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Groupon, Inc. (GRPN)

Q4 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to Groupon's Fourth 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, Jennifer Beugelmans. Please go ahead.

Jennifer Beugelmans

Vice President-Investor Relations, Groupon, Inc.

Good morning and welcome to Groupon's fourth quarter 2019 financial results conference call. On the call today are our CEO, Rich Williams; and CFO, Melissa Thomas.

The following discussion and responses to your questions reflect management's views as of today, February 19, 2020 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 earnings press release and in our filings with the SEC, including our annual report on Form 10-K.

We encourage investors to use our Investor Relations website at 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.

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On the call today, we will also discuss the following non-GAAP financial measures: adjusted EBITDA, adjusted EBITDA, margin free cash flow, 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 will find additional disclosures regarding the non-GAAP measures, including reconciliations of these measures to the most comparable measures under US 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. Our gross profit comparisons are FX-neutral, including gross profit per customer.

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

Richard Williams

Chief Executive Officer & Director, Groupon, Inc.

Thanks, Jennifer, and thanks to all of you for taking the time to join us today. In addition to this call, we've also issued our fourth quarter release and quarterly letter to stockholders. I hope you'll take the time to read them both and review our slide deck, as they all go into significant detail about our results and strategy for 2020 and beyond.

Our fourth quarter performance was disappointing by nearly every measure, and failure to meet the financial expectations we set will understandably frustrate our shareholders, as it has us. This performance shortfall, coupled with the significant headwinds we faced, call for profound change, and we're taking immediate and decisive action to return the company to growth.

We worked with our board and external advisors to develop a strategy and execution plan to unlock the potential in the platform and assets we've built over the last 10 years. We believe that our plan can return Groupon to high single digits billings growth by 2022, while expanding adjusted EBITDA margins.

Our strategy is simple, turn Groupon into the local experiences marketplace. This means planning a quick exit from the goods category, dedicating resources to expand our local experiences marketplace, and executing a new course of action focused on four core priorities.

First, building high-quality inventory density in core cities and bringing on merchants' full catalogs; modernizing the mobile experience for customers and providing new tools to help merchants grow their businesses; relaunching the Groupon brand and marketing strategy to move from deal-centric to a local experiences marketplace; and reducing our costs and rightsizing our spend to support our go-forward business.

We will be laser-focused on the biggest opportunity for Groupon and where our true strength lies, local experiences. It's $1 trillion opportunity. We had $3.4 billion in billings related to this market in 2019, and we are clear leader in this space with significant scale. This is where we can grow. This is where we have the right to win.

We are very excited about our go-forward opportunity, but obviously, we have to acknowledge our fourth quarter and full year performance shortfalls. Heading into the fourth quarter, we set expectations that we believed we could achieve based on our accelerated pace of product launches and other execution successes.

Our North American Local business had momentum as we exited the third quarter and unit performance had improved steadily each month of the quarter. Midway through the fourth quarter, it became clear, however, that we were seeing far fewer customers engaged with goods, and it impacted overall traffic to our site. The lower traffic ultimately impeded performance in all of our categories. This was particularly notable in November and affected our holiday peak period, when goods engagement has historically been a business driver.

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Adding to these challenges, certain conversion initiatives in Select did not deliver on expectations. Our traffic declines and these other factors, which Melissa will discuss in greater detail, combined to create a headwind that we could not overcome during the fourth quarter. Before I discuss our strategy, let's touch on Goods.

Our management team and board have been evaluating the role of Goods for some time. Our fourth quarter performance and the challenges Goods has posed over the past few years have clarified our path forward. Delivering on our growth strategy requires total focus on capturing the local experiences opportunity. Over time, Goods has become a less meaningful driver of engagement and an increasingly inefficient use of our impressions.

It has effectively become a distraction, in which we can no longer compete and that we cannot afford, as it has taken roughly 40% of our impressions to deliver roughly 20% of our gross profit. This is the crux of our plan to exit Goods.

Groupon is the largest multi-category local commerce platform in our markets and we are well-positioned to capitalize on the massive opportunity in local experiences. In 2019, we were a market leader and trusted brand, but with less than 1% market share. While the competitive landscape is fragmented, others are mobilizing against this opportunity, so we need to act now to extend our lead. To do this, we have to move quickly against a singular mission, winning in local experiences. We intend to put our power behind our four priorities: inventory, modernization, brand, and cost structure, in order to set the stage for Groupon's return to growth.

Let me share some additional context about each of these. First, on inventory, we believe that increasing our inventory and, more specifically, elevating inventory quality and density in targeted core cities is mission critical. When merchant density is higher, we see an increase in purchase frequency as much as 15% to 20%. We also know from our partnership work that our customers want a more comprehensive catalog of experiences overall.

We need to offer unbeatable selection in the most desired locations, and this requires an incredibly targeted, granular approach to matching supply and demand, connecting high-quality merchants and experiences with high-intent consumers at the neighborhood level. To do this, we intend to realign our sales teams to target cities and approach merchants with a new go-to-market strategy that's focused on improving quality supply in specific neighborhoods and provide upfront competitive pricing.

We will urge every merchant to give us their full catalog of experiences, from market rate to slightly discounted, to deeply discounted offers in order to strengthen our value proposition for consumers. We expect this approach to allow us to better leverage our deeply experienced and skilled Local sales team and further empower our market-leading sales force efficiency.

