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# Groupon, Inc. (GRPN)

Q2 2019 Earnings Call

## CORPORATE PARTICIPANTS

Heather Davis

*Vice President and Head of Investor Relations, Groupon, Inc.*

Michael O. Randolfi

*Chief Financial Officer, Groupon, Inc.*

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

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## OTHER PARTICIPANTS

Thomas Champion

*Analyst, Cowen and Company, LLC*

Deepak Mathivanan

*Analyst, Barclays Capital, Inc.*

Ygal Arounian

*Analyst, Wedbush Securities, Inc.*

Thomas Ferris Forte

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good day, everyone, and welcome to Groupon's Second Quarter 2019 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the company's formal remarks. [Operator Instructions] Today's conference call is being recorded.

For opening remarks, I would like to turn the call over to the Vice President of Investor Relations, Heather Davis. Please go ahead.

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Heather Davis

*Vice President and Head of Investor Relations, Groupon, Inc.*

Good morning, and welcome to Groupon's Second Quarter 2019 Financial Results Conference Call. On the call today are CEO, Rich Williams; and CFO, Mike Randolfi.

The following discussion and responses to your questions reflect management's views as of today, July 31, 2019, only and will include forward-looking statements. Actual results may differ materially from those expressed or implied in our forward-looking statements. Additional information about risks and other factors that could potentially impact our financial results is included in our press release and in our filings with the SEC, including our annual report on Form 10-K for the year ended December 31, 2018 and subsequent quarterly reports on Form 10-Q.

We encourage investors to use our Investor Relations website at [investor.groupon.com](http://investor.groupon.com) as a way of easily finding information about the company. Groupon promptly makes available on this website the reports that the company files or furnishes with the SEC, corporate governance information, our quarterly stockholder letter, and select press releases and social media postings.

On the call today, we will also discuss the following non-GAAP financial measures, adjusted EBITDA and FX-neutral results. In our press release and our filings with the SEC, each of which is posted on our Investor Relations website, you'll find additional disclosures regarding the non-GAAP measures, including reconciliations of these measures to the most comparable measures under U.S. GAAP. All references to SG&A in 2018 exclude the charges for the IBM patent litigation.

As we discuss our results during this call, note that all comparisons unless otherwise stated, refer to year-over-year growth as-reported. All gross profit comparisons are FX-neutral with the exception of gross profit per customer, which are as-reported.

And with that, I'm happy to turn the call over to Rich.

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## Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

Thanks, Heather, and thanks to everyone for joining our quarterly conference call. We look forward to discussing our results and taking your questions. Hopefully, everyone has had the opportunity to read our quarterly letter to stockholders, which we posted yesterday on our Investor Relations site. It contains a discussion of our second quarter results, as well as our updates on our 2019 strategic initiatives.

With that, I'll hand the call over to Mike for some additional color, and then we'll take questions.

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## Michael O. Randolfi

*Chief Financial Officer, Groupon, Inc.*

Thank, Rich. In the second quarter, we generated gross profit of \$292 million and adjusted EBITDA of \$47 million, while supporting our strategic initiatives focused on card-linking, bookability, mobile experience, and building out our distribution platform.

In North America, gross profit was \$199 million, down \$21 million or 9% year-over-year. Q2 North America Local gross profit was \$158 million, down \$8 million or 5%. Q2 North America Goods gross profit was \$28 million, down \$10 million or 26%, driven by fewer North American customers, lower traffic, and shifting impressions to support our strategic initiatives.

We're seeing the benefits of improved segmentation with gross profit per customer for Q2 on a trailing 12-month basis in North America of \$30.05, up 6% versus the prior-year period.

In Q2, North America net customers declined by 1 million, which reflects the continued optimization of marketing spend towards customers that have higher potential for long-term gross profit generation and ongoing traffic headwinds, including email and SEO.

Turning to International, gross profit was \$94 million, down \$5 million or 5%. Q2 International Local gross profit was \$66 million, up \$2 million or 3%. International Goods gross profit was \$20 million, down \$6 million or 22%, resulting from a continued cautious consumer in Europe, especially in the UK, coupled with intensifying competition in our home and garden category. In response, we continued to invest in our value proposition through price, which is driving better unit trends in the region, albeit at the expense of near-term Goods gross profit.

