

Lodging Industry

Web Storm Rising

Hotels Face Increasing Pressure on Rate as Web Bookings Increase

- **THE EXPLOSION OF ONLINE TRAVEL BOOKINGS.** Most recently, usage of Internet travel sites has exploded and is estimated to continue to grow aggressively in the years to come. Travel Web sites first targeted the airline industry and introduced consumers to heavily discounted e-fares. The hotel industry is next and year-over-year growth in online lodging revenue has already begun outpacing growth in the overall online travel sector.
- **HOTEL BRANDS AND CONSORTIUM SITES ARRIVE LATE TO THE SCENE.** What started simply as an online alternative to bricks-and-mortar travel agencies, travel Web sites have evolved into online merchants, cannibalizing hotel profits in the process. Web sites such as Expedia, Travelocity, Orbitz, and Hotels.com now dominate the online space. In order to compete, five hotel companies have banded together to retake lost ground. Just as the hotel site, Travelweb, began making advances, companies have come under fire from corporate travel planners experimenting with a new negotiating strategy, reverse online auctions.
- **HOTELS BEGIN TO LOSE CONTROL OVER PRICING.** Until the proliferation of online travel sites, it was difficult for independent hotels to compete on a national level with the major brands. The Internet has provided them with a medium to advertise and competing over rate has been the preferred strategy. Furthermore, as more and more rooms go unsold, many franchisees have begun rebelling against their brands and lowering their online prices to boost occupancy.
- **DOES THE HOTEL INDUSTRY FACE COMMODITIZATION?** Online travel agencies, merchants, and auctions, as well as slower business demand, put increasing pressure on rate. As the fall negotiating season approaches, our research indicates that corporate rates will remain flat or decrease slightly in 2003. We believe that commoditization is taking place. Just how far it will go has yet to be seen.

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Web Storm Rising — What Does This Mean for Hotel Rates?

The proliferation of travel Web sites such as Expedia.com, Travelocity.com, and Hotels.com has put an increasing amount of pressure on hotel rates during a time when the lodging industry is struggling to build momentum since occupancy peaked in 2000. There has never been a period of time when consumers — corporate and leisure travelers — have been able to access as much information about hotel properties and their rates than what exists today.

Recently, a lot of attention has been directed toward the relationship between hotel companies and third-party Internet distribution sources. The majority of the discussion focuses on the potential rate deterioration that will be caused by steep discounting by both independent hotels and franchise properties within national chains. Further fueling this topic have been the articles that made headlines in *The Wall Street Journal*, declaring a “price war” between the major chains (Six Continents, Starwood, and, most recently, Cendant) and the online booking sites. It appears that a major battle is shaping up between the hotel companies and the online sites as rate transparency becomes even more apparent in the industry and the suppliers (i.e., Starwood) are offering to beat even the lowest rates available on the Internet.

We feel that it is important to set the record straight on the significant issues that have been raised by online travel. As we will explain in this report, we believe that online travel sites will continue to put downward rate pressure on the industry through greater rate transparency and by creating an environment whereby independent hotels can compete head-to-head with traditional brands. Franchisees will further challenge the major hotel operators such as Marriott, Hilton, and Starwood as they trade room rates for occupancy without always considering the long-term consequences. The impact of the rate transparency and the steep discounting will affect corporate negotiated rates in 2003, as corporate travel planners will gain greater pricing leverage as hotels compete for their business. Ultimately, we believe that meaningful rate recovery will not occur until late 2003/early 2004 and that, on average, 2003 average daily rate (ADR) will remain flat to slightly down from full-year 2002 levels.

Furthermore, we believe that the pricing leverage has begun to shift in the favor of corporate travel planners as they develop new techniques for negotiating hotel rooms, such as reverse online auctions, which we believe will grow substantially over the coming years. We will also explain our viewpoint on the “lowest-price guarantee” policy being adopted and why we believe it is more of a marketing tool than an actual threat to rate.

It is important for investors in lodging stocks to have a better understanding of the realities and the myths surrounding the effects of growth in the online travel sector. We believe that the recent explosion in growth of third-party Web sites will continue to put pressure on room rates and will decrease the profitability of the sector, negatively affecting stock prices in the quarters ahead. Our view is based, in part, on the precedence set in the airline industry several years ago, when rate transparency became widespread as Internet travel sites entered the market, and the airline industry was commoditized. In fact, we believe that by the end of 2005, online lodging

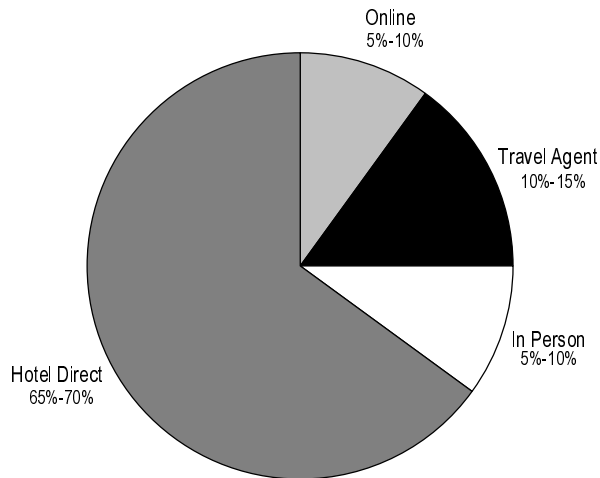
revenue will have more than tripled the \$3.8 billion generated in 2000 — there appears to be no escaping this technology trend that threatens hotel revenue. Furthermore, it is our opinion that the hotel industry faces similar risks of commoditization and must establish strategies for maximizing its exposure to the growing number of consumers who research and book their rooms online, while minimizing the threat that consumers may lose their brand loyalty and begin making decisions solely based on rate.