We plan on rolling this out in phases, with cities coming online starting this quarter and building throughout the year. By year-end, we expect to have at least 10 major cities deployed. In addition, we plan to accelerate our inventory expansion with partnerships that will begin to benefit from our first-generation of open platform APIs by the end of Q2. We expect these partnerships to not only add inventory in our target cities, but also efficiently deliver inventory breadth to all Groupon markets.

On modernization, we need to deliver a beautiful mobile product that matches what consumers want from Groupon, a personalized experience with curated local merchandising. And for merchants, we need to offer new tools that will help them grow their businesses by attracting and retaining customers.

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In the second quarter, we'll be launching a new app that will begin to bring this new experience to life for our customers. Throughout this year, you can expect to see our consumer product road map prioritize bookability, search, discovery, and curation. We also intend to lean further into cloud-based machine-learning capabilities to help us deliver on these goals faster.

We plan to complement these efforts with initiatives that expand our bookable inventory. We've already seen how bookability can drive the business, as we scaled booking in international dining with 18% gains in purchase frequency for customers who buy and book through Groupon.

We also need to begin prioritizing new merchant features, as merchant satisfaction is critical in our two-sided marketplace. For this year, our merchant product road map includes dedicated new tools with a focus on self-service options that will help merchants join the Groupon marketplace more quickly with more pricing options and improved campaign reporting.

In addition, over time, we expect to roll out even more ways for merchants to reach customers and promote on our platform via new advertising options that can extend our platform and revenue streams. All of these efforts are meant to build a foundation to enhance our long-term partnerships with our merchants.

Building a more modern marketplace should allow us to remove friction from the customer journey, from discovery to purchase, to redemption; help our merchants grow their businesses; and improve the overall health of our marketplace.

With respect to brand, Groupon is already a beloved brand and a household name with well over 80% aided awareness in the United States, a position few brands ever achieve. Our opportunity, however, is not just being known. It's being top-of-mind when our customers are looking for the best things to do in their backyards and beyond.

Building this top-of-mind awareness requires leveraging our equity and deals, and advancing the brand position to reflect our focus on local experiences. Today, we're well-known for value and discovery. We have an opportunity to illustrate the convenience and incredible breadth of the Groupon-able moments we serve.

For most consumers, we estimate that these moments happen 80 or more times per year. As we scale inventory in the right locations and modernize our products, we believe we'll be in a great position to relaunch our brand in the second half of 2020. Across all customer touch points, we plan to lead with our experiences value proposition.

Supporting these efforts will be a full funnel marketing strategy, combining targeted, hyper-local marketing, and new channel development, including social, with broader brand advertising and efficient transactional advertising to build the brand, drive consideration, and efficiently reduce reliance on email.

With strong, experience-driven brand positioning, market-leading product and inventory, we believe that Groupon should be best positioned to become the de facto standard in local experiences.

Last, on cost, we believe we can further strengthen our culture of operational efficiency. With the planned exit of goods and the opportunity to rightsize the organization to align with the needs of our go-forward business, we believe we can deliver leverage in our cost structure over time as we grow the top line.

In closing, I'm incredibly excited about the opportunity ahead of us. And while I know we have a lot of work to do, here is one of the data points that gives me confidence in our future. In North America, we have approximately 8

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million customers that we'd consider our best customers. Our best customers in North America have a household income of $75,000 to $100,000, live in a city, and they love new experiences. They've told us that they like to keep busy. And when they're looking for something to do, they want to do it in their own neighborhood and in the near future.

In 2019, they purchased approximately 58% of our total units, spent about $2.1 billion with us, and purchased about seven times on average. Just one more purchase from these best customers represents a $300 million opportunity in net operating bookings. Given the profile of this customer, driving their purchase frequency up by just one time per year is not hard to imagine.

We also have 18 million active customers who look similar and one more purchase from them is worth another approximately $450 million. In other words, we have valuable customers. They're loyal and engaged, and are not going away. They've told us that they are looking for a go-to destination for local experiences, and that absolutely should be Groupon.

Before I turn the call over, I'd like to cover some other exciting news. I'd like to officially welcome Valerie Mosley and Helen Vaid, who have been elected to our board of directors, and Richard Merage of MIG Capital, who has been appointed as a board advisor. All three bring unique and valuable perspectives and will be great assets as we move through this transformation.

I'm also very happy that Melissa Thomas will become our permanent CFO. Melissa has long been a key part of our senior team, and I'm thrilled to have her take on this expanded role permanently.

With that, Melissa will take you through the fourth quarter.

Melissa Thomas

Senior Vice President, Chief Accounting Officer & Chief Financial Officer, Groupon, Inc.

Thanks, Rich. And thanks again to everyone joining us this morning. As you heard, we know we must move quickly to return Groupon to a growth trajectory on both the top and bottom line. We have a great opportunity to build a more valuable business by solely focusing our efforts on the $1 trillion-plus local experiences market. At the same time, any company facing transition must appropriately size up and plan for challenges that are inherent to change, and Groupon is no different.

Today, I'll use my time to walk you through the drivers behind our Q4 performance, including insights on units and traffic trends, and talk through our operating goals for 2020, as well as our financial outlook for 2022. After that, we'll open the call for questions.

In the fourth quarter, gross profit was $310 million and adjusted EBITDA was $84 million. Our fourth quarter and full year performance fell far short of our expectations, and we did not deliver on our goal of $270 million of adjusted EBITDA for 2019. We are incredibly disappointed with these results.

