UNDRESSING GROUPON
An Analysis of the Groupon Business Model

Ahmadali Arabshahi
December 16, 2010

Introduction

Groupon is fascinating. How can a two-year old startup employing simple technologies (e.g. email and a website) generate hundreds of millions of dollars in economic value? Where is the value coming from? In this essay, I try to provide an answer and uncover the business model's underlying principles. I find, and think that you will agree, that the model has many subtle intricacies.

From a simple perspective, Groupon is a mediation platform that connects people seeking bargains with merchants who are willing to provide them. From another perspective, it is an online couponing system. But neither description does the model justice. A better way to gain insight is to think of Groupon as a monetization strategy. The company has a very large number of email subscribers and has figured out how to monetize them in a self-reinforcing virtuous cycle. They do it by providing something of value to merchants. Our analysis begins by examining this something of value.

Before that, we take a quick look at the subscribers:

The Subscriber Base

Groupon's massive subscribers base – 40 million according to news reports – is an email distribution list segmented on the basis of geographical boundaries and a key factor in the company's ability to mobilize customers.

Email is both the mechanism for reaching subscribers and the basis of the connection's persistence. But more importantly, it is cheap – something that can be appreciated by contrasting it with the practices of advertising in newspapers or slipping flyers under doors. With traditional methods, marginal costs increase with greater geographic coverage. But with email, the cost of sending a promotion is the same regardless of location.

Because of this property, Groupon can target the maximum relevant geographic area when promoting a local merchant. Each deal region – usually a densely populated urban best described as an "expanded local" – is large enough to cover any subscriber with the potential to participate. The harvesting of the maximum geographic area maximizes Groupon's ability to generate customers for merchants.

Value to Merchants

Merchants benefit from a Groupon transaction most obviously because of a large influx of customers over a short period of time. In the long term, a merchant can also benefit from repeat customers and referrals. We assume rational managers, so a Groupon transaction presumably leads to greater immediate profit, greater future profit, or both (i.e. not sacrificing one for the other).

In a nutshell, Groupon delivers customers using a combination of a promotional service, a price discrimination service and a supporting prepayment service. What is special is the massive scale of the business – by virtue of the large subscriber base, the "expanded local" size of each region, and the numerous markets, both domestic and international.

A Promotional Service

A promotional service is an integral part of every Groupon deal in the form of a marketing message embedded in the deal email. The creative often-funny messages are prepared by expert writers and highlight the attributes of the product or service.

The proximate goal of the messages is to drum up excitement for the deal and coax subscribers to pull the buying trigger. It is trial inducement - "we are providing this super discount to get you to try the product". But it is also an advertising message that raises awareness of the merchant over a greater "expanded local" region.

A Prepayment Service

Groupon collects payment for services provided in the future and pays merchants in advance. The service is like a prepaid gift card and benefits merchants because of the time value of money. Cash now is better than cash later. A merchant can theoretically bootstrap itself by doing a Groupon and using the cash to start or expand operations. Prepayment also benefits merchants because of non-redemptions.

The last component of value is the most significant:

An Engine for Price Discrimination

Groupon's core business is price discrimination – for now, a fancy word for discounted deals.

The fuel of Groupon's ability to deliver customers is the massive scale of the subscribers and the notion of the harvesting of the maximum geographic region – the "expanded local" – covering all potential customers.

The spark is the maximization of deal acceptance.

Groupon's promotional efforts are obviously important in convincing subscribers to buy. But ultimately, most subscribers pull the trigger because of a super discounted price. Price discrimination is therefore the second key factor in Groupon's ability to generate customers.

First a quick and simplified overview of the microeconomic theory:

In a typical market with one price, a merchant can increase customer demand by lowering price. But the benefit comes at a cost – the original customers who were willing to buy at the original price also receive the lower price and consequently provide less revenue as a group.

The answer: price discrimination – the practice of distinguishing and separating potential customers on the basis of price-sensitivity and offering a different price to each group. The revenue from the original customers is protected – by continuing to show them the original price, while additional revenue is generated from new price-sensitive customers who would otherwise stay away – because of the targeted lower price. The merchant gains as long as the lower price is higher than the marginal cost of producing their product or service.

The challenge lies in identifying price-sensitive potential customers, commonly addressed in two ways:

In 3rd degree price discrimination, an observable characteristic is used as a proxy for the price sensitivity of a customer. The observable characteristic forms the basis of segmentation and defines a coherent group for targeting. One example is the practice of offering student discounts. Students are presumably non-employed and consequently more price-sensitive as a result of the financial constraint.

