Digital Deals: Birth of a New Global-Local Market

An Opus Research | Internet2Go report

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Commissioned by

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Key Findings:

- Daily deals stand on the solid shoulders of print and digital couponing. More than any other marketing or advertising channel, coupons and promotional offers can directly influence consumer behavior.

- The daily deals model appeals to both consumers and merchants, though challenges exist in sustaining that appeal. Deals also sit at the center of three powerful digital marketing trends: local, social and mobile.

- The daily deals market in the US will be worth $3.1 billion in 2011 and more than $6 billion by 2013.

- The average deal price in Q1 2011 was just over $40. Roughly 35% of deal buyers are new customers. Between 10% and 20% of new deal buyers later come back and pay full price.

- There are two types of daily deals: specific item/service promotions and dollar deals. Dollar promotions may be "safer" in some respects, but item deals appear to perform better overall for merchants.

- Over the past year daily deal sites have mushroomed to more than 400, with multiple vendors in at least 80 US markets. There may be as many as 160,000 deals distributed in the US by the end of 2011.

- Survey data suggest that as many as 60 million consumers in the US subscribe to daily deal programs today. That doesn't immediately translate into deal buyers however. Only about 19% of Groupon's subscriber base, for example, has ever purchased a deal.

- Just over 50% of deals are profitable for merchants and up to 48% of merchants indicate an intention to offer another daily deal. Some merchants have moved marketing budget away from other media channels in favor of daily deals.

- Though they're typically not being communicated to business owners, a number of daily deal best practices are starting to emerge.

- The daily deals market is intensely competitive. Over the next two years there will be industry consolidation, as well as diversification of deal types and distribution. There will also be greater national advertiser participation and more options for local merchants.

- Merchants and consumers show limited awareness of or loyalty to particular deal providers. Yet winners will necessarily emerge.

Introduction: Welcome to Deal Mania

Deal mania is in full swing. Already a multi-billion dollar industry after only a couple of years, daily deals have captured the attention of traditional publishers, media companies and a host of online competitors. The phenomenon has also exposed the value and potential of the local market to those who didn't recognize it clearly before.

The fast-growing deals segment is not without challenges and problems, however. Skeptics and detractors question the value of the deals product for local merchants as well as the sustainability of the model in general.

As consumers and increasingly savvy "deal seekers" gobble up aggressively discounted offers, an expanding army of telephone sales reps seeks to capture local merchant marketing dollars. Accordingly, many small and medium-sized businesses (SMBs) receive multiple calls per month (even per week) from an increasing array of deal sites and vendors.

Many local merchants are attracted to the tangible and low-risk nature of the daily deals model ("customers not clicks"). However many have also been burned by a lack of education and planning. While some SMBs have enthusiastically embraced daily deals, even shifting budget from other marketing channels, a vocal minority is now speaking out against daily deals as bad for merchants.

Notwithstanding these critiques, daily deals are here to stay. They build upon Americans' long-standing love affair with coupons and retail sales. Coupons and discount offers, more than other forms of advertising, have a proven ability to influence consumer behavior, according to several studies conducted by the National Retail Federation and BIGResearch.

While the consumer behavior behind the daily deals phenomenon is well established, the specific daily deals product will necessarily evolve and change. Competitive pressures, merchant demands and fickle consumers are forcing an evolution even now.

A kind of "land grab" is underway. Deal providers are trying to build scale and position themselves to own as much of the value chain as possible. With relatively few barriers to entry, a host of companies has joined the deals fray. Just in the past year deal competitors have mushroomed to more than 400 vendors and sites.

The current market cannot sustain 400 providers, however. Most companies without sufficient scale or a dedicated niche will be marginalized in the near future. Winners and losers will likely emerge over the next 18 months. Indeed this period will be pivotal in determining the nature and structure of the US deals market going forward.

The Rise of Digital Deals

Americans love saving money. As a result coupons and newspaper free standing inserts ("FSIs") have been perennially popular forms of advertising for retailers and brands. But their digital counterparts have, until recently, been relatively ignored. According to Scarborough Research, 86% of Americans got their coupons from two primary sources in 2008: newspapers and direct mail. By 2010, not that much had changed for the industry.

According to coupon marketer Valassis, there were more than $450 billion worth of coupons distributed in 2010, approximately 88% of which appeared in newspapers and other printed media. Less than 1% ($3.7 billion) of that total was actually redeemed by consumers, according to a January 2011 "Coupon Facts Report" from Valassis subsidiary NCH Marketing Services, Inc.

Though digital coupons saw significant growth (37%) in 2010, NCH reported that they remained "less than a projectable share of the total 332 billion coupons distributed." However that's now changing rapidly as brands and manufacturers play catch up to online consumer behavior. (Advertising and marketing spending have always lagged consumer adoption of new media.)

As the data suggest, for years the online coupon market was essentially stagnant. Part of the problem was brand/merchant fear of fraud. Retailers and major brands were resistant to online coupon distribution because they feared a loss of control of offers. As a partial consequence, the value and quality of online coupons was limited.

With the onset of recession in late 2007 things began to change for US consumers. Economic pressure made people interested in finding discounts and deals whenever possible. Shoppers turned to the Internet to save money. That fact, combined with a well-documented decline in print newspaper circulation, prompted retailers and other advertisers to start distributing more of their deals online.

The recession marked something of a turning point for the industry. A surge of consumer interest in online coupons began in 2008. According to comScore, "27 million people visited coupon sites in October [2008], up 33% from a year earlier . . . The number of searches conducted using coupon terms also increased by 100% from January to September."

Contrary to stereotypes, some of the strongest growth in online coupon adoption came from affluent consumers, who had historically shunned paper coupons. According to comScore, as of May 2011 visitors to coupon sites had grown to 43.9 million monthly unique visitors.

A new "culture" of online coupon discovery and search has now taken hold. There's little evidence it will disappear.

The iPhone and the Coupon Market

If recession-induced consumer demand fueled online coupon growth, so did the iPhone. It accelerated the development of not only mobile couponing but the broader coupon market as well. Clearly mobile coupons pre-date the iPhone. However the introduction of the iconic device, and especially iTunes app-store distribution, helped mobile couponing take off. By early 2009 there were at least 250 iPhone apps dedicated to or featuring coupons in one form or another. Today the number has grown to roughly 900 apps.

While early smartphone adopters and mobile subscribers generally expressed ambivalence — even hostility — toward mobile advertising, coupons and deals were much better received. Several studies at the time, including by Opus Research, showed consumers were more open to relevant mobile offers or coupons than more traditional ads.

An early study (2008) from Opus found that 43% of mobile users were at least “somewhat interested” in receiving local-mobile offers on their handsets. Later that same year mobile marketing platform HipCricket reported an almost identical 42% of US mobile consumers were at least “somewhat interested” in receiving coupons on their mobile phones.

That early interest in coupons or deals has only grown in the three years since. Data from a range of sources including Opus, InsightExpress, Harris Interactive, Interpublic Group and others have documented consumer enthusiasm for money saving offers on mobile phones. That enthusiasm and interest has also helped to fuel the broader digital coupon market, as well as support demand for daily deals.

Digital Coupon Demographics

Males have not been well represented among users of traditional paper coupons. However, as mobile coupons have grown over the past few years, men have joined the deal hunters. They now “over-index” in mobile coupon interest and usage. According to 2010 research from InsightExpress (“Mobile Shopping Behaviors & Advertising Effectiveness”), male smartphone owners seek out and use mobile coupons in stores more widely than the general population:

- Electronics store – 30% (general population 10%)
- Clothing store – 33% (general population 15%)
- Department store – 30% (general population 15%)
- Service location – 16% (general population 7%)

In fact, digital coupon usage generally flips historical print coupon demographics. Roughly 25% of newspaper coupon clippers are 65 or older, but digital coupon interest is inversely correlated with age. That’s according to research conducted by AOL and Information Resources (IRI), among 36,000 US consumers in 2009 (“Consumer Coupon Trends”).

Fighting the traditional "coupon clipper" perception, Coupons.com reported that online coupon users are affluent, well educated and almost equally split between men and women. According to the findings of a 2010 Coupons.com survey among 1,017 US adults:

- 61% of respondents with a household income of $100,000 or more redeemed a coupon within the past six months
- 39% in the $100,000+ income group, who redeemed online coupons, were nearly twice as likely to do so as those with household incomes below $35,000
- Adults with college degrees were almost twice as likely to have used coupons (past six months) as those without high school diplomas
- 77% who've used coupons in the past six months live in metro areas
- 51% of male respondents used a coupon in the past six months

Daily Deals Are Born

The rise of digital coupons laid the groundwork for the arrival of Groupon and the daily deals segment in Q4 2008. Chicago-based Groupon emerged from the ashes of a failed site called The Point, founded nearly three years before.

Groupon is a kind of conceptual successor to early reverse auction site Mercata. Ahead of its time, Mercata failed to gain mainstream adoption when it launched in the late 1990s. The Groupon model is not identical, avoiding reverse auctions but still requiring a threshold of buyers to "tip" a deal. Groupon uses Internet display ads extensively to capture consumer email addresses. The display ads, which became a kind of industry template, typically promote 50% to 90% off local restaurants and services (Figure 1).

Figure 1: Groupon Display Ad Appearing on NYTimes.com

Source: Groupon/NY Times (2011)

Groupon “sources” or acquires daily deals from local merchants through its own telephone and premise sales channels. According to statements made by CEO Andrew Mason in Q1 2011, roughly half of Groupon’s 8,000 employees are involved in sales. LivingSocial recently said that of its almost 2,000 employees approximately 1,200 are salespeople.