As we entered the fourth quarter, we expected to face ongoing traffic headwinds, customer losses in North America, and challenging macroeconomic conditions in Europe. We also expected continued momentum in North America Local, positive contribution from conversion initiatives, including our recent guest checkout and universal card product launches, net neutral gross profit impact from Select, and higher marketing leverage compared with Q3.

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The fourth quarter was much more challenging than we predicted. Traffic headwinds, particularly from organic channel such as email, became significantly worse than recent trends. Competition in Goods rose to levels that left us unable to compete effectively. And our conversion initiatives, including universal card, did not deliver the benefits we had expected.

To give you insight into the trajectory within the quarter, first note that our plan, which considers historical buying patterns on our site, calls for a meaningful shift of impressions and other assets to the Goods category throughout the quarter. Midway through the quarter, however, it became clear that we were not competing well in Goods, and November performance was particularly poor.

The lack of engagement with our Goods offering impacted the overall traffic to our site, and ultimately performance in all of our categories. While guest checkout delivered more conversion lift than we expected, other conversion initiatives, such as universal card, did not contribute as we expected.

The Select program was expected to be net neutral to gross profit in the fourth quarter. But the program underperformed due to higher than anticipated customer acquisition costs and a lower than expected number of enrollees converting to paid members. The program also began over-indexing towards our Goods category in the second half of 2019.

This, coupled with results in the fourth quarter, led to our decision to discontinue new enrollments in our Select program. That said, we've learned a lot and continue to believe a loyalty program will play a role in driving value for customers and merchants in the future.

Our millions of customers who are loyal and engaged remain an important opportunity. I encourage you to take a look at our slide that illustrates the potential impact of taking customers who purchased two to three times per year, or about 30% of our customer base, up to four times per year.

Next, I'll touch on specific trends within North America and International gross profit performance, as well as global marketing and SG&A expenses. In North America, gross profit was $207 million, down $40 million or 16% year-over-year.

Q4 North America Local gross profit was $170 million, down $10 million, or 6%, and Local units declined 11%. Q4 North America Goods gross profit was $31 million, down $25 million, or 45%, and Goods units declined 32%.

North America net customers declined by 1.2 million in the fourth quarter. And while we anticipated that our customer balance would continue to decline as it had during the first three quarters of 2019, Q4 customers came in much worse than expected, which was primarily driven by fewer Goods customers.

Gross profit per customer on a trailing 12-month basis was $30.48, up 5% year-over-year. With the planned exit of Goods, we expect some volatility in our active customer numbers. And while we work through this, our primary focus will be on driving unit velocity and purchase frequency, which we believe will be indicative of demand on our platform.

In light of the unfolding North America performance, late in the quarter we made the decision to shift impressions to our Local category. And we were encouraged by the momentum we picked up heading into 2020, including a return to unit growth in North America Local in January. While there is a lot of work ahead, we see this as an early sign that our strategy to focus on local experiences is the right path forward.

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Turning to International, gross profit was $103 million, down $14 million, or 11%. Q4 International Local gross profit was $74 million, down $5 million, or 6%, while Local units grew 4%. Local gross profit performance was impacted by a mix shift toward lower margin deals. While we must bend the curve on gross profit growth, we are encouraged by our ability to drive Local unit growth in International for three consecutive quarters, despite a very challenging macro environment.

As we drive towards a more personalized and curated experience on Groupon supported by high-quality local supply, we believe we can do an even better job servicing the right experience to the right customer at the right time, and accelerate and sustain marketplace velocity.

International Goods gross profit was $20 million, down $7 million, or 26%. International gross profit per customer on a trailing 12-month basis was $22.11, down 5%. Net customers declined 400,000 in the quarter, largely driven by declines in the UK, as well as other countries experiencing tough macroeconomic conditions.

The UK continues to be a headwind to growth in International, and 2019 was the worst year in retail in the UK in more than 20 years. While our International performance was impacted by macro conditions, we have work to do around local supply density and modernizing the marketplace.

North America is further along in development than International, but the opportunities for improvement are similar. Based on this, we plan to gain economies of scale by applying our global strategy, and we believe we can execute more efficiently than we have before by globalizing our efforts.

In the fourth quarter, on a consolidated basis, marketing expense was $82 million, or 26% of gross profit. Last quarter, we said we expected to gain further leverage in marketing spend as a percent of gross profit, which we did, but not to the levels that we expected. We see the relaunch of our brand and deploying a full funnel marketing strategy as a major opportunity for Groupon and over time, we would expect marketing leverage to improve as we align our spend with this opportunity.

SG&A for the fourth quarter was $188 million, an improvement of $7 million, or 4%, year-over-year. This decrease was primarily driven by lower performance-based compensation, which was partially offset by higher stock-based compensation. Throughout 2019, we continued to do a solid job managing expenses, and we believe we can accelerate our efforts based on our plan to exit Goods and rightsize our organization to align with the needs of our core Local and Travel categories.

Moving to free cash flow. As a reminder, the fourth quarter is typically our highest quarter of free cash flow generation, given the seasonality of our business and the timing difference between cash collections from customers and settlements with merchants and suppliers.

With that as context, the steep decline of our Goods category in the fourth quarter had a material impact on our supplier payable balance at year-end and reduced our free cash flow by over $100 million for the year. This, combined with lower year-over-year adjusted EBITDA, resulted in full year free cash flow of $4 million, a substantial decline from 2018.

We have a strong balance sheet and ended the year with $751 million of cash and currently have $400 million of capacity available on our undrawn revolver. This strength provides us with important financial flexibility to support our growth strategy, which we believe will create value for our shareholders. It's important to note that we expect to take a onetime working capital step-down in 2020 due to the planned exit of the Goods category.

