Groupon “deal feed,” selecting both merchants/brands they liked as well as general categories they would be interested to hear more about (e.g. spa services). The merchant could then use the Groupon Stores platform to design its own deal and push the offer to both explicitly and implicitly interested parties (depending on merchant or category selection in users’ deal feeds). This model differed from the first-generation iteration in a few ways. First, the element of “group buying” disappeared; merchants were not required to list any requisite tipping point in order for these deals to become effective. Second, there was no minimum discount threshold; standalone Groupon features typically offered savings between 50% and 90%, but merchants had carte blanche. Finally, there was a difference in merchant payment: whereas in the traditional model merchants were paid following the customer purchase of a Groupon coupon, in the store setting, they were only paid when the coupon was actually redeemed, thereby eliminating the slippage factor.

Sitting somewhere between high- and low-touch models was the recently-launched Groupon Merchant Services platform, ultimately an e-commerce solution for merchants. Launched in the face of growing competition from LivingSocial and a host of other daily deal companies, this service aimed to work with merchants from more than a simple marketing angle. The
platform (GrouponWorks.com) offered an array of services ranging from capacity planning to deal optimization to editorial services. Merchants could leverage these services to determine what type of deal would work best for their businesses, to get advice on how to handle the requisite customer support needed on the day of the Groupon feature, and for other ongoing consultations.

Finally, in March 2011 Groupon announced plans for Groupon Now, an innovative mobile application designed to better assist merchants with managing their inventory. Whereas Groupon 1.0 had focused on distributing coupons for future use (thus meaning little timing control for the merchant), Groupon Now was focused on providing immediate offers based on users’ locations and preferences. Businesses could select when they wanted their deals to be available, enabling them to better manage expectations and profits, and users reclaimed the privilege of consumer choice.

Indeed, each of the four solutions – First-Generation Groupon, Groupon Stores, Groupon Merchant Services, and Groupon Now – offered a unique value proposition to merchants. The Groupon executive team was struggling to decide where to invest most heavily.

What Next?

Historically, small businesses created more than 50% of the US gross domestic product and generated more than 75% of net new jobs each year. Over the past decade, there had been two key marketing platforms that added value to the bottom lines of these businesses, the Yellow Pages and Google; the Yellow Pages was a proxy for the rise of the telephone as a lead generation platform, whereas Google emerged as a proxy for the rise of the Internet as a platform for lead generation. Internet experts such as Battelle believed that Groupon had the potential to be a new third proxy, one that subsumed the platforms of both the telephone and the Internet, and added multiple dimensions beyond them both. Local online advertising was a $1.4 billion market in 2010, and there was ample opportunity to grow it even further when one considered that 36% of small businesses in the US still did not even have a website at that time. Moreover, paid local search spending was expected to decline from $3.1 billion in 2010 to $2.8 billion in 2015, whereas spending on email was projected to double during the same period. The market for Groupon’s platform was unequivocally ripe.

But projections aside, some wondered if merchants may eventually begin thinking less about unit-based economics and more about macro factors such as cannibalization and customer lifetime value. Groupon’s rollouts of Groupon Stores and Groupon Merchant Services signaled a commitment to the merchants, but analysts wondered what was next. How could Groupon ultimately own the relationship between merchants and customers? Did it even want to own that relationship?
## Discussion Questions

How does Groupon create value and for whom is this value created?

What do you think has prompted Groupon’s slow transition toward deals with national brands?

Could a less sales-intensive approach like Groupon stores be the next phase of product growth?

Which competitive model should Groupon worry most about? Why?
Exhibit 1: Sample Groupon Daily Email

Exhibit 2: Groupon Description of “Groupon Stores”
Exhibit 3

Market Share of Visits - Group Coupon Sites

Weeks are labeled with 'Dec 2009' through 'Nov 2010'.

- > www.livingsocial.com
- www.groupon.com
- www.buywithme.com

Weekly market share in 'All Categories', measured by visits, based on US usage.

Appendix:

History of Groupon Infographic from Mashable
Groupon Stores Merchant FAQ

What are Groupon Stores?
Groupon Stores are virtual storefronts where merchants can run their own deals. You create a store, gain followers, and then start running deals whenever you like and as often as you like. Our e-commerce platform supports the whole process, from setting the terms to fulfillment. You can promote the deal to everyone that follows your store and we make it easy to send via Facebook, Twitter and email.

How do Groupon Stores work?
Opening your Groupon Store takes less than two minutes. Gain 25 followers and start running deals. It’s as simple as that.

How do I get people to follow me?
Each Groupon Store has a unique URL that you can share on Facebook, Twitter, and via email with a message to Follow you for great deals and updates.

What do Groupon Stores cost?
Opening a Groupon Store is free. When you run a deal, Groupon takes a small commission on each groupon sold.

Who sees my deals?
Everybody who follows your store, including your previous Groupon customers, will see your deals. Further, your deal(s) will go to wherever you choose to share them with using tools like email, Facebook and Twitter.

When does my deal run?
Once we verify your business (which usually takes 2-3 business days) and you have 25 followers, you can run deals as often as you like. You can set the deal to run at any date you’d like. Deals will launch at midnight on the day you choose to run.

Can I set limits on my deals?
Yes. You can limit the total number of purchasers. You can also set restrictions on how customers use the deal. For example, if you’re a restaurant you can limit the use of Groupons per table or per order.

How do I get paid for my Groupon Stores deals?
When a customer redeems a Groupon, enter the redemption code under the barcode into our redemption system in your Merchant Center. We’ll mail you a check for all redeemed Groupons every two weeks if your balance is more than $50.

If there is a balance to be paid that is less than $50, the check will go out either when the last Groupon is redeemed in the current month or the expiration date. After the expiration date of the deal, we will still pay for redeemed Groupons.

Do Groupon Stores have “tipping points” like traditional Groupon deals?
No, but you can limit the number of customers who can buy your deals.