PRICEWATERHOUSECOOPERS

Hospitality Directions
Europe Edition*

Issue 14 November 2006

How to maintain success in the online travel space

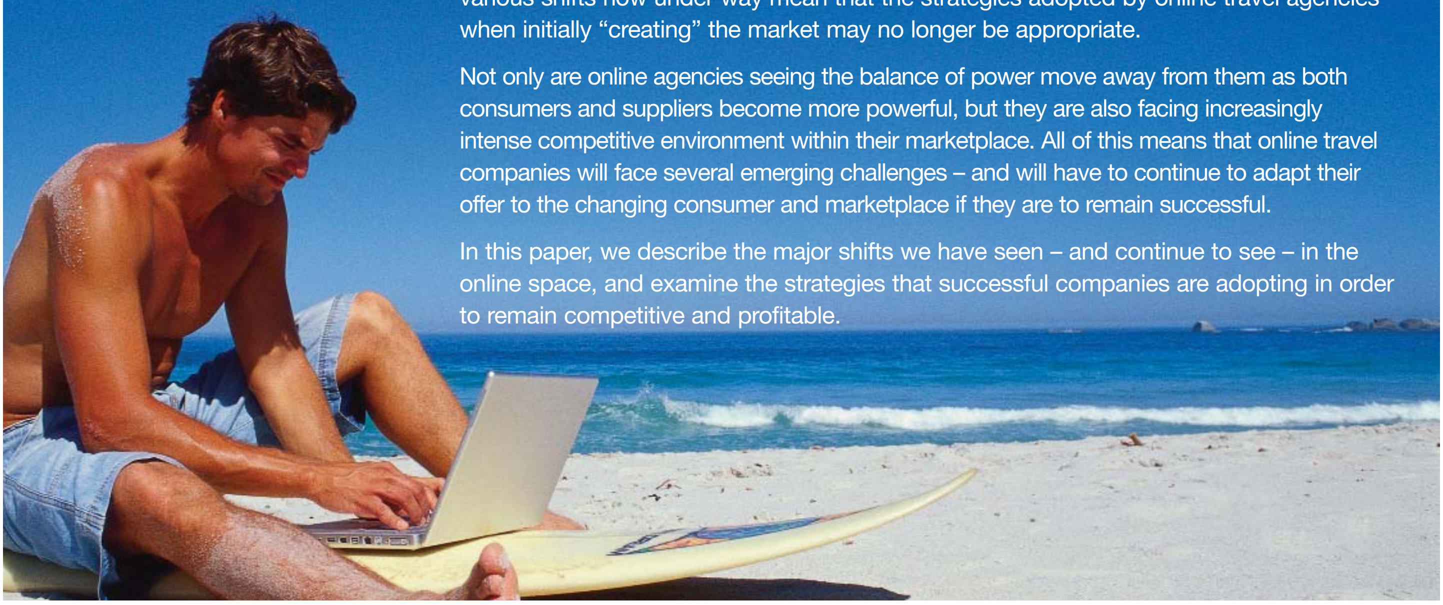
Healthy growth continues to drive the market – but shifting competitive dynamics and consumer profile signal major challenges ahead

Despite the impact of recent shocks, Europe's travel sector is continuing to expand and experiencing steadily growing consumer demand, albeit at a relatively modest annual rate of around 2 per cent to 3 per cent. However, a major shift is now under way in how consumers book their travel. As a result, much of the growth in Europe's travel market is concentrated in the online arena, where the accessibility of the internet – combined with increasing consumer confidence in the online channel – has driven activity and revenues upwards.

As the online travel industry evolves and matures, a number of parallel changes are taking place. This ongoing evolution is significant in scale – and is impacting all areas of the travel market: consumers, suppliers and the operators themselves. In combination, the various shifts now under way mean that the strategies adopted by online travel agencies when initially "creating" the market may no longer be appropriate.

Not only are online agencies seeing the balance of power move away from them as both consumers and suppliers become more powerful, but they are also facing increasingly intense competitive environment within their marketplace. All of this means that online travel companies will face several emerging challenges – and will have to continue to adapt their offer to the changing consumer and marketplace if they are to remain successful.

In this paper, we describe the major shifts we have seen – and continue to see – in the online space, and examine the strategies that successful companies are adopting in order to remain competitive and profitable.



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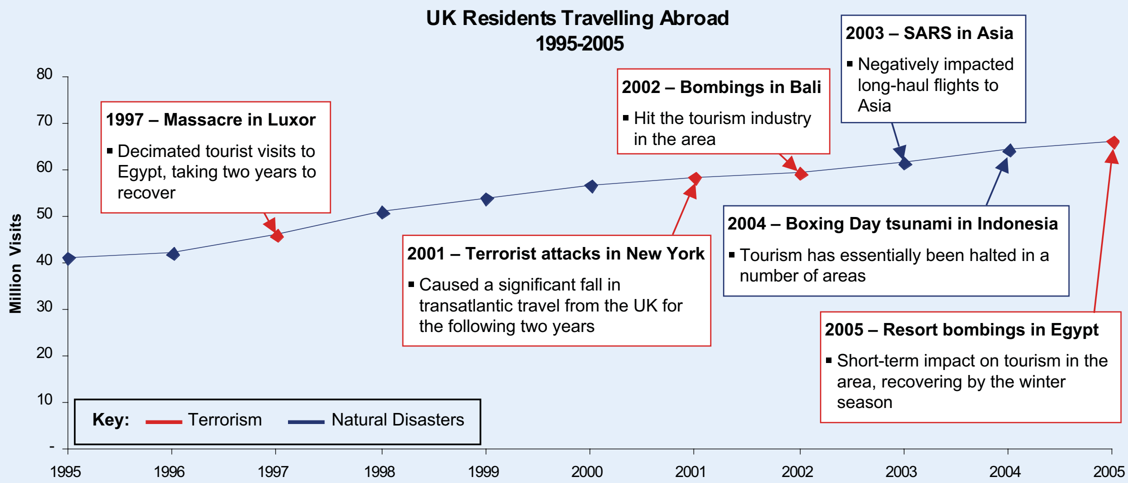
A changing marketplace

Figure 1: the UK travel market has continued to grow – despite shocks



Source: International Passenger Survey

Fast growth – despite the shocks

In spite of a number of global shocks in recent years, Europe's travel market remains a buoyant area in which to do business.