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As we look ahead to 2020 and beyond, we are confident that our plan to exit Goods in order to focus on our local experiences marketplace is the right thing to do. We believe our strategy and clear execution path will unlock purchase frequency and grow the business. That said, we also know that the first year of a transformation is the hardest to predict, particularly when there are challenges that are not completely within our control. We are committed to providing disclosures and guideposts that show we are making progress against our top-four priorities.

We also know that it's important to help our investors understand what these changes mean for our financial model. To achieve this, we are providing 2020 operating goals, a more detailed financial outlook for 2022, and a target financial model that we hope will give you a clear picture of the direction in which Groupon is headed.

Starting with 2020. There are three core challenges that we will need to address in 2020. First, as part of the plan to exit our Goods category, we will need to consult with various works' councils in our international geographies. And while we have a plan that estimates timing and execution, ultimate timing is dependent upon those consultations and negotiations. In addition, we are still evaluating the accounting impact to our ongoing and discontinued operations.

Second, we'll be focused on minimizing the internal disruption caused by the planned Goods exit and overall execution of our strategy. And third, we'll be heavily focused on keeping our cross-shopping customers engaged in the go-forward Groupon value proposition. To provide context, our customer base, excluding Goods-only customers, was 35 million at the end of 2019, with approximately 7 million of these customers being Goods cross-shoppers.

As we navigate these challenges, we will be heads-down focused on executing against our core priorities. In 2020, you can measure our progress against our strategy as we hit five key milestones. Within inventory, we intend to execute our density strategy in 10 cities.

Within modernization, our top milestones are launching our new mobile app in the second quarter and expanding bookable offers throughout the year. We believe that our inventory and modernization work will allow us to grow North America units year-over-year in the second half of 2020.

In marketing, as we discussed, we intend to relaunch our brand and deploy a full funnel marketing strategy. And finally, with SG&A, our goal is to reset our cost base with the exit of Goods.

Given our transformational plan to exit Goods and the disruption this exit may create, we are not in a position to provide 2020 gross profit or adjusted EBITDA guidance. We recognize, however, that you will need insights for building your models. So, I'd like to provide some context on the potential impact of our plan to exit Goods.

In 2019, we estimate the marketing spend directly attributable to Goods was $62 million and SG&A spend directly attributable to Goods was over $75 million. Both of these numbers exclude stock-based compensation and depreciation and amortization. The goal of approximating these direct Goods costs is to help you size the cost structure of the Goods category and its impact to adjusted EBITDA in 2019.

Based on our plan to exit the Goods category, we anticipate that its financial results ultimately will be presented as a discontinued operation. However, these metrics are not intended to estimate discontinued operation's financial information, nor do they take into account any indirect cost.

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The planned exit of Goods unlocks our ability to reset our cost structure to align with our singular focus on the local experiences marketplace. As a result, we are also taking a hard look at our cost structure more broadly and plan to aggressively take costs out of the organization over the next 12 to 18 months.

At a minimum, we estimate we can take approximately $75 million of SG&A costs out related to the planned Goods exit. We are also pursuing an additional $50 million or more of SG&A savings. It will take us some time to work through these opportunities, but I can assure you that they are a key focus area for us.

That said, due to the timing of our planned exit of the Goods business, we will not realize the full benefit from the removal of costs directly associated with Goods until 2021. In 2020, we expect to incur onetime costs to ensure we have the right execution capacity, including an external execution partner, to successfully exit Goods, capitalize on the local experiences marketplace opportunity, and rightsize our cost structure. In addition, we expect to incur restructuring costs in 2020.

Net-net, we expect about $80 million of impact on adjusted EBITDA in 2020 from the Goods exit and related disruption as well as headwinds such as lower bonus funding in 2019 and the migration of our on-premise data centers to the cloud. It is important to note that the timing of the planned Goods exit could have a meaningful effect on the magnitude of this adjusted EBITDA impact in 2020.

One last item I'd like to address in a little more detail is our plan to migrate to the cloud. As I indicated, we will experience some expense headwinds in 2020 as we ramp up our migration to the cloud. We estimate that this initiative will take three to four years to complete.

And in total over that time period, we expect that our SG&A expenses will increase by about $40 million to $50 million. We believe that by moving to the cloud, we'll be able to enhance our overall site performance and help accelerate our machine-learning capabilities.

As we exit 2020, we expect to be well-positioned for growth. While there may be some timing noise over the next year created by the moving pieces I just outlined, we're excited about the future. In fact, looking ahead to 2021, we expect to see some inflection in key metrics for Local, including units, purchase frequency, and revenue, and to see the benefit of our cost actions.

Using 2021 as a building year, by 2022 we believe we can achieve unit growth in the high-single digits, billings growth in the high-single digits, revenue growth in the mid-single digits, and an adjusted EBITDA margin in the high-teens.

We have included these goals, as well as a high level view of our target financial model, in our slide deck for your reference. In addition to these goals, I want to point out the new data disclosures in our investor deck.

Our goal is to provide insights into the current state of the business, our challenges and opportunities, and to keep you informed of our progress. Based on your feedback, we can do a better job of sizing the opportunity for you and be crystal clear on what we believe it will take for the organization to achieve its potential.

We are grateful for your time today and recognize that we are asking you to process a lot of information. We welcome your questions and feedback and look forward to reporting on our progress throughout 2020.