International customers increased slightly in the second quarter. Q2 gross profit per International customer on a trailing 12-month basis was \$23.37, down 7% as-reported and 3% on an FX-neutral basis. This decline was driven by lower gross profit in Goods.

In the second quarter, on a consolidated basis, marketing expense was \$89 million, which was lower by \$5 million or 6%. In North America, Q2 marketing expense was lower by \$9 million or 14% as we continue to refine our marketing spend toward higher-value customers. In International, for Q2 marketing, we invested an incremental \$4 million as compared to the prior year to support the long-term potential of that segment.

SG&A for the second quarter was \$210 million, an improvement of \$8 million or 4% versus the comparable year-over-year period, as a result of our ongoing efficiency efforts.

During the second quarter, we repurchased 4.2 million shares for \$15 million, ending the quarter with \$260 million remaining on our share repurchase authorization. For the second quarter, we ended with \$597 million in cash and \$400 million on our undrawn revolver, which we refinanced in the second quarter with increased capacity and on better terms than our prior \$250 million revolver.

As Rich mentioned in his stockholder letter, over the last few quarters, we've developed a membership program in North America called Groupon Select, which offers great value for members for a monthly subscription fee of \$4.99. Initial indicators are positive with improved frequency, higher average order value, and increased customer propensity to search on site.

Today, we have over 150,000 members in the program, and it is scaling very quickly. To support member acquisition, we intend to leverage promotional offers for sign-up, and encourage enrollment through our checkout path, which is expected to reduce overall conversion. This equates to an anticipated investment of approximately \$10 million in the third quarter, most of which we expect to recover through membership fees as we enter the fourth quarter.

With that, while we expect customer metrics such as units to demonstrate improved trends in the third quarter as compared to the first half of 2019, we expect gross profit and adjusted EBITDA to be lower in Q3 than Q2. We continue to anticipate 2019 adjusted EBITDA of approximately \$270 million.

With that, let's open the call for questions.

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. [Operator Instructions] Our first question comes from the line of Tom Champion from Cowen. Your line is open.

Thomas Champion

*Analyst, Cowen and Company, LLC*

Q

Hi. Good morning. Mike, I'm just curious if you could talk a little bit more about the drivers of North American gross margins? Looks like a fairly substantial pullback in Goods might have been a driver, but just anything else you could point to?

And then maybe also, just any updated thoughts on customer trends in North America and getting that trajectory towards stability by the end of the year? Thank you.

Michael O. Randolfi

*Chief Financial Officer, Groupon, Inc.*

A

Sure. So, yeah, a few things. On gross margin, I mean, we continue to see nice improvement in North America, as you've noted, in gross margin, and it's entirely on the Local side. And there's really two elements there. First, we continue to surface to customers that which is most appealing and interesting to them, but also that which we believe we're going to earn the most GP on. And so our algorithms are naturally continuing to get increasingly refined over time, and that gets reflected in the overall margin.

The second thing is, we continue to see, as we've seen in the last year, an increased mix shift towards health and beauty, and particularly in the higher-end health and beauty space. So, think about things like cosmetic procedures, LASIK procedures, high-end dental. Those are areas where we've continued to build out really nice supply, and that supply performs really well on our site, on our apps, with our demographic. And so those tend to be higher-margin categories, and they've done really well for us. So those are the two drivers with regard to margin.

On the customer side, what I would say is, we've talked about this over the last few quarters. Our expectation through this year is that the trends you're seeing in customers will be the trends you continue to see through this year. And as we've talked about, we continue to become increasingly granular and segmented with regards to who we market to, how we market to, how much we spend, and to ensure we're getting our 12 to 18-month payback. And so the trends you're seeing in the second quarter are the ones I would expect in the third and fourth quarter.

Now what we've also talked about is as we've looked at how those customers and what the trends are as we go into 2020, and we look at – as we've cycled out some of the lower-value customers coupled with a lot of our initiatives which are targeted to continue to drive engagement amongst our higher-value customers, our expectation is, is that the customer trends that you're seeing now will moderate in 2020. And that's been consistent with the commentary that we've provided in the last couple calls.

Thomas Champion

*Analyst, Cowen and Company, LLC*

Q

Thanks, Mike.