As Figure 1 shows for the UK market, disruptive events including 9/11, SARS, the Iraq War and the Asian Tsunami have failed to deter people from travelling. Rather than affecting the industry's level of activity, the collective impact of these shocks has been to make people defer or alter their travel plans, rather than abandoning them entirely. Travel flow has also continued to hold up relatively well in more recent months, despite the disruption caused by the luggage restrictions imposed after the alleged terrorist plot against US outbound flights from London. Despite the disruptions, in fact, a number of airlines recorded a year-on-year increase in the number of passengers they carried in August (e.g. Easyjet: +8.4 per cent, Air France-KLM: +4.7 per cent).

Long-term solid ascent

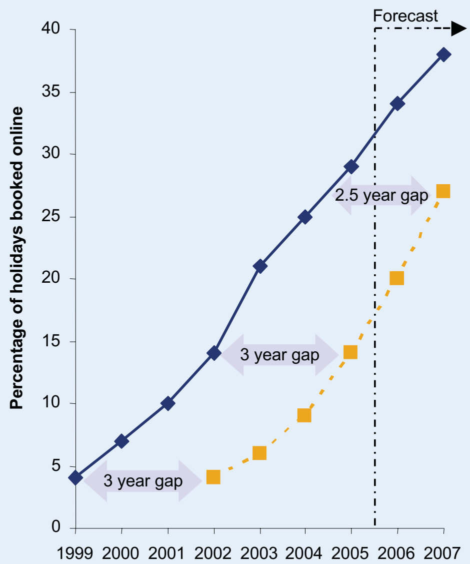
This generally benign environment looks set to continue, as evidenced by solid growth forecasts. Inbound traffic in Western Europe is expected to continue growing at an annual rate of about 2.5 per cent p.a. through to 2009.

This steady, although unspectacular, growth is driven by a number of factors. For one, the emergence of low cost carriers in Europe has made it easier and cheaper for people to travel for short breaks. For another, leisure travellers have become more adventurous, becoming increasingly willing to book independently-organised trips rather than their traditional two-week packaged holiday.

The online market is set to continue to grow significantly, although at slower rates

This ongoing growth in travel will continue to sustain the online travel market which is taking market share from the more traditional off-line booking methods. In Europe, the online market – leisure and unmanaged – is estimated to have been worth some €28bn in 2005, having grown at 52 per cent p.a. between 2002 and 2005 (see Figure 2) .The

Figure 2: Online providers' share of the travel market, 1999-2007



CAGR,%	1999-02	2002-05	2005-07
US	51.8%	27.5%	14.5%
Europe		51.8%	38.9%

Source: PhoCusWright Online Travel Overview, Oct 2005
(Note includes leisure and unmanaged business)

drivers behind this growth include consumers' increasing acceptance, familiarity and trust in internet channels, expanding broadband penetration, and – in particular – expansion in travel suppliers' online presence, coupled with the underlying healthy state of the travel market as a whole.

Experience from the US, where the market is about three years ahead of Europe suggests that annual growth in the European online travel sector will remain at over 20 per cent p.a. until around 2010, before gradually slowing down as the market matures.

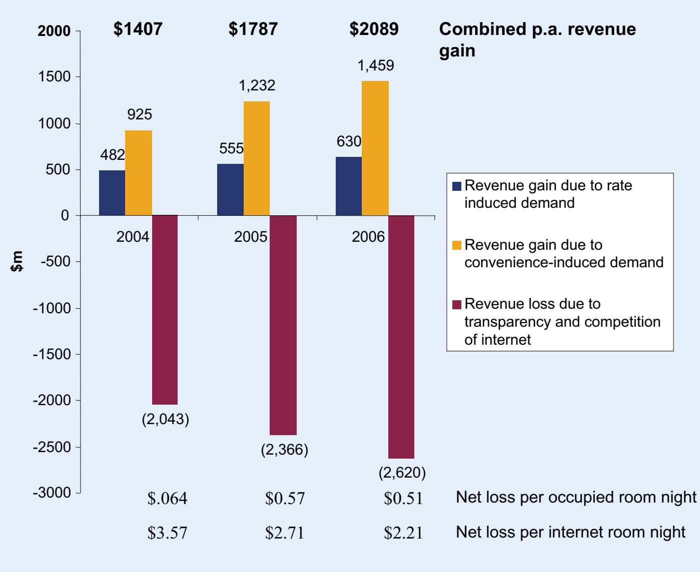
As in the US, air travel continues to be the largest and most highly-developed segment of Europe's online travel market by a wide margin. PhocusWright estimates that online air travel bookings accounted for around 56 per cent of the total value of travel sales booked online in Europe in 2005. Hotels remain a less well-developed and less penetrated market, but one where growth is rapid and gaining momentum. Our analysis of trends in online accommodation bookings suggests it is reasonable to expect growth of around 35 per cent p.a. to 40 per cent p.a. in this market between 2007 and 2010.

The consumer now holds increasing power

A key challenge that online agencies are facing up to is that the emergence of the internet has commoditised the travel market, with price becoming the key criterion in consumers' choices about elements of their travel plans.

The increasing importance of consumer power underlines the paradoxical impact that the emergence of the online travel has had on the travel industry as a whole. It is

Figure 3: Price deflation in hotel rates is outweighing demand gains to push revenues down