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

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Eric Sheridan with UBS. Eric, your line is open.

Eric J. Sheridan
Analyst, UBS Securities LLC

Q

Thanks for taking the question, and thanks for all the detail on the call, the get through. Maybe two, if I can. On slide 8, you talk about the factors you can control in the transition the business is going to go through. Is there a way to frame what investments, whether it be in dollars or in terms of time and effort, has to be put behind those factors you can control? And how we should be thinking about those factors evolving, not only through 2020, but against the medium-term goals of 2022?

And then, secondly, when we think about capital and deploying capital, not against the business, but also against shareholder returns, any update on how you're thinking about shareholder returns against what your balance sheet looks like and the free cash flow conversion of the company? Again, not just in 2020, but maybe across the medium-term goals for the company. Thanks, guys.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

A

Thanks for that, Eric. I'll start, and then Melissa can jump in on especially as we get to capital allocation. As you look at slide 8 and that column around the from and the to, I think just to try to frame that a little bit, and we've laid this out as you think about our milestones over the course of the year. But they're going to be, frankly, all consuming. And every piece in here is a critical piece as we think about moving forward just highlighting, the first one on that slide being the Goods exit itself, and that's going to be a significant undertaking for us.

As we mentioned in prepared remarks, also we brought in some additional execution capacity and strategic capacity on that side to help us navigate that. So we're doing the right things by all of our core stakeholders there and moving through. So that's going to be a pretty significant undertaking, obviously, less about significant incremental investment outside of bringing in some help from our execution assistance on that side.

When we really move into the other pieces of traffic and inventory, US experience, et cetera, those are the crux of our strategy. And so much about that – it's less about incremental investment overall and more about reallocation and focus of the investment that we already make as a company, so putting our resources on these biggest opportunity areas as 100% of their time and energy. So, while there will be some areas where we had the up, I would particularly expect us to put some additional capacity on the sales function as we start to scale up and roll out to additional cities.

I would also expect that to be really buffered or addressed and self-funded, frankly, by moving resources from other parts of the company to enable us to do that. So I think a lot of this is really geared around reallocation and focus of our energy, given the total capacity of the company, and less so about incremental investment on a unit level. So, on capital?

Melissa Thomas
Senior Vice President, Chief Accounting Officer & Chief Financial Officer, Groupon, Inc.

A

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Yeah. So just to reiterate what Rich said, essentially really this is allocating our capital and our resources kind of differently within the organization across supply, marketing, and product. When you think about ultimately kind of how we're thinking about capital allocation over the next few years, we are going to be focusing more of our capital allocation really to support our strategic goals that we've outlined and that Rich outlined in detail.

When you think about kind of over the longer term, though, and free cash flow generation of the company, we have in our slides outlined what we believe as our target financial model. Essentially what that calls for is a free cash flow conversion rate of 65-plus percent once we're operating at scale here. So, what I would look at, think about 2020 and 2021 as the building years, and that's where capital allocation will be more focused on really capturing that $1 trillion-plus local marketplace opportunity.

Eric J. Sheridan
Analyst, UBS Securities LLC

Q

Thanks so much.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

A

Thanks, Eric.

Operator: Your next question comes from the line of Deepak Mathivanan with Barclays. Deepak, your line is open.

Deepak Mathivanan
Analyst, Barclays Capital, Inc.

Q

Hey, guys. Thanks for taking the questions. A couple of questions. So, first, what happened specifically in November that led to the sharp decline in traffic? Was it all related to goods, or is there any external changes that kind of accelerated the impact? And then subsequently you noted the rebound in January. What was driving that? That's the first question.

The second question, I understand the challenges in the Goods business. How confident are you on the opportunities to kind of unlock the growth in Local? Can you provide some color on kind of what categories maybe you're planning to improve density in? Are these challenges in your view, sort of, largely related to selection and conversion, or is it broadly also due to sort of the top of the funnel consumer demand for the platform? Thank you.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

A

Thanks for that, Deepak. Great questions. So specifically, yeah, I think, in fact, as I look at November, it's hard to separate – I think impossible to separate the external factors and just broadly in the market from what we saw. I think we saw an extremely frothy competitive environment, but we're large scaled e-commerce players. We're playing in some of our historic strongholds, particularly on the paid marketing side. So all of those were contributing factors.

But I think at the end of the day it boils down to the value proposition that you're putting in front of a customer. And I think what we've seen in particular over the course of the last year in the Goods landscape specifically, just it's a different world out there and it's accelerated really quickly. Customer expectations of shipping experiences have fundamentally changed, and the requirements of comprehensive inventory, et cetera, and/or specific orientation around experience-based retail, those have been very, very fast.

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And I think within that, we had a spot where consumers just weren't engaging with our product in the way that they have in the past. And I think a lot of factors contributed to that. So we saw that occur in November. So I think, as we mentioned, our primary challenges were around Goods in that period. And that, however, has a cascading impact on traffic overall and, as a result, all of our categories. But Goods was really the crux of that. And that's the time when where the entire merchandising strategy of the company is generally pushed around Goods.

So we had to get in there and start to make some changes on that front. And given the late timing of the holiday peak this year really overlapping December, we didn't have an awful lot of time in order to really not just effect change, but really drive a broader impact and affect the overall output of the quarter.

But that leads me into really the second part of your question, the rebound in January, what's driving that in Local? And really it's building off of some of the changes we started to make as we saw an especially challenging holiday peak period in Goods. And the number one piece of that is we started reallocating impressions and reallocating merchandising to our core Local business.