**Operator:** Our next question comes from the line of Ygal Arounian from Wedbush Securities. Your line is open.

Ygal Arounian

*Analyst, Wedbush Securities, Inc.*

Q

Hey, guys. Thanks for taking the question. I'll ask one and then a follow-up. So [ph] I wanted to see if you could parse (12:25) into the volume a little bit. The total was down 12%, and U.S. was down 18% and International is flat. So first, what's driving the disparity there?

Then, as we try to understand success of the card-linked and voucherless initiatives and becoming more of an everyday Local discovery platform, I was wondering if you could help break out what some of the volume looks like in Local versus Goods maybe in as much detail as you're willing to share? Obviously, customers are declining right now, but volume is declining faster. So just to help us think through kind of the puts and takes there.

Michael O. Randolfi

*Chief Financial Officer, Groupon, Inc.*

A

Sure. So going on discussing units, so there's a few things there that I would just highlight. And I'll talk about International and North America separately.

On the International side, we don't typically break out Local versus Goods. But what I would say is, billings is a pretty good proxy, and what you could tell from that in International is that International units on the Local side were actually growing in the last quarter, partially offset by some declines on the International Goods side.

And essentially on what we saw in International Goods is we continue to see a particularly softer consumer. There's a lot of indications that consumer confidence trended on the lower side over the last couple of quarters, actually, the lowest it's been in five years in the UK, that coupled with what we see as increased competition in a highly-fragmented market, particularly in the home and garden category, which is popular this time of year. So that's what's driving some of the declines on International Goods. But where we're most focused, what we view as most strategic on International Local, we continue to see growth.

On North America, similarly, if you look at our unit breakout and using billings as a proxy, you could see North America Local billings down 8%, North America Goods down 25%. You could see that the unit impact is going to be greatest on the Goods side.

And let me just break that out a little bit for you. Keep in mind, of the 25%, almost half of that is attributable to the fact that we have fewer customers this year than last year. About a quarter of it is attributable to us utilizing impressions specifically from Goods to support strategic initiatives, and it's specifically targeted towards the lean into our Select program. So we've been using impressions such as email or impressions and space on our site to encourage enrollment into our Select program.

The other quarter of it is going to be primarily due to declines in the free and SEO, as we've talked in prior quarters. The way I think about units though is, we've talked about this. All the initiatives that we're focused on, whether it'd be card-linking, bookability, our mobile experience and expanding supply, are all targeted towards increasing, over time, the frequency of our customer. And so those are trends that we expect to improve over time and consistent with what we talked about in our prepared remarks. As we go into the third quarter, we would expect unit trends to start to improve on a year-over-year basis relative to the first half of the year.

Ygal Arounian

*Analyst, Wedbush Securities, Inc.*

Q

Okay, great. That's really helpful. And then I want to ask on Groupon Select. First, I think you made a comment that you're going to push it into the checkout, and that's going to reduce conversions. So I want to make sure I understood that correctly and why the dynamic works that way.

And then just like overall kind of philosophically how you think about Select? It's \$5 a month, but it drives a lot of incentives. There's a lot of 25% off Local services, free shipping. I spent some time with it. It feels like you can almost get back your \$5 a month, or even through kind of one decent-size purchase you can get four to five months of your monthly subscription fee back through that purchase and that discount, [indiscernible] (17:12) good consumer value.

And can you just talk about how you think about it? If it scales, can it have a negative revenue margin impact? Are you subsidizing growth and frequency through this initiative at least in the short term as you try to scale it out? Just some thoughts around that would be helpful. Thanks.

Michael O. Randolfi

*Chief Financial Officer, Groupon, Inc.*

A

I'll start, and I'm sure Rich will add additional commentary on this. So, on the conversion path, but first, before I get into that let me just talk about one of the reasons why we've been pushing this over the last quarter or two is, this was something that we started testing early last year, and I would say it's still early days. But what I would also say, based on our indicators that we've seen so far, the consumer behavior, when someone enrolls in Select is really, really positive. We're seeing meaningful step-ups in purchase frequency, meaningful step-ups in the average order value, and a greater propensity to search. So we're really, really pleased and excited about that.

And with that, if you think about the economics, you're right. It is a great consumer proposition, and that's the intent and that's by design. If you think about the math of Groupon Select, we essentially are charging a fee of \$4.99 a month, so we will get somewhere between \$55 to \$60 per customer in gross profit per year.

