Transcription from Affinity Management Web Conference:

Groupon, Groupies & Other Temptresses

Hi, this is Damon DeVito and I want to talk to you today about Groupon, groupies and other temptresses. We all need sales. Everybody wants more revenue in any economy, but certainly in this economy. Revenue is tough to get. In the recreation businesses unit volume in most cases is down industry-wide, and more than that, the revenue per unit is down. When someone comes and says they have a great way to deliver you a pile of revenue and some new customers without a lot of work, maybe even no more work, how could you not look at that, right?

Groupon is about to go through – they hope – an IPO and make a ton of cash on Wall Street, and continue to grow their business. They are growing 12% month over month! How could this be bad? They've got some critics out there. Their CEO responded to the critics as "insane," which is some serious hubris and confidence to take that kind of approach when you're about to go public. But look, he's a smarter guy than me, and he's presiding over a big company. Here's what I want to tell you about how Groupon and others like it affect your business, or might affect your business.

The Pitch

Virtually everyone I've talked to has been approached with a Groupon or Groupon-like business. A lot of them have tried it. And this is the pitch from Groupon's website:

> "Groupon negotiates *huge* discounts (emphasis mine) – usually 50-90% off – with popular businesses. This goes to thousands of e-mail subscribers daily, and we send businesses a *ton* of new customers (that's my emphasis again). That's the Groupon magic."

That's more or less verbatim from the Groupon website. They have a massive database of people who love deals and they e-mail them out a deal every day, not caring what it is, as long as it is attractive and sells. Unless a minimum number of people buy it, you don't have to offer the deal. But once they do theoretically you can set a max on it, although that doesn't always work.

Here's the pitch behind it: You have no up-front costs as a merchant. If you're selling golf lessons, or golf rounds or tennis lessons, or you're trying to get somebody to come in to dinner at your restaurant, you're selling equestrian riding time, whatever – you have no up-front costs. Very appealing to most of us. Groupon takes care of everything. You don't even have to write the description of what you do. In fact, you can't – they do it for you. They know their style, and you can give them some bullet points, but they take it from there so you don't have to do anything except collect checks. That's the pitch. You will get many new customers, and they'll come back, and they'll spend even more beyond this campaign. Short term you will see massive unit growth during a stretch of time. Instead of 50 customers in a certain month, with Groupon maybe you have 150 or 1000 more customers.

This sounds terrific. It's great to have more customers, right? How can this be bad? And in fact, there are testimonials from their website. "This instantly boosted the number of brunch guests at our restaurant by five times. The effect was immediate – wow, my sales increased five times immediately." But again, unit volume, right? The number of people, not sales revenue, but it still boosted the number of guests by five times. Massive right? Separate person: "Better than advertising because we see a return on it. It's huge for us. Groupon was 27% of our sales for the month." 27% of our sales for the month. It doesn't say whether it was unit volume or revenue dollars. I'm guessing it was unit revenue volume. "Better than advertising." What a big statement. This is better than advertising. We don't want to advertise any more. We're just going to offer coupons through a third party. Wow. Different mentality.

The Reality

How do the actual economics work? This isn't all necessarily on their website, but if you were a merchant, and you called a salesperson at Groupon, this is what you'd learn. 50-90% is the discount they are looking for. In other words, for their customers, for the people on their e-mail list to be attracted to whatever deal is offered, it has to be at least 50% off of whatever you normally charge everybody else. Now you can be cute, and try to package it all different ways, but the reality is, unless it's something like a 50-90% discount, then you're not going to be effective with it and they're not going to be real excited about it. One way or the other, you're going to be discounting your price by at least half. That's to the customer. The customer is going to pay half to 90% off.

Groupon, they get all that cash immediately. You'll eventually get your share of it. Yours comes in installments over the life of your offer. Even though they got all the cash up front, you've got to wait for some of yours. The credit card fees associated with it come out of your part, not theirs, is my understanding. And they control all the words, image and timing, so you're giving up a bit of your brand here. That's part of what comes with, "Look, we'll do all the work." Well, you may want this thing to hit in June, and that may not be good for them, or you may get bumped by some other offer, and you may go into July, which you didn't want. That's just another risk.

The same with words and your image. You're going to agree upon something, but if somebody makes a mistake out there, ultimately you're not the one who wrote it, right? You're going to end up honoring something because they're your customers. These people live in your town, they frequent your business, and you're the one that has to deal with any hurt feelings, so what's going to happen? You're going to eat it. Any errors that get made, you're going to eat.