In 2nd degree price discrimination, customers are categorized based on actions that reveal their price sensitivity, used when observable characteristics are lacking or impractical as a basis for segmentation. Customers are typically lured into signaling their price sensitivity based on their response to a set of choices crafted by the business. Coupons are a well-known example as users who go to the trouble of collecting them are taking an action that signals their price sensitivity.

A 3rd Degree Price Discrimination Service to Merchants

The primary Groupon service to merchants is a 3rd degree price discrimination service. From the perspective of merchants, Groupon subscribers are a readily identifiable group. The observable characteristic is that they are Groupon subscribers. The service provides a way to target the market segment directly with a promotional message and offer. All a merchant has to do is to sign a contract for the service.

It can be tempting to think of the service as block pricing - a form of 2nd degree price discrimination - because of the "deal activation threshold" requirement of a minimum number of customers. Block pricing, however, is designed to identify price sensitivity at the individual level by presenting potential customers with a quantity-based choice. With Groupon, the job of identifying price-sensitive customers is already done. Furthermore, the group is targeted with a single price, not a selection designed to elucidate price-sensitivity.

One way to appreciate the service is to contrast it with an alternative. A comparable method would have to include advertising on a grand scale – perhaps a half page advertisement in the New York Times. And the advertisement would have to include a price discrimination couponing mechanism to filter consumers based on the inconvenience of clipping them. Can you imagine coupons in the NYT? It would look terribly odd even if the editors were to allow it!

Two Tiers of 2nd Degree Price Discrimination

Groupon provides merchants with access to a unique targetable market segment of price-sensitive consumers. But how does Groupon identify price-sensitivity at the individual level in order to build the group in the first place?

As discussed previously, 2nd degree price discrimination is the method of identifying price-sensitive customers on the basis of their choices or actions. When a consumer subscribes to Groupon, they are essentially making a choice that signals their price sensitivity. If the process were a conversation, it would look like this:

Groupon: Hey, I have super duper deals, but you must give me your name.
Consumer: Oh yeah! Put me down because I'm price sensitive.

Groupon is therefore a self-selection mechanism for price-sensitive consumers to reveal themselves. Price-sensitive consumers cannot resist the bait – it is catnip for them. Subscribers provide their email address, which conveniently serves as a pipeline for continued messages.

But there is more. There is also a second tier of 2nd Degree Price Discrimination!

When subscribers are presented with a deal, there are strings attached. First, subscribers must prepay. Groupon provides the platform to do so. Secondly, they must agree to be bound by the limitations of the deal (e.g. admission after 7pm only). Lastly, subscribers must take action within the one-day limit of the deal offering. In combination, the actions are a set of choices that constitute another tier of 2nd degree price discrimination. Subscribers are signaling their price-sensitivity by agreeing to the hurdles placed in front of them.

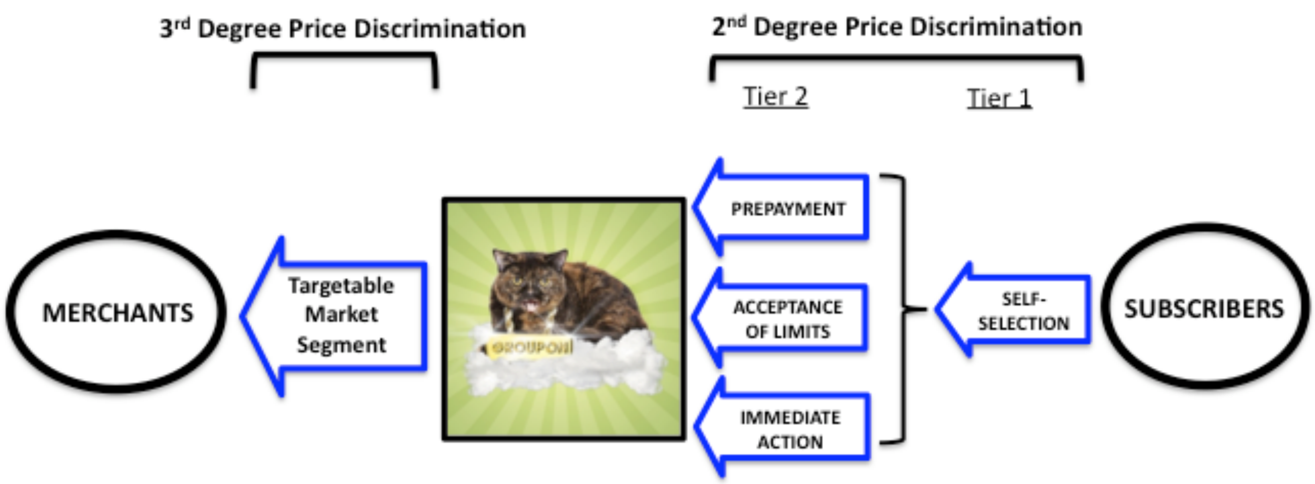
So in totality, Groupon is a highly effective two-tier 2nd degree price discrimination mechanism that filters subscribers in a way that credibly demonstrates a price-sensitive group.