Regardless of whether or not you believe that the lodging industry is at risk of commoditization, it is hard to dispute that the Internet is one of the most effective tools for making travel decisions. Before its advent, booking a hotel room often involved calling major hotel companies to request brochures of hotels in a given destination, narrowing the choices down to a select few, calling those properties to determine rate and availability, and then making a decision. Now this process can be done in a matter of minutes through a third-party travel Web site and a fast Internet connection. Before we discuss the recent issues that are threatening pricing leverage in the lodging industry, let's take a look at the online travel market and where it is headed.

How Rooms Are Booked

At present, there are essentially four basic ways to buy travel: 1) direct, over the phone; 2) using a traditional travel agent; 3) in person; and 4) online.

Exhibit 1. Room Bookings by Distribution Channel



Source: Bear, Stearns & Co. Inc.; industry sources.

DIRECT SUPPLIER CONTACT

Calling a hotel company's "800" number or the property directly is an easy, no-frills way to book hotel rooms. It is estimated that approximately 65%-70% of all hotel rooms are purchased this way (50%-55% by calling the property directly and 15% by calling the central "800" number).

A large percentage of the rooms that are booked directly with the property originate from negotiated rates with companies who have travel needs in that particular local market. The property-based sales force spends a considerable amount of time identifying, contacting, pitching, and then negotiating with local companies to establish preferred rates at their hotel. Once these rates are set (usually on an annual basis), the travel planners at those respective companies or at companies who do business with them can call the hotel directly and book the preferred rate. This preferred rate is usually offered only at one particular location and the hotel often has the right to tell the travel planner that the rate is not available during peak occupancy periods.

Many larger organizations that have locations across the country or who have travel needs in multiple markets will negotiate a national rate and preferred rates will be established at each property where the company anticipates heavy travel. Typically, these rates will be negotiated, not at the property level, but at the national level by the chain's national sales office.

Despite the purchasing power that accompanies the promise of high-volume bookings from a single customer, the corporate preferred rates are typically higher than what the leisure traveler would normally be able to find by calling the 800 number, searching the Internet, or simply walking in. This may not seem intuitive, but it results from higher weekday demand driving prices during the week and competition for the lower

weekend demand generated by the leisure market. In short, companies need hotels during the week and hotels need customers over the weekend. The nature of the lodging industry having a fixed inventory regardless of demand periods forces hotels to discount their rooms when demand is low, but allows them to drive rate when demand is high.

TRAVEL AGENTS

Many corporate and leisure travelers prefer to use the services of a travel agent. Research indicates that approximately 10%-15% of hotel rooms are booked through travel agents. These travel agents provide the live booking services that consumers are most familiar with. Travel agents are known as “experts,” advising itinerary construction, finding hotel rates and airfares, and aiding in the general planning of any business or leisure trip. The trend away from traditional bricks-and-mortar travel agents has increased over the past few years as their customers have begun to do their own research and book their rooms online. Of note, most travel agents do not typically use the Internet for booking travel for their clients. Instead, they use a Global Distribution System (GDS) to tap into a hotel’s inventory, which limits them to certain rates (commissionable for hotels but not airlines), and while they may not have access to the lowest available rate, they can provide the highest level of customer service before, during, and after a customer’s hotel stay.

IN PERSON

In-person booking is a form of direct-supplier contact, but involves customers who “show up” at the hotel. These buyers tend to be travelers en route to their destination, traveling salesmen, last minute travelers, or more spontaneous travelers who enjoy “winging it” in building their itineraries. About 10% of hotel rooms come from walk-in business, with a higher percentage at highway locations and a lower percentage at resort locations. As one might expect, vacationing families en route to their final destinations and traveling (via automobile) salespeople constitute the largest percentage of this group. The typical corporate traveler flying to meet with a client, attend a seminar, etc., is less likely to arrive at their final destination without a hotel reservation.

ONLINE

Increasingly, consumers are turning to the Internet to book travel. More travel is sold over the Internet than any other consumer product. The Internet brings together a vast network of suppliers and a widely dispersed customer pool in a centralized marketplace. These sites can be supplier-sponsored (Marriott.com, Starwood.com, Hilton.com, etc.), online travel agencies (Expedia.com, Travelocity.com, etc.), online travel merchants (Hotels.com, Travelweb.com, etc.), opaque auction sites (Priceline.com, Hotwire.com, etc.), or consortium sites sponsored by several competing hotel companies (Travelweb.com is currently the only site). In our opinion, the scramble for market share among the millions of online travel buying households will be the key event in the online travel space over the next five years. Suppliers, agencies, and niche players will all race to gain competitive edges in technology, content, functionality, value, customer service, reach, and brand recognition.