And what we've seen from that business, which partly gets into how are we confident in our ability to unlock the value there, is we're seeing our customers respond. We went from a place where, I think, you can overall see unit trajectory and Q4 was not in a good place. We were strongly negative in that in the medium to high-single digits, and at least in the US.

And we saw a pretty quick return there to growth and customers reacting really well to the merchandising that we're putting in place. And within that, we're also able to merchandise more of the inventory we've been accumulating in that space and we're seeing customers respond really well to that.

So that's a big piece of our building confidence. But as I mentioned in the prepared remarks as well, we also have a really strong and big customer base in Local that we've been exposing a lot of goods to. And as we've started to focus more of our product and our classification and merchandising to Local, we're seeing good responsiveness there.

So, on your second question, I guess second part of that second question, is this a selection thing, a conversion thing, a product thing? If you look at our strategy, we'd say it's an all of the above thing. I think, absolutely if you consider the growth in low discount or market rate inventory, just having coverage, having what people are looking for is a big driver.

That's been a nice growth story for us over the last couple of years, just providing high-quality inventory to merchant territory consumers when they're looking for it. That's broadly a conversion opportunity. It's also a stickiness and top-of-mind opportunity on the brand. So, certainly we need to continue to do more of that.

And I think what we've seen, especially as we've accelerated just broad coverage of inventory over the last couple of years, we've seen, as we've built density, consumers have responded really well to that and they've responded with higher purchase frequency, which is really critical to unlocking the core opportunity there.

But we know we need to make changes to the product. And I think this is a spot where, especially as you gain inventory, your product has to be a lot better when it comes to search and discovery and browse and navigation. And particularly in Local, the ideas of things like time of day, day of week, and context make a really big difference.

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And frankly, as we've been trying to optimize around multiple different businesses and categories, we haven't moved that as fast as we need to move it. We haven't moved it as far and as fast as some of the competitors and the smaller upstarts in the space have moved it.

And that's just something we need to be doubled down on with 100% of our time, energy, and resources being spent on moving that forward. So we can unlock what is what we believe a very, very big market opportunity here, where we have a leadership position despite having some challenges over the last couple years.

Operator: Your next question comes from the line of Thomas Forte with D.A. Davidson. Thomas, your line is open.

Thomas Forte
Analyst, D.A. Davidson Companies

Q

Great. Thanks for taking my question. I wanted to know, as of today, how many International markets you operated in and the number of those markets that are cash flow positive? Thank you.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

A

Hey, Tom, thanks for that. So, we operate in roughly 15 markets today – o in 15 markets, if that's what you mean, on the country level. We operate in hundreds of cities. Melissa, you want to add?

Melissa Thomas
Senior Vice President, Chief Accounting Officer & Chief Financial Officer, Groupon, Inc.

A

Yeah. I mean, we haven't provided cash flow details on our specific business, Tom. So beyond that, really you can kind of look at our disclosures on what we think the business is generating from a P&L perspective. So you can certainly kind of look at that as a guide. For 2019, International has been particularly challenged, and Q4 essentially was no different. UK, given the macroeconomic conditions that we've seen there, certainly faced kind of the similar dynamic to what we saw in Q3.

But we did also see kind of broadly across Europe macro challenges impact us there. We still believe in International opportunity. And we still believe we're under penetrated there and have a lot of room to run. But certainly still seeing macro and Goods was a global issue, not just a North America issue, in the fourth quarter.

Thomas Forte
Analyst, D.A. Davidson Companies

Q

Thanks for taking my questions.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

A

Thanks, Tom.

Operator: Your next question comes from the line of Ygal Arounian with Wedbush Securities. Ygal, your line is open.

Ygal Arounian
Analyst, Wedbush Securities, Inc.

Q

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Hey, guys. Thanks for taking the questions. I have a few. So first, just want to address maybe the balance of the traffic between Goods and Local. Local declining 11% in the US, and then rebounding in January. So, Goods has historically – and I know this is deteriorating, but Goods has historically driven some traffic to Local. So, we're going to be pulling that out. We are reallocating impressions to Local, so that should offset. And I know we had a rebound in January. So, just how to think about like maybe the degree of growth in January, how sustainable that is? Are there going to be puts and takes, or is this really all a positive by taking out Goods and reallocating the impressions?

Second, on customers, you noted the headwinds increasing in 4Q. I think maybe you could just refresh my memory, but I think you were expecting the customer headwinds to flatten out in 2020. So, is that something that's going to continue pressuring? And how does that lead to unit growth, headwinds or otherwise, in 2020?

And then lastly, a modeling question. Just want to make sure I understood you, you're going to be reporting Goods as discontinued operations beginning in 1Q. So, we should be thinking about pulling that out of our kind of revenue and EBITDA numbers immediately. Thanks.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

A

Thanks, Ygal. I'll start on the traffic side, and how to think about overall the exit path and impression reallocation and just how balance of traffic plays into that. So, yeah, Goods has been a significant part of our traffic. It's highly seasonal, in particular, just we didn't obviously see the kind of seasonality we expected in Q4. But it has been, historically, a significant driver of traffic, particularly that time of the year.

I think the key piece, however, to think about it is how we manage our impression pool. And as I mentioned, historically, it's been around 40% of traffic going to Goods. And at certain times of the year, in Q4, that could be as much as 60% or 70% during peak periods. But what we've really seen change there over time is not just the volume of traffic or mix. It's just that the overall utility or productivity of the impressions that we've been allocating to Goods has been declining.

