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# Launching Yelp Reservations (A)

In early 2013, the media conglomerate InterActiveCorp (IAC) was looking for a buyer for RezBook, the online restaurant reservation platform developed by Urbanspoon, a popular restaurant review site and IAC holding. The prospective sale of RezBook came as a surprise to Mike Ghaffary, the Vice-President of Business and Corporate Development at Yelp. Yelp was a popular and growing review platform that had been engaged in long-standing battle with Urbanspoon for restaurant review dominance. For some time now, Yelp had been considering an entrance into the reservation space with the goal of vertically integrating its site to improve the hungry diner's consumer experience. The announced sale of RezBook had raised this issue to the forefront of Yelp executives' minds; a management meeting addressing the subject was set for later that day to recap prior industry research and get up to speed on the current state of the restaurant reservation space. Ghaffary knew that his role would be to outline Yelp's potential strategies in confronting this new development and to recommend a profitable path forward.

RezBook was a small, cloud-based service looking to capitalize on its technological superiority over OpenTable, the established market leader in the online reservation space. RezBook's lower pricing structure was quickly gaining traction among smaller restaurants and bars. SeatMe, a two-year old startup led by its 26-year-old founder Alex Kvamme, was also engaged in the struggle against OpenTable. Although the company only had a small presence in San Francisco, SeatMe also had an ultra-low pricing structure and cloud-computing capabilities. While Yelp did not have its own proprietary reservation platform as of early 2013, the company did have an important partnership with OpenTable. OpenTable provided Yelp users with the ability to make a reservation without leaving the review page, while Yelp provided OpenTable with access to over 100 million consumers, many looking for restaurant reservations.

Yelp had set ambitious goals for 2013-2014 outside of entering a new market, including mobile convergence between the Yelp app and Yelp site, further expansion into Europe, and creating a better communication network with advertisers that focused on showing where leads originated. Ghaffary predicted that management would be hesitant to enter the online reservation market given such an ambitious agenda. For the meeting, the team would need a comprehensive outline of all of Yelp's options for entering the space. Outside of buying an existing company, Yelp could instead choose to build a proprietary platform, which would likely require a two-year, multi-million dollar investment.

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If management wanted to go the acquisition route, Ghaffary would need to debrief the considerations for dealing with each of the potential targets. Yelp had to think about all of its options, and Ghaffary needed to make a proposal for the company's next move.

## Reviewing a Reviewer

Yelp is an online review platform that allows users to post reviews for businesses and other places, ranging from restaurants and hotels to public parks and subway stops. Founded in 2004 by two former PayPal employees, Yelp's aim was to "connect people with great local businesses." Yelp quickly became influential—research estimated that a one-star increase in an independent restaurant's ratings caused more than a five percent increase in sales.[1] Yelp and other user-generated content platforms were democratizing the way that information was delivered to people searching for a business or service. This change was especially salient in the restaurant industry, which had traditionally been marked by a lack of information.

Industry and market interest in the company were growing rapidly. After rejecting an offer to be acquired by Google in 2009, Yelp decided to go public in early 2012. At the time, Yelp's popularity was still rapidly growing in the United States, and the company had extended its presence to 10 countries.[2] The March 2012 IPO drew much fanfare, with Yelp boasting an initial $1.47 billion valuation.[3] In its filing documents with the SEC, the company trumpeted its ability to bring the power of "word of mouth" to an unlimited group of people via its online platform. Moreover, the company argued to investors that the more traffic the site received, the more accurate (and more valuable) Yelp would become. To underscore the company's confidence in its business model, Yelp's prospectus advertisements boasted that "we know we've arrived . . . (Yelp) has become a verb."[4]

Ghaffary was a sectionmate and good friend of Yelp CEO Jeremy Stoppelman at Harvard Business School in 2005. When Ghaffary helped Yelp write its first advertiser contract that same year, the company only had a handful of employees. Ghaffary considered joining Yelp when the firm had reached around 20 people in 2007. By the time he finally came on board in October 2010, the company had hundreds of employees. By the end of the first quarter of 2013, Yelp counted 1,479 employees in its ranks.[5]