Internet Distribution Channels

As the online lodging markets grows, several distinct business models have evolved, each with its own unique way to attract customers and sell hotel rooms. In this section, we will walk you through the five most prevalent types of online travel sites.

SUPPLIER-DIRECT WEB SITES

Supplier-direct Web sites allow customers to research and purchase travel products directly from the supplier over the Internet. By cutting out the middleman (either a traditional travel agency or an online travel agency) and selling directly to consumers, suppliers are aiming to reduce distribution costs, mainly commissions. These sites are popular with brand-loyal customers who may have little interest in shopping around for a better deal. Often, hotel companies are rewarding customers for booking on their proprietary sites through bonus points in their loyalty programs or offering lowest price guarantees. Hilton, for example, currently offers an additional 1,000 bonus HHonors points for booking online, and Starwood and Six Continents guarantee that the lowest price will always be available at their proprietary sites.

AGENCY MODEL

Essentially, an agency model is a company that performs many of the same tasks as a traditional travel agent but conducts business over the Internet rather than in person or over the phone. While most online travel agent sites have a leisure travel focus, some are frequently used by small business and some have an exclusive business travel focus. Generally, these sites offer complete trip researching and purchase capabilities, including air, hotel, and car rental. Increasingly, these sites are selling more complex or non-traditional travel products like cruises, vacation packages, bed & breakfasts, rental condos, and adventure travel. Like traditional travel agents, online travel agents are compensated through commissions paid by the travel suppliers. Hotel companies have the ability to set pricing and determine the number of rooms available to be sold over each site on any given night. Hotel companies are able to completely control the sale of their rooms under the agency model and can alter pricing and availability 24 hours a day. Agencies are used as an extension of their own sales efforts to reach a broader audience but they are restricted from setting their own pricing for the hotel rooms. Examples of online travel agencies include Travelocity.com, Expedia.com, and GetThere.com.

MERCHANT MODEL

An increasing number of online travel agents are expanding their product offerings to include inventory they secure at given prices (either through a contract to sell or outright purchase), mark up, and then resell at a profit. In these instances, the online travel agents are not reliant on commissions for revenue. Their profit is the difference between their contracted price and the price at which they sell to customers. Once a hotel company allots inventory to a merchant, the hotel loses control over the ultimate price of the room. Furthermore, if a hotel allots all of its remaining inventory to a merchant, it will be unable to accommodate would-be customers who contact the property directly because they are essentially “sold out” during that time period. Therefore, online merchants are a less favorable way for hotels to sell inventory than online agencies. Examples of online distributors using the merchant model are Hotels.com and Travelscape (administered by Expedia), although both Travelocity and Expedia both have added a merchant component to their agency sites.

OPAQUE MODEL

Companies like Priceline.com and Hotwire.com use the opaque model to sell excess hotel inventory to consumers. They function by matching a customer's broad parameters (where they want to go, when they want to go, etc.) and then offer a price they are willing to pay. The site then "matches" the bid to their available inventory and, if they have available inventory and can make a sufficient profit on the sale, the bid is met.

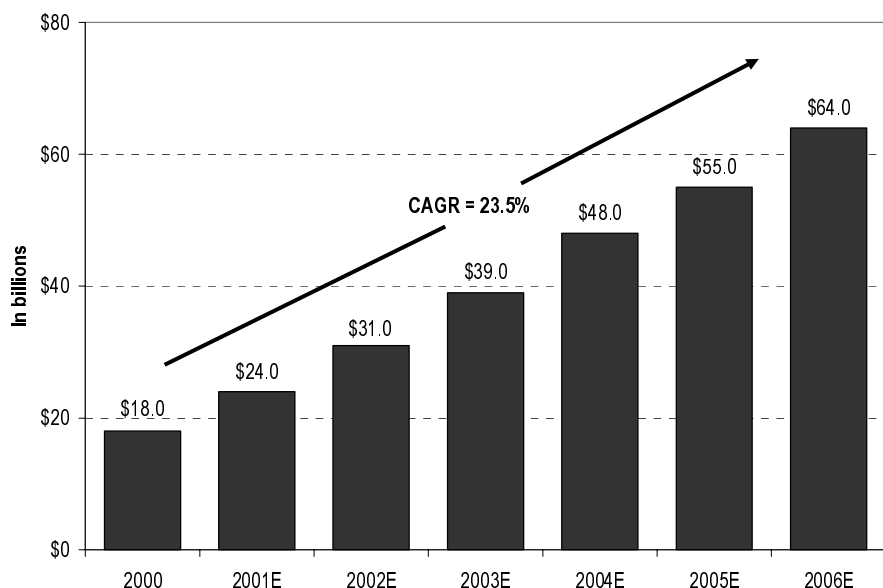
CONSORTIUM SITES

These sites are developed by groups of industry suppliers to compete directly with the full-service online travel agency sites. In addition to offering the inventory of the sponsoring sites, the consortium sites will offer complimentary travel products as well. The suppliers are looking at these sites as a means of directly capturing a bigger portion of the online travel sales pie. The theory is that by taking market share from the traditional online travel agencies, these consortium sites will be able to reduce commission payouts to the online travel agent sites. The first such site is called Travelweb.com (previously Hotel Distribution Systems) and is sponsored by Hilton, Hyatt, Marriott, Six Continents, Starwood, and hotel technology provider Pegasus Solutions. This is the hotel industry's equivalent of the airline's Orbitz site, which quickly gained market share in the online airline travel space. Orbitz is currently being investigated for potential anti-trust violations and anti-competitive practices and it is our belief that the future of Travelweb will be affected by any negative findings in the Orbitz investigation. Travelweb has been very successful to date, capturing 4% of the online lodging market within months of opening.