Price Discrimination Degree Transformation / Arbitrage

We can now begin to appreciate the beauty of the Groupon business model.

On the merchant side, Groupon provides a convenient 3rd degree price discrimination service in the form of a coherent targetable market segment. On the subscriber side, Groupon identifies price-sensitive consumers with a two-tier 2nd degree price-discrimination mechanism comprised of a self-selection filter and a set of hurdles consisting of prepayment, acceptance of limitations, and required action within the time limit. And Groupon sits in the middle.

The business model transforms the more powerful but difficult method of 2nd degree price discrimination to a more convenient and palatable 3rd degree price discrimination service. The arrangement is essentially an arbitrage platform. In the process, Groupon extracts a premium. One way to visualize it is from the perspective of the financial flow. Groupon sells a product or a service to individual consumers at a discounted price but then effectively buys it from a merchant at an even lower price. The difference is revenue to Groupon. The notion of arbitrage stems from the fact that Groupon risks nothing in terms of having to accumulate inventory or assume any obligations. Conventional wisdom states that arbitrage should not persist in the long-term. The increase in competition from Groupon clones makes complete sense when seen in this light. Groupon's margins - the arbitrage spread – will likely erode over time.



Important Functions

There are some subtleties in the Groupon business model that might not appreciated by imitators. A number of important problems must be addressed. Whether by accident or design, the Groupon business model addresses them.

The Quality Signaling Problem

Businesses face a fundamental problem in discounting. A lower price can be interpreted as a signal of inferior quality. Price and quality are two sides of the same coin and reflect each other. If there is a mismatch, consumers can become suspicious. It's the old adage of "if the price is too good to be true, then it probably is". Because of this, merchants must provide an assurance of quality when running a discount program.

Groupon serves an essential function by providing an assurance of quality for their deals. The marketing message states it explicitly, talking about "top rated locals deals" and "the best local businesses". Customers must be persuaded that a deal price is low because of the exclusivity of the offering rather than because of a problem with the product. This is accomplished in several interesting ways:

- The Promotional Message

The promotional messages in deal emails provide assurances of quality by highlighting the attributes of the product or service. But beyond that, a more subtle confirmation bias reinforces the quality. A natural interpretation of a Groupon discount is that a merchant believes so strongly in the quality of their product that they are providing a deep discount to encourage people to try it, confident in the belief that buyers will become repeat customers. By framing the promotional message in a way that "confirms" this viewpoint, Groupon can take advantage of people's natural susceptibility to "confirmation bias" to validate the interpretation and to reinforce the premise of product quality.

- The Deal Activation Threshold

Groupon claims that the deal activation threshold is valuable to merchants since it guarantees a minimum number of customers. The claim sounds plausible and is integrated into the deal buying experience as the number of customers is counted down.

But in truth, the guarantee of a minimum number of customers is not really valuable to merchants. With most deals, justification of the discounted price requires far fewer customers. In fact, assuming rational pricing (i.e. Price > MC), a merchant should be willing to accept any number of additional customers. So even though merchants value large numbers of additional customers, there is no good reason to value the guarantee of a large number of customers.

Then why does Groupon promote the claim so prominently?

The answer is that the claim reassures customers by preemptively addressing the question - "what is the merchant receiving in return for a special discount?" By providing a false explanation – that the merchant is providing a special deal in exchange for a guarantee of a minimum number of customers – Groupon strengthens the premise of the specialness of the deal and displaces potential doubts as to the quality.

- A One Day Limit on the Availability of Each Deal and Limited Merchant Exposure

A continuous or constantly recurrent discount program can send a negative signal to potential customers. It suggests that the discount price is not special. Perhaps the product quality is low and the merchant has been forced to discount in order to sell it.

To avoid the problem, the duration and frequency of discount programs must be limited in the same way as "one day only" sales in the real world. But there is a cost in that the limitation also limits the extra customers from a longer discount program.

Groupon provides a solution because of its ability to generate a massive number of customers from a single day promotion. A merchant can receive the same number of customers in one day as with perhaps a continuous month-long discount program. And the merchant avoids the negative signaling pitfalls of overexposure from a long duration discounting campaign.