As a part of that, we've also just seen more division and more clear division in the customer base. And as you point out, historically, it has been more of a driver of Local activation. And at times, I think in the past, we've shared as one of our largest channels of Local activation. That's just no longer the case. And we've seen that the customer base is becoming more specific in what their shopping behavior really drives.

And so, those things combined, where you have a lack of utility of the impressions and a lack of cross-shopping behavior and more division or more calcification in the customer base, it makes it a lot easier to make these kinds of decisions. Still very hard call to make, given the overall size of the business, but it makes it a lot easier.

So as we moved into January or really in – and as we exited Q4 and into January, our focus has been on really managing that impression pool and starting to move more and more and more to Local. I think you can see that as a consumer if you go to the Feature tab on the mobile app, you're going to see an awful lot less Goods. In some cases, you may see none, as we're learning through a lot of what you point out, which is what are the puts and takes in this process and, in particular, what are the puts and takes with our cross-shoppers.

That's a core focus for us as we move through this process, is understanding how to retain as many Local/Goods cross-shoppers as possible, because all of those folks, they get their haircut, they look for things to do on the weekends with their families. All things that we're focused on moving forward. And how do we get them more engaged in the Local side of the marketplace? And that's really the piece there.

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Within there, the puts and takes, some of them I would consider is – and I said this, we're going to be pretty aggressive, especially in North America, on that transition of impressions toward Local. What we're generally seeing, as we mentioned, is Local responding really well, and that's a big unit swing in a relatively short period of time as we've seen these impressions go.

But at the same token – or by the same token, you're going to see things like Goods revenue potentially declining really rapidly in North America as we migrate over. And you know that there is that third-party/first-party part of our business and the difference between revenue between Goods and Local, you're going to see that as we move some of these pieces. But our focus is on maintaining the health of the customer base and driving that Local engagement and growth. So, there will be puts and takes, long story short. And Melissa, add some color.

Melissa Thomas
Senior Vice President, Chief Accounting Officer & Chief Financial Officer, Groupon, Inc.
A

Yeah. On the January side, I think the one item that I would mention there as well, and you can see in the goals that we've outlined in the press release and mentioned on the call that one of the target points we had was in 2H we expected North America units to return to growth. Ultimately, we are seeing the benefit in January of monetizing the impressions we get more effectively by shifting from Goods to Local.

But the way that I would think about it is that's kind of step one of the process. Really, 2H is when we start to see some of our strategy take hold as you think of the different investments we're making around our inventory, our product through modernization, as well as ultimately the brand relaunch. And what we've tried to outline for you in the investor deck is essentially kind of a time line of when you should expect those key milestones to start to hit so that you can measure that progress there.

So, that's on January. On the headwind side for customers, so you had mentioned – or asked a question on what we're seeing there, what we're expecting. So, the headwinds did increase in Q4 on the customer side, and that was largely driven by Goods lack of engagement on the platform. So, we did see customer losses come in at a more accelerated pace than we expected and what we had seen in the prior quarter.

As you look forward to 2020 and 2021, we have not provided ultimately customer numbers there. The way that I would think about it, though, is we mentioned that we have 8 million Goods-only customers, and we have 35 million – the 35 million remaining customers are engaging with Local and Travel and cross-shopping across our platform today. Where we're going to really be focused is on retaining those cross-shoppers who historically have purchased across the platform.

So, I would kind of focus on that 35 million customer base that we've referenced in our remarks. And ultimately what we'll be driving towards is retaining the cross-shoppers, and then engaging ultimately that customer base across the platform.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.
A

Yeah. And the only other thing that I'll add there is when we talked about the moderation of our customer losses in 2020, we hadn't contemplated an exit of Goods in there. So, as I mentioned, we do have more of a calcified customer base there that's been more focused and specific to Goods only. As we start peeling back in Goods and moving more to Local, you should expect that to – some of those customers, we're going to work hard to get them into Local. But we should also expect that some of them that are Goods-only shoppers that think about us only as

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a Goods brand, as they start seeing less and less Goods, we should expect them to increase their attrition rates. I mean, I think it's just reasonable to expect that. I wouldn't want you to think anything else.

Melissa Thomas

Senior Vice President, Chief Accounting Officer & Chief Financial Officer, Groupon, Inc.

A

Yeah. And then the last point on timing of discontinued operation. So, the way that you should think about that is ultimately we expect to trigger discontinued operation when we exit the operations of those businesses. So, the time line that we've given there is we would expect that by end of the third quarter we would be exiting the North America business. And for International, that timing will likely be by end of year.

As we said in our prepared remarks, there works councils dynamics that we need to work through there, such that that could impact the timing. But that's really how you should think about when we would get discontinued operations treatment. It's going to be later in the year when we ultimately exit.

Operator: Your next question comes from the line of Brian Nowak with Morgan Stanley. Brian, your line is open.

Brian Nowak

Analyst, Morgan Stanley & Co. LLC

Q

Thanks for taking my question. Just wanted to touch on the local experiences strategy a bit. Maybe talk to us about sort of the strategy to have sufficient density in 10 cities by the end of the year, how many cities do you have sort of that density that you're looking for in right now? And what are some examples that we could sort of look at just to sort of understand where you're headed with this?

And then from an execution perspective, talk to us about what changes you have to make to the sales force or how do you think about sort of timing of reallocating and retraining the sales force to really focus a lot more on these local experiences within the 10 cities? Thanks so much.

Richard Williams

Chief Executive Officer & Director, Groupon, Inc.