How Online Hotel Bookings Have Grown

The recent decline in corporate travel has forced the major hotel companies (Marriott, Starwood, Hilton, etc.), smaller hotel operators (Prime Hospitality, Boca Resorts, etc.), and independent hotels to look for ways to compete for its share of the waning demand. Hotels that typically were focused on filling rooms with corporate business travelers Tuesday through Thursday (their bread and butter) now find themselves reaching out to the leisure market to fill rooms. The Internet has proven to be the logical route for hoteliers to take to increase their exposure to this growing audience of leisure customers. Sparked by the low airfares and reduced room rates, more and more consumers have begun traveling for pleasure, and they have turned to the Internet to research and book their vacations. Exhibit 1 illustrates the historical levels of Internet bookings and industry projections for growth. Growing from \$18 billion in sales in 2000, Jupiter believes that by the end of 2006, the online travel industry will generate over \$60 billion per year in travel reservations, including airfare, hotel rooms, rental cars, vacation rentals, etc.

Exhibit 2. U.S. Online Travel Revenues

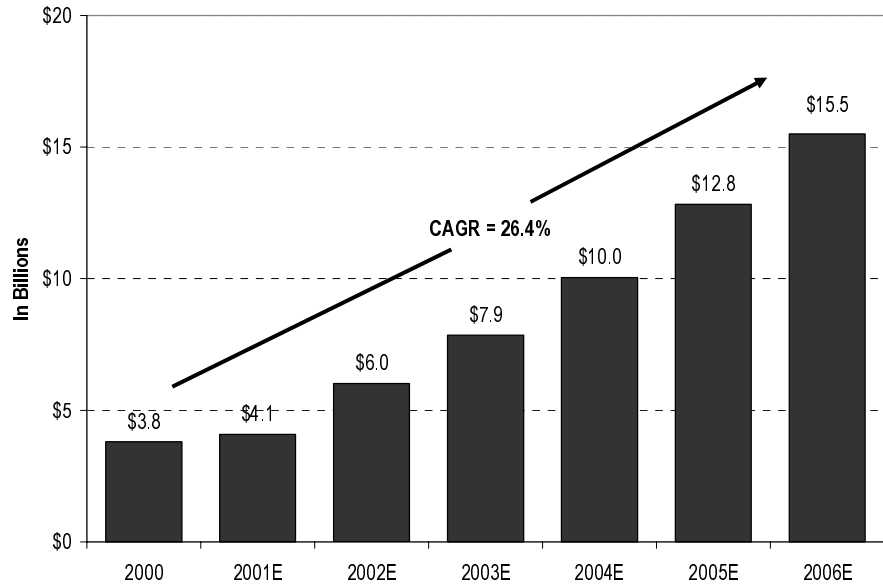


Source: Bear, Stearns & Co. Inc.; Jupiter Research.

LET'S TAKE A LOOK AT LODGING

Narrowing down the online travel arena to a more specific look at lodging, we believe that demand for booking rooms online will grow leaps and bounds over the coming years. In fact, Jupiter research indicates that while the online travel industry will grow at an annual rate of 23.5% through 2006, revenues specific to lodging will grow over 26% during the same period from \$3.8 billion in 2000 to \$15.5 billion. Due to increased advertisement by the major online travel sites, recent media coverage of the availability of discounted rooms, and the increased use of the Internet in many consumer decision-making processes, the major Internet travel sites have seen rapid growth and we expect this to continue for years to come. Exhibit 3 illustrates Jupiter's projections for growth in the revenue generated from booking hotel rooms online.

Exhibit 3. U.S. Online Lodging Revenues



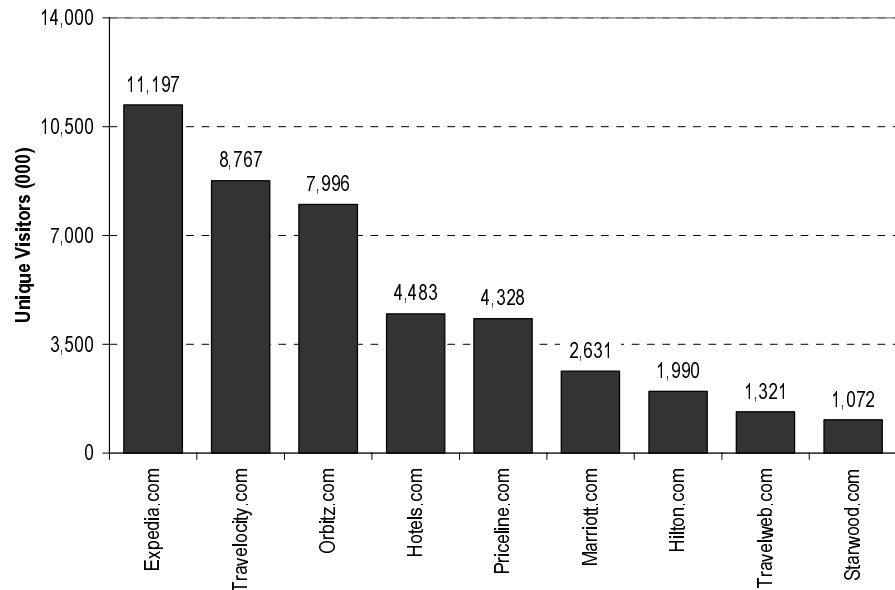
Source: Bear, Stearns & Co. Inc.; Jupiter Research.