Daily deals’ phenomenal growth can be partly attributed to a compelling consumer proposition: local services at least 50% off. The range and quality of these deals was also unprecedented online.

The pitch was equally persuasive on the merchant side: “buy real customers not clicks.” Local businesses were convinced to sacrifice margins for the promise of guaranteed revenues and new customers. In addition the model brought e-commerce to local service businesses for the first time, by making consumers buy the deal before they walked into the store.

This e-commerce component is what chiefly differentiates traditional coupons from daily deals. Coupons offer a discount but are free to consumers and the deal is applied at the time of purchase (on premises). Daily deals must be bought before the service is rendered, and they’re not always redeemed. Indeed, Merchants are paid whether on not consumers ultimately redeem the deals. Some estimates put “breakage” or non-redemption rates at just under 20% of all deals bought.

Groupon and its main rivals have historically taken 50% of the face value of the deal and paid the remaining 50% to the merchant. A deal priced at $100 (and worth $200 in services) would thus yield $50 to the merchant and $50 to the deal provider. In the most common scenarios merchants make 75% less on a daily deal than they would on a new customer transaction in its absence.

These dramatically reduced margins are fueling a debate about the ultimate value of daily deals to local businesses. There are some deal vendors that are taking a lower fee or percentage of the deal price as a competitive maneuver. Google is rumored to be one of those companies, as it rolls out its new “Google Offers” daily deal product.

Generally, however, the “no risk” value proposition behind daily deals has made them popular with many local businesses and helped make Groupon “the fastest growing company in history,” according to a highly flattering portrait of the company in Forbes magazine in 2010.

Deals Already a Multi-Billion Dollar Market

Quick to generate revenue and with few barriers to entry, the daily deals model has been adopted by scores of companies in the past two years. From aDealio to Zozi, the number of vendors swelled to more than 400 at the end of 2010 according to deals aggregator Yipit, which tracks active deal sites.

Daily deals have also become a global phenomenon, with multiple competitors operating in well over 100 countries today.

Groupon, the largest of the deal sites, reported gross revenues of more than $644 million in Q1 2011 (on its S-1 pre-IPO SEC filing). If the company simply maintains its current pace of sales and revenues, it could generate more than $2.5 billion in topline revenue for full year 2011 (on a global basis). US revenues are about 42% of the total. Number two provider LivingSocial will likely see more than $1 billion in gross revenue this year.

The US deals market, as a whole, should clear $3 billion in gross revenue in 2011 (Figure 2). By 2013 it could exceed $6 billion. The Opus forecast below uses some generally conservative assumptions. It also seeks to account for deal fatigue and consumer attrition, while assuming continued growth in the number of deal buyers overall.

Figure 2: US Daily Deals Revenue Growth 2010 – 2013

Year	Gross Revenue (US only)
2010	$1.1 billion
2011	$3.1 billion
2012	$5.25 billion
2013	$6.75 billion

Source: Opus Research (2011)

The operative variables in the model are consumer adoption rates, average purchase frequency and average deal value. Estimating deals revenue more than two years out is much more speculative because of the fluidity and rapidly evolving nature of the current market.

While the revenue projections look huge in 2013, we assume a relatively modest average deal value of $40, declining to $30 by 2013. We also assume that deal buyers will purchase an average of 2.5 deals annually in 2011 and 3 deals per year by 2013. Both of these numbers are based on proprietary and third party empirical data. The harder thing to estimate is the overall growth of deal buyers. By 2013 we assume there will be roughly 75 million deal buyers in the US market.

This last assumption, about the overall number of buyers, may be somewhat aggressive. However the actual growth rates of subscribers and deal buyers, admittedly starting from a small base, are far in excess of what we assume above.

Deals: Local, Mobile, Social

In addition to their merchant and consumer appeal deals operate at the intersection of three major online marketing trends: social, local and mobile. Though not by design, the cross-platform nature of deals makes them perfectly suited to the emerging "SoLoMo" marketing environment.

Figure 3: Deals at the Center of "SoLoMo" Trend

Source: Opus Research, 2010

Amazon, eBay, Gilt Groupe and others, including several traditional retailers, have extended daily deals to the realm of products and more conventional e-commerce. However the majority of daily deals are service-oriented and must be redeemed or used offline, in specific local markets.

Deals are "platform agnostic" and can be flexibly distributed through any digital channel: search, display ads, email or mobile apps. Anywhere a conventional online or mobile ad is shown a deal can equally be presented. Deals are especially well suited to mobile, which is a major new frontier for the product. As already discussed, coupons and discount offers typically hold greater consumer appeal than more conventional mobile ads.

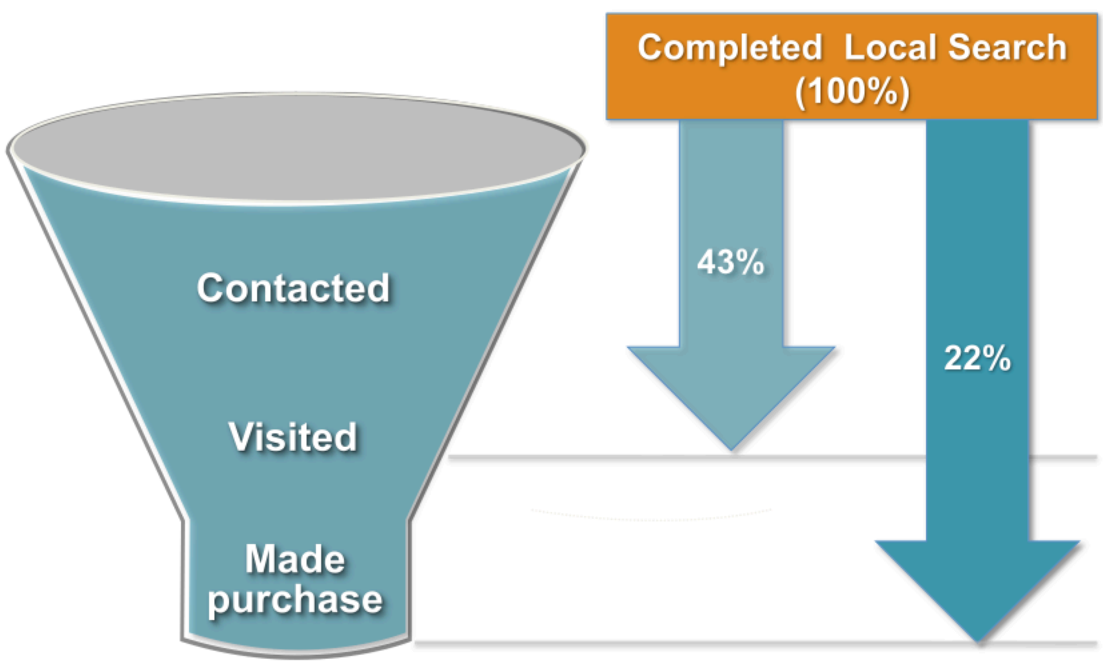
Mobile Users Are Ready to Buy — Now

Research has shown that mobile consumers are typically closer to a buying decision than PC users. This behavioral difference has been documented in numerous studies over the past three years. Data released by Microsoft in June 2010, for example, showed that mobile search behavior is much more "compressed" than comparable PC search. According to data presented by Microsoft at the 2010 SMX Advanced conference, 70% of mobile search tasks are initiated and completed within an hour. That compares to one week on the PC.

More recent data from Google and Ipsos ("Mobile Movement Study," April, 2011, n=5,000) indicate that 75% "local information seekers" either take immediate action or act within a few hours of completing a local-mobile search. Actions in this context include calling a business, visiting a store, getting directions or making a purchase. According to the same survey 95% of smartphone owners have looked for local information on their handsets.

Further confirmation of mobile users' readiness to act comes out of a March 2011 survey of more than 1,500 mobile users by Nielsen on behalf of AT&T Interactive. This study found that among mobile users conducting a local search or local business lookup, 43% visited the business and 22% ultimately made a purchase (Figure 4).

Figure 4: Local-Mobile Users Are Ready to Act



Source: AT&T Interactive-Nielsen, 2011 (n=1,526)

These data collectively reflect that mobile users' needs or interests are often more immediate than those of PC users. This fact, combined with the consumer appeal of deals and their capacity to influence behavior, make for a potent mobile marketing combination.

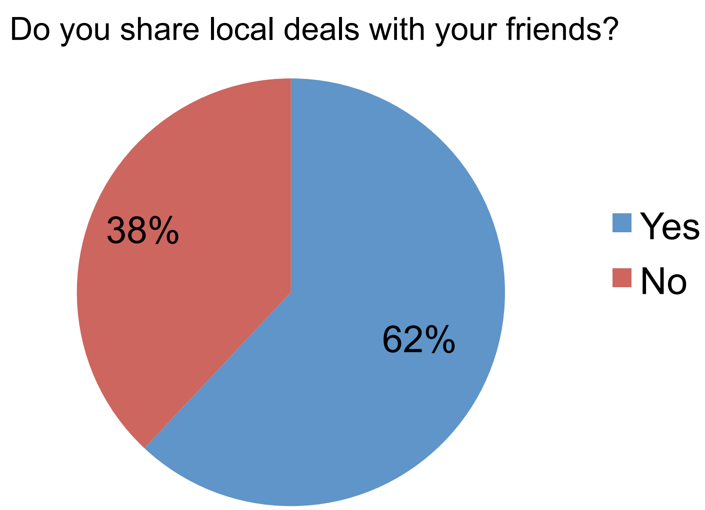
Deals As Social Commerce

Daily deals can also be considered a form of social media. Indeed, many pundits refer to the category as "social commerce." At many sites deals must "tip" before they can be obtained by anyone. In other words, a sufficient number of consumers are required to buy a deal before it becomes available or unlocked.

