Groupon is a business that offers subscribers daily deals from local merchants. The catch: a group of people (usually at least 25) has to purchase the discounted coupon (a "Groupon"). If you really want to go to that Italian restaurant in your area with a 50 percent discount coupon, you will need to message your friends to pay for the coupon as well. As soon as the minimum number of coupons is sold, the offer is open to everyone.

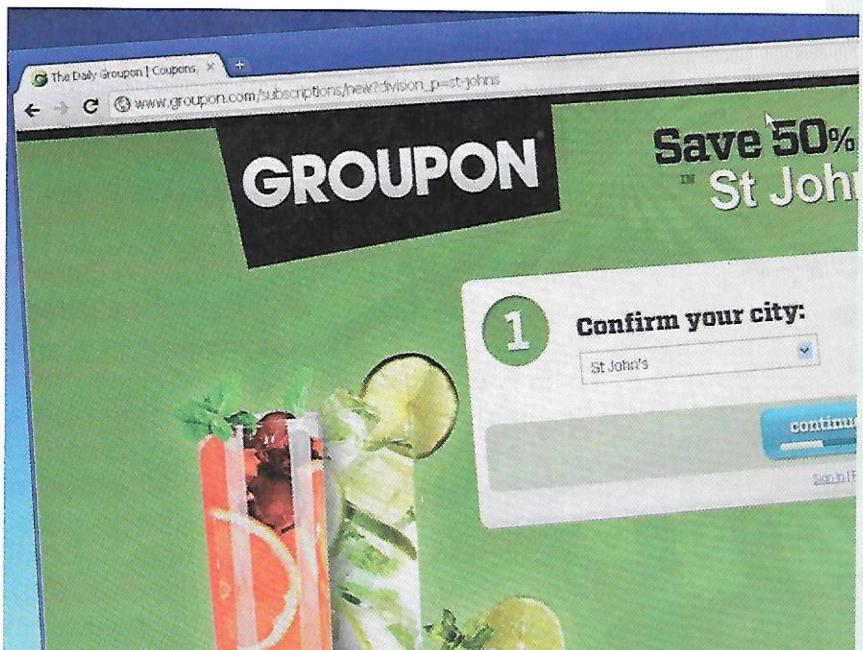
Here's how it works: Most Groupon deals give the customer 50 percent off the retail price of a product or service offered by a local merchant. For example, a $50 hair styling is offered at $25. The Groupon offer is e-mailed to thousands of potential customers within driving distance of the retailer. If enough people use their PCs or smartphones to sign up and buy the Groupon, the deal is on, and the customer receives a Groupon by e-mail. Groupon takes a 50 percent cut of the revenue ($12.50), leaving the merchant with $12.50. In other words, the merchant takes a haircut of 75 percent! Instead of generating $50 in revenue for hair styling, the merchant receives only $12.50.

Who wins here? The customer gets a hairstyling for half price. Groupon gets a hefty percentage of the Groupon's face value. The merchant receives many (sometimes too many) customers. Although merchants may lose money on these single offers, they are hoping to generate repeat purchases, loyal customers, and a larger customer base. Moreover, the deals are short term, often good for only a day. The hope: lose money on a single day, make money on all the other days when regular prices are in effect. It's a customer acquisition cost.

Founded in 2008 by Andrew Mason, Groupon rocketed to prominence in less than three years, going public in June 2011. By that time, Groupon had more than 83 million customers, operated in 43 countries, and had sold over 70 million Groupons. Nevertheless, Groupon, like many social network sites, has been struggling to show a profit. In 2011, it lost $254 million on $1.6 billion in revenue. Its biggest expense is customer acquisition. Groupon clearly believes that new customers are worth it: Groupon spent $768 million in marketing in 2011.

The question is whether Groupon's business model can work in the long run. Critics point out that Groupon's revenue per customer has been falling, the conversion rate of customers into subscribers is slowing down, the tens of millions of e-mails Groupon uses to inform users of deals are poorly targeted, there are increasingly fewer Groupons sold per customer, and the revenue per Groupon is falling.

The solution, according to the company, is scale: get big really quick, and develop the brand so that competitors will never be able to find an audience. With enough customers and fast enough growth, Groupon may still turn out to be profitable. Groupon embarked on an acquisition spree in the first part of 2012, purchasing companies such as Uptake, Hyperpublic, Adku, and FeeFighters, which it believes will help its position in the small and medium-sized business market.



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No one knows if this business strategy will work. Many merchants report that the Groupon deals are not creating a larger group of repeat customers. Instead, only the most price-sensitive customers show up at the door, and then never return when prices go back to normal levels. Competitors are springing up everywhere around the globe, including Google Offers and AmazonLocal.

Groupon may overcome some of the hurdles it faces by virtue of its brand and scale. But investors will want a return, and Groupon's biggest challenge will be showing a profit of any kind in the next few years.

Sources: Alistair Bart, "Groupon's New Operations Czar Grasps Shaky Helm," Reuters, August 22, 2012; Shayndi Rice and Shira Ovide, "Groupon Investors Give Up," *The Wall Street Journal*, August 20, 2012; Stephanie Clifford and Claire Cain Miller, "Ready to Ditch the Deal," *The New York Times*, August 17, 2012; Chunka Moi, "Google Offers a Two-Pronged Attack on Groupon's Business Model," *Forbes*, June 29, 2011; Jenna Wortham, "Loopt Flips Daily Deal Model Upside Down With U-Deal," *The New York Times*, June 23, 2011; Don Dodge, "How Does Groupon Work? Is Its Business Model Sustainable?" Dondodge.wordpad.com, June 11, 2011; Michel de la Merced, "Is Groupon's Business Model Sustainable?" *The New York Times*, June 8, 2011; and Utpal M. Dholakia, "How Effective are Groupon Promotions for Businesses?" Rice University, March 12, 2011.