Exhibit 4 identifies the nine most popular online lodging sites and their number of unique customers that visited each site in June 2002. None of the top three sites are proprietary sites at this point — in fact, they are ranked sixth, seventh, and ninth, respectively — and we believe that it will be difficult for the branded hotel companies to alter this. Expedia, the most visited site in June with more than 11 billion unique visitors, experienced over four times the volume of Marriott’s site, the highest ranked proprietary site with 2.6 billion visitors. Compared to the other lodging companies listed, Expedia welcomed five times as many visitors than Hilton and over ten times as many as Starwood.

Over the last year, Expedia, Travelocity, and Hotels.com have excelled at attracting the majority of online travel shoppers to their sites by offering more options (they are not limited to a single brand or family of brands), providing an easy-to-use interface and combining the ability to book hotel rooms with airfares, rental cars, etc. Heavy advertising online, in print, and over the radio have also helped disseminate information about their sites.

The two consortia sites, Orbitz and Travelweb, have made strong debuts. Orbitz, sponsored by the major airlines, was open for business less than one year before it had leaped into third place below Expedia and Travelocity. Travelweb, the hotel consortium, is rising quickly since its debut less than six months ago, having already displacing Starwood’s site by almost 250 million visitors in June.

Exhibit 4. Number of Visitors to Online Travel Sites, June 2002



Source: Bear, Stearns & Co. Inc.; Nielsen//Net Ratings.

KEY TAKE-AWAYS

As the popularity of booking travel online increases, hotel operators need to learn how to manage this increasingly more complex distribution channel. In the past, rates have traditionally been set once a year for corporations, government agencies, travel clubs, etc.; on a monthly basis for bricks-and-mortar travel agencies; and daily or weekly for telephone callers and walk-in customers. Now, with the advent of the Internet, hotel companies must monitor their rates almost hourly to ensure that they are properly yield-managing their inventory. Sophisticated hotel operators with designated revenue managers will be able to harness this channel and manage their inventory effectively, while less sophisticated operators will either give away the farm or lose potential revenue to their more experienced peers. In addition to the pressure that the Internet will put on rate, an additional outcome could be an increase in operating costs for the smaller companies as they increase resources to compete more effectively against their larger peers.

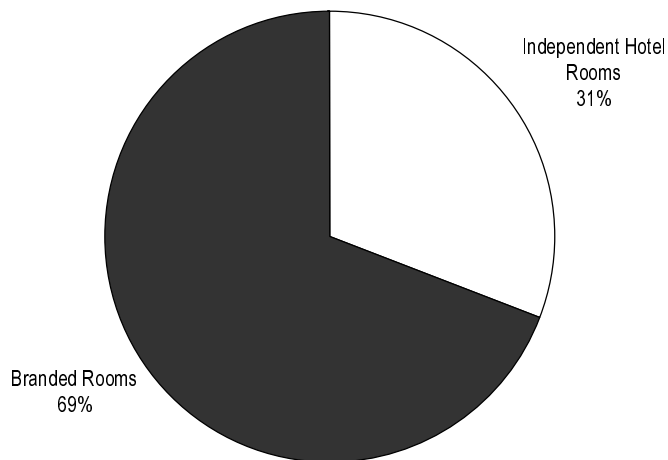
The Brands Battle the Independents and the Franchisees

Two major challenges facing the branded hotel companies in their battle to win market share for their proprietary or consortium sites are the independent operators and their own franchisees. Independent operators, even those with the smallest of sales and marketing budgets, have been using the third-party online sites to gain exposure to the traveling public. These operators have embraced the Internet as a means to reach out to new customer groups and many have chosen to stand out from the crowd by offering steep discounts to attract attention to their property or by buying advertising space on the Web site itself. Franchisees are also proving to be a thorn in the side of the franchisors as brands have little control over the rates that the property managers elect to offer via the Internet or the more traditional distribution channels.

HOW MANY INDEPENDENT HOTELS ARE WE TALKING ABOUT?

One common misconception about the lodging industry is that independent hotels — the mom and pop roadside motels whose sole advertising is a sign out front and an ad in the yellow pages — constitute only a fraction of the rooms in the United States. Keeping with that thinking, the proliferation of online travel and its capability to expose independent properties to mainstream America should not be a concern to the larger brands like Marriott, Hilton, and Starwood. However, our data show that a fairly sizeable number of independent hotel rooms compete against the brands at every price point. Exhibit 5 shows the total number of rooms in the U.S. by brand versus independent, followed by the break-out of rooms in each price segment.