Interested deal buyers often try to ensure this happens by notifying friends or family members and encouraging them to get the deal too. The formal "tipping" requirement has effectively disappeared at the largest deal sites because consumer-buying volume is never in doubt. And though "tipping" has been deemphasized in some places, daily deals remain highly social. Deals continue to be frequently shared via email or social networks.

Data from Q1 2011 show a high degree of viral deal exposure: 62% of respondents, in a survey conducted by WiFi ad network JiWire (n=5,000), shared deals with friends and family (Figure 5).

Figure 5: Daily Deals Routinely Shared with Friends



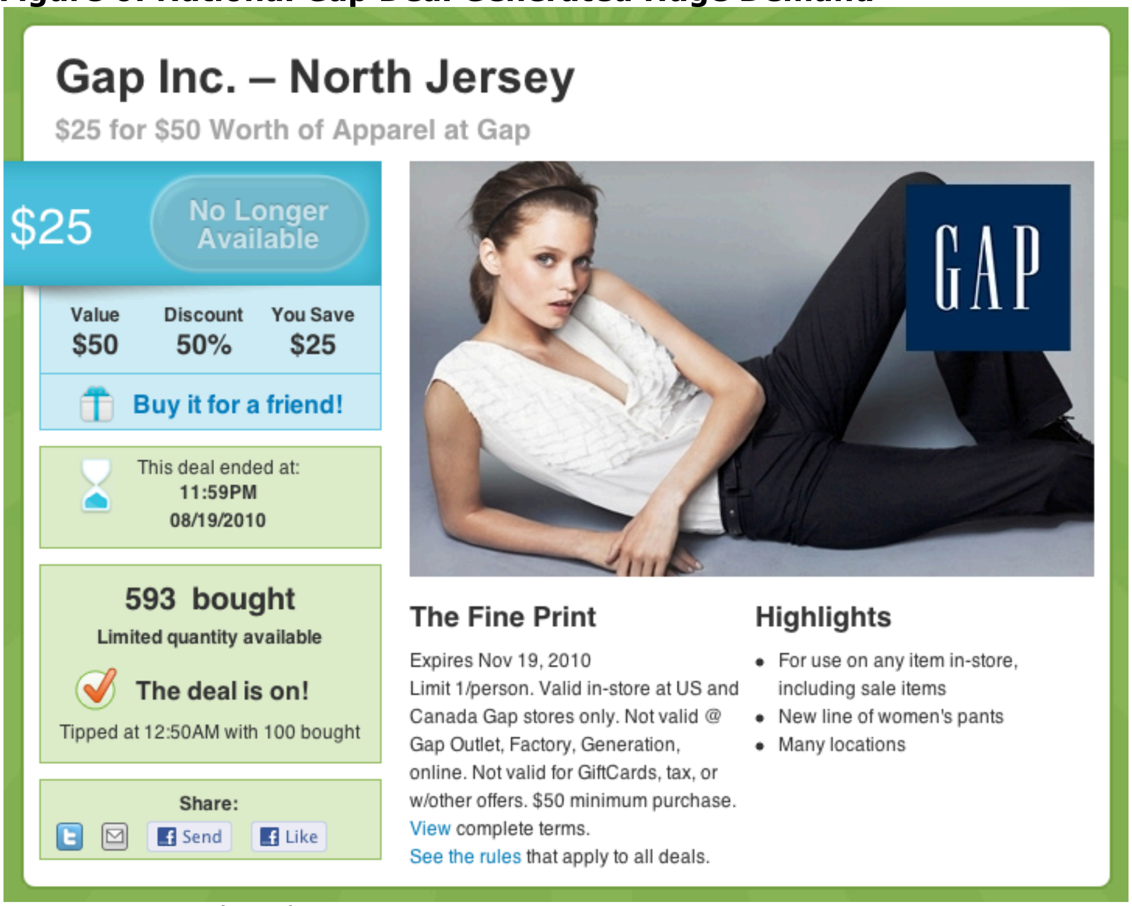
Source: JiWire Q1, 2011 (n=5,000)

National Brands Get in on the Action

Daily deals began as a primarily small business phenomenon. However some of the most successful deals to date have involved national brands and retailers such as The Gap, Barnes & Noble and Amazon. In 2010 Groupon showed the national potential of daily deals. The deal in question was a nationwide offer from The Gap ($25 for $50 worth of in-store merchandise).

Though the terms and offer were national, it was presented as a local deal to each Groupon email recipient (Figure 6).

Figure 6: National Gap Deal Generated Huge Demand

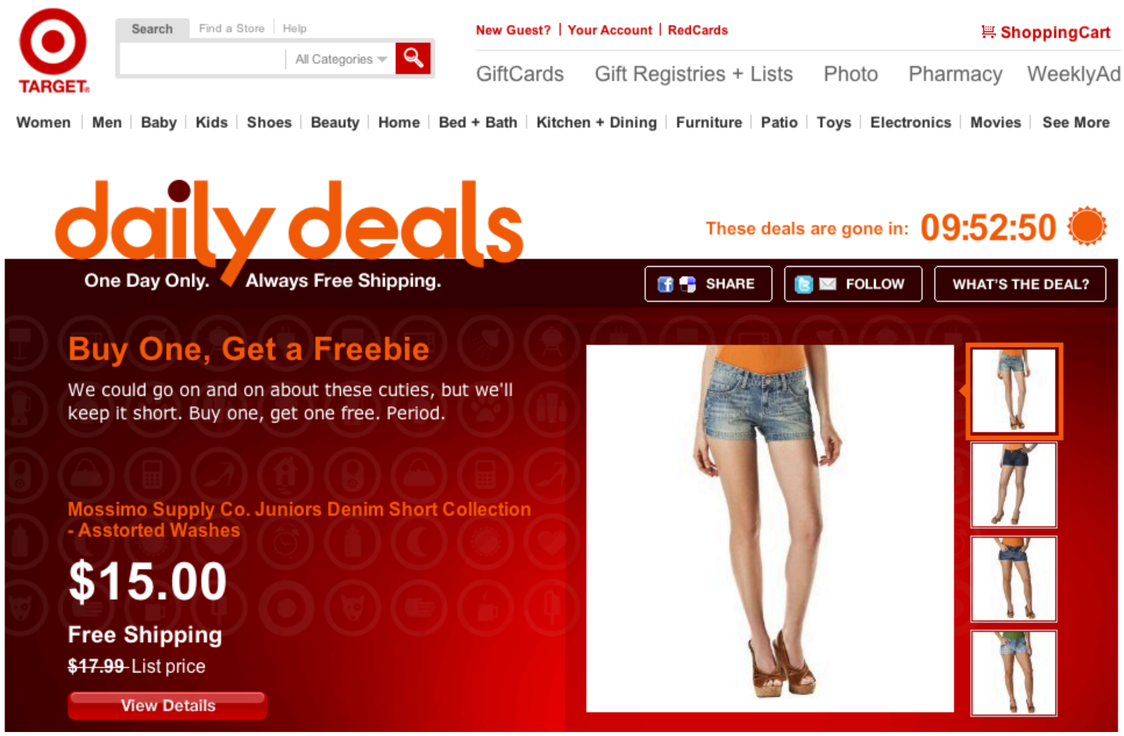


Source: Groupon (2011)

This deal saw 440,000 buyers across the country, generating an estimated $11 million in gross revenue. On an even larger scale, LivingSocial ran a deal promoting a $20 Amazon gift card for $10. The company sold 1.4 million in just over 24 hours. LivingSocial may have taken a loss on the promotion to generate brand awareness and acquire more consumer email addresses. Nonetheless it demonstrated the power of daily deals for national promotions. There have also been movie ("The Lincoln Lawyer") and magazine promotions (Newsweek) via daily deal sites.

Traditional retailers have also caught daily deal fever. Target, Walmart and other national retailers are offering daily deals on their sites. Fifty percent off sales have long been a staple of retail marketing. However the vocabulary and packaging of daily deals are making their appearance on retail sites and in their email marketing.

Figure 7: Daily Deals Creep into Traditional Retail



Source: Target (2011)

National brands and major retailers will likely continue to experiment with deals as a way to drive foot traffic into physical stores. While some major brands are ambivalent about discounting, there should be considerable action and growth among national and regional businesses offering various flavors of daily deals. Local Offer Network, an aggregator of daily deals, reported earlier this year that there were now "70 sites in the US exclusively offer[ing] national daily deals."