Source: PWC Analysis, PWC Hospitality Directions, Europe edition March 2005

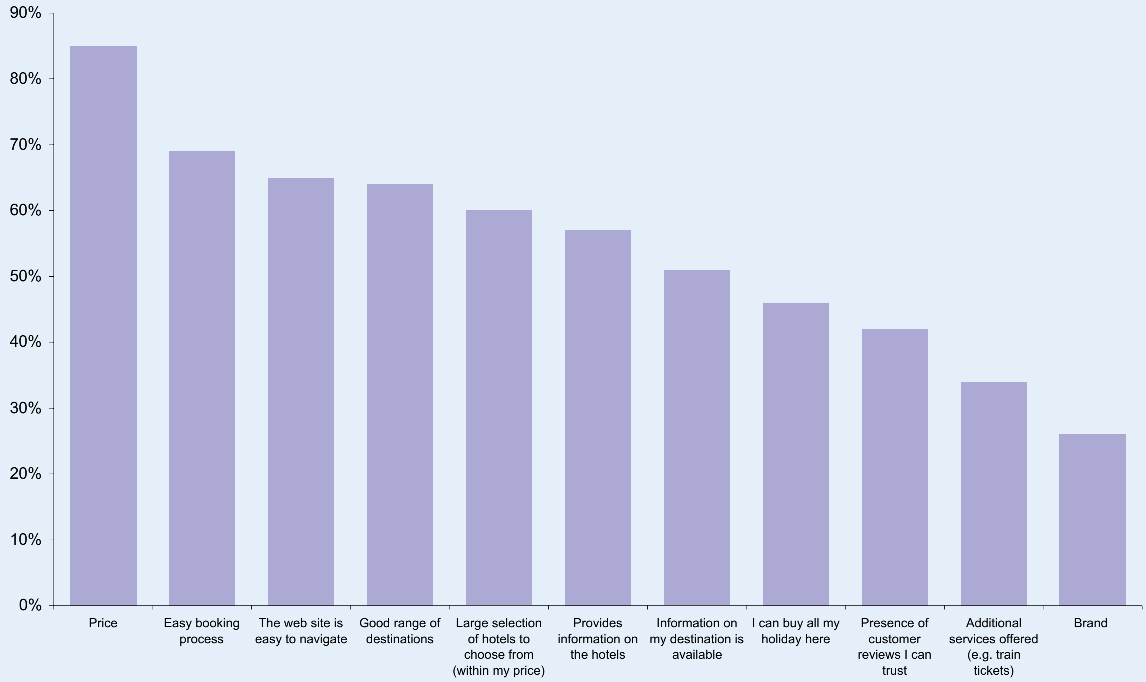
widely recognised that the explosive growth in online travel has been broadly beneficial to the industry in terms of volumes, demand and throughput. But it has also had the effect of pushing prices down, with negative implications for the industry as a whole.

A previous PwC analysis ("Effect of the Internet on Lodging Demand – Update and Additional Analysis" – PricewaterhouseCoopers Hospitality Directions Europe Edition, Issue 11) published in March 2005 estimates that the hotel global industry lost around US$600 million in revenues in 2005, as price deflation more than outweighed the revenue gains due to the increased demand resulting from lower room rates and greater convenience. An extract from this research is shown in Figure 3.

The increasing importance of price as a key determinant of where consumers decide to book their travel choices has also been well-documented in other recent research reports. For example, research by Goldman Sachs in the US in 2006 shows that 61 per cent of the consumers interviewed mentioned price as the key consideration when choosing a travel website, with other factors such as trust, ease of use and convenience mentioned by only around 15 per cent.

With service fees being more visible for airlines than in other areas of the travel market, and with like-for-like product comparisons being easier to make for air travel than for accommodation, it is hardly surprising that the area in which consumers are most likely to adopt a price-sensitive site-switching approach is in purchasing airline

Figure 4: UK: What drives you to use one online agency instead of another?

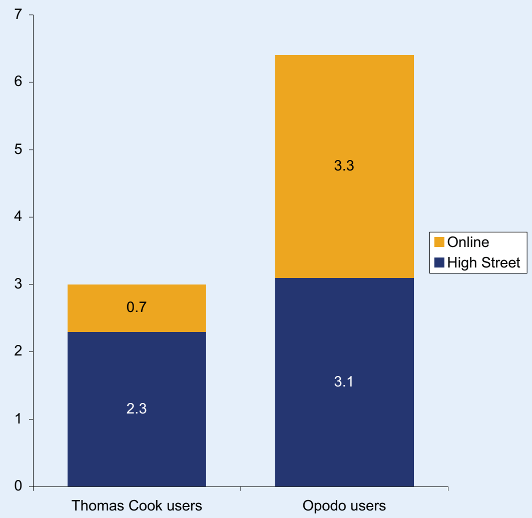


Source: PwC primary research based on a sample of c.200 interviews

tickets. However, further industry research from PhocusWright shows that substantial numbers of travellers shopping for hotels and car rentals are also willing to switch if they find a lower price. This was confirmed by PwC research conducted in the UK in June 2006, in which price was mentioned by some 85 per cent of consumers as one of the factors that drives them to choose one online travel agency over the other (see Figure 4).

Another way in which the consumer's relationship with travel providers has changed is in the level of consumer promiscuity online relative to offline, aided of course by the greater ease of switching providers online. Research by TripVision, a single-point database of UK travellers' behaviour and attitudes, shown in Figure 5, demonstrates how customers of online travel agents on average use a much wider range of travel agents, both online and offline, than customers of the traditional high street travel agent.

