**GROUPON: COMEDY OR DRAMA?**

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How seriously are we to take the IPO of Groupon, Inc.? We shall permit others the fun of debating the merits of the business plan put forward by Groupon’s managers. We have serious concerns whether the concept of daily, local couponing makes sense strategically, but as our expertise rests in accounting and finance, let’s take a close look at the entity’s S-1 filing with the SEC, where there is plenty to digest. As we do so, we shall laugh and cry together.

Let’s begin with the income statement. Sales exploded from $30 (all account balances are in millions of dollars) in 2009 to $713 in 2010, an almost unheard of 23-fold growth. Unfortunately, expenses had an even greater astronomical growth, going from $37 in 2009 to $1,170 in 2010 for net losses of $(7) and $(456), respectively. The biggest expense accretion resides in acquisition-related expenses of $203; however, even if we remove this item from consideration, expenses are still $967 and they still swamp revenues. Persistent earnings are clearly negative and serve as one huge red flag.

The balance sheet also displays repugnance. Current assets are $174 while current liabilities equal $370. Any business sophomore knows that isn’t good. Total assets equal $382 and total liabilities $372, so total stockholders’ equity is a mere $10. Having only 3% equity isn’t good for banks, much less anybody else; the financial leverage risk is huge.

This is a company in trouble from the get-go. Let’s make this more concrete by using the Altman bankruptcy model for non-manufacturers. This Z-score model is:

 Z = 6.56 \* WC/TA + 3.26 \* RE/TA + 6.72 \* EBIT/TA + 1.05 \* BVE/TD

where WC = working capital, TA= total assets, RE = retained earnings, EBIT = earnings before interest and taxes, BVE = book value of equity, and TD = total debts.

One interprets the Z-score as follows. If Z>2.6, then we predict the firm is healthy and relatively free from financial distress. If 1.1<Z<2.6, the company is in the indeterminate zone. It faces some financial distress, but more investigation is needed to determine how serious it is. But, if Z<1.1, then the model predicts that the firm faces a serious chance of going into bankruptcy.

Groupon’s Z-scores drop off the cliff; the scores hardly indicate any pulse for this patient. In 2009 the Altman Z-score is -4.75 and in 2010 it is -14.33. Why is anybody taking this IPO seriously?

Even if Groupon pulls off the IPO and brings $750 into the treasury, it does not improve the situation sufficiently to take the firm off life support. Adding $750 to current assets (cash) and to stockholders equity, the Z-score then becomes 1.65 and the score is in the indeterminate zone. That’s because the IPO, even if all goes perfectly for the company, will fix the balance sheet woes; however, it does nothing to cure the income statement disease of greater expenses than revenues.

We quickly should add the balance sheet is not totally repaired because 2010 goodwill is $132 and other intangible assets are $41, so goodwill and other intangibles make up 45% of total assets. As intangibles can lose value as rapidly as they are added to the balance sheet initially, we caution investors about the risk inherent in these fair value measurements of goodwill and intangibles. We think investors are better served to look at tangible assets, which are only $209, which in turns implies that tangible equity is a pitiful $(199).

Management begs us to look at consolidated segment operating income. This metric is operating income with add-backs for online marketing expenses, stock-based compensation, and acquisition-related expenses. Of course, these adjustments have no economic foundation and serve only to create a value that is in the plus column. Rational investors will ignore this nonsense and perceive that it distracts one from important numbers like net income.

Managers also ask us to consider free cash flows, and normally we would, but there are two problems here. The first deals with the probable overstatement of cash from operating activities and the second concerns the stock-for-stock transactions when executing most of the business acquisitions.

Cash from operating activities equals net income plus or minus some noncash income statement items and adjusted for changes in most of the working capital accounts. The problem is that none of the changes in Groupon’s working capital accounts correspond to their respective changes on the balance sheet. This is almost surely the consequence of several large business acquisitions. The purchase of items like accounts receivable and inventory is included in investing activities and not operating activities. Therefore, cash from operating activities is biased and probably biased upward. We do not know what these numbers are, so we cannot adjust for this distortion. The S-1 does tell us the net working capital purchased, but as we are unsure whether all of the working capital accounts pertain to operations, we cannot use this figure in the adjustments.

Second, these acquisitions are mostly implemented by the issuance of stock. A proper analysis of the cash flows requires the analyst to treat this purchase as a two-part transaction: first the corporation issues stock to finance the business purchase and then the entity employs the cash garnered from the stock issuance to buy the net assets of the target company. The issuance of stock is, of course, a financing transaction and the purchase of net assets is an investing transaction. In particular, the investing transaction should be treated as a capital expenditure inasmuch as the acquirer is buying the net assets of the investee.

From note 3 we can estimate these additional acquisition cash flows as $143. Our estimate of free cash flows is now:

|  |  |  |  |
| --- | --- | --- | --- |
|  Cash from operating activities |   | $ 87 |  |
|  Reported capital expenditures  |  $ 15 |  |  |
|  Reported acquisition cash flows |  (4) |  |  |
|  Adjustment for additional acquisition  “cash flows” |  143 |   154 |  |
|  Free cash flows in 2010  |  | $ (67) |  |

This number is still distorted because we don’t have enough information about the working capital accounts purchased in the acquisitions, but this estimate is much better than management’s estimate of free cash flows. Thus, if we focus on free cash flows, they are negative and we remain unimpressed with Groupon’s IPO.

Overall, the balance sheet stinks. The income statement reeks. Cash flows are in the toilet. Instead of participating in this IPO, we would rather purchase lottery tickets.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*