Closing the Loop (Online to Offline)

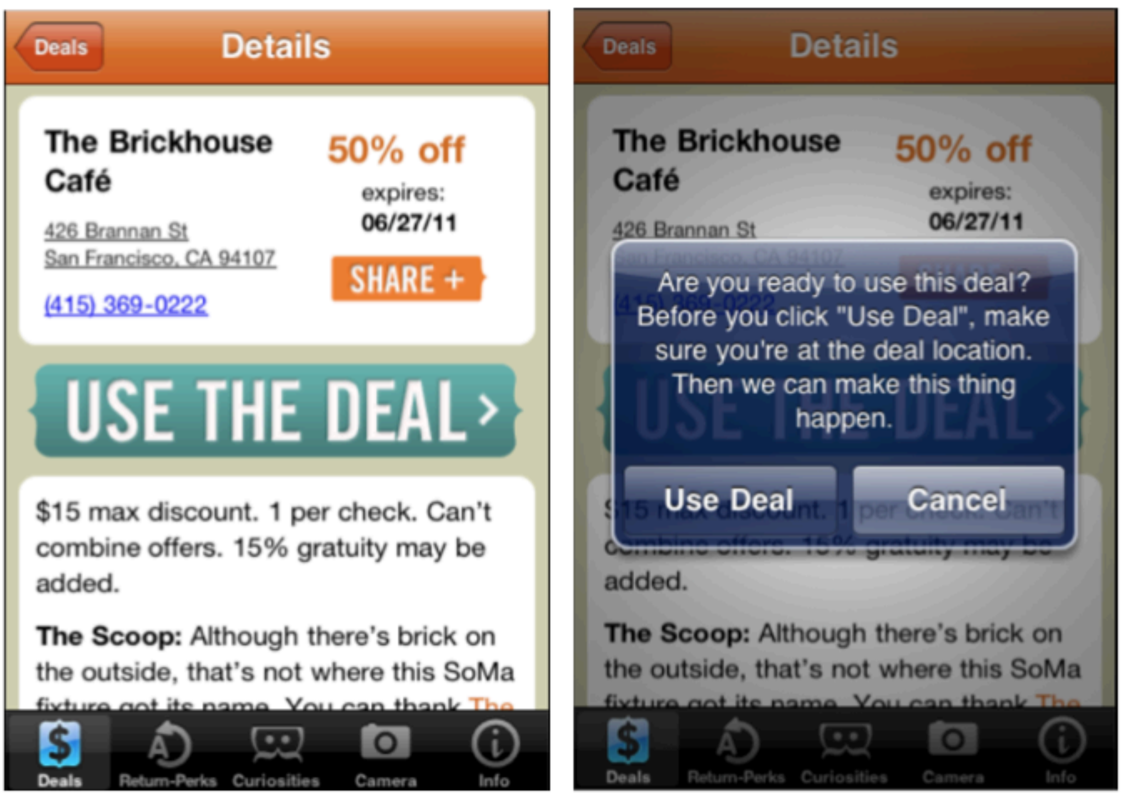
One of the factors that previously obscured the relationship between online research and offline purchase behavior was the inability to track consumers from the Internet to the point of sale. Paper coupons, printed from the Internet, were historically one the very few ways to do so. Manually tracking coupon redemptions at the register is flawed, however, because local merchants often keep imperfect records — if they keep any at all.

Because daily deals are bought online they provide immediate feedback about the success of a particular promotion or campaign. Purchase metrics can quickly be reported to merchants for a transparent analysis of success and ROI. To gain complete visibility into the number of deals bought versus redeemed, there's still some work involved. Deal vendors frequently query both merchants and consumers to determine whether a particular deal has been used.

Mobile distribution and deal redemption (in lieu of printing) add some new twists to deal tracking and reporting. Sites such as Foursquare, Facebook (with check-in offers), Scoutmob or ShopKick offer deals or rewards only upon check-in at a local business. These are variations on the more traditional coupon model, where the offer is free to consumers and redeemed at the point of sale rather than purchased in advance.

In the "check-in" examples, a user must indicate her presence at the business location to receive the deal. An interesting twist on the business model, mobile app Scoutmob charges a per-customer bounty (like OpenTable) for each person it actually sends to the merchant's location. Once the user is physically present she presses the "use deal" button (Figure 8). The phone's location software or GPS validates the user is in fact at the business. There's no question whether the consumer visited the store or used the deal; it's one and the same.

Figure 8: Scoutmob Deals Rely on GPS for Confirmation



Source: Scoutmob (2011)

The Daily 'Dealcosystem'

In roughly two years the daily deals market has evolved into a relatively developed ecosystem of sales channels, platforms, aggregators and consumer distribution points. As with other online sectors, few companies are able to control all elements of the value chain: sales, content and distribution. For all but the largest or most visible companies there's some inevitable reliance on third parties to fill the gaps. In addition, what might be called "the daily dealcosystem" echoes other online ad ecosystems and sits on top of existing buyer-seller infrastructure and local sales channels.

Figure 9: Daily Deals Ecosystem

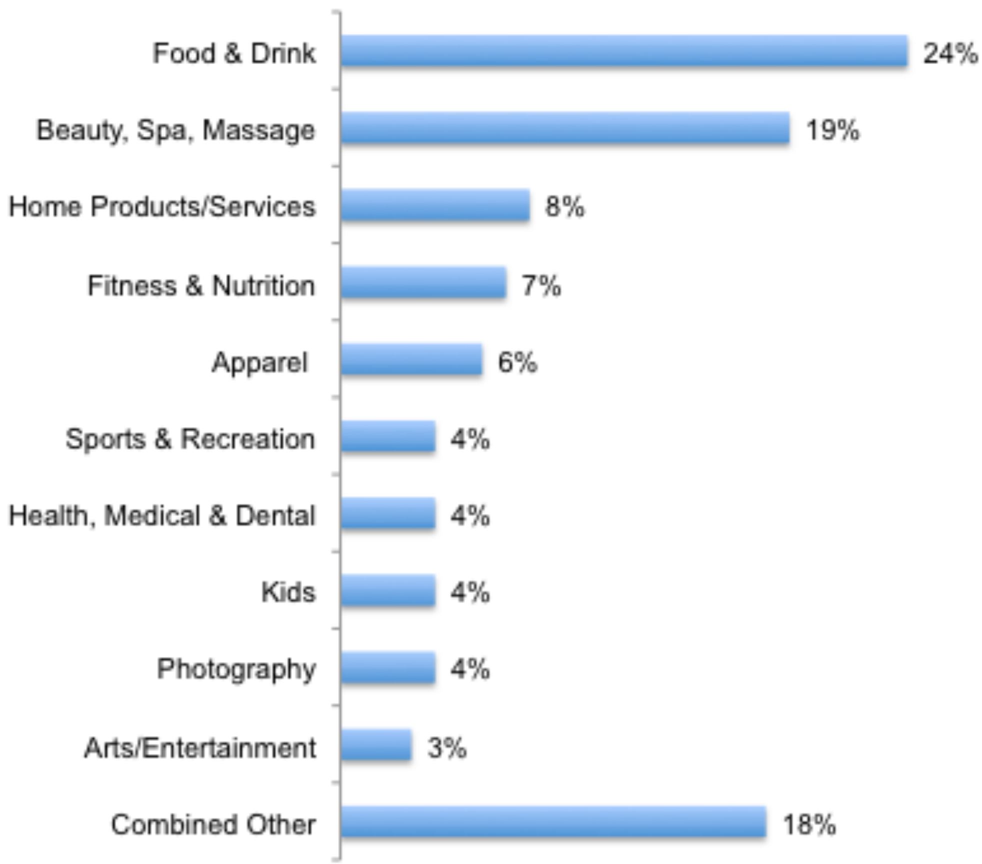
Source: Opus Research (2011)

The categories and companies in Figure 9 represent a sampling of the players in the ecosystem. The chart is by no means exhaustive; there are more elaborate versions featuring dozens of companies. In addition many companies occupy more than one category. For example, AT&T Interactive, which operates YP.com and the YP Local Ad network, could be represented in three "buckets": as a publisher, syndicator of deals and a local sales channel. That's also true of Groupon, The Dealmap, CityGrid and others as well.

Deal Demand and Consumer Metrics

Daily deals are offered in at least 80 US markets, up from roughly 48 in Q1 of 2010, according to Local Offer Network. More than 63,000 deals were published in the US in 2010. Almost 40,000 were distributed in Q1 2011 alone according to the deals platform and syndicator. If that pace holds, deal volume by the end of 2011 will be nearly three times what it was last year. Figure 10 shows the concentration of deals by category for Q1 2011.

Figure 10: Concentration of Deals by Category



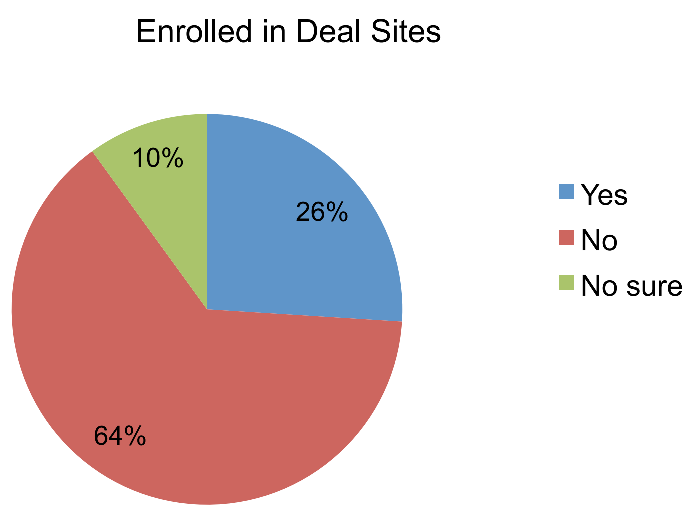
Source: Local Offer Network (Q1 2011)

The average deal price in Q1 2011 was $43 according to Local Offer Network's review of the almost 100,000 offers in its database. The company said that 86% of deal buyers purchased only one deal at a time and 14% of transactions included "multiple vouchers for the same deal."