Figure 5: Average number of travel agents used by Thomas Cook and Opodo users



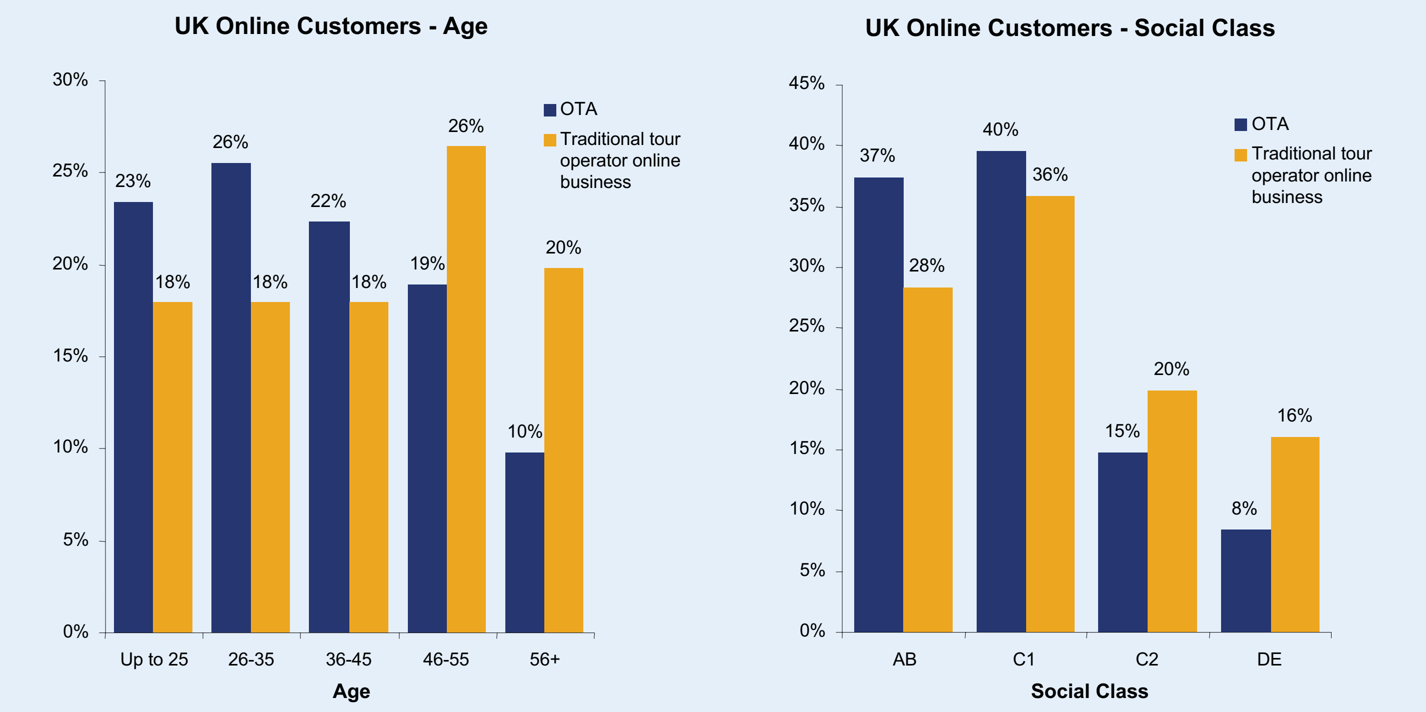
Source: TripVision

The consumer's profile is changing

As well as experiencing pressures on price coupled with strong growth in demand, online travel providers are also facing ongoing rapid change in the behaviour, profile and habits of the online consumer. This in turn is forcing them to adapt and update their offering on a continuing basis.

Data from TripVision underlines the pace and direction of the change on the consumer side. The online traveller is younger, more affluent and better educated than the general population – characteristics that are significantly more pronounced among travellers who book online with OTAs (online travel agencies such as Expedia, Travelocity, Lastminute) than among those who book through the online sites of traditional tour operators (see Figure 6). This distinction is likely to continue to evolve, as more – and more diverse – travellers organise their trips on the

Figure 6: Demographics of online travel customers in the UK



Source: Tripvision: data from a representative sample of 25,653 UK interviewees

internet. Research by hotels.com shows that the fastest-growing consumer segment in the UK for online travel is people over 55 years of age and from the C2/DE segments.

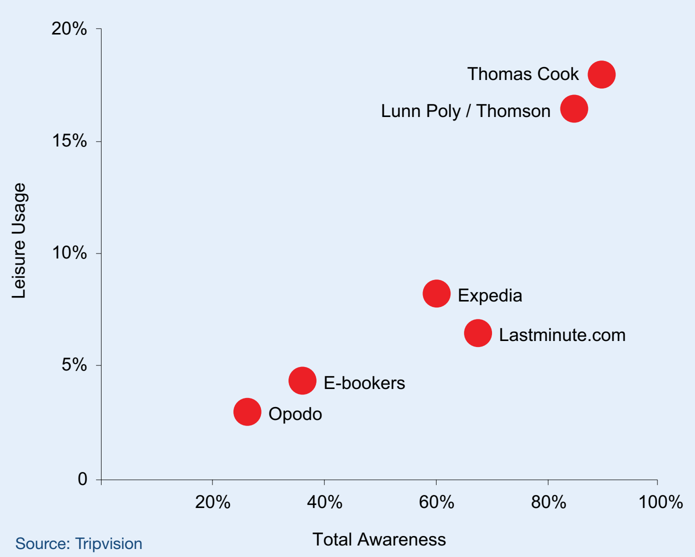
In an era when customer knowledge is power, this ongoing change in the profile of the 'typical' customer means that while online travel agencies have to date taken a relatively generic approach to addressing the needs of the online traveller, it is now becoming more important that they apply increasingly sophisticated techniques to build knowledge of their customer base. This knowledge will be key to their ability to attract, convert and retain customers in the future.

And reaching that consumer is becoming more expensive

The final part of the consumer jigsaw for the online travel agents is how to try and best target potential customers, and the costs of doing so. Here, a couple of key points stand out: first, that although brand awareness of some of the major online travel agents is high, aided by high levels of above the line marketing spend, the performance of these brands in terms of their usage versus their awareness is relatively weak (see Figure 7). This suggests that although above the line advertising works to generate awareness, it does not translate as well into bookings – potentially because of the targeting inefficiencies from using traditional mass media brand advertising, but also because of the greater promiscuity of online customers, as already discussed.

Second, the cost of reaching consumers is set to continue rising: key word price inflation on the likes of Google is expected to grow at 10 per cent+ p.a., whilst the marketing cost per visitor and per transaction has been growing in the more developed US market, a trend

Figure 7: Leisure usage and total awareness of selected online and offline travel agencies



Source: Tripvision

we would expect to see in Europe too. To offset these pressures, online travel agents are attempting to do three things: first, increase the average transaction fee per booking, through increased sales of higher value packages (which we will discuss later); second, continue refining their website presentation to lower the look-to-book ratio; and third, increase the levels of repeat business from existing customers. In our opinion, a combination of all three of these is likely to be required to help offset steady increases in marketing and customer acquisition costs

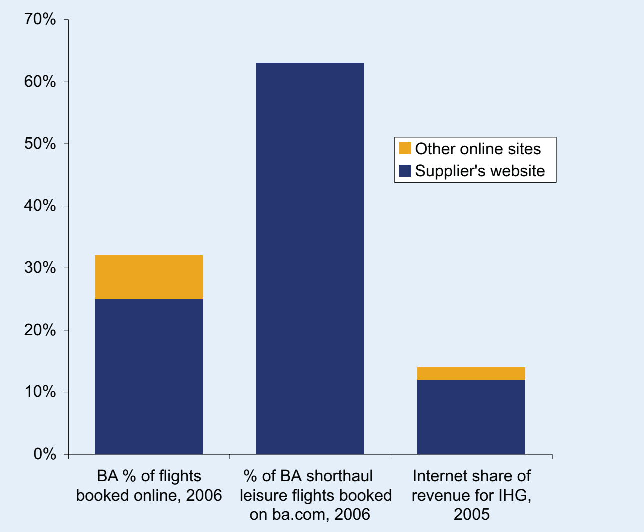
The environment is also becoming more competitive

The online market is in a constant state of evolution and flux on the supplier 'sell-side', as well as the consumer 'buy-side'. On the supplier side, there are three emerging trends that today's online providers are watching with care.