Upon release of Yelp's 1Q13 results on May 2, the company had a market capitalization of $1.63 billion. Revenues for the quarter were just over $46 million, driven almost solely by advertisement revenue—with advertisements primarily purchased by local businesses. The growth rates of the company's reviewer base and average monthly visitors were still strong. As of March 31, 2013, the company had amassed over 39 million reviews, a 42% increase over the prior year's value.[6] Unique visitors on an average monthly basis were 102 million during the quarter, which represented a 43% increase over the prior year's quarter. Despite a large customer base and growing popularity, the company was burdened with high costs of operations and had never turned a quarterly profit, posting a $4.8 million loss for the first three months of 2013.[7]

Much of the cost structure was driven by sales and marketing expenses, the largest expense category on Yelp's statement of operations. This high spending on sales and marketing could be leveraged if Yelp did decide to enter the reservations business. See **Exhibit 1** for more information.

Earlier in 2013, management had set a list of company goals for the year, none of which explicitly included acquisitions. Yelp's primary objectives for 2013 were threefold. First, the company aimed to achieve full mobile convergence, allowing customers and reviewers alike to seamlessly transition from the Yelp mobile application to the Yelp site. Second, the company looked to expand its markets further into Europe, after gaining a foothold there in the prior few years. Last, the company looked to "close the loop" with advertisers, showing them the source of advertisement leads, and with consumers, to show them the best way to reach businesses. The Yelp team had developed multi-pronged action plans to achieve these major goals; bringing these plans to fruition would require a concerted effort from the entire organization.

Yelp had a history of being relatively conservative in its merger and acquisition philosophy, especially when compared to its peers in Silicon Valley. Every month, Yelp's management would create a list of potential acquisitions and strike through those that did not offer a very strong possibility of aligning with Yelp's goals. With so much already on the company's plate for 2013, Ghaffary had questioned the move to enter headlong into the restaurant reservation space. Yelp was arguably the best company in the world at providing reviews for local businesses. Why distract the team from further building on this competitive advantage? In the eyes of management, any potential entrance strategy would need to thoroughly and convincingly answer this fundamental question.

## The Restaurant Industry

As of 2013, the restaurant industry logged around $661 billion worth of sales, representing around 4% of the United States' GDP. The industry employed about 13.1 million people or about 10% of the entire United States workforce.[8] As of 2013, there were 980,000 restaurant locations in America, with estimates suggesting that fewer than 5% took reservations online.[9]

Managing or owning a restaurant is a difficult business. Most restaurateurs have historically priced their main food items around three times the input costs, which allows the restaurant to pay for the raw ingredients, cooks, wait staff, and other fixed costs such as rent. Specialty items such as drinks and desserts are often marked up many times over their input costs, making these offerings especially profitable.[10] Even so, the industry relies heavily on volume. Generally, over half of all new restaurants do not survive their first year. Moreover, only about 20% of restaurants are still open five years after their founding.[11]

The industry itself is highly diverse and relatively fragmented in terms of product quality, size, and service. In 2013, over 93% of restaurant locations employed fewer than 50 people, and around 70% of establishments were single-unit operations.[12] For those taking reservations, OpenTable was the most-used platform to manage bookings and capture online traffic. Although the company held an enviable position amongst its peers, many restaurants complained about the platform's outdated technology and high prices. For all of the discontent, however, many restaurants felt the dual comforts and the constraints of the old system gave them little incentive to switch.[13]

## OpenTable: The Established Leader

As of May 2013, OpenTable held the pre-eminent position among restaurant booking platforms, with over 20,000 locations using its software. Founded in 1998, the company was the first major online restaurant reservation booking platform available to businesses. The most common system that OpenTable uses to manage restaurant bookings is called the Electronic Reservation Book (ERB).[14] These free-standing computer terminals (see **Exhibit 5**) contain the OpenTable software, and are installed for an average fee of around $600-$700.[15,16] The company went public in May 2009, and by mid-2010, the company boasted a 90% market share in the online reservation space.[17]