As part of the Select program, you're right that we provide meaningful discounts on a given transaction. There's two things to take into account on that discount per transaction. First, in almost all cases, the discount still is at or below the current take rate. For example, if you look at Local, you look at our current take rate of 32%, 33%, the discount is 25%, so we're still earning money on the individual transaction.

And the other thing I would say with regard to the order discount is, keep in mind, we have many of our transactions today where we already are providing an order discount. So the order discount that we provide in Select at 25% isn't always a true incremental 25% relative to what consumers get today.

But the way I would think about it is a Select customer should earn us at least that \$55 to \$60 of gross profit on a per customer basis, if not more, which is almost double the average gross profit per customer that we generate today. So with that, we've continued to lean into it.

Why it effects conversion is, is we to encourage enrollment as people come through the purchase path, we highlight to them the additional savings they could generate through Select, and we offer it as an option. And we try to encourage them to enroll as they're getting ready to purchase.

Any time you add a step in the purchase path process that increases a degree of friction, and any time you do that you end up reducing conversion to some degree. In this instance we think it really makes sense because every customer enrolling, we have the potential to earn double the GP per customer as our average customer. And so that's why we're leaning into it.

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

A

Yeah. I think that's right. And just to speak a little bit about the philosophy and where we are on it now, you asked whether we're thinking about it as a way to subsidize growth and frequency. That's not really how we're thinking about it.

Ultimately, we're looking for a way to monetize what has historically been member-like behavior in our customer base. So we've had that member-like behavior for years, but we haven't had a member-like monetization model to go along with it. We saw an opportunity to do that and to build that.

And we – really we set a philosophy for the program out of the gate to make it as incredibly compelling as we could, really to drive engagement and frequency and commitment to the platform and to Groupon over time more so than thinking about [ph] in a way as subsidiary of (21:57) growth. And I think hopefully now as you've heard Mike walk through the economics of the program, you see there's really – there's not a 'subsidy' there more so than it is just making the core Groupon value prop even more compelling.

And our goal pushing forward is to double down on what you mentioned now, which I think it is compelling today, but as we bring more features in, more partners in, and more unique experiences in, we think we have a program that starts to get into the no-brainer territory, the why wouldn't you territory, that ultimately over time can support higher membership fees.

But today, our focus is entirely gain traction in the program, gain trial in the program, get as many of our customers into the Select experience as we possibly can so that we can continue to add value, share the economics with them, and build those healthier relationships over time.

Ygal Arounian

*Analyst, Wedbush Securities, Inc.*

Q

Great. Super helpful. Thank you so much.

Michael O. Randolfi

*Chief Financial Officer, Groupon, Inc.*

A

Thanks, Ygal.

**Operator:** Our next question comes from the line of Deepak Mathivanan from Barclays. Your line is open.

Deepak Mathivanan

*Analyst, Barclays Capital, Inc.*

Q

Great. Thanks, guys. Two questions. So first, Rich, on the Select program once again, it seems like the early days. The adoption is pretty good for the program. Where do you think it can reach in terms of penetration, say, in the next two to three years?



And on the impact from impressions allocated to Select, are you confident that this will moderate sort of after 3Q and 4Q? Or is it a more kind of like a longer process on a more stable run rate?

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

A

Okay. Thanks, Deepak. Yeah. As you mentioned, it is early days, and it's hard to tell at this point what we think the upper bounds can be over the next couple of years. But when we look at it, it's much the same way as we think about Groupon overall, I mean the core of the program is savings on the services that most consumers spend on every single day. So, I don't think we're constrained by domain or by end.

I think we have a big audience that's addressable here, but we need to continue to refine the program, really refine our marketing tactics to incent trial, et cetera. I think over the next couple of quarters, we'll have a better feel for what the next few years will look like, but we do need to really continue to invest and scale to start to get some of that knowledge base built over the coming quarters.

As far as impact on impressions, Mike, you have a perspective on that?

Michael O. Randolfi

*Chief Financial Officer, Groupon, Inc.*

A

Sure. So I think there's two things there. I'd say, first, as we've included it in the purchase path, we will continue to refine that. And what you'd expect is, is over the coming months, we'll identify how to continue to have that be represented in the purchase path, while reducing the negative impact. There probably is always some negative impact from being in the purchase path.