As an aside, the nature of the merchant determines how well it can cope with the additional customers; there are three categories. The first are businesses that can scale to accommodate the massive influx of customers on an immediate basis. A fitness club with huge surplus capacity is an example. They benefit from a Groupon transaction. The second are businesses that cannot scale but are expected to provide service non-the-less. A small cupcake shop with limited surplus production capacity and customer expectation of on-demand satisfaction is an example. They might not benefit from a Groupon transaction and in fact might suffer. And the last are businesses that cannot scale and are not expected to provide on-demand service. Massage therapists or other businesses that require appointments are examples. They benefit the most from a Groupon transaction. Since there is no expectation of on-demand service, the additional customers are time-shifted – via an appointment mechanism for example – and serviced over a longer duration.

The Credibility Problem

Would you trust a carpet dealership that has been advertising a going-out-of-business sale for over a year? Since a discount means nothing when applied to an inflated price, merchants face a credibility challenge and must assure potential customers of the authenticity of their discounts.

As an independent third party, Groupon serves an essential function by providing an assurance of deal value. Subscribers must be convinced that the deals are valuable and authentic.

The first way Groupon does this is by ensuring that the deals are in fact valuable. This is probably the reason the deals are often so extreme - following the old soviet adage of "when in doubt, add more steel" or more like, "when it doubt, shave another 10%".

The other way is to manage perceptions. In their marketing, Groupon talks about "huge discounts" and "incredibly low prices". But beyond just saying it, they must ensure that all their activities are congruent with a message of deal value and authenticity. Several elements stand out:

- A Single Deal Each Day

Groupon runs a single deal a day in each city. Why not several? Because Groupon needs to promote an aura of exclusivity for each deal. The implicit message is that the deals are so rare and special that there can only be one a day.

This seemingly innocuous detail governs the scaling strategy of the business model. The limitation of a single deal a day limits the revenue potential from each city. So to scale revenues, Groupon must expand geographically.

- The Myth of the Collective Buying Power

The Groupon marketing message talks about "collective buying power". The company claims to negotiate a super price on "behalf" of their subscribers. It makes subscribers feel warm and fuzzy and reinforces the message that the price is special by providing a plausible reason for it.

But in reality, the "collective buying power" does not belong to subscribers. It actually belongs to Groupon. Power implies choice, and Groupon gets to choose the merchants. Groupon also negotiates a very significant margin for itself by leveraging the "collective buying power".

A careful examination shows that Groupon's interests are not perfectly aligned with that of their subscribers. While subscribers benefit from the lowest price possible, Groupon has an incentive for a higher price because revenue is a percentage of the transaction amount. The conflict of interest must be managed to avoid any damage to Groupon's credibility.

- The Groupon Promise

The Groupon promise is essentially a guarantee of satisfaction. The company provides a refund out of its own pocket if a customer is not satisfied. The guarantee is a fantastic way to reassure customers and costs very little in practice, especially in relation to margins.

<u>The Customer Quality Problem</u>

One of the problems with discounting is that it can attract lower quality customers. The term "lower quality customer" is not meant to be pejorative. Social hierarchy is a fact of life and merchants are naturally sensitive to the kind of clientele they attract. Because of the correlation between income and social class, price is often used as a mechanism to enforce standards.

This creates a problem for price discrimination. Consider an upscale restaurant. Suppose that the restaurant has excess capacity and wants to increase customers. Now imagine if the merchant indiscriminately offers coupons with steep discounts. There is a good possibility that the restaurant will attract undesirable customers who will alienate their existing full-price clientele.

Groupon provides a solution to the customer quality problem, albeit incidentally perhaps.

The demographics of the Groupon subscriber base are highly favorable. A consumer must possess some degree of computer literacy in order to subscribe, something that correlates strongly with education, social class, and discretionary income. Even though Groupon subscribers are price-sensitive, they are not price constrained. Subscribers are typically educated, young, urban professionals. Most merchants are more than happy to cater to them.

<u>The Segmentation Problem</u>

Two conditions are necessary for successful price discrimination. A price-sensitive market segment must be identified. But importantly, the segment must be isolated from the existing customer base. A merchant must prevent existing full-price paying customers from taking advantage of the lower deal price – a situation that lowers revenue and defeats the purpose of price discrimination.

Groupon meets this challenge in two ways. First, deal offerings are not public knowledge. They are targeted emails to Groupon subscribers only. Regular customers are excluded unless they also happen to be Groupon subscribers, which is unlikely because of the second reason: a minimal overlap between Groupon's subscribers and merchants' regular customers because of a natural separation based on price-sensitivity and geography. Groupon subscribers are price-sensitive and drawn from a larger "expanded local" regional area. In contrast, merchants' regular customers are mostly price-insensitive – because of the higher-end nature of most merchants – and drawn from the local vicinity.

