



## How Sustainable Is Groupon's Business Model?

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*What customer wouldn't want to score a deep discount on dinner, beauty treatments and other services, especially during a downturn? Barely three years old as an industry, online group buying sites are witnessing rapid growth, as more subscribers sign up, more partner businesses sign on, revenues climb and venture capitalists swarm to invest, further driving up business valuations as a result.*

*The most prominent group buying site, Chicago-based Groupon, has 2011 revenues estimated at between \$3 billion and \$4 billion. Google last December offered to buy the firm for \$6.4 billion. After the acquisition was unsuccessful, the search giant launched its own venture, Google Offers. Facebook, too, is entering the space, joining the roughly 500 group buying sites that have emerged worldwide.*

*But much of that "wild exuberance" is miscalculated and could bring ruin to investors, warns Wharton marketing professor [David Reibstein](#) in an interview with Knowledge@Wharton. Taking Groupon as a case in point, he says the industry's current growth rates are unsustainable. Also, he faults the site's business model, arguing that it will leave customers, suppliers and investors disenchanted.*

*An edited transcript of the conversation appears below:*

**Knowledge@Wharton:** Online group buying sites are a growing industry. Competition is fierce. More than 500 group buying sites have sprung up even though the industry is in its infancy. What is driving all this action?

**David Reibstein:** Part of it is because the Internet has provided a lot of power to the customer. Group buying has provided the ability to pool customers together to give them much more collective bargaining power. There's been a long history of customers trying to pool resources so they can buy more. Often there would be resellers who pool together and form cooperatives or even franchises that would collect individuals, but now consumers are pooling their buying interests together. And so, it is turning a lot of power over to the customer. That's great.

**Knowledge@Wharton:** What are the strengths of this industry?

**Reibstein:** It continues to offer some value to customers in terms of pooling them together and providing them some strength. It has often been the case that businesses have been able to buy from suppliers and get quantity discounts. This is now allowing consumers to buy in groups and afford ... quantity discounts. That is fantastic. There's no reason why this notion of customers pooling interests to be able to do group buying should go away.

There is an advantage to the merchants as well. The advantage is, rather than sell one by one and customer to customer and doing the marketing effort one by one, it is really allowing businesses to be able to sell a significant amount of volume with more of it being channeled through one customer.

**Knowledge@Wharton:** What exactly do venture capital investors find attractive about this space?

**Reibstein:** Unlike the customer, the investors are attracted by the huge growth and the valuations that are going on in this industry. I firmly believe there's going to be a lot of money lost in some of



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these investments. What is it investors invest in? They invest in growth. They say, "Wow, this industry went from close to nothing [to] 500 suppliers." If you look at the total dollar volumes that are being passed through here, it looks like a tremendous amount -- and it is. But the question is will it continue to grow and particularly, will it continue to grow at the rate at which the number of suppliers is growing? The growth rate for [each] supplier will be negated by the number of suppliers. But investors are clearly attracted by the growth rate and the valuations.

**Knowledge@Wharton:** The biggest of these companies, Groupon, is estimated to post revenues exceeding \$3 billion in 2011. What is it about Groupon's business model that is driving such growth?

**Reibstein:** The way this works is they go to merchants [and] say, "I am willing to sell some of your inventory and I am going to take a cut out of [the profit]. But you're going to have to give me a deep discount. If you don't give me a deep discount, we're not going to make it available to people." To some degree, they are operating just like a retailer. I am going to buy volume, I'm going to break that down and sell it to individual customers. And I'm going to sell it to those individual customers for more than what it cost me. That's exactly how every retailer operates. The difference is they are not buying any of the inventories. They are just a reseller.

**Knowledge@Wharton:** Why do you believe that business model will not support the current growth rates?

**Reibstein:** Let me talk about some of the fundamental weaknesses. Obviously, one is, however brilliant of an idea it is, there is also now a huge increase in competition. When Groupon had few competitors, it was more viable than it is now with 499 competitors.