The second thing is, is if you just think about the math, people paying \$5 a month – \$4.99 a month and how quickly just a small number of members can drive fees, you could very quickly see that the fee benefit you generate, which we see ramping into the fourth quarter, can quickly mitigate if not quickly overcome any detriment that you have from that initial conversion path hit, while you're getting people enrolled.

So what we see going into the fourth quarter is, we expect to continue to get better in terms of how it's presented in the purchase path. But more importantly, we expect fee revenue from the program to be ramping up going from the third quarter to fourth quarter.

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

A

Yeah. And the only other thing that I'll add there, Deepak, is we're like everybody else in the online space, we've spent years refining our checkout process. And as Mike mentioned earlier, any time you add something new, especially an extra step to the checkout process, the consumer reacts to that friction.

We're not going to be satisfied with that friction, this is an early program for us and it's early in our checkout funnel. We have a dedicated team that's working on conversion in our checkout funnel that is making Select a part of that conversion optimization effort. So we're not going to just sit back and be satisfied with some conversion friction there.

Over the next couple of quarters, a big part of our testing will be refining that checkout pipeline to make it as smooth and seamless for consumers as possible, and hopefully we can mitigate some of that conversion headwind that makes the compounding effect of the membership fees even more powerful as we go forward. But

we have real work to do there over the next few quarters, and we have a team whose sole focus is really pushing on those elements.

Deepak Mathivanan

*Analyst, Barclays Capital, Inc.*

Q

Okay. And if I can just ask one follow-up, how does it work on the margin side? Do you need to go in or renegotiate and get the merchant enrolled into the program or is that something that's purely under your discretion?

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

A

It's a great question, for one. Thanks for that, Deepak. But it's purely at our discretion at this point for the base of the program. But one of the things you are seeing is exclusives. So we are actually approaching merchants for exclusive experiences for Select members because we want a Select customer to have an incredible experience and the best possible experience at Groupon, which includes at the merchant.

So increasingly, we're having those conversations with merchants, but they're really about driving incremental value for both the merchant and the customer, but not to participate in the program overall, if that makes sense.

Deepak Mathivanan

*Analyst, Barclays Capital, Inc.*

Q

Okay. Very helpful. Thanks, Rich.

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

A

Thanks.

**Operator:** [Operator Instructions] Our next question comes from the line of Thomas Forte from D.A. Davidson. Your line is open.

Thomas Ferris Forte

*Analyst, D. A. Davidson & Co.*

Q

Great. Thanks for taking my question. So Rich, you're doing a really good job running the business to generate free cash flow, and the market is clearly not giving your stock credit for it. So I wanted to ask how investors should think about two possibilities; one, an accelerated repurchase effort given the free cash flow generation, and then, two, potentially going private, again given the cash flow generation. Thanks.

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

A

Thanks, Tom. The big thing for us, as I've said before, is to your point, if we're going to do a great job running the company generating free cash flow, we need to stay focused on running the company and building a great business. And I think in this space, in general, it's nice of you to say we're doing a good job here, but we're not satisfied with where we are. And we see an opportunity to not just run a solid business that generates good adjusted EBITDA and free cash flow. We see the potential to create a much, much bigger business that is a growth business that can be a part of consumers' and merchants' everyday lives. So, we feel we have to be doing both, which really plays into our capital allocation strategy and how we think about that.

And I think, as you know, we've repurchased over \$900 million of stock over the last four or five years, so we've done a lot there and to return value to shareholders. We're always balancing that, whether that's stock repurchases or other ways to return value to shareholders, we're investing in our organic efforts that are critical to transforming the business, things like voucherless and Select, our efforts around booking and card-linked as well as with M&A, which we've been very clear about and have been very public about that we expect to be more aggressive going forward, especially as we see ways to accelerate the strategy, as we see ways to generate more value.

And so we're constantly balancing those pieces, but ultimately that bakes into us focused, first and foremost, on building a great company and running a great business, while we transform the core of how this product works for consumers. And that's about us being focused on the long-term sustainability of that free cash flow and adjusted EBITDA and the long-term growth potential and the total platform.

Thomas Ferris Forte

*Analyst, D. A. Davidson & Co.*

Great. Thank you, Rich.

Richard Williams

*Chief Executive Officer & Director, Groupon, Inc.*

Thanks, Tom.

**Operator:** [Operator Instructions] And we have no further questions in queue. This will conclude today's conference call. You may now disconnect.

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