Suppliers go direct

The accessibility and ease of the internet is not only fostering the growth of the online travel intermediary market. It is also encouraging the principals at the top of the value chain – for example hotel groups themselves – to bypass the intermediaries altogether and go direct to consumers. This trend is well established in the airline industry, but is now becoming more marked in the accommodation sector as well, with groups such as Marriott working hard to generate traffic and bookings via their own websites (see Figure 8). As well as this trend

Figure 8: Use of direct internet channels for selected air and hotel suppliers



Source: Company Annual Reports

towards direct bookings, commissions paid by the suppliers to intermediaries have also come under pressure – for example BA has progressively cut commissions paid to agencies since 2003, from 7 per cent to 1 per cent, and earlier this year to 0 per cent.

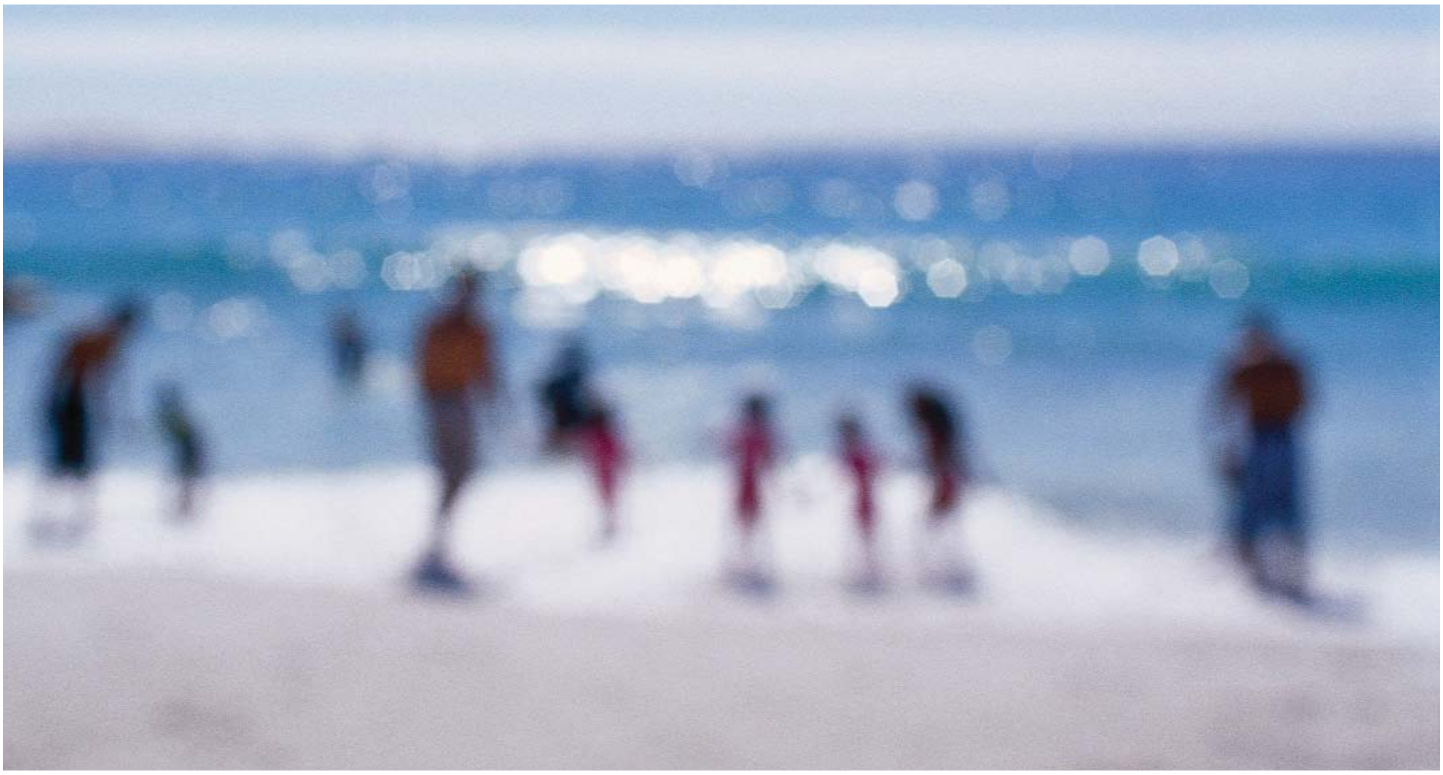
However, this direct route between provider and consumer suffers from some particular limitations in the European market for accommodation. Industry estimates suggest that only about 30 per cent of the hotels in Europe are members of chains, as compared to about 70 per cent in the US. A further hurdle is that consumers do not tend to pick hotels by brand. A leisure traveller to Rome is more likely to look for a good hotel near the Coliseum, rather than going straight to a branded site.

Hotel chains are responding to these challenges by pushing the consumer experience angle, e.g. setting up 'blogs' on their sites that allow their customers to give a warts-and-all view of their hotels. In doing this, they are imitating successful sites such as Tripadvisor.com, which generate traffic and advertising potential by acting as forums for exclusive independent comment and reviews. However, there is still the question of whether customers can – or will be prepared to – trust "independent" reviews published on suppliers' own sites.

The tour operators fight back online

A second trend on the supplier side is that the established tour operators are seeking out ways to compete and thrive amid the new online environment and shifting consumer dynamics. This primarily involves investing strongly in their online presence. While this is clearly the right strategy, it is equally evident that they will tend to serve a different market from the likes of Expedia, Travelocity and the niche specialists. This is because their continued focus on the 7-to-10-to-14-day packaged holiday market puts them in what is essentially a different consumer segment. Tour operators have also traditionally focused on a different mix of destinations than intermediaries mainly serving the short-break market.