Now, the price is discounted for the customer 50-90%, and if something was normally $100 in your business – what your sale price would be – the Groupon customer is expecting to pay $10-50. Whatever it sells for – let's just say it's $50 – you get roughly half of that and Groupon keeps half of that. You're going to have some credit card fees on top, but let's set those aside for the moment. Your sale of $100 has now turned into a $50 sale, of which you get half. Now you're getting $25, and maybe as low as $5, and you're getting it in installments. That's the real economics. Think of it this way – It's great, I've got five times as many brunch customers. But I also got 75% less revenue – maybe as much as 95% less revenue – from them. Each sale is probably unprofitable. Is my dollar volume better?

Units vs. Revenue

Let's look at that a little bit. You've got to think about units versus revenue. Groupon would say, "We see people come to golf courses and restaurants all the time. Here's how many customers we brought to your competition. What's it really cost you to serve an extra hamburger? What's it really cost you to have an extra golf round, right? This is all profit for you." That's the pitch.

Realistically though, there are costs associated with services and goods. Let's just say that there's a 30% contribution to overhead; a 30% contribution margin. Not bottom-line profit –this is before rent, before your salary, before heat, before insurance, before all that stuff.   Just what is going to your overhead? Now some of you may say, oh, well, mine's 100%. None of them are 100%. That's just bad accounting. But you know, if you're selling a service, you could probably convince yourself that maybe it's 70% or 80%. Maybe a golf round is a 70% or 80% contribution. But let's just say it's 30%. In restaurants for instance approximately one-third goes to overhead, one-third to labor, and one-third to cost of goods. On a $100 sale, roughly 60% of that or $60 goes to your direct costs. That leaves you 30% or $30 for overhead and profit. And if you sell enough units, then you cover your overhead and you have profit and that's great.

On a $5-$25 sale, assuming you sold the same unit, which you did, if you're honest about what you're giving a discount on, your 70% that is direct costs is still $70, so you generated $5, maybe $25, but you sold somebody something that cost you $70. You sold five times as many of them, but you're actually a whole lot worse off than you would have been if you didn't sell any of them. You have no profit. You have no contribution. And really, you're spending up to $65, as low as $45 to basically buy a customer. But, even then, you're not going out and making them feel great, saying, look, I'm going to buy you dinner, and I want to buy your loyalty and I want to hear your ideas, or I want to give you a gift. They're buying a coupon. Is that really the feel-good brand image you want? They feel like they're getting a deal out of you.

Example 1

Here's a real-life example, not from their website. Here's a vendor that, if you Google, you can find this example. There are others, but this one struck me. One vendor, in a certain period of time, would normally have sold a certain amount of units, and she said, well, I'm going to do a Groupon offer and maybe – maybe – in my wildest dreams, I'll get 150 unit sales. It led to three times that, about 450 (I'm rounding) unit sales. The store was busy. The terms weren't quite honored correctly. What got into print, at least until she saw it and Groupon was able to get it corrected. There were a bunch of people with coupons that they were supposed to be able to buy only one or two, and instead they were able to buy five. She ended up with a little more exposure than she was looking for, but hey, you were looking for more volume. This is all great, right? She sold the equivalent, in retail dollar sales, of $46,320. I don't know this person's business really well – I think that's probably a good amount of money to her.

$46,320 is the retail equivalent of what was sold. The 50% discount is what was offered, so knock out $23,000 of that, if you visualize three buckets here. Of the $46,000, $23,000 went to a discount, it just evaporates. Groupon's take on it was a little over $11,500, and the merchant got $10,000 after credit card fees. If the merchant had sold the same amount of stuff, she would have gotten $46,320. Instead, the merchant got $10,000. Guess what? The stuff that they sold cost them, to buy, $23,160. She lost $13,160. That doesn't factor in rent, or the owner's time, or any kind of image hit that the merchant took out of this, or the amount of time they spent going to a show to research what this widget was that they were selling. This is their hard cost. I bought something for $23,160. I sold it on Groupon and my net result was I got $10,000. Now Groupon got $11,530. They sent an e-mail. They wrote an e-mail and they sent an e-mail. That's great business. And that's why they're going public.