While there is evidence of consumer "deal fatigue," enrollment in daily deal programs appears to be accelerating. According to a survey of 22,000 US visitors to the "top 100 sites," by Forsee Results, two-thirds of respondents said they were signed up for at least one daily deal program. Conducted in May of this year, the survey also found that 60% of those receiving daily deals had purchased one within the past 90 days.

These numbers are impressive. But while the survey sample is very large, one shouldn't conclude that two-thirds of all online consumers are now enrolled in daily deals programs. That would translate into about 140 million people today. As a counterpoint, the AT&T Interactive-Nielsen survey of over 1,500 mobile consumers found a substantial but much more modest percentage (26%) of users enrolled in deal programs.

Figure 11: Mobile Users Enrolled in Deal Programs



Source: AT&T Interactive-Nielsen Q1 2011 (n=1,526)

If the more conservative AT&T survey data are taken as a proxy for the broader online population of deal-program subscribers, it would mean roughly 50 to 60 million users overall. The total US online population is about 212 million, while the total US mobile subscriber population is 234 million, according to comScore. The number of deal buyers (vs. subscribers) may be substantially less however.

Consider that Groupon disclosed in its S-1 filing that it had 83.1 million subscribers globally (Q1 2011) but slightly fewer than 16 million of them had purchased at least one deal. In other words, roughly 19% of Groupon subscribers are deal buyers. Depending on one's perspective this is either a half-empty or half-full story. The small group of deal buyers relative to email subscribers either points to conversion failure or a huge consumer opportunity still waiting to be tapped.

Have Deal Will Travel

Consumers may be willing to travel considerable distances to get a deal. How "distance sensitive" are deal buyers? WiFi ad network JiWire found in its Q4 2010 consumer survey (n=5,500) that as discounts increase consumers are willing to travel farther, as one might predict.

JiWire asked consumers "how much farther are you willing to travel for a discount?" on a $100 item. The company proposed a range of escalating discounts tied to increasing distances. The survey found that nearly half (45%) of respondents were willing to travel 30 minutes for 25% off and slightly fewer (40%) said that they'd travel an hour for a 50% off deal.

Figure 12: How Far Consumers Willing to Go for a Deal

Percent saying "yes"	Travel time to get deal	Deal value
55%	15 minutes	10% off
45%	30 minutes	25% off
40%	1 hour	50% off
28%	2 hours	75% off
31%	2+ hours	100% off

Source: JiWire Q4 2010 (n=5,500)

Lightspeed Research asked consumers a similar question earlier this year: "What is the farthest you have been willing to travel to use a deal?" The largest block of respondents (55%) said they had traveled or would have been willing to travel between up to 20 miles. But 35% said they were willing travel more than 20 miles to get a deal; and almost 20% said that they would go 30 (or more) miles for a deal.

Figure 13: How Far Consumers Have Traveled for a Deal

Made a daily deal purchase	Total responding
Less than 5 miles	10%
6 - 10 miles	22%
11 - 20 miles	33%
20 - 30 miles	17%
30+ miles	18%

Source: Lightspeed Research May 2001 (n=3,300)

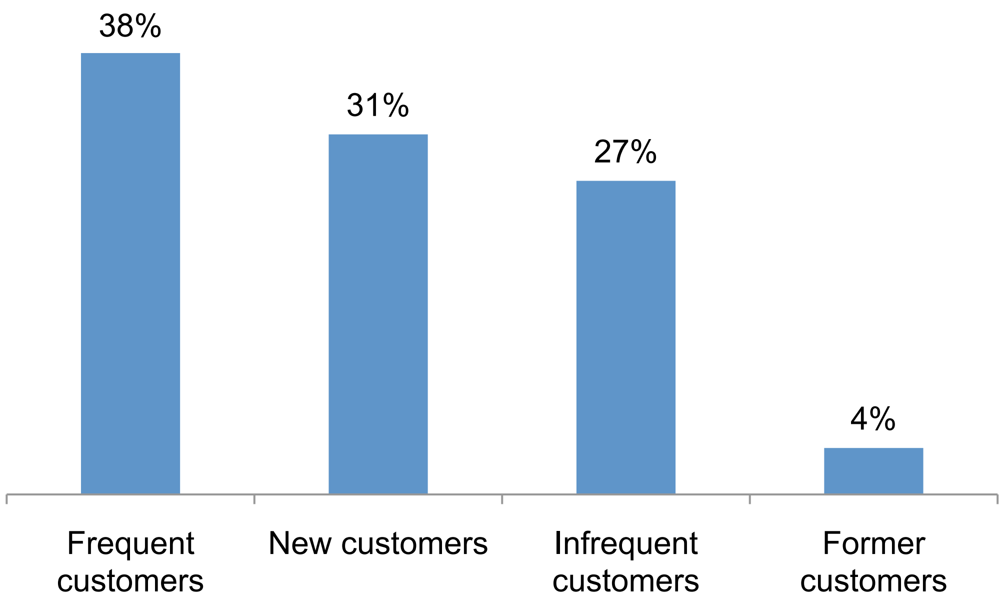
Do merchants actually want to attract customers from outside their immediate area? It depends on the type of business. In general, however, those from farther aware are going to be less inclined to return to the business in the absence of a deal.

Deal Buyers: New or Existing Customers?

There are several key ROI questions at the heart of the daily deals model for merchants. One of the most important asks whether deal buyers will come back or are they simply having a "one night stand"? A related question is: do daily deals cannibalize existing customer relationships? The evidence in both cases is somewhat mixed.

A June 2011 Rice University survey of 324 local merchants running daily deals across several large sites found that 80% of deal buyers were reportedly new customers. By contrast, the Foresee Results study found that 65% of deal buyers were current or former customers (Figure 14). Only 31% of deal buyers in Foresee Results survey were truly new customers — a significant discrepancy with the Rice data. However the weight of evidence suggests that the correct new-customer figure is closer to 31% than 80%.

Figure 14: Many Deal Buyers Already Customers



Source: Foresee Results Q2 2011 (n=22,000)

Lasting Relationship or 'Just a One Night Stand'?

There's been substantial debate about whether deal buyers are desirable customers and whether they'll return and pay full price. Considerable feedback and discussion suggests that many are highly price sensitive and don't spend much, if anything, beyond the face value of the voucher. Groupon claims, however, that its customers "spend an average of 60% above the value [of the daily deal]." The company also asserts that 89% of merchants say daily deal customers are "likely repeat customers."

A 2010 daily deal survey from Rice University ("Groupon Effectiveness Study") polled 150 small businesses that had run Groupon daily deals. The following statement was presented as representative of a common merchant experience with deal buyers:

> *One restaurant owner observed that "Most of the Grouponers were what we call 'deal- seekers'; they felt entitled to special treatment, didn't spend more than what the Groupon itself cost, they didn't tip, and most won't be repeat customers."*

However, the May 2011 Lightspeed Research indicated that 60% of deal buyers spent more than face value of the deal. These data are somewhat misleading, as explained below, because they don't distinguish between new and existing customers who bought deals.

Figure 15: Spent More than Face Value of Deal

Made a daily deal purchase	Total responding
Yes	60%
No	40%

Source: Lightspeed Research May 2001 (n=3,300)

The June 2011 Rice University study found that "35.9% of deal users spent beyond the deal's face value." Though lower than 60%, this is still a meaningful number. On the question of repeat visits, several deal vendors have reported between 10% and 20% of new-customer deal buyers will return at full price. The Lightspeed survey reported 65% of deal buyers returned to the business later without a deal.

Figure 16: Customers Who Returned to Business Later

Made a daily deal purchase	Total responding
Yes	65%
No	35%

Source: Lightspeed Research May 2001 (n=3,300)

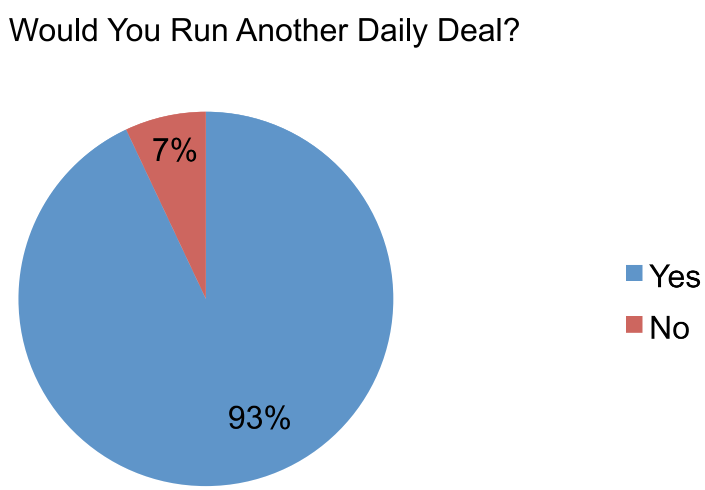
Yet almost two-thirds of the "repeaters" in the Lightspeed study were already customers of the deal merchants. In other words, existing customers had bought the deal and later returned to buy at full price. These findings are consistent with the Foresee Results data, showing that 65% of deal buyers were current or former customers.

The June 2011 Rice University survey reported that roughly 20% of deal buyers, who were truly new customers, returned to the business and paid full price on a later visit.

The ROI of Daily Deals

Groupon has claimed 95% merchant satisfaction and interest in repeating a daily deal. A telephone-based survey by deal aggregator Yipit in early 2011 found 93% of merchants would run another deal (Figure 17). Other data, however, reflect more merchant ambivalence. Several surveys indicate that just under 50% of deal merchants would do it again.