The company had its own website and also operated its system on each of its restaurant customers' websites. Apart from the ERB installation and training fees, OpenTable derived revenue from reservations made online, asking clients for $.25 per head for diners booking on restaurant sites, and $1 per head for those booking directly on the OpenTable site.[18] Restaurants also paid OpenTable a monthly fee, which averaged around $270.[19] Due to this hefty price structure, restaurants using OpenTable tended to be either high end or well-established. While there were a large number of restaurants outside of these 20,000 OpenTable users, a majority of them did not take reservations (e.g., fast food restaurants), and OpenTable was not willing to compete down-market for what, in its view, was such a small (and relatively less profitable) piece of the industry. There were, however, a large number of restaurants (possibly numbering in the hundreds of thousands) that took reservations by pen and paper; a significant amount might be convinced to take reservations online if a less expensive solution were widely available. The exact size of this segment of the market was unknown, adding to uncertainty around how effective a new pricing model could be.

Restaurants who used OpenTable as a booking service knew that OpenTable's relatively large scale in the space created network effects. Restaurants had a difficult time placing value on OpenTable's clout in the space, worrying that many diners enjoyed the ease of booking in a central location. While other smaller companies made pitches to restaurants touting their platforms' better user-interfaces and lower prices, the scale of OpenTable and its broad name recognition among diners were difficult to value for restaurants considering switching reservation providers. Although its software system was showing signs of age, the incumbent OpenTable attempted to prevent restaurants from leaving for more nimble competitors.[20]

In 2013, Yelp had a contract in place with OpenTable. On each restaurant's review page, Yelp placed a "Reserve" button under the main description of the restaurant. When a Yelp user clicked on this button, a pop-up box would appear on the screen with available times, with a "Powered by OpenTable" notice in the bottom left (see **Exhibit 2**).[21] From Yelp's point of view, the fact that customers did not have to leave its site to book a reservation was a benefit—keeping customers on the platform longer and improving advertising prospects. It also provided Yelp with valuable information about final dining decisions that the company could use to improve its core product. OpenTable benefitted from the increase in customers (and revenue) driven by Yelp's burgeoning popularity. With RezBook up for sale, the relationship between Yelp and OpenTable became more complicated. In the eyes of many in the industry, OpenTable was a natural buyer for RezBook; a combined entity would pair scale with new technology.

## RezBook: The Catalyst for Market Disruption

RezBook was initially developed by Yelp competitor Urbanspoon. A pilot of the program launched in November 2009 among 100 Seattle-area restaurants before the nationwide launch in June 2010.[22] Urbanspoon also offered an online review platform with 20 million total restaurant reviews on the site and in blog posts.[23] Ghaffary understood that Urbanspoon had positioned RezBook as a low-cost, tech-savvy platform for the future, a direct challenge to OpenTable's traditional dominance in the space.

RezBook's product was simple and effective: customers could either call in to the restaurant or book through the Rez functionality on Urbanspoon's app. Restaurants would then be able to see the entire night's set of reservations on RezBook's cloud-based booking system, which synchronized the online and manually-entered bookings in calendar and floorplan modes (see **Exhibits 3 & 4**).[24] For its part, the restaurant would pay RezBook a $1 fee per diner, plus a flat $200 monthly fee. Restaurants using the RezBook system needed to purchase a discounted iPad (around $500) through RezBook in order to take advantage of the $1 pricing; using a non-RezBook device would increase the fee to $2 per diner with no monthly charge, eliminating its low-price advantage over OpenTable.[25] In a departure from the OpenTable pricing model, diners who booked reservations directly through the restaurant's website would not cost the restaurants a per-head fee.[26]