But the merchant lost $13,160. She's not going public. She's going broke. To be honest, she'd probably have been better off just giving Groupon the $11,000 and not doing the offer. She'd have come out ahead. But, you say, that's not really true, because she's getting new customers. These people have a lifetime customer value. If you've heard other web conferences, you know I'm a big, big proponent of looking at the lifetime value of a member or the lifetime value of a customer. But what did this person say? What you suspect. All the people that bought were current customers. They all came in with their $40 coupon. They spent $40, and they're exactly the people that I already had. And I don't really feel good about what brought them into the store this time – they were already coming in. But there is this sense that now the thing that is bringing them back is a coupon, when I really wasn't putting a coupon in their hands before. I could have done it directly. I could have left the store. I could have given them a coupon for next time. I didn't want to do that. This merchant didn't really pick up any new customers, and she doesn't know what it did to her image with the customers. It's called cannibalization. You're driving revenue, but you're cannibalizing your own sales to do it. If you do it a little bit to get a lot it's okay. If you do it a lot to get a little bit, it's the road to the poorhouse.

Personal Experience

Let me share some personal experience. I subscribe to what amounts kind of a local copycat. I suspect their e-mail database is very, very small. Typically I watch a whole bunch of these things and don't buy from them very much, but one of these offers caught my eye. A pizza place that I go to virtually every Friday on the way home and pick up pizza for my family, and spend roughly $30 each time, offered a coupon. I could pay $15 and get $30 worth of food at the restaurant. Excludes alcohol; excludes all the things I don't care about anyway, gratuity – I just pick up my pizza and I go. I pay $30 every week for my pizza. I can spend $15 a week for the same pizzas and nobody will know the difference. I'll just be paying less money. So I bought two: the maximum. For each of my coupons the restaurant got $7.50, but after credit card fees I'm sure they got $7.00. This was not, I should emphasize, on Groupon. This was on a local deal saver, deal-of-the-day-type deal that has now sprung up everywhere, copying Groupon.

This pizza place got $7 instead of $30. Times two. So, two weeks in a row I went in and, instead of giving them $30 for my pizzas they got $7.00. I got the same pizzas. Same time, same everything. They lost a ton of money on me. Maybe they got some totally new customer base to come in and recognize that they're there. Well guess what? How far do people go for pizza? A few miles. There are 3,000 people within a few miles of them. They have one primary competitor. Is this really the best route to going out to find new customers, or could they have done something more clever and more creative? Now a couple weeks have gone by, I've used my coupons, I feel great, I go in, I'm like, I'm stealing money, this is incredible! I feel bad for these people, but I'm happy for my deal. Week three: Do I go in and spend the $30 again? How do I feel about that? The other pizza place is comparable quality, a little more personal, a little less convenient by a couple minutes. I've always had these tradeoffs, and who do I call week three for pizza? It wasn't a conscious decision, but in preparing for this call, I realized I haven't been back to this place that offered the coupon since using my coupons. And why is that? If I'm honest with myself, I didn't have a bad experience. I mean, I really got a great deal. I should be in their debt.

It's the opposite. Now I don't want pay more than $15 to go there. I feel like now I'm overpaying if I pay $30. It's stupid. I pay the same price at the other place. I've already told you the quality is comparable and the other tradeoffs are different but comparable. Why don't I go back? Well, they've hurt their image in my mind. Now I view them as a place that's not as cool, they have to do these coupons to get in. I think a little less of them. Do I really think of this consciously? No. I'm going order pizza tonight. It's a Friday. And maybe I'll go there, because now I've done this little analysis with myself, but, to me, it's very, very interesting that they certainly got less money from me, and I think they got less unit volume as well. And I don't see a whole lot of new people in there, and how could there be? They're very local, as most of us are – let's be honest. Most of the people that are going to listen to this call, or read the transcript after, if you're in the hospitality business and you're not a resort, you're probably drawing from a definable set of people that are within a certain geography of your business, and, if you sought them out by their interest level and their income level, you probably could be more direct. Yes, it's more work. Yes, it's harder to measure. Yes, you don't know if you succeeded at the end, but these coupons are guaranteed economic failure in most cases. I would rather have a shot at doing it some other way.

When to Use and When Not to Use Groupon

If you know a lot about Groupon you might counter, "But wait a minute. Gap is doing it. Gap's using Groupon. Gap's doing stuff with Foursquare. They're doing very high-profile stuff, where they gave out a $50 merchandise certificate and you only had to pay $25. Gap probably only got $12.00 or $12.50 of that. Maybe a bit more given their size. They sold 441,000 of them. It wasn't like a secret offer in one little market."