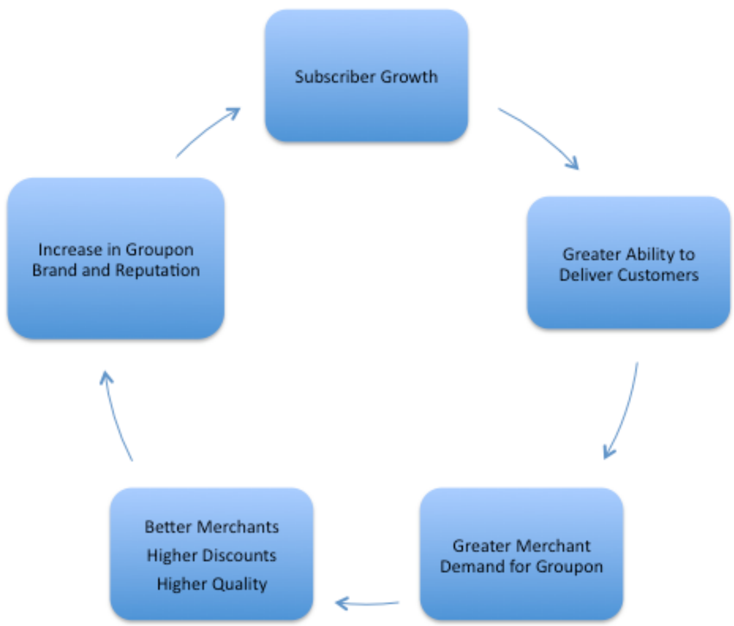
The Big Picture

Groupon is a solution to a hitherto underappreciated problem.

Quality merchants want to price discriminate to increase profits. Likewise, quality price-sensitive consumers want to consume more goods and services. Groupon provides a platform to mediate between the two groups and to increase the utility of both. The business model is a construct where information, incentives, signals, and other factors are all aligned in such a way as to achieve a better equilibrium.

A Virtuous Growth Cycle

When a system exhibits explosive growth, a positive feedback loop is often involved. Groupon owes its rapid growth to a self-reinforcing virtuous cycle:



The process is as follows:

- The Groupon brand signals:
  - An assurance of quality
  - An assurance of deal value
  - An exciting way to discover new experiences
- The message results in subscriber growth

- Because of the subscriber growth, Groupon's ability to deliver customers is enhanced
- As a result, there is greater merchant demand for Groupon
- Because of the greater merchant demand, Groupon gains leverage in:
    - Choosing higher quality merchants
    - Negotiating higher discounts
- The higher quality and deeper discounts reinforce the Groupon brand and reputation
- The cycle repeats

Resources

Groupon has been growing rapidly and maintaining super high margins despite a ridiculous number of competitors. So what gives them an edge? Certainly, being the first out of the gate has been an advantage. But what is the manifestation of the advantage?

The key resources become apparent by looking at the virtuous growth cycle.

- The Subscriber Base

Groupon's subscriber base is larger than all its competitors and a distinct competitive advantage. As seen in the virtuous cycle diagram, the subscriber base is central to Groupon's ability to deliver customers. The value of the subscriber base critically depends on the permission for continued messages, which is implicitly granted when a subscriber signs up. The privilege of intruding on a person's consciousness is very valuable. But it is also very fragile. Groupon must be careful not to abuse the privilege as customers can easily unsubscribe (i.e. Grouponicus emails).

How has Groupon managed to accumulate so many subscribers? The answer is the next key resource.

- Brand and Reputation

Groupon's most important resource is its brand and reputation.

As seen in the virtuous cycle diagram, subscriber growth, which is critical for the success of Groupon business model, relies on assurances of quality and credibility. Subscribers must believe Groupon. By managing signals, staying congruent, and doing the right things consistently, Groupon has accumulated brand equity and can therefore makes assurances as a trusted independent third party.

The Groupon brand also attracts subscribers because of its association with "discovering fun activities in your city" and finding "cool new experiences" as described by the Groupon marketing messages. Who knew you could get a Brazilian wax while taking a boat tour of NYC? The feeling of coolness is a reflection of the culture of the company and cannot be imitated easily, embodied in everything from the witty promotional messages to the fresh color scheme of the website.

- Merchant Relationships and Expertise

Groupon has invested heavily in sales and customer service capabilities. The functions generate revenue directly and are therefore very important. The accumulation of knowledge, experience and relationships with merchants can be considered a resource.