Exhibit 5. U.S. Hotel Rooms: Branded Versus Independent



Source: Bear, Stearns & Co. Inc.; Smith Travel Research.

Exhibit 6. Independent Hotel Rooms by Market Segment

Segment	Independents	Total U.S.	% of Total
Luxury	181,908	737,791	24.7%
Upscale	355,092	1,139,602	31.2%
Midprice	301,939	1,138,219	26.5%
Economy	201,503	615,162	32.8%
Budget	245,137	554,581	44.2%
Total U.S.	1,285,579	4,185,355	30.7%

Source: Bear, Stearns & Co. Inc.; Smith Travel Research.

Roughly one-third of all hotel rooms in the U.S. are unaffiliated with a national brand, with the highest percentage of independent rooms in the economy and budget price segments. That being said, in absolute terms, there are more independent rooms in the luxury and upscale segments than there are in the economy and budget segments. In our opinion, the sizeable number of independent hotels forces brands to recognize that their competition will increasingly turn to third-party sites to sell their excess inventory and branded hotel companies will need to maintain a presence on more Internet sites than just their own proprietary site or a consortium site controlled by hotel brands.

In effect, independent hotel companies are using third-party Web sites as a pseudo “Internet brand.” Comparisons can be drawn to the loosely knit group of luxury hotels that constitute the Leading Hotels of the World, Ltd. that leverages collective marketing budgets to reach a larger audience. However, we believe that the Internet provides a platform that has become even more effective at delivering room nights to independent hotels without the economic burden of costly marketing affiliations or national advertising.

**INTERNET SITES HELP
LEVEL THE PLAYING
FIELD**

While Marriott, Hilton, Starwood, and the numerous other brands have spent hundreds of thousands of dollars developing and maintaining their own proprietary sites, a hotel like the Red Carpet Inn in Albany, New York has access to millions of Expedia customers for little to no cost. The Internet is helping to level the playing field for the independent hotels by providing them exposure to a wider audience and allowing them to constantly adjust their rates to compete head-to-head. As a result, it will be difficult for the brands to accomplish their goal of driving all of the revenue through their proprietary sites.

When consumers are browsing a hotel company’s proprietary site (such as marriott.com), they typically have already decided that they are interested in staying at a Marriott property and are interested in finding out which of their products (Marriott Hotel, Courtyard by Marriott, Springhill Suites, etc.) is closest to their destination. Typically, a search will generate a list of Marriott brands closest to the desired destination and the consumer can decide on the most convenient location relative to how much they are willing to spend. However, when a customer searches a site like Expedia.com to research hotel accommodations near their destination, they have often not committed to a particular brand, rather they are committed to finding the best property relative to what they are interested in spending. In this scenario, the travel site generates a list of all hotels, branded or independent, that meets the search criteria. This list could include dozens of properties and consumers typically tire of looking at the list after the first ten to 15 properties. In fact, through conversations with online travel sites, our research uncovered that being listed in the top five assures the highest levels of bookings, and that after the fifth slot, bookings drop dramatically.

**HOW IS THE PECKING
ORDER DECIDED**

So, how does a hotel operator secure a listing at the top of the order? Well, different travel sites have their own criteria, but we have identified the following list of steps that an operator can take to improve its chances:

- Provide the site with a larger percentage of the total room inventory.
- Offer steeper discounts to a preferred site.

- Offer the greatest amount of “value” to the third-party sites relative to the operator’s rack rate in order to ensure that the site can continue to market the fact that it has access to “great deals.”
- Purchase banner advertising on the site.
- In some cases, pay the site for the right to have a higher listing.

Once again, when dealing with third-party travel sites, the independent operator has the same opportunities to improve its standing in the list as the major hotel companies without having to go out of pocket for a substantial amount of cash. Instead, control of room inventory is the currency that travel sites readily accept. By securing access to a large number of hotel rooms at steep discounts to rack, the Internet sites are able to continue their quest to dominate the market share on the Web and can continue to grow. Independent hotel operators have few alternatives to gain access to the online customer and are more willing to yield this control to the third-party sites. Most branded operators resist handing over blocks of rooms to Hotels.com, for example; however, in certain circumstances, they find themselves doing just that, in order to capture a greater share of the lagging demand. As third-party sites increase in usage and become more of a contributor to the hotel industry’s top line, it will become harder for the lodging companies to change the mindset that non-proprietary online travel sites are here to stay.

**THE FREE SPIRIT OF
THE FRANCHISEE**

One key benefit of operating a franchised property is the flexibility to run your own business while still having access to a wealth of knowledge and experience that a national brand can offer. There are limitations to this freedom (brand standards, for example), but the franchisor is not typically involved in the operations of the hotel on a daily or weekly basis. One area where franchisees have a fair amount of control is determining the rates at their particular hotel and, on occasion, this can make franchisors somewhat anxious.

Executives at the major brands are faced with two options:

- mandate minimum room rates and dictate the specific Internet sites where franchisees can list their hotel; or
- implement brand-wide preferred prices for national accounts and supplement the properties’ own local sales efforts, diminishing the need for franchisees to offer large blocks of rooms to Web sites at a discount.