However, like everything else in the online travel arena, this could change. As broadband rolls out, continuing change in the profile of online consumers could see the online travel agencies decide that the packaged holiday market is worth going for in a major way or, more likely, tour operators could aggressively attempt to enter the short-break market. This could see the traditional tour operators and online agencies meet head-to-head in a competitive clash that would be interesting for all concerned – and probably most beneficial to consumers seeking the best value.



The impact of 'metasearch' services

The third trend to highlight is the growth in metasearch services such as kayak.com. These websites 'scrape' price and availability information from a vast array of other sites and guide consumers to the cheapest deal that meets their requirements. Kayak announces proudly on its homepage that it is not a travel agency, and its ad-funded business model involves redirecting users free of charge to the site where they can make a booking, with no commission paid by the ultimate supplier.

This trend underlines the shifting and often unclear nature of the competitive dynamics in the online travel market. Depending on a hotel or airline's own online strategy and approach, kayak.com could be regarded either as a distribution channel partner or a competitor. As the market evolves, this fine line between distributor and competitor will if anything become even more blurred.

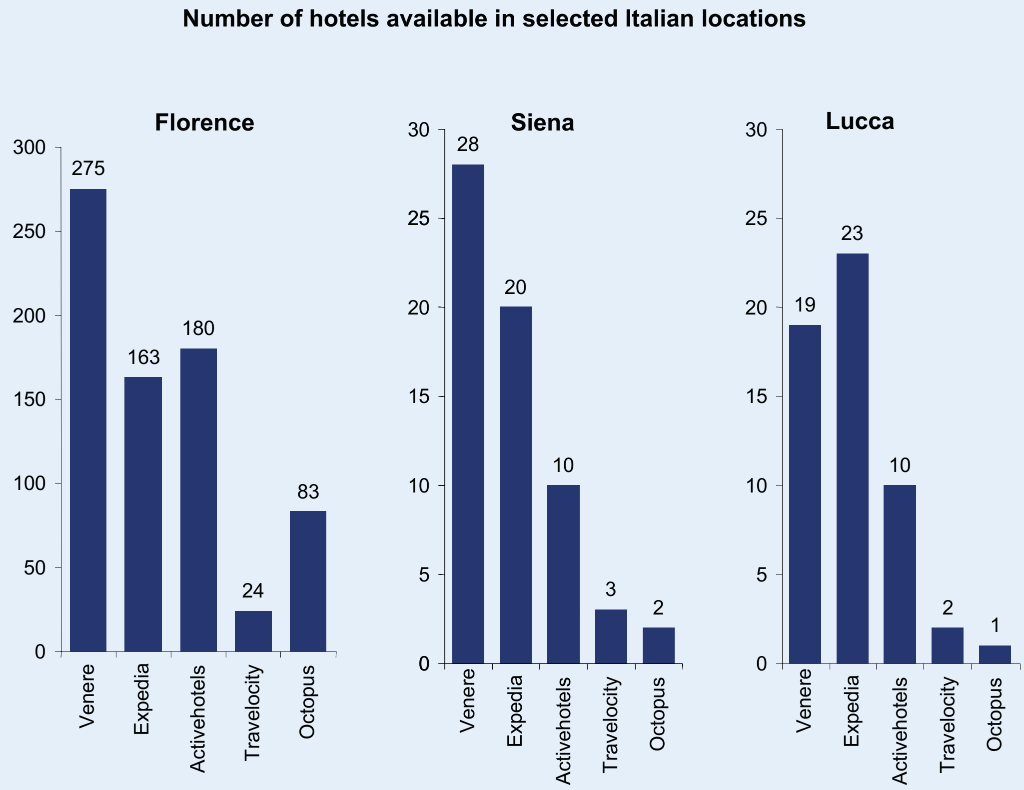
The search for differentiation: how online companies win the battle

The set of market dynamics that we have described presents online travel agencies with two critical questions. First, how can they avoid being caught in a price battle that can lead to everyone losing and nobody winning? And second, how do they convince customers to stick with them, rather than look elsewhere for the cheapest and/or most convenient site and book there instead? We will now look at the strategies that players in the market are adopting as they attempt to answer these two questions.

The first point to make is that the airline bookings market has now moved so far towards commoditisation that establishing differentiation in the online air ticket marketplace appears virtually impossible. With airlines' own sites competing head-on with a host of online agents, and automated price comparison sites also establishing themselves, the air travel sector is now largely driven by price and volume.

However, the online market for hotels/lodging and other services does still offer clear opportunities for differentiation – and it is here that companies are focusing their efforts. Unlike airlines, people's choice of accommodation depends on a wide range of variables, meaning that while price is still a factor, it is nothing like as dominant as with air tickets. At root, consumers know that a couple of hours on an uncomfortable flight will not ruin their entire holiday (and that differentiation between the offer of low cost airlines is limited) – but that cramped, poorly located accommodation certainly will. Also, with consumers becoming more willing to book their travel online, other products such as ground services are also becoming increasingly important as a potential source of differentiation.

Figure 9: Hotel offers in 'secondary' locations in Italy



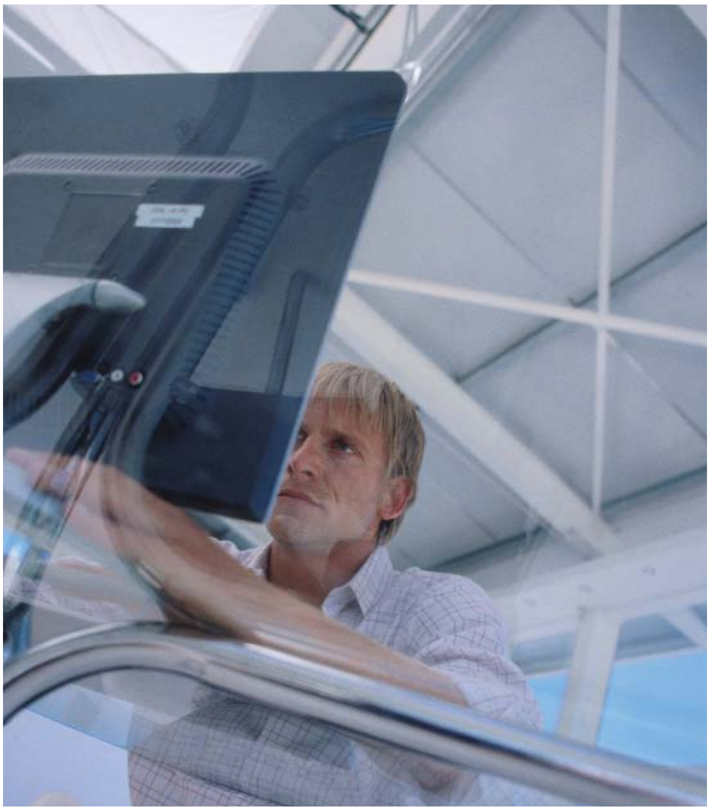
Source: PwC Analysis

Ways to break from the pack

With this in mind, online travel providers are using some broad strategies to differentiate themselves, reduce the downward pressure on their pricing and build the 'stickiness' of their offering to consumers.