The majority of RezBook's customers represented trendy, independent restaurants in urban areas that had not yet "gone digital" with their reservation systems (i.e., they were still using pen and paper). While the platform only could claim to have around 2,000 locations using its services by May 2013, the brand had amassed powerful ambassadors among the influential restaurant elite, ranging from such hip eateries as State Bird Provisions and Locanda in San Francisco to Birreria in New York City.[27] Although the service held currency with a growing portion of the restaurant industry, Rezbook was located in Seattle, far afield from Yelp in San Francisco. Moreover, Ghaffary had always been lukewarm towards the brand's culture in prior interactions, feeling like it was missing a "spark" common among startups). Going forward, major questions still remained about expanding the brand to a broader group of restaurants. Analysts estimated that the average RezBook customer at the time brought in around $2,500 in revenue per year.

The parent company of the Urbanspoon and RezBook brands, InterActive Corp (IAC), was a significant player in the internet services and retailing sector, owning around 150 brands including such household names as About.com and The Daily Beast.[28] The company was founded in 1986 and had been led since 1995 by media mogul Barry Diller, who owned a 42.5% voting share in the company at the start of 2013.[29] The company's recent performance had impressed analysts—IAC boasted over 5,000 employees and was worth almost $3 billion. In the first quarter of 2013, IAC posted a 16% year-over-year revenue gain, marking the company's 16th-straight quarter-over-quarter revenue increase of greater than 10%.[30] IAC trumpeted its ability to buy and sell companies with ease. At the time, the webpage describing IAC's company history was little more than a long list of the company's high-profile website acquisitions and turnarounds.[31]

Some in the industry were hesitant to deal with the company, citing Diller's high level of control and IAC's convoluted organizational structure. GovernanceMetrics International, a research and ratings firm, found a weak link between executive compensation and performance in the company, and the recent additions of family and celebrity members to the board (such as Diller's stepson and former First Daughter Chelsea Clinton), had raised eyebrows in the press.[32] Despite these organizational facets of the company, performance metrics were proving that the company's strategy, for the time being, was working. When IAC announced that it was planning on selling RezBook, interested parties knew that the process would be professional and aggressive, given IAC's track record. The company had already completed two major brand acquisitions within the first four months of 2013 (having purchased OkCupid and Newsweek).[33] With close to thirty years as a major player in media mergers, IAC would be a patient and informed seller.

## SeatMe: The Upstart Startup

SeatMe was a newer entrant, having been founded less than two years earlier in 2011. The platform operated on Apple-enabled devices for a monthly fee of $99, and restaurants did not have to pay a per diner fee. Based in San Francisco only a few miles away from Yelp, SeatMe had 15 employees and was led by its 25-year old founder Alex Kvamme. The platform was serving 100 restaurants; in Ghaffary's eyes, this scale seemed to prove that the technology and product worked but had not yet produced interesting economics for the company. SeatMe had received seed funding on November 8, 2012 from Khosla Ventures, Maveron, and BoxGroup for an unspecified amount.[34] With this financing and vote of confidence from the venture capital world, Kvamme and his team had been laser-focused on "killing OpenTable" in the marketplace.[35] Due to its flat pricing structure, analysts knew that SeatMe gained around $1,188 in average revenue per customer per year, assuming the customer stayed with SeatMe the entire year.[36]

Rumors in the technology world spread that Square, the mobile payments service company which would end 2013 with revenues rumored to be over $100 million, might be a natural choice to combine forces with SeatMe in mobile device-enabled services.[37,38] To some in the industry, this rumor hinted that the online reservation space could be on the brink of a period of rapid consolidation, as smaller players sought to be bought out by larger players looking to improve their technology base. The next few weeks would reveal whether a chain reaction of mergers would occur, or if the companies would maintain their positions and continue to grow internally.