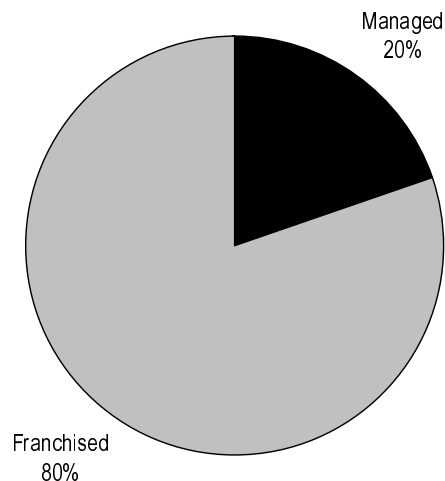
It is important to understand the dynamics behind these two options. After consulting with an attorney who specializes in hotel franchise law, it is our opinion that mandating minimum room nights or restricting franchisees from using third-party sites entirely would likely result in lawsuits by franchisees or allegations of anti-trust violations. Setting minimums for pricing would likely be viewed as collusion by the courts and restricting franchisees from marketing their rooms on specific sites probably could bring lawsuits over lost revenue. In the case of the latter, a franchisee would likely be successful in arguing that it could have sold at least one of its empty rooms on any given night if it were allowed to use Internet sites to sell its excess inventory. Hotel franchisors would only be protected from liability in circumstances

where the hotel was 100% sold, more often the exception than the standard. As a result, most franchisors encourage their franchisees to participate in brand-wide rate programs and warn their franchisees against aggressive rate discounting both online and off.

Brands typically establish national accounts (enticing companies with nationally discounted rates) and encourage franchisees to participate in pricing programs designed to provide a substantial amount of room nights at discounted rates that are only available to certain companies or organizations, but not to the general public. The logic behind programs such as AAA, AARP, government rates, etc., is to drive enough business to hotels in order to limit a property's reliance on Internet sites. Participation in many of these programs can be mandated and is typically provided for by requiring franchisees to participate in a brand's reservation system. Within the reservation system agreement, franchisees agree to participate in certain rate programs that dictate how preferred rates are determined. A hotel first establishes a rack rate and then is required to apply certain discounts to the rate depending on the program. A mega-consortia rate (offered to qualified travel companies that purchase substantial amounts of rooms and then re-sell them to their clients) might be offered a 25% discount to rack, while AAA may secure a 15% discount. If the franchisor is able to demonstrate to its franchisees that these programs deliver on their promises, franchisees are more likely to be more loyal to their brand and, in lieu of offering deep discounts on Travelocity.com, might choose to offer special Web rates on the proprietary Web sites that are sponsored by their franchisor.

The lack of control over the rates of their franchisees is a growing concern for companies like Hilton, Marriott, and Starwood. Each of these companies has a sizeable number of hotel rooms controlled by franchisees (as of March 31, 2002, the three companies combined had over 500,000 franchised rooms in their systems). The following exhibits show the breakdown between the number of hotel rooms that Marriott, Hilton, and Starwood manage versus franchise.

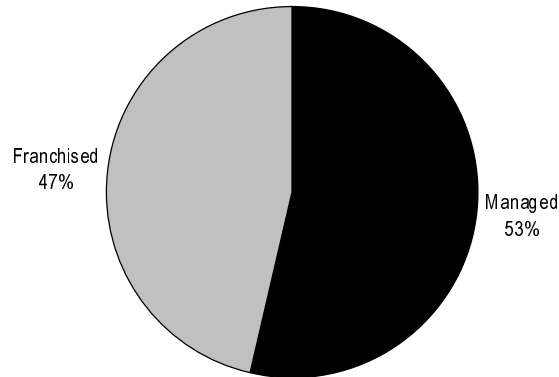
Exhibit 7. Hilton — Managed⁽¹⁾ Rooms Versus Franchised Rooms, as of 3/31/02



(1) Managed includes all rooms that the company owns, leases, or manages.

Source: Bear, Stearns & Co. Inc.; company filings.

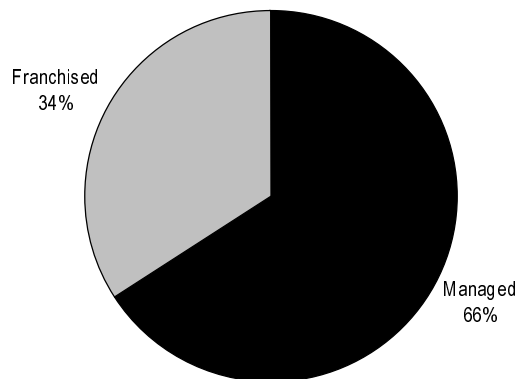
Exhibit 8. Marriott — Managed ⁽¹⁾ Rooms Versus Franchised Rooms, as of 3/31/02



(1) Managed includes all rooms that the company owns, leases, or manages.

Source: Bear, Stearns & Co. Inc.; company filings.

Exhibit 9. Starwood — Managed ⁽¹⁾ Rooms Versus Franchised Rooms, as of 3/31/02



(1) Managed includes all rooms that the company owns, leases, or manages.