- Operations and Execution Expertise

The growth of Groupon has been phenomenal. Scaling a business so quickly is no joke. It demonstrates operational chops and management prowess. But does it demonstrate an ability to innovate? It can be argued that Groupon stumbled onto its business model. So perhaps the jury is still out on the question.

The Competitive Picture

Groupon faces two distinct competitive threats.

The first is from businesses with similar business models. There are hundreds of them, but the impact has been minimal. Margins will probably suffer in the future, but they are so high that it will take a long time for any serious problems to emerge. A factor in Groupon's favor is that the market is still growing and far being saturated. Another is that Groupon's massive scale provides a huge advantage in their ability to deliver customers and will protect market share in a more competitive environment.

For the time being, Groupon does not have to worry about imitators. The real threat is from the emergence of a superior business model.

Let us revisit the fundamental problem solved by Groupon – the need to mediate between merchants who wish to price discriminate and price sensitive consumers. Groupon's business model is a version 1.0 solution – there is a lot of room for improvement.

One problem is the model channels an inordinate number of customers to a single merchant (sometimes too many) at the exclusion of all others. Another is that it is very expensive, extracting of a heavy 50% share of the revenue – ironic since Groupon is in the business of providing a price discrimination service.

A superior model would be more plural and less onerous in terms of price. Or stated differently, it would produce higher quantities of the service at a lower price.

What would such a model look like?

First, a little ground work:

The Equivalence of Advertising and Price Discrimination

Product and price are two sides of the same coin. The worth of a product to a consumer – its utility – is subjective and depends on how much a consumer desires the product. Price, on the other hand, is an objective measure – the cost of the product in the real world.

The two are intimately connected in that they both determine the value of a product – the spread between the subjective worth of a product and the real world price. Value increases not only when a product is desired more but also when the price is lowered. Consider a silver necklace at a bargain price of ten dollars. It is actually *more* valuable than an identical gold one at a million dollars.

In the same way, advertising and price discrimination are intimately connected. Both have an equivalent objective: increasing a consumer's perception of value. Advertising does it by raising a consumer's subjective perception of the utility of the product. Price discrimination does it by lowering the price.

One thing to note: price discrimination is much trickier. Unlike advertising – which moves the value needle in only one direction (unless a marketer really screws up) – price discrimination can easily lower value if done incorrectly. Because of the complexities of signaling, a lower price can perversely lower the subjective worth of the product. Super luxury goods – where prices are completely disconnected from the inherent worth of the products – are good examples in that customers actually seek a high price in order to signal wealth.

<u>The Google</u>

The equivalence of advertising and price discrimination means that Google and Groupon are essentially in the same business – a surprising realization since the business models are so different. Both companies provide a service to influence consumers' perception of product value – Google via advertising and Groupon via price discrimination. And both aim to deliver customers – one virtually, the other in the physical world.

It begs the question: can Google compete with Groupon? If so, how?

The short answer is that they can. Moreover, they can do it well because they possess all the necessary tools and resources to innovate and create a superior business model.

Two potential scenarios are presented here. The first is an evolved version of the Groupon business model. The second is a more profound integration of price discrimination into the existing Google Adsense and Adwords platforms.

- A next generation business model

The Groupon price discrimination degree transformation model has two sides – the merchant facing side and subscriber facing side. The merchant facing side is the "real world" and involves the merchant sales and service functions. The subscriber facing side is "data" oriented and involves the fundamental task of identifying price-sensitivity.

On the "data" side of the equation, Groupon's two-tier 2nd degree price discrimination function is a relatively crude way of identifying price sensitivity, relying on self-selection and several hurdles. It works in a binary way and cannot measure the magnitude of price-sensitivity.

Google, on the other hand, has access to vast amounts of data, including Gmail user data, search queries, click-through data, and all manner of other information from their vast constellation of services. On top of that, they are experts at computational algorithms. They can easily implement sophisticated analysis to identify price-sensitive users and to measure the magnitude of the price-sensitivity as a quotient assigned to each user. For example, if a user frequents websites with information on how to save money then Google would know that the user is price sensitive. But if a Gmail user receives a reservation confirmation email from a very expensive restaurant then Google would conclude that the user is price insensitive.

The Google system would be much closer to the ideal of 1st degree price discrimination and far superior to Groupon's two-tier 2nd degree price discrimination function. It would give Google a competitive advantage in their ability to target users and to maximize profits for merchants.

All that would remain is to grow a subscriber base. Google could do that cheaply by advertising on its own platforms. More effectively, they could get permission from Gmail users to message them – easily done with a prominent "Turn on daily local deals" button in Gmail. A massive subscriber base would instantly spring to life.