Not more hotels, but different – the first strategy is to focus not only on increasing the volume of hotel choices on the site (which remains a key factor driving consumer interest), but also on providing different, unusual and even exclusive accommodation and destinations. Alongside the big generalist travel sites such as Expedia and Travelocity, there is now a growing generation of specialist accommodation sites such as hotels.com and octopustravel.com which are exploiting niche segments in which they are becoming a leading player. The competitive advantage of such specialists lies in their product differentiation: while the biggest general sites tend to offer a wealth of options in major tourism and travel centres such as London, Paris and Madrid – which specialists are unable or unwilling to match – the smaller specialist sites tend to focus on lower-volume but popular niches such as Brighton, Valencia or Tuscany. Figure 9 on secondary locations in Italy illustrates this trend. Online travel agencies can also suffer from a degree of "sameness" in their offer, as they tend to use GDS systems to provide supply content in certain cities/geographies where they have not sourced their own supply direct. Niche local operators that have sourced their own content can be more attractive for these destinations, as they will tend to have a broader range of independent hotels, many of which may be unique to their site (or a relatively small selection of sites).

Becoming more supplier friendly – the key criteria used by hotels when determining which online intermediaries to use are varied, and include price, ease of use / flexibility and volumes delivered for the hotel. The largest online travel agencies have historically focused on building their merchanting business, as this is higher margin, and have



been inflexible around room allocations. In contrast, specialist online sites that have built a more supplier-friendly agency model, such as laterooms or venere.com, have experienced strong growth in their supply relationships, which in turn has helped drive growth at rates above the overall market. This remains an evolving part of the market, but one where we believe it is possible to create some differentiation for the suppliers, and hence, in turn, some differentiation on the content side for consumers.

Expanding the range of sites presented to the consumer – As the consumer base which uses online travel sites becomes more mass market, and the type of travel that is booked online also changes, we believe there is scope to provide a more tailored consumer facing website to address each of the different consumer segments, rather than having one site to cover all consumer segments and travel occasions. This enables the same content (i.e. air or hotels) to be sold, but by using different websites enables a more targeted approach to be used for an increasingly varied and sophisticated consumer base. For this reason, large online agencies have been expanding their brand portfolio to include specialists without re-branding them (Figure 10). We believe that this trend will continue.

Figure 10: Expansions in brand portfolios

	FY05 Revenues $m	Brands		
		OTAs	**Hotel Specialists**	**Other**
Expedia	2,119	Expedia.com TravelNow.com Classic Vacations Hotwire.com	AllLuxuryHotels.com hotels.com vacationspot.com	tripadvisor
Travelport	697*	Cheap Tickets ebookers.com Orbitz Neat	Octopustravel.com HotelClub.com RatesToGo.com	away.com
Sabre	830**	Travelocity Zuji.com lastminute.com	all-hotels medhotels.com	ShowTickets.com holidayautos.com IgoUgo
Priceline	963	priceline.com	Bookings Active Hotels	MyTravelGuide
Opodo	70	opodo Rumbo viaggi.com	Otedis Karavel.com	

Source: PwC Analysis *B2C only ** Travelocity revenues only, excludes revenues from Travel Network and Airline Solution

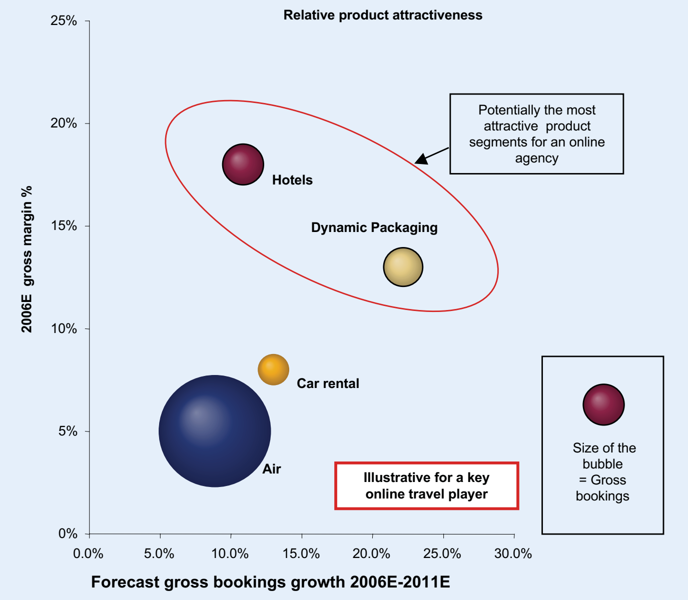
Offering different products packaged together – Online travel sites are moving towards bundling various discrete elements of their offering in a dynamic way. To an extent, this echoes what mass-market tour operators used to do in the days before the internet. However, the online specialists' current move towards modular bundling is likely to be more flexible than the traditional tour operator model (although they too are introducing greater flexibility into their traditional model), offering the consumer more choice in terms of their air and accommodation options. Online travel agents are in some cases also offering local ground services unrelated to the customer's travel plans, such as theatre tickets, restaurant bookings and theme park entry. This all-round service helps to encourage consumers to stick with the site – especially where the service would be more difficult to obtain direct before arrival, such as booking tickets for a popular show.

By bundling multiple products together, online travel agents are able to generate higher revenues per booking, helping to offset increased customer acquisition costs. With commissions on flights now virtually non-existent, margins on hotel sales of 15 per cent to 20 per cent are particularly attractive for the online operators – and by bundling various products together the price transparency typically associated with online travel becomes more opaque (see Figure 11). The opaqueness of pricing on individual components in dynamic packaging is also beneficial from a supplier perspective, as discounts can be given on distressed inventory without compromising the "Best Available Rate" (or BAR) guarantees typically made on suppliers' own websites.