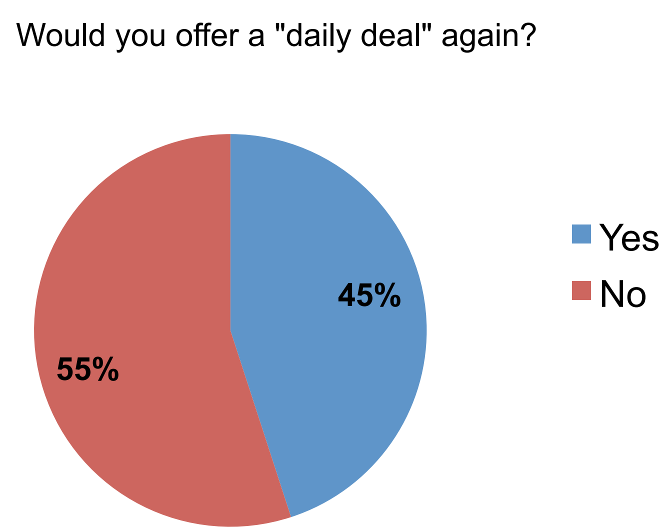
Figure 17: Large Majority Want Another Deal (Yipit)



Source: Yipit, 2011 (n=80; SMBs that had run a daily deal w/in past 12 months)

In February 2011 Opus Research found that 77% of 8,475 small businesses survey respondents had not run a daily deal. But of those that had, nearly 55% said they would not do it again.

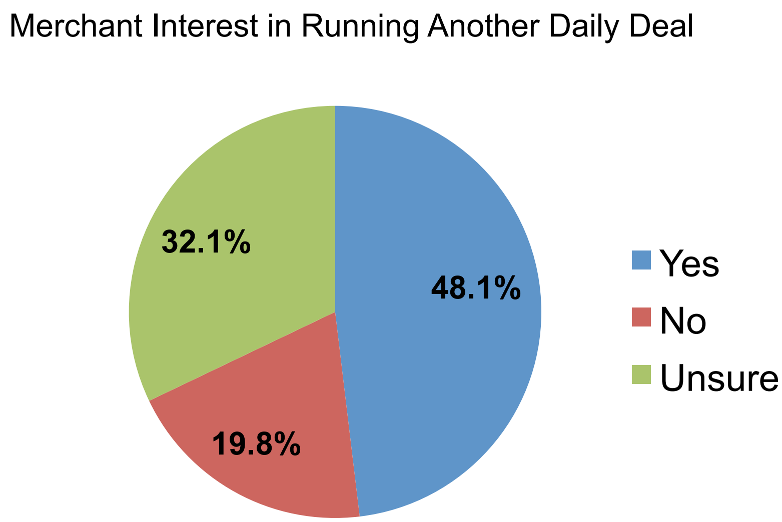
Figure 18: Most Wouldn't Run a Second Deal (Opus)



Source: Opus Research, 2011 (n=1,546 SMBs that said they had run a daily deal)

The Opus data is in line with the 2010 Rice "Groupon Effectiveness Study," which found that 42% of Groupon merchants would not run another deal. The larger Rice 2011 follow-up survey reported more "positive" results: 48% of merchants said that they planned to (Figure 19).

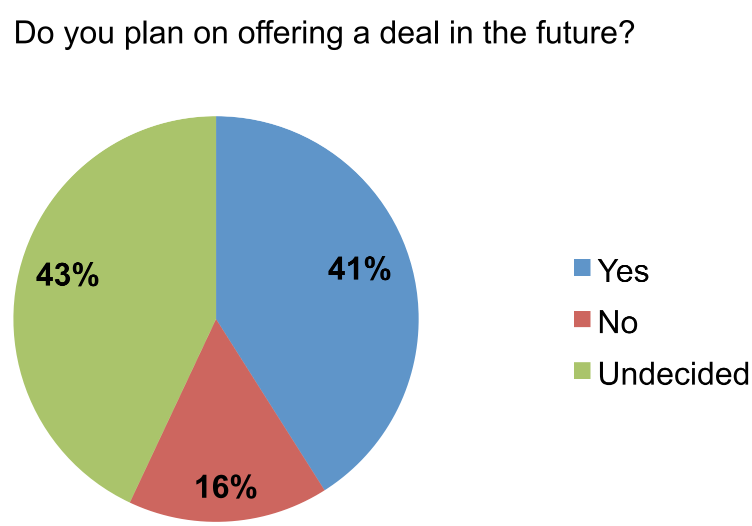
Figure 19: Many Plan to Offer Another Deal (Rice)



Source: Rice University, June 2011 n=324 daily deal merchants

An online survey by CityVoter (Q2 2011, n=321) found that 41% of deal merchants planned on offering another deal, while a larger number were uncertain or negative.

Figure 20: High Percentage of Merchants Undecided (CityVoter)



Source: CityVoter, June 2011 n=321 SMBs who used daily deals

Putting aside the Yipit survey findings (93% would repeat), which are an outlier, the average number of merchants willing to repeat is about 48%. In other words, about half of merchants would choose to run another daily deal; the other half would not.

Specific Item vs. Dollar-Value Deals

There are two general flavors of daily deals: those that offer a specific item or service (e.g., Italian lessons 50% off) and those that offer money to spend on anything from the particular merchant (e.g., $15 for $30 worth of baked goods). In the former case the consumer must purchase a specific item or service; in the latter, she has discretion over what to buy.

The 2011 Rice University study looked at the impact of each type of promotion on the merchant and the consumer. Rice found that 65% of its merchant-respondents ran item-deals and 35% ran dollar promotions. The study found mixed results. Perhaps unexpectedly, 59% of item deals were profitable but only 47% of the dollar deals. More of the item-deal merchants (79%) intended to run future deals vs. dollar-deal merchants (59%). Item-deals also brought in more new customers than dollar deals; some became repeat customers.

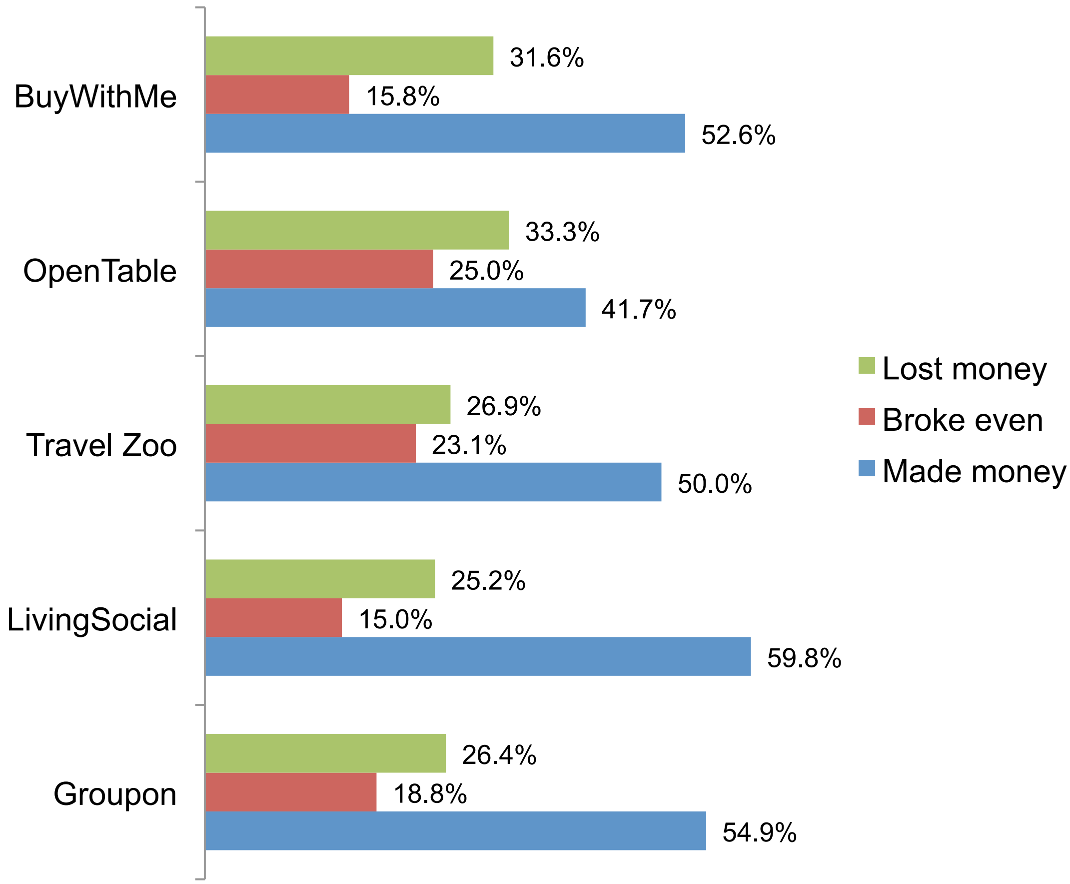
Overall, however, item-deal consumers rarely spent money beyond the face value of the offer. Dollar-deal buyers, on average, tended to spend more than the price of the deal. While dollar-deals may be “safer” in many respects, item–deals (according to the Rice data) appear to perform better overall and deliver a better response for merchants.

How Many Deals Make Money?

The survey data reflected in Figures 17 through 20 paint a picture of merchant uncertainty and ambivalence about daily deals and their effectiveness. Merchant attitudes are probably directly tied to whether the deal experience was profitable. On average slightly more than 50% of deals turn out to be profitable, while 25% to 30% lose money.