Ghaffary figured that SeatMe had two options. The first option involved taking another round of venture financing, providing a track for independent growth through the medium term time frame, hopefully at a higher valuation range. A higher valuation could make buying more difficult for potential acquirers, so Ghaffary knew that another round of funding would mark SeatMe's decision to "go it alone" for at least another few years. The second option was to sell to a larger company, which could lead to negotiation headaches for Yelp. While Ghaffary's prior experience interacting with SeatMe and Kvamme left him with admiration for the company's confident and assertive mentality and collaborative culture, Ghaffary knew that startup founders might willingly forgo attractive opportunities to exit because they wanted to maintain sole authority over their operations. Moreover, Ghaffary was unsure how SeatMe's seed financiers would respond to a deal-making process; each extra party at the table increased the possibility of making the negotiations more complicated.

SeatMe was also only two years old, and Yelp's negotiators would have to consider the possibility that buying such a young startup might be a losing proposition. Despite SeatMe's incredibly low price point (see **Exhibit 6**), the platform was only in use in 100 restaurant locations, leading some to speculate that the reservation booking platform space might be over-saturated. Moreover, restaurants that might be looking to change providers would be hit with switching costs both predictable (a new initial fee) and unpredictable (lost time training employees to learn the new system). These countervailing forces had the potential to clip SeatMe's wings even before it got off the ground.

## Strategic Choices

Ghaffary put down his phone and stared at the company reports littered on his desk. He had just gotten off a call with Yelp's head software engineer, asking about the feasibility of the company building its own proprietary reservation platform. He received mixed news: Yelp could likely build a proprietary platform, but doing so would take at least two years to complete, and would involve hiring expensive new engineering talent costing millions of dollars. In addition, a call with Yelp's analysts had yielded the information that technology companies in the sector were being conservatively valued at around 3.5x revenue.[39] With the management meeting only 30 minutes away, Ghaffary had compiled a list of players in the industry with their number of locations, pricing structure, and other important notes (**Exhibit 6**).

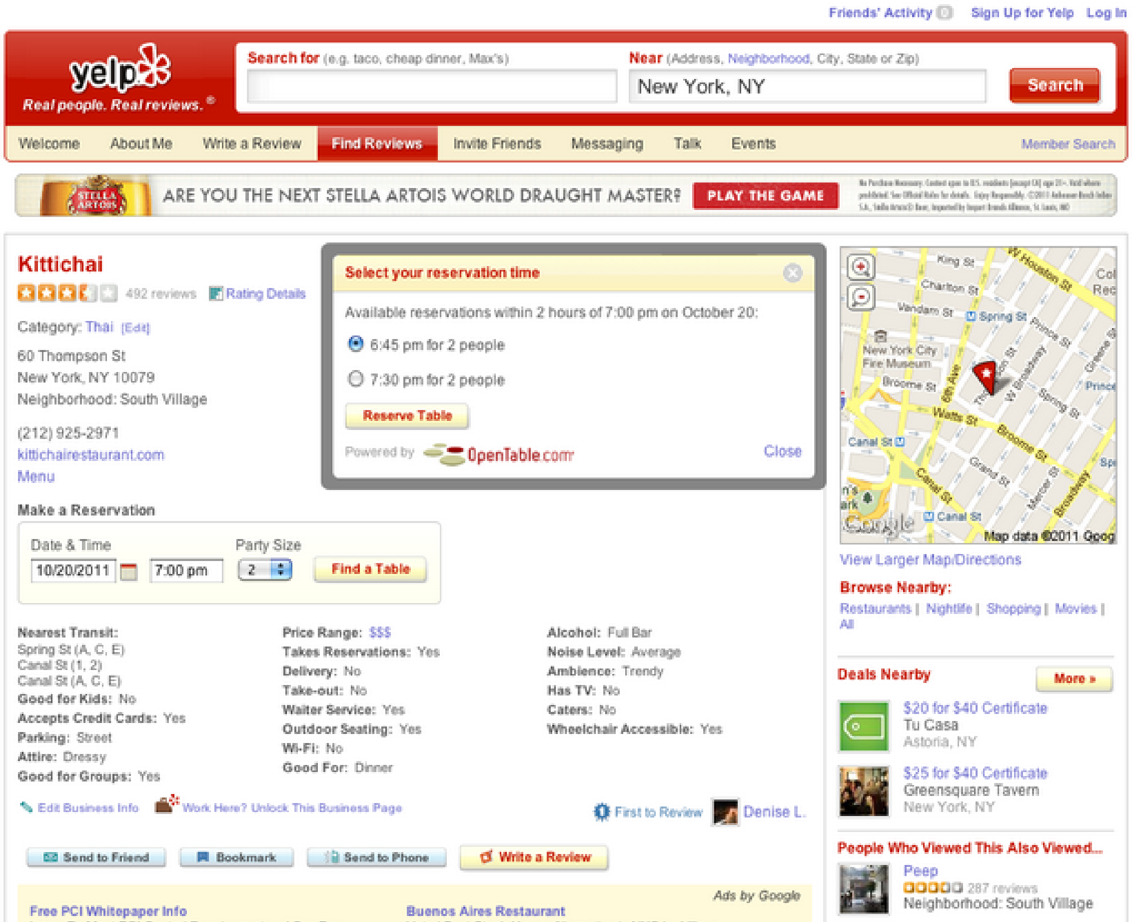
Although he had done his due diligence, Ghaffary had to make sure that he mapped all of the potential avenues for action to their associated outcomes. First off, should Yelp even consider entering the restaurant reservation space? The company had set well-defined priorities for 2013-2014 in streamlining its technology, expanding into new geographies, and strengthening existing relationships with consumers and advertisers. Ghaffary did not want to recommend entering into an adjacent market unless it created real value for Yelp.