Providing differentiating and exclusive content – Another trend is that the specialist sites are moving to boost the richness and stickiness of their offer still further by creating and providing exclusive content. This reflects the fact that consumers trust the Internet more and more for qualitative information about their travel choices. Indeed, recent research studies by the Internet Advertising Bureau and the Henley Centre show that the majority of consumers rate information found by searching the internet more highly than that from their friends and relatives.

This exclusive content will commonly include customer-generated reviews of hotels and destinations, where the openness and independence of the content and opinions

Figure 11: attractiveness of additional product offerings



Source: illustrative US online travel agency

– which can be both positive and negative – help to reinforce consumers' trust and loyalty. In some cases, the exclusivity and stickiness of the content can support an advertising-based business model, under which consumers come to the site purely for advice and then go or are transferred elsewhere to make their booking. But in most cases the content is aimed at reinforcing customer loyalty to the online travel agency where they have found the information.

Winners and losers

Given its current state of flux, forecasting what will happen in the long term in the online travel market is difficult. What is clear is that the market is becoming a tougher environment in which to prosper, as consumers and suppliers gain greater power in the value chain and more competitors enter the marketplace.

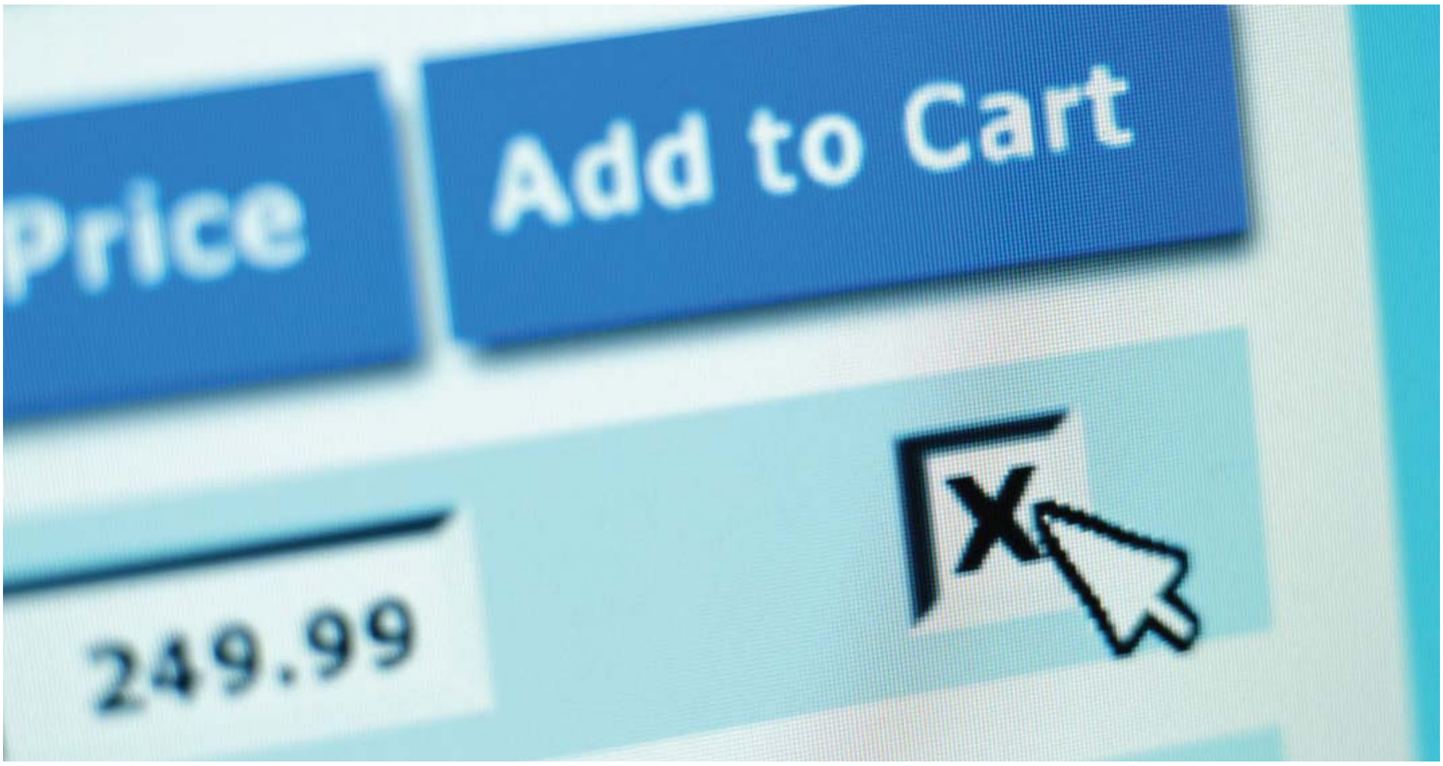
Our research shows that successful players will be those who are able to create a differentiating point of contact with their customers while continuing to maintain strong supplier relationships.

Breadth and depth of product will continue to remain key – and it will need to be what customers want, when they want it. Price will also remain a leading selection criteria. But, at the same time, convenience – in terms of offering a package or enabling consumers to buy other products – will become more important as some consumers seek greater sophistication and wider services from the online agents they use.

Online travel agencies can also thrive by creating a community with their customers to drive loyalty. The introduction of more sophisticated loyalty schemes and improvements in the targeting of marketing initiatives are also likely to become more important, and will increase the barriers to entry for new players. These initiatives remain relatively nascent for the online travel industry, but the online gaming industry provides some interesting parallels in terms of knowing which of your customers generate significant revenues, and developing incentives and loyalty schemes that are focused on these key customer groups.

Maintaining good supplier relationships is also a major consideration, since this underpins providers' ability to continue to offer consumers what they want. Our research shows that specialists and smaller operators might have an advantage over larger OTAs in this area. This finding, together with the increasing importance of direct channels, adds further interesting dimensions to the forces that will shape the industry in the coming years. To remain an attractive channel for suppliers, an intermediary will have to continue to offer them significant added value – primarily through having a loyal customer base, strong marketing, extensive reach, and ease of booking.

The online travel market has made great strides and achieved impressive rates of growth in recent years. But in many ways, the real challenges are just beginning.



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