In at least one survey, however, merchants who claim to have had profitable deals didn’t automatically want to repeat. The CityVoter data (Figure 20) show 54% of merchants made money, while 25% broke even and 21% lost money. Yet only 41% of merchants were willing to do another deal, not the full 54%. Another 43% were “undecided” and 16% said “no” to another deal. Thus, 13% in the profitable category were undecided or negative on a follow-up deal.

Figure 21: Profitable vs. Unprofitable Deals



Source: Rice University, June 2011 n=324 daily deal merchants

The June 2011 Rice study found a similar number of merchants (55%) who characterized their deal experiences as profitable, while 18% of merchants reported that they broke even and roughly 27% said the deals were unprofitable. As Figure 18 illustrates, 48% of merchants said they would do another deal. That means that approximately 7% of "profitable" merchants were "unsure" or in the "no" group.

One of the reasons behind negative or unprofitable deal experiences is a lack of merchant education or sophistication about daily deals. The market is still relatively young and most SMBs have little or no experience with this new channel. Too often sales reps don't take the time to educate business owners about how to prepare for the influx of customers or how to structure deals to maximize the chances of success.

Emerging 'Best Practices' for Merchants

Even though they're not being communicated to merchants in most cases, a set of best practices is starting to emerge. The following is an abbreviated list of recommendations drawn from our analysis, third party research and conversations with numerous deal vendors and market observers. Some of recommendations are not equally available from all deal providers, while some are matters for negotiation.

- **Don't abandon other marketing:** Daily deals are not a total substitute for general marketing or advertising. Deals can be a highly effective complement to other marketing efforts.

- **Understand customer value:** Have a clear understanding of what a customer is worth (per visit and lifetime value). Roughly 10% to 20% of new-customer deal buyers will return later and buy at full-price.

- **Items vs. dollar deals:** Merchants report that specific-item deals are more effective and profitable than so-called "dollar promotions." If doing a dollar promotion, however, set the deal value at less than the full cost of the service or product (e.g., average cost of single meal, salon visit) to encourage spending beyond face value of the deal.

- **Have a plan to follow up:** The deal vendor won't turn over the email list in most cases. Develop a plan to acquire new customer contact information (i.e., address or email) and/or how to drive them to "Like" or "follow" the business on social media sites.

- **Not all vendors are equal:** Research vendors and understand the differences in policies and payment terms. Seek out merchants that have run deals; learn what worked and what didn't. Get case studies online or from deal vendors (if possible in the same industry segment).

- **Deals on labor-intensive services:** Where merchant time is "inventory" (e.g., massage therapy) a popular deal could impact servicing of full-price customers or result in a loss. Scheduling restrictions should be built around these deals.

- **Discount selectively:** Avoid discounting a well-performing service or best-selling product.

- **Cap the deal:** Limit the overall number of deals available (at one time this wasn't possible). If not possible, plan for lower and higher demand scenarios and how those might impact the business.

- **New customers only:** Make the deal available to new customers only (if new customer acquisition is the objective). As a practical matter this may be challenging to enforce but the offer can state this explicitly if allowed.

- **Limit availability:** Make the deal available on selected days, dates or periods — if inventory management is the objective. This is now becoming possible and may be more readily available in a mobile context (e.g., LivingSocial Instant).

- **Encourage multiple visits:** There are ways to structure deals to reward multiple visits. Some deal vendors say they are increasingly trying to work with merchants on packages of multiple deals. More loyalty oriented deals and offers will soon be available

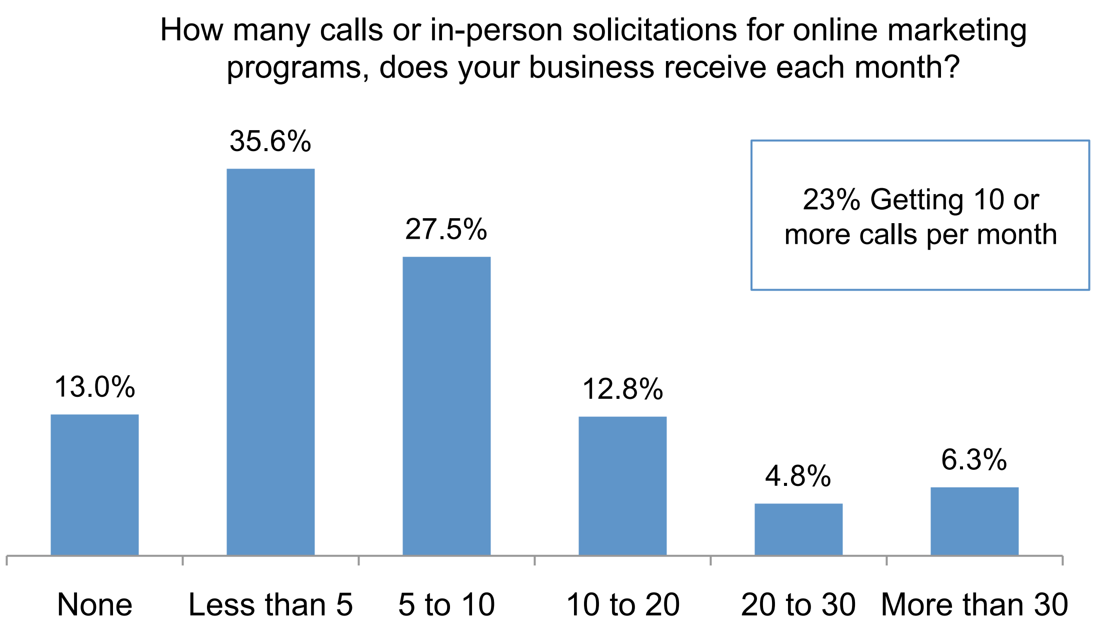
- **Redemption cycle:** Deals will be redeemed over the course of a year but will likely be concentrated at the beginning and end of the period. This may affect staffing requirements.

Self-Service vs. Full-Service

Entrepreneurs often assume it's only a matter of time before large numbers of small businesses will engage with self-service tools and online marketing programs. Those with SMB-sales experience know how wrong such assumptions can be. Perhaps in a generation it will be different.

The overwhelming majority of business owners would rather outsource online marketing to a trusted partner than become marketing experts themselves. This desire to outsource is magnified by the increasing complexity of online marketing, not to mention the growing portfolio of "solutions" being pitched at them all the time.

Figure 22: Sales Calls Received per Month



Source: Opus Research, Q1 2011 (n=6,796 SMBs)

The previously discussed CityVoter survey found that nearly half (46%) of merchants were receiving three or more sales calls per month just from deal vendors. Opus Research found that 23% of SMB survey respondents receive at least 10 sales calls or visits per month, and 51% report receiving more than five (Figure 22). That means almost 75% of SMB survey respondents are getting at least five calls per month.

Impact of Deals on Other Media Spending

As this report has already pointed out, the deals market is full of inconsistent data. While many local merchants express ambivalence or even antipathy toward daily deals, there's evidence that still others are shifting budget from other marketing channels. The early 2011 Yipit telephone survey reported that 43% of merchants were reducing their ad spending in favor of daily deals. The larger June 2011 Rice University study found something similar.

The Rice-surveyed merchants spent money on 12 marketing programs, ranging from traditional print directory advertising and direct mail to radio, TV, email and paid-search. These businesses reportedly spent about 11% of their average annual revenues (roughly $198,000) on marketing in 2010. Remarkably, daily deals constituted "the single-largest category [of spending] . . . with businesses spending an average of 23.5% of their annual marketing budget on daily deals."

These merchants are clearly the exception, given that between 75% and 85% of SMBs have yet to run a daily deal. However it's possible the Rice merchant group is something of a leading indicator for a larger number of SMBs that will later enter the daily deal market. Rice researchers found that all traditional media and marketing programs were negatively affected by spending on daily deals:

> *The largest spending drops are in yellow pages, print advertising (e.g., in magazines and newspapers) and self-managed direct mail marketing. Spending on yellow pages advertising was down 27.5%, print advertising was down 21.6% and self-managed direct mail was down 17.6%. Local radio and TV advertising also dropped substantially.*
>
> *Just as interesting, spending on email promotions and online search programs was up substantially (7.8% in each case) because of daily deal promotions, suggesting that these businesses may be using these marketing programs to drive consumers to their direct deals, and maintaining contact with them afterwards.*

The growth in spending on deals and other online media, as well as the corresponding decline in traditional media spending, are reflective of broader trends toward digital media in the SMB market and not simply the "disruptive" impact of deals.

The Outlook for Deals

The meteoric rise of daily deals has lead many observers to predict that the market will crash and burn as rapidly as it has grown. Evidence of consumer deal fatigue, merchant complaints and increasing customer acquisition costs fuel this point of view. And while some companies may disappear or fail to live up to the expectations of the public markets, any collapse of the segment as a whole is extremely unlikely.

As previously explained, deals are grounded in well-established consumer behavior. They also “work,” in most cases, to accomplish advertiser or merchant objectives: move merchandise, sell services or bring people into stores. As small merchant experience increases we should also see fewer unprofitable deals in the future.

Nonetheless the market is likely to see significant changes over the next several years. The following are several predictions about near-term developments in the segment.

Industry consolidation: Consumers indicate in surveys that they’re aware of only two or three deal sites at most. That probably maps directly to the number of vendors from which they’re willing to receive offers. In every online consumer vertical there are a discrete group of sites that have meaningful usage or scale. We can expect that pattern to be replicated in the daily deals segment.

It will be all but impossible for 400 deal vendors, white label platforms, aggregators and tool providers to survive. Only those with sufficient scale, vertical differentiation or direct merchant/consumer relationships will be able to sustain profitable businesses.