Well, okay, in reality, it's true. One major retailer did this, and what happened? They are estimated to have lost about $7.5 million in revenue. You can figure out the profit that goes with it on what they had to fulfill, based on what we talked about earlier. Pretty standard – retail margins are keystone, so they're going to deal on a 50% cost of goods in most cases, and if you really want to get curious and be technical, go ahead and pull their annual report and you'll be able to tell exactly what their cost of goods is. But suffice to say that Wall Street analyst Brian Sozzi promptly downgraded Gap. He had them as a "buy" and he moved them to a "sell." This was at a time when it wasn't like all retailers were getting downgraded, and here's why: Gap's promotions were believed to be unsustainable and undermining profit. Essentially, you're generating a lot of unit volume, and you're giving up profit, and it's just hard to keep doing it over and over again as a strategy. Exactly what we talked about, but with a small business. It's the same principle.

Could there be some reason out there, some business that this could be a boon for? Absolutely. If you're rumored to be closed, and you're open, but everybody thinks you closed – Okay, get out some awareness. But be honest with yourself. Call it a marketing expense. Don't trick yourself into thinking your sales are going up. Just say, "Look, I need to get the word out. I could do it a million other things, but this is pretty quick. I'm going to do it." Or, "I've got a brand new business and my timeline got messed up and I can't get anybody in the door under the Grand Opening promotion." Okay. This maybe lets people know that you're in there. Pitch it as a Grand Opening special. Maybe that works. I'd still have reservations, but I could be convinced in some cases that maybe that's a good use of an aggregator like a Groupon. Or maybe you can't make payroll Friday, and you just absolutely need to generate some money, and maybe Groupon or one of its groupies, like a Local Guy or Rue La La or something like that, some deal-of-the-day can help you with that. But otherwise, my recommendation is keep control of your currency.

YOU Control Your Prices

You don't control a ton in business, but you control your prices within reason, you can control your service, and you can control your product to some extent. When you go this group coupon route, you're giving up control of all of it. You're not managing your brand or your image. It's a different version of the Valpak. You are out there and you are essentially telling people, "Look, I need to put out coupons for you to come in." It affects your image. It affects your brand. I didn't go buy pizza at the pizza couponer for the few weeks after, but it wasn't a conscious decision. I just didn't think as much of these guys after I had paid half price, and knew they got half of that.

Bought customers are disloyal, low-spending deal-chasers. They may pull up in a Mercedes, but the fact that they are taking their time to pursue these deals means that the next day, they're not looking at your website – the next day they're looking at Groupon again. Where are the deals somewhere else? And if your deal was really successful, guess what? Your competition is immediately going to be copying it. How will they know? Because the customers will tell them, and the providers will tell them. Groupon or the others will say, "Hey, we saw this big effect with XYZ Club, and you ought to do it." You're dealing in disloyalty. It's really a deal with the devil, in my opinion.

You're also starting a price war. Let's say you're really, really successful, and everybody starts copying. If unit volume is trending down overall, and you're cutting price, guess what? Somebody else who's in a fixed-overhead business is going to turn around and cut price right back. If you did this, they're going to do it, and now you have to do it again to get them back.

You've started a price war. Do you have enough money to survive a price war? Can you lose money selling for a year or two to try to put your competitor out of business? The problem in our business is, if it's a country club, an equestrian facility, a shooting club, a fishing club, you tend to work with a lot of land, and those businesses tend to just resurge under a new owner, and just have new capital and come right back in your face, so the idea of putting them out of business doesn't work as well in our business. I would submit that a price war, in most cases, is a really bad idea. In general, you don't want to follow the lemmings. A lot of people are doing this. Groupon is hugely successful. All your customers will tell you to do it. "Hey, I need some new ideas," you ask your employees. "You should try Groupon. I used it. I bought something. This store sold a million pizzas." Hold that thought.

YOU Sell Your Stuff

If you're in the golf business, you've been approached with a local radio station version of this. "We'll take a bunch of your rounds and sell them for you at half price on the air and pitch we'll put some of it towards radio advertising." Look, if you want to buy radio advertising, just buy it. Or, if you want to trade them, trade it and tell them they can't re-sell your rounds. I've done both. I'm not saying either is a great idea, but I've done both, and I've had mixed results. Sometimes great, sometimes it flops, but I don't let anybody sell what I sell for less than me. I sell our rounds. Our lessons, memberships, our hamburgers, etc. When we sell it, I don't want somebody else selling it. I want them to refer customers to me. I don't want an advertiser deciding what my price should be and putting it on their website where it says, "Hey, you're going to get a great deal because you're loyal to me," instead of loyal to Damon and his client.