**Exhibit 1** Yelp 1Q13 Consolidated Statements of Operations (as a percentage of net revenue)

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| | (as a percentage of net revenue) | |
| **Consolidated Statements of Operations Data:** | | |
| Net revenue by product | | |
| Local advertising | 85% | 78% |
| Brand advertising | 10 | 15 |
| Other services | 5 | 7 |
| Total net revenue | 100% | 100% |
| Costs and expenses: | | |
| Cost of revenue (exclusive of depreciation and amortization shown separately below) | 7% | 8% |
| Sales and marketing | 61 | 69 |
| Product development | 16 | 15 |
| General and administrative | 19 | 39 |
| Depreciation and amortization | 5 | 5 |
| Restructuring and integration costs | 1 | — |
| Total costs and expenses | 109 | 136 |
| Loss from operations | (10) | (36) |
| Other income (expense), net | (1) | — |
| Loss before income taxes | (11) | (36) |
| Provision for income taxes | — | — |
| Net loss | (10)% | (36)% |

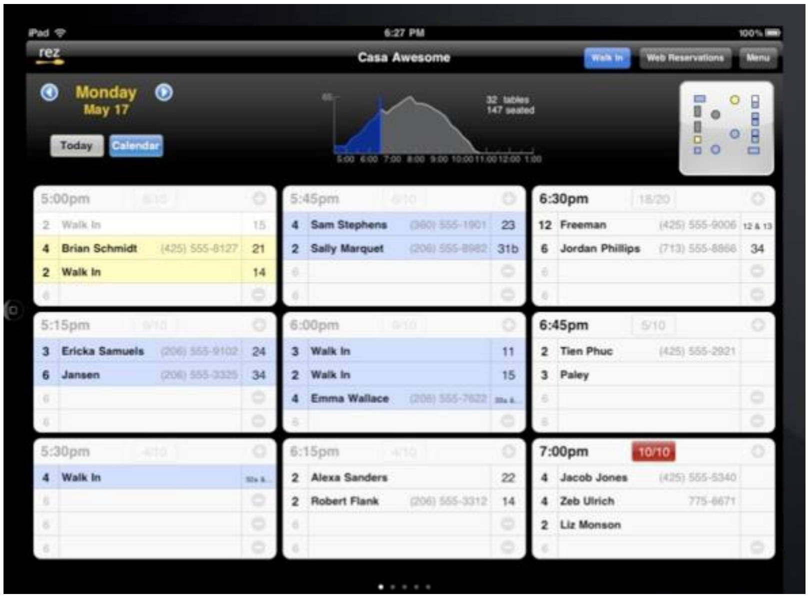
Source: Screenshot of Yelp 10-Q for first quarter 2013, p. 19. *EDGAR SEC Company Filings Database*, accessed January 14, 2015.