A

Thanks for that, Brian. So, I'll start. I think, one, it's a very competitive space. So, one thing we're not going to do is lay out our road map for our city focus on that side. But as I mentioned just in one of my comments just a little bit ago is that, as we've been building breadth of catalog, especially as we brought on more and more third-party partnerships and that just build broader coverage for Groupon, we've seen some natural density case studies developing in the business.

We've also been focused as a company on building upon those in more targeted areas. So as much as we talk about cities, I guess the point of that is, it's really a neighborhood challenge. This is really about getting much more into the sub-ZIP Code level and making sure not just at that sub-ZIP Code, but for a broader market, you have the supply that matches the intent and consumer demand that exists there.

So just a much more targeted strategy, that's also more strategic in how it's constructed. And I'll talk about the sales changes there in general. But it is that – as we've seen it, it's that combination of having the expected and trusted brands in a given market at a broad level, and then with the really specific neighborhood level density in core categories that fit that market. So it's just a much more targeted and much more granular approach.

On that front, when you think about sales force and the change in the go-to-market strategy, as we mentioned in – you can see it in our investor presentation, this is something we're moving on right now. So we're already rolling

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out training, we're rolling out different performance-based management structures. Just how we think about overall conversation to target getting very specific kinds of inventory and inventory quality on the platform, there are significant changes there.

But I'd say the biggest single focus is really leveraging our technology and intelligence around demand and supply to be much more effective at allocating our energy and resources to specific neighborhoods. And that's – as we've talked about in the past, in this company we went through a bit of, I think, a natural progression here where we started out, as an example, in the earlier days of Groupon as just basically one-size-fits-all selling, where every salesperson in the company could sell anything from a car wash to a Michelin-starred restaurant.

We learned through that process that we really need vertical specialization and focus, and so we built that vertical capacity, and within that started to scale broadly on our inventory. And now I think we're moving into that natural progression, where it's about bringing those two things together, broad sales capacity ,a knowledge of neighborhoods and locale, and real vertical specialization and know-how, supported by the technology to make that efficient and scalable.

So there is a whole series of things that we're doing on that front, but it's already underway. As I mentioned, we expect to be in two cities launched this quarter, scaling up to 10 across the year. And it's basically a rolling process to move from that 2 to 10, and we expect to learn and adapt as we go through it. So our teams are excited. They're in market now, and we're getting a lot of good feedback. And I expect us to take that feedback and continue to advance over the course of the year.

Operator: Our final question comes from the line of Michael Ng with Goldman Sachs. Michael, your line is open.

Michael Ng
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks for the question. I just have a few on the EBITDA path and on modeling. First on 2020, you mentioned we should see an $80 million EBITDA impact from the Goods exit. So, would it be as simple as taking your prior guidance of $300 million and subtracting $80 million? Why or why not?

And then second, it seems like there are a few moving parts for 2020 and beyond. I think you guys mentioned an additional $75 million of SG&A related to Goods and an additional $50 million of cost savings opportunities, partly offset by the $40 million to $50 million of cloud expenses. How should we assume these cost savings and cloud expenses flowing over time? Is it more front weighted? Thank you.

Melissa Thomas
Senior Vice President, Chief Accounting Officer & Chief Financial Officer, Groupon, Inc.

A

Yeah. Okay. So I can take those. So first your question on 2020, so just one clarification point there. On the $80 million EBITDA impact that we provided, about half of that is related to Goods exit and any related disruption that we're expecting there. The other half of that is related to essentially lapping lower bonus funding from 2019, just based on performance relative to targets there, as well as the cloud computing migration. So, that's just some clarification point on that.

As you think about kind of the $300 million guide that we'd given in the past, I think the one thing I would keep in mind is that was also predicated on us hitting our approximately $270 million guide. We've clearly seen deterioration in the business since that time that has effectively kind of reset that baseline there. So I wouldn't say that it's really the $80 million that I called out in my prepared remarks.

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As you think about kind of SG&A more broadly, so there's a few things there that I would mention. So as I said in my prepared remarks, we do estimate we've got about $75 million of direct costs associated with the Goods business. We do expect that we will be able to take those $75 million of costs and realize those savings over time. But that timeframe, just given a end of Q3 exit in North America, as well as end of year expectations for International, as you can imagine, the timing of realization of those cost benefits will not fully be there until 2021.

What we also are essentially going after is another $50 million on the indirect cost side. And the way to think about this is ultimately we are able in a kind of local experiences only world to reset our cost structure. And the way I would think about that is really kind of a onetime reset of our cost base that we will be looking to do. The exit of Goods certainly does unlock the ability for us to do that. So, again, you'll start to see those costs over the next, call it, 12 to 18 months is what we've said there in terms of time line.

As you think about cloud, that $40 million to $50 million that we highlighted there, that's really over the next three- to four-year period is when you'll see those expenses play out. So, that's how I'd start to think about that kind of cost time line.

Michael Ng
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thank you. That's very helpful.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

A

Thanks, Michael.

Operator: This concludes our question-and-answer session. I will now turn the call back over to Rich Williams for closing remarks.

Richard Williams
Chief Executive Officer & Director, Groupon, Inc.

Thank you. And thanks again, everyone, for joining today. We understand that our investors are frustrated. We are as well. But we also hope that you believe that this strategy is the best path forward for Groupon. We also hope that we've effectively outlined our strategy and our plan and resources to execute. We appreciate your support and welcome your feedback. Thanks again.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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