But that is not the big weakness. The Groupon business model works better during a recession than it does during a vibrant economy. I will explain why, and this is where it gets intriguing. The reason some retailers might be willing to provide supply to Groupon is because they have excess inventory. That is particularly the case for services. One of the services I notice frequently [offered on group buying sites] is that of beauty salons. They have so many seats and so many beauticians. If I don't sell that 3 p.m. to 4 p.m. time slot on Thursday afternoon, I cannot carry that time slot in the inventory tomorrow. It perishes. It perishes in the same sense as an [unsold] airplane seat [once] a plane takes off down the runway. Because of the recession, there has been an abundance of people who are forgoing beauty salons and other sorts of luxury, discretionary services. Rather than let that airplane seat go [unfilled] and the beautician hour go with no revenue, [companies] would [rather] sell it for a little above whatever the incremental costs are. So there is a willingness to do deep discounting.

As the economy picks up and there is less excess inventory, the availability of supply will go down. The willingness of the merchant to offer deep discounts will go down. The business proposition to the customer will be less attractive if [the item or service being offered] doesn't have the same deep discount.

**Knowledge@Wharton:** A big chunk of Groupon's subscriber base is said to be made up of educated young women, and that is one reason why Groupon features many beauty and wellness offerings. How crucial is the makeup of the subscriber base for the success of the business model?

**Reibstein:** If you look at the nature of the customers who are buying from Groupon, they tend to be younger, more white-collar, they may be better educated and may be a similar profile to those who shop at [warehouse club chain] Costco. And so, they tend to be relatively savvy shoppers. Many of the merchants offer these deep discounts, not with the hope of perpetually offering them, but given that they have excess inventory right now, it would be nice to let people sample their product or service with the hope that they are going to like it and subsequently will come me back and buy it when it is not being offered on Groupon [and] is at its full retail price.

Unfortunately, the people Groupon is attracting are those who are referred to as "deal prone customers" -- who are, to put it differently, price-sensitive customers. These customers tend not to be the most loyal of customers. And because you have attracted them with a low price, you are more likely to lose them because somebody else offers a lower price. The merchant might say, "Well I am not making money on these customers, but hopefully I am building some future business." But there is the challenge of whether

they are really building future business, because what they really getting is a fickle customer. Merchants are going to discover that the Groupon customer is not where you build your future business. Therefore, the savvy merchants are going to learn that this is not a good way for them to do business.

**Knowledge@Wharton: How could this industry change customer expectations? What would that mean for retailers?**

**Reibstein: There is a real concern that [the model] takes regular customers and makes them more deal sensitive. Imagine the risk for a spa that has a set of customers who are willing to pay \$120 each [for services]. Those customers either see or learn of a Groupon offering. It's one thing when [a Groupon deal attracts] an incremental customer who is paying \$60 for what normally would have been \$120, and [the business is] getting \$60 it was not going to get [otherwise]. But it is disastrous when you take customers who were going to pay \$120 and now you only get \$60 from them.**

You want [to attract] those customers who were not at all part of your existing customer base.... What would be really bad is if you make your Groupon offering frequently enough that the customer just sits around and waits, [thinking,] "Rather than getting my normal salon service, I am going to wait until they offer that 50% to 80% discount." [In that case,] the entire normal margin that the salon owner was going to make is totally gone.

**Knowledge@Wharton: There have been cases where retailers have been swamped by customers with Groupon coupons and unable to cope. Also, there may be offers where Groupon does not attract the minimum required number of customers to "unlock" an offering. What are the downsides there?**

**Reibstein: Indeed, there have been some merchants that have been overwhelmed with the volume, and the correct solution is for retailers to be able to put a cap or a ceiling [on the discount]. That may create a little bit of frustration among customers, but that doesn't really hurt Groupon [because] it gets people to respond even quicker and buy it now before the deal closes. I think it works to Groupon's advantage to have a ceiling.**

As for the floor, if you don't get a minimum number of people buying an offer, that makes sense, too. This is, again, in the same spirit of retailers buying from manufacturers; generally there is a minimum order that is required, and [group buying] is very similar to that.