If you're in the golf business, there's a tee time version of this, I believe it's Golf Now, but there are others who will approach you and say, "You can have our technology and you can have access to our website, and it's all fantastic. Don't put anything out there you don't want to, but if you have perishable inventory that are going unused that you can't use anyway, just stick them on there, and we'll sell them and you'll get all or most or some of the money. Oh, and give us a little bit to cover our overhead. Don't give us any money. Just give us a couple times." Guess what? It's the same thing. You're hurting your image. You're breeding disloyalty. You lost control of your currency. Customers talk. Everybody knows what you're doing. You can't hide these things. It's going to affect the price you charge every single day.

Example 2

I want to end on a blunt note, with another real life, personal example. I received an e-mail from somebody who is, in this case, a groupie or another temptress. They sell a discount book. "We've got our loyal following and we've got X-amount thousand customers, and they go where we tell them to go, and you're in the book. But really, they're not coming to you because your offer is so tight that they're going to places where the offer is more generous. The e-mail said, "Can we meet?" And I said, "Maybe. What's the meeting about? " And here's the response: "Thanks for your speedy response, Damon. The agenda of our meeting is $50,000 in found money for your client in 2012." Okay, sure. Tell me more, right? "You're getting very little business from our 3500 *members* (people who have basically bought a coupon book), because most of our *members* have no incentive to play at your golf course." In this case, it's a golf course and a wedding facility. Think of that. They have no incentive to play there. This is a top course in the state on everyone's list, impeccable conditions, service is fantastic, very successful place with excellent food. They have no incentive to play there. Now, bear in mind, we've already given them a little bit of a discount. It's just not a big discount. And you hear, "Quite frankly, our members pay $60 for our book, and they use it almost exclusively. Quite frankly, they are playing elsewhere. Here's how you get $50,000 more next year." And it goes on to essentially suggest a giveaway by offering some outrageously low price, which supposedly won't hurt because it's at some time when we're not successful anyway. Just do this and you're going to have an extra $50,000." And then it goes on to say, "If I walked up to your client (the club owner) and handed him a suitcase filled with $50,822, would he take it?" And then I thought immediately, "If I offered your wife an envelope with $50 cash, would she take it?" And I think the answer is - it depends. It depends on what the strings are with the $50, doesn't it? If I was to say to her, "Listen, we want you to run out in the middle of a busy street and run back and forth for five minutes, or if you get hit by a car, you can stop sooner," I think she'd say, "You're crazy! I don't want your $50." If I said, "I'd like you to shake my hand, or pay me a compliment about the color blue that I'm wearing," maybe. If I said, "Look, there's no strings attached – just take it," maybe, although I think she'd be suspicious.

But I think if I were to attach the kind of strings that we've talked about today, which is: It's going to affect your image, it's going to affect your brand, and it's going to affect how loyal people are to you. You're going to lose money. If you spelled it out to the wife and said, "I'm going to give you $50, but you're going to have to turn around and somehow hand over $100 to another guy." Would she take the $50? Probably not. Most people are going to say, "I don't think that's such a good deal."

Yet, when we become busy business people chasing revenue without enough time to think about marketing, you get tempted. It's a tough economy, and everybody's doing it, and you may think, "Boy, these guys are going to have a successful IPO, or this other one is just like Groupon, and it's cheaper, and I should do it." There are a lot of temptresses out there. But my strong suggestion is – take the harder route. Manage your brand and image. Control your currency and breed loyalty.

If you want to talk more about how to do that, if you want to bounce around ideas for a few minutes, I'm happy to do it at no cost. You can contact me at Affinity, 434-817-4570 or ddevito@affinitymanagement.com. Now put your thinking cap on and go out and build your business. I hope this was helpful to you, and wish you all the best. Thanks.

Note: This transcript has been lightly edited for clarity.

Damon DeVito is co-founder and Managing Director of Affinity Management. Affinity was founded in 1997 and provides advisory services and professional management to private clubs,

golf courses, equestrian facilities and other member-based businesses. For more information on Affinity Management, visit www.affinitymanagement.com or call (434) 817-4570.

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