On the merchant side of the equation, Google could easily imitate the Groupon model. They possess the financial resources to build their own sales and customer service organization in the same way as Groupon. But they have a much more powerful option: to externalize the merchant facing sales and service functions to independent locally based affiliates.

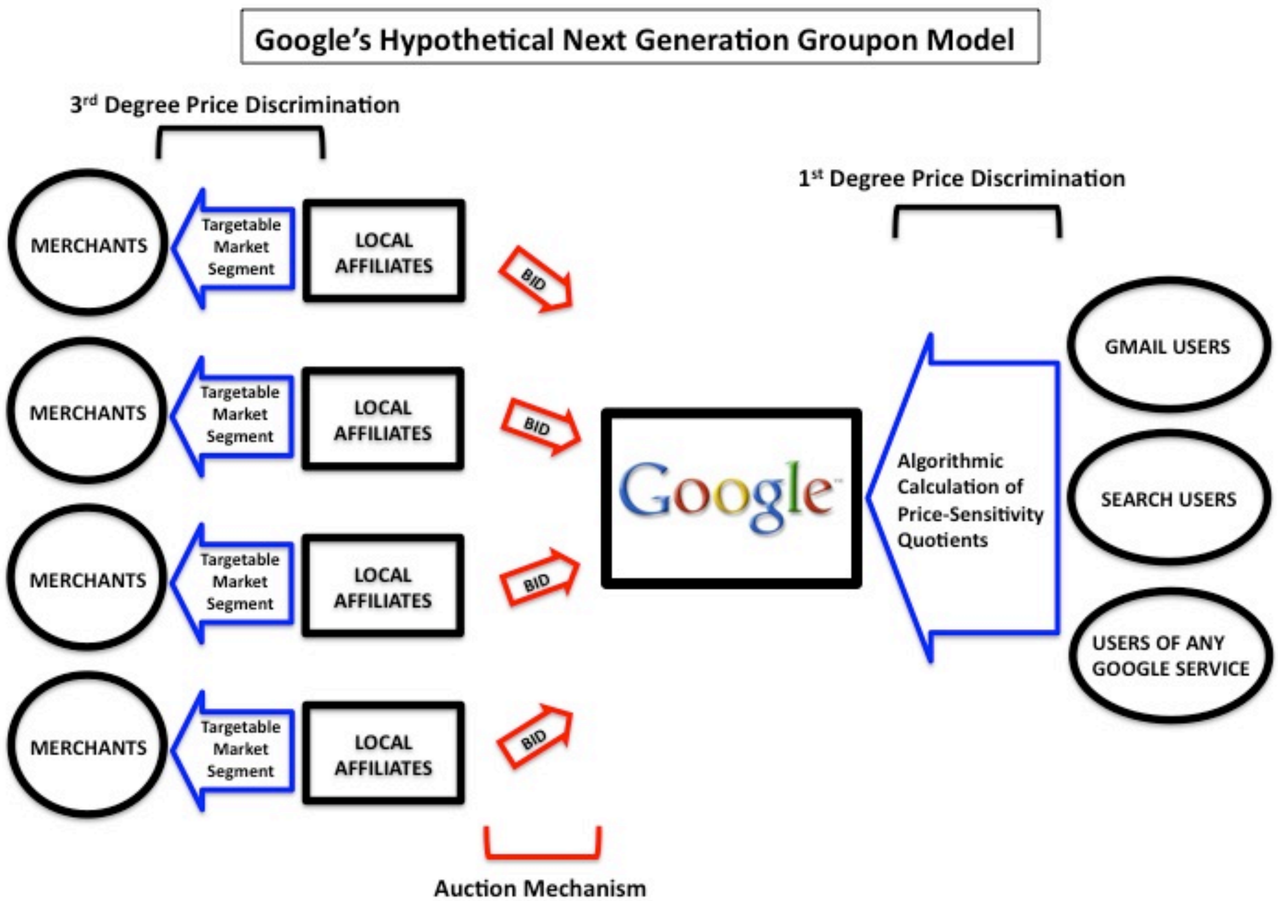
The "we provide the platform only" model would be superior for two reasons:

First, a distributed collection of local affiliates would hold an information and relational advantage over a centralized army of non-local sales and service employees (i.e. Groupon's Chicago office). Native folk know their communities better and are more effective in cultivating merchant relationships than outsiders.

Secondly, an externalized model would have a financial and scalability advantage. Internal sales and customer support employees need care and feeding and require a huge amount of working capital to support their operations (look at the funding that Groupon is soaking up). An externalized model would be more capital efficient and therefore more scalable, absent the investment requirements of growing a sales and service organization. External independent local affiliates – properly incentivized with a profit motive – would be far more effective and cost efficient in covering the many small local areas that are currently being ignored by the Groupon model.