**Exhibit 2** Yelp/OpenTable Partnership—Example Reservation



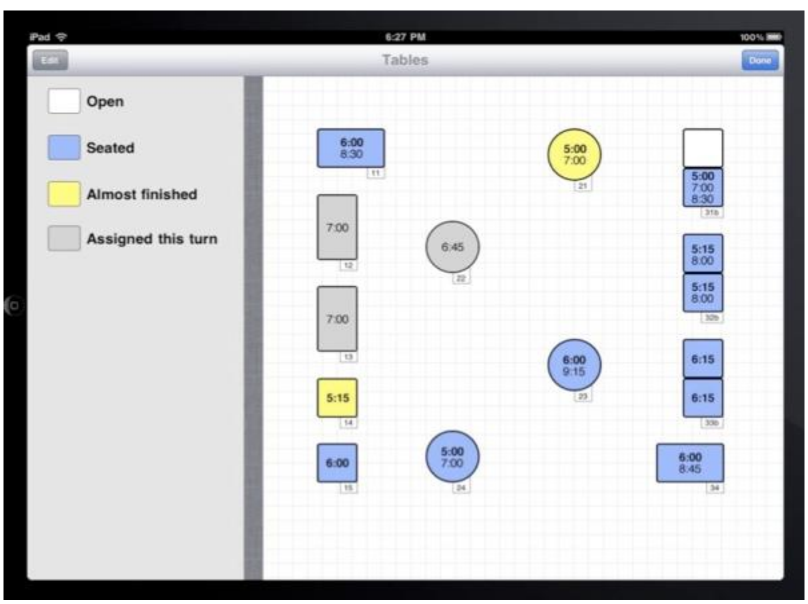

Source: Author's screenshot of Yelp/OpenTable functionality, adapted from endnote 14.

**Exhibit 3** RezBook Calendar View




Source: Author's screenshot of RezBook interface, adapted from endnote 24.

**Exhibit 4** RezBook Floor Plan View




Source: Author's screenshot of RezBook interface, adapted from endnote 24.

**Exhibit 5** OpenTable Electronic Reservation Book (ERB)


Source: Author's screenshot of OpenTable interface, adapted from endnote 15.

**Exhibit 6** Table of Major Restaurant Reservation Booking Platforms in May 2013

| Company | Year Launched | Locations as of May 2013 | Initial Fee | Monthly Fee | Per Diner Fee | Loyalty Program | Extra Notes |
|---|---|---|---|---|---|---|---|
| OpenTable.com | 1999 | 20,000 | $600–$700 | $270 average | $1 per head booking on OpenTable site, $.25 for booking on restaurant site | Diners earn points per reservation, which can be redeemed for a discount coupon | Stock price increased over 116% in a year after its May 2012 IPO |
| Urbanspoon's RezBook | 2010 | 2,000 | $500 (for subsidized iPad) | $200 | $1 per head booking on RezBook, no fee otherwise | Encourages restaurants to offer special deals to customers who use their service | Customers book through Urbanspoon's Rez function. Reservations are recorded in the restaurant's RezBook app |
| SeatMe | 2011 | 100 | $0, but restau-rants must provide their own iPad | $99 | $0 | None | Young company, uncertain future, switching costs |

Source: Adapted from company websites, interviews, and *Wall Street Journal*, http://www.wsj.com/articles/SB10001424052748703691804575254680739522068, (see endnote 16), accessed January 15, 2015.

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