An exception could be traditional media companies and established online publishers that feature deals as part of a larger consumer or B2B offering (e.g., Yelp, OpenTable, AT&T’s YP.com, CBS). These types of businesses don’t rely on deals as a primary revenue source and could remain in the segment even if they don’t achieve the same growth or scale as the market leaders.

Reduced margins: The conventional wisdom is that 50% margins can’t be sustained. Competition and growing merchant sophistication will inevitably put pressure on what vendors can charge businesses. We agree that as a broad generalization this is true. However, the varying strength and bargaining power of different deal vendors, as well as the relative negotiating strength of merchants, will impact deal margins.

We will likely see a wide range of deal structures going forward. One-off deals may feature one margin while a multi-deal program could have a different structure. New customer acquisition and loyalty deal programs could equally have differing margin structures.

Increased mobile distribution: Mobile is becoming a key distribution platform for deals. Many deal insiders speak of mobile as the key to improved relevance and an antidote to some of the current challenges around so-called "deal fatigue." There's some truth to this theory. However mobile deal distribution is definitely not a panacea for what ails the segment. We do agree that it will be a critical and, in some cases, primary way to reach consumers however.

Greater national advertiser participation: National advertisers and brands will continue to experiment with and expand their participation in deals. Deals may become a routine way in which new products are launched or new stores opened. Most national retail chains will translate or repackage their weekly sales and FSI data into deal content for distribution in several forms across the Internet and mobile.

Deals in more ad units: A central element of the appeal of deals, beyond the discounts themselves, is that they're effectively advertising that doesn't appear to be. To invoke the marketing cliché, "they're ads that consumers see as content." Thus they have advantages over more conventional advertising, especially in a mobile context. We should see deals appear more frequently in display advertising online and in mobile. In addition more search advertising will feature deals or offers. Google "Offer Ads" are an example of this.

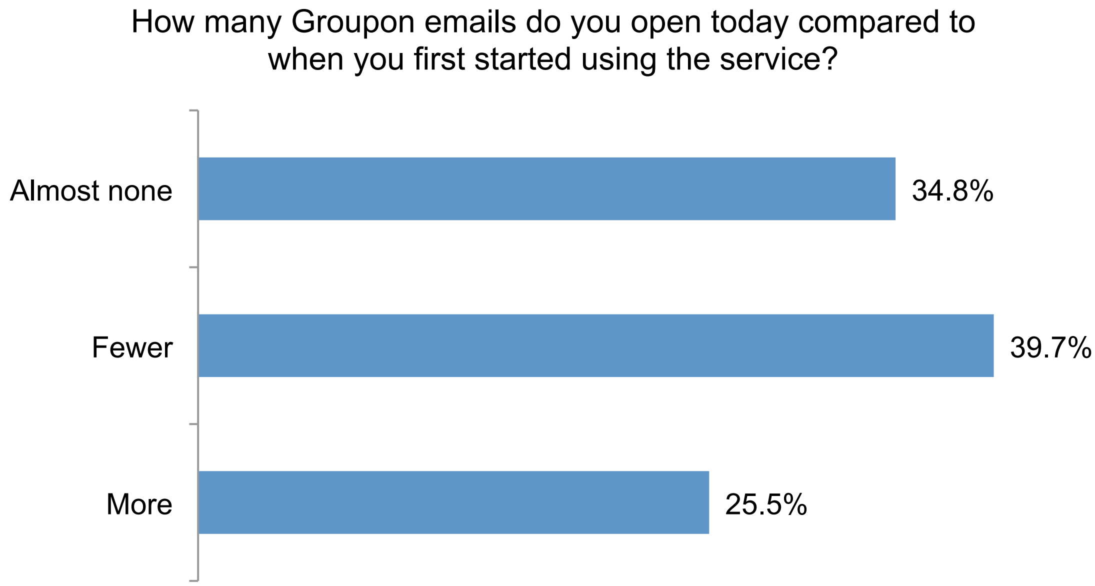
More types of deals: We've already seen deals expand dramatically in travel, into entertainment and live events and automotive. It's reasonable to expect deals — or the packaging of sales and marketing as deals — will continue to expand into adjacent areas and verticals. This development will be in tandem with the entry of new categories of advertisers into the segment.

A greater focus on loyalty: Most deals and deal providers have thus far been focused on new customer acquisition. In fairly short order we should see a much greater focus on loyalty as well. More tools, services and products should emerge to address existing customer relationships. Equally we should see merchants being allowed to build more conditions and restrictions around deals to prevent them from cannibalizing existing business and help maximize their profit potential.

How Real Is 'Deal Fatigue'?

Another critical issue is consumer "deal fatigue." We can define "deal fatigue" as decreasing engagement with deal marketing and a decline in purchase frequency. There is credible evidence that many subscriber-buyers do become less inclined to purchase deals over time. For example, a non-representative survey of readers of the online publication Business Insider found that 75% deal subscribers were opening "fewer" or "almost none" of the emails they received compared to when they first subscribed to Groupon.

Figure 23: Majority Report 'Deal Fatigue' Over Time



Source: Business Insider reader survey, March 2011 n=943

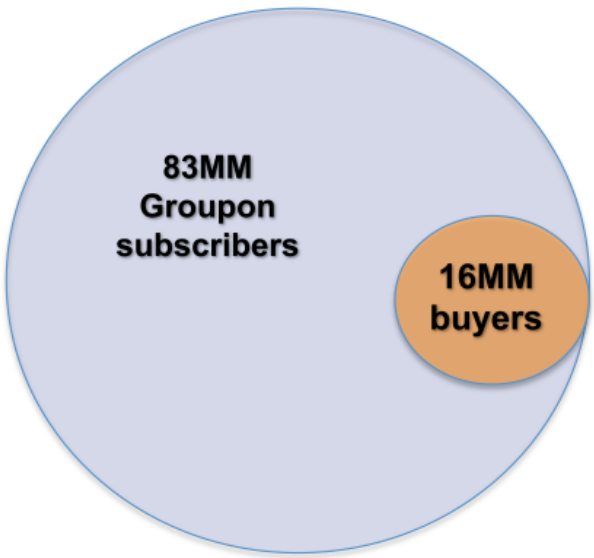
The data in Figure 23 cannot immediately be generalized to mainstream consumers. Survey respondents were self-selected and the data are not representative of the broader population. Yet the sample of nearly 1,000 respondents is large enough to prevent easy dismissal of the results. It also seems to confirm what many early adopters have informally reported: after a few months to a year, engagement with daily deal mailings begins to wane.

An analysis performed by deal aggregator Yipit, based on data disclosed in the Groupon S-1 filing, found something similar. Yipit examined deal-buying behavior in Boston, one of the company's earliest markets. There was impressive subscriber and overall revenue growth that masked underlying "deterioration" in the company's core user engagement. According to Yipit, quarterly revenue per subscriber declined from Q1 2010 to Q1 2011, chiefly because people were buying fewer deals over time.

Yipit cited "declining revenue per user, increasing customer acquisition costs and declining operating margins" as "worrisome." Yipit also concluded that Groupon's personalization initiative – running numerous deals in a single market to create greater individual relevance – was having a negative impact on the company's profitability. This was partly because "sales costs are increasing as it needs to run smaller deals with more merchants to personalize the experience."

Several people have disputed the Yipit analysis and its conclusions. Yet they are consistent with anecdotal feedback and the survey data in Figure 23. By the same token there is still enormous room for growth in the market. As mentioned, Groupon reported 83.1 million email subscribers in May. However only about 19% of them had ever bought a deal (Figure 24).

Figure 24: Enormous Room for Growth Still Exists



Source: Groupon filings, May 2011

Underscoring the remaining growth opportunity in the deals segment, an analysis of 1,172 restaurants and spas in Philadelphia and San Diego by Israeli startup Palore found that 13.7% of merchants (with websites) had run a daily deal. This figure is lower than but consistent with other empirical data that argue more than 75% of the market has yet to be penetrated.

Just as with any business, however, consumer deal buyers will have a lifespan and "lifetime value." While we can say with some certainty that deal fatigue exists, more data and analysis are needed to fully quantify its extent and to assess any patterns.

There Will Be Winners

The Groupon Boston case study also presents something of a microcosm of the entire industry. In early 2010 there were nine deal sites in Boston offering approximately 15 deals on any given day, according to Yipit. A year later there are more than 23 sites generating roughly 91 deals. Conventional wisdom and anecdotal reports in the media argue that there's little or no differentiation and no loyalty to any one brand or deal site.

A parallel line of argument says that merchants won't be loyal to any particular deal vendor. And in fact, the June 2011 Rice study found merchants were open to using deal providers other than those with which they had already worked: "72.8% [of merchants] indicated openness to considering a different daily deal site for another promotion."

But as the market becomes "noisier," we would argue, consumers and merchants will favor specific sites and ignore others. The open market will start to close. Merchants aren't going to speak to every deal vendor sales rep who calls. Lower profile and "no-name" vendors will be crowded out unless their selling proposition is especially compelling. For example, will a merchant be more inclined to take a call from a "Dealbird" or from a Facebook or a Google?

Those without brand equity or established sales assets and merchant relationships will simply be ignored or marginalized in the near future.

While differentiation may be challenging — and there are many skeptics who don't believe it's even possible — we believe it is possible and inevitable. There will be winners. Established brands, pure-play deal providers with significant reach and scale and those addressing niche or vertical markets are best positioned for longevity in this booming new industry.

For sales inquires please e-mail info@opusresearch.net or call +1 (415) 904-7666