To illustrate this, imagine a local newspaper with a restaurant review column. They could become a Google affiliate and begin to offer a deal a day for a featured restaurant. They would handle the sales, customer service, and promotional email design – all the functions performed by the merchant facing side of Groupon. They would then use the Google platform to offer a deal. The platform would take care of all the necessary technology functions, including sending emails, running the website, and payment processing. And because of lower overhead, the affiliate would share in the revenue for much less than the onerous 50% Groupon fee.

This hypothetical Google platform would require considerable thought and design. All the important issues discussed in this paper would have to be addressed. But it could be a game changer. There is tremendous room for innovation. One possibility is the integration of an auction model, in the same way as the current Adwords program. Third-party affiliates would compete for access to the Google platform. The competitive dynamics would ensure that only the best deal affiliates would continue to thrive.



- The integration of price discrimination into Adwords and Adsense

A potentially more profound application of the principles of price discrimination is integration into the existing flagship Google Adwords and Adsense platforms.

The entire basis of Google's advertising business is relevance. Advertisements are primarily targeted on the basis of search and context relevance as well as location, language and other parameters. As described already, Google possesses the resources to algorithmically identify price-sensitivity on an individual basis. Consider if this parameter is added to Google's advertising platform as a targeting option. In addition to relevance, advertisers would be able to tailor their messages based on the price-sensitivity of the viewer. A price-sensitive user might be shown an advertisement that highlights a discount whereas a price-insensitive user might be targeted with a message that highlights the high-end features of a product. The platform could also be used to distribute daily deals but with even greater flexibility.

If Groupon's power is derived from the scale of its target audience, one can only marvel at the possibilities with Google in this scenario.

Credit Card Companies

Perhaps no other business is in a better position to identify price-sensitivity than credit card companies. Offermatic, a new market entrant, uses credit card transaction information as the basis of distributing daily deals. But it appears as though they target deals based on relevance, which would mean that they are completely missing the point. Unless the deals are coupons for specific products, then the service will actually harm merchants. By ignoring price-sensitivity, merchants are chasing their own tails in a zero-sum game of stealing customers from each other or worst, possibly cannibalizing their existing full-price paying customer base.

Nonetheless, credit card companies have access to data that can yield price-sensitivity quotients for consumers. Whether they can build a business model around it is another matter. The first challenge is getting permission to message users. Perhaps it can be done, but consumers are generally not favorably disposed toward credit card companies.

Building a Better Model

We could play a game of build the business model.

Our goal would be to engineer a business model that is cooler and more efficient in connecting price-discriminating vendors with price-sensitive consumers. There is a lot room for creativity. Concepts and tools such as crowd sourcing, open APIs, notions of disintermediation, mobile platforms, twitter, the Facebook social graph, and a hundred other resources can be melded into a better platform. It just takes imagination.

Looking to the Future

If you think about it, the human condition is very inefficient.

Let us consider our privileged existence as typical American citizens. As I was leaving my apartment today to drive to the grocery store on a very cold day, a neighbor was leaving the building on foot, probably headed to the subway station. The subway station is on the way to the grocery store and it would have cost me nothing to give the person a lift. Perhaps he was willing to pay several dollars for the ride and perhaps I could have forwarded the payment to some charity. If only there was a platform to make it possible.

The reason for my trip to the grocery store was to buy milk. Unknown to me, another neighbor was there at the same time. She could have easily picked up another carton of milk and dropped it off at my place. I would have been more than happy to pay a small fee for the service. And perhaps she would have been happy to do it. It sure would have saved some gas. If only there was a platform to help make it possible.

At the grocery store I started wondering what happens to food once the expiration date passes. Google gave me the answer. It is thrown away, even the really expensive fresh crabmeat. I would have bought it if it were just a bit cheaper. If only there was a platform to help make it possible.

And these were observations from just one morning.

So what the heck does this have to do with Groupon?

With all the talk of price discrimination, social this, and Facebook that, it is easy to lose track of what is important. On an abstract level, Groupon functions to promote a more efficient usage of economic and human capacity. There is an increase in social welfare as both merchants and consumers end up with a higher utility. The price point right now might be a little high, but that is normal for the early stages of any product or service. What Groupon has done is to demonstrate the economic potential of leveraging simple technologies to address deeply embedded inefficiencies in life. And the economic potential is huge!

As Groupon looks to the future, it must find its purpose in the greater historical context. Will the company sell out or will it embrace a greater mission? They seem to be going for the latter. But do they have the innovation chops to succeed? The opportunities are there - to create next generation platforms to leverage technology and the Internet to make life better for all.