**Knowledge@Wharton: Wouldn't a supplier or retailer's existing client base feel shortchanged when others with coupons pay less?**

**Reibstein: The very loyal customer who is paying full retail price will start to resent [those who are using the Groupon discount], particularly if you go to a restaurant [and you are] willing to pay the full retail price. If everybody else who is walking in with a Groupon coupon is paying less, you will feel like an idiot. So retailers start developing some of that resentment in their best customers.**

**Knowledge@Wharton: How would customers paying full price respond?**

**Reibstein: This piggybacks on what I mentioned earlier. You could anticipate consumers will start saying, "I see you offering it to [Groupon users] at \$50 off, and I expect you to give it to me. If you don't, then I am going to be more irritated." That has not happened as yet that we know of.**

But I am sure there have been customers who were normally going to pay full retail price who now aren't because they were able to get a Groupon deal. A savvy customer could say, "I am not going to buy anything at Groupon that I wasn't normally going to buy. I'll just go online and look to see what is on there. If I see something that was already on my shopping list and now I can buy it at a cheaper price, then it's great."

**Knowledge@Wharton: You said this model works best in a recession economy. We've heard the same thing being said about Walmart. Shouldn't group buying work just as well, or better, when the economy is stronger and people have more disposable income?**

**Reibstein:** It is the case that Walmart's market share grew during the recession. Walmart still works well, but it works better in a recession. There's no question that during the recession, consumers were looking for bargains. Previously, they were not as inclined to look for bargains.... If the economy were to recover, then just looking for the bargain becomes not as much of a selling point. Everybody's fear is when the recession ends, that they have trained customers to be looking for bargains.

**Knowledge@Wharton:** The group buying market globally is largely underserved. These firms could enter huge untapped markets. Wouldn't that help them continue to grow at the current rate or even better?

**Reibstein:** The answer is yes. They still have opportunities to grow by going into untapped markets. But then the question is going to be, how long will their growth continue, and what's going to happen in those markets as more and more competitors enter?

**Knowledge@Wharton:** Groupon's valuation was last put at \$6 billion. Do you see any parallels between what is happening in this industry and the dot-com boom and bust of 10 years ago?

**Reibstein:** That \$6 billion is what Google offered them [in December 2010]. I think Google was foolish to make that offer, and the only thing worse was for Groupon to turn it down. [Groupon later raised \$950 million in fresh financing, giving it a valuation of \$6.4 billion.] Groupon's value will not persist if it stays in its current model. There is this wild exuberance, because of the growth, that has gotten everybody euphoric. But the question is, will it persist? Obviously, I don't believe that it will.

I see a lot of parallels with the dot-com boom, and that includes the enthusiasm of growth and everybody running to the same spot. It's like a school of kids on a soccer field ... where they are all going to where the ball is. There are too many people in one spot, but that's where the energy is....

**Knowledge@Wharton:** What can Groupon and the other group buying sites do to fix the flaws in their business model?

**Reibstein:** There are lots of things that can be done to make the model even better. Groupon just announced one, which I think is big. There is Groupon Mobile, which is really cool. Groupon Mobile knows if you are near a merchant that is on Groupon, and it will message you that the pizza shop you are walking in front of is offering a 50% coupon....

The next enhancement that would make sense is to get down to individual information and be able to know that John likes pizzas and we're going to offer that to John. Or that John bought a new sweater and maybe a blue shirt would go with that sweater. If they start customizing offerings individually, it will be all the more powerful.

**Knowledge@Wharton:** Could the explosive growth of group buying become too big to handle for Groupon?

**Reibstein:** I am not at all worried about that. When you have growth, it is hard to manage it. But when you get the kind of valuations that you have seen [for Groupon], they can afford to find people to handle that growth volume. Everybody wishes they had that problem.

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