Source: Bear, Stearns & Co. Inc.; company filings.

It is clear from these charts that franchisees constitute a large percentage of these companies' room inventory. Maintaining controls over the rates that they charge and the channels that they utilize to sell their inventory requires franchisors to pay close attention to the practices of their franchisees.

Ultimately, we believe that it will be difficult, if not impossible, to drive all bookings through mandated brand-wide preferred pricing programs and through a company's proprietary Web site. As such, it is our opinion that it will be difficult for hotel brands to displace third-party sites as the most popular travel sites on the Internet.

**“YOU ARE ONLY AS
SMART AS YOUR
DUMBEST
COMPETITOR”**

This statement is a common phrase in the hotel industry when the operating environment is in a challenging stage. The difficulty with maintaining rate integrity in the hotel industry is that the level of experience in yield management is not the same between the larger hotel operating companies, smaller management companies, franchise companies, and independent hotel operators. As a result, if the management team at a full-service Marriott franchised hotel decides that it is important to grow its market share, it may decide to try to move customers from the limited service

Hampton Inn next door by lowering its rates closer to those of the Hampton, a substantial discount to its rack rate.

This can lead to the management at the Hampton Inn feeling the need to lower its rates in order to attract business that would rather stay at a full-service property and is only dissuaded by rate. If rate discounting continues for extended periods of time, the effect can be the lowering of the public's perception of what is a fair price to pay for a hotel room. Traditionally, occupancy levels rise and fall in correlation to the general health of corporate business, but rates are more difficult to raise even when the economy is strong. To illustrate this point, let's take New York City as an example. Over the past few months, occupancy has made steady gains and is down only slightly from last year's data; however, many hotels have only been able to accomplish this by discounting rates. Travelers that once acquiesced when presented with \$300 room rates now expect to pay \$200-\$250 per night and will be slow to accept increases to their negotiated rates. This is particularly detrimental to the hotel industry because corporate rates are typically negotiated once per year and competition for large corporate business is fierce.

It is our belief that the disparity between the experience levels of hotel operators will contribute to slower increases in rates as less-savvy operators continue to dump rooms at discounted prices to online travel sites and impair branded hotel companies' abilities to aggressively drive prices a la 1999 and 2000.

Franchisees and independent hotel operators have embraced the Internet and have changed the balance of power away from the brands and into the hands of third-party Web sites. Combined with sometimes unwise pricing strategies employed by less sophisticated competitors, the hotels managed by the major hotel companies have been forced to lower their rates and offer up a larger percentage of their inventory to the non-proprietary distribution channels. We believe that the industry will be slow to recover from these decisions and it will be hard-pressed to regain its pricing leverage in the near-term.

Hotels Fight Back with Lowest Price Guarantees

A few months ago, there was a lot of publicity on price wars between the hotel brands and the online travel sites. The articles cited Starwood's and Six Continents' decision to guarantee that the room rates available on their own sites would always be the least expensive and that they would lower their rates an additional 10% if they were proven otherwise. While the articles may have sounded alarming at first, we don't consider this to be a threat to rates or the start of a price war, rather just another way for these companies to direct traffic to their own sites and away from the online discounters.

Here is a loose example of how this promotion may work:

- Starwood may offer a hotel room to one of the online merchants for \$70, who in turn sells it to the consumer for \$87.99 (approximately a 25% mark-up).
- Starwood may offer this same room on its own Web site for \$95. However, under Starwood's proposed offer, if a consumer takes the \$87.99 online rate to Starwood, the company has pledged to sell it for 10% less, or \$79.

From Starwood's point of view, they have accomplished two goals. First, they have persuaded a customer to at least check the rate on Starwood.com. Once logged on, Starwood has the opportunity to market other promotions (a free weekend night giveaway, bonus loyalty points, etc.) and increases the chances that consumer will book on their proprietary site whenever booking hotel accommodations.

The second goal is to reduce transaction costs. In the scenario above, had the consumer booked the room over the third-party site, Starwood would have essentially paid a transaction fee of \$17.99 (the difference between what the consumer was willing to pay and what the Web site paid Starwood). However, even after the 10% discount, Starwood was able to recapture \$9 of the transaction cost, reducing the total fee to \$9, which it gave back to the consumer rather than a competitive Web site provider.

A LOOK AT THE CONSUMER

We believe that the online travel market will eventually bifurcate into two user groups. The first group consists of the brand-loyal customers who will favor the brands' proprietary sites, while the second group will be more inclined to search several of the third-party sites for the best deal with less concern about the particular brand.

In our opinion, however, the brands want to move as much online travel business as possible to their own sites in order to promote brand loyalty, lower the commissions paid to online agencies, and recapture the profits made by the online merchants.

BRAND-LOYAL CUSTOMERS

The first group is brand-loyal customers that will favor supplier-direct sites. These hotel, air, and rental car customers will most likely be loyalty program members that have strong brand preferences. The fact that there may be variations in scheduling, pricing, or locations is likely to hold little sway with this group of customers. Their focus is more likely to be on maintaining or enhancing their preferred status with the brand for the rewards that it brings (preferential treatment, special deals, free product, etc.).

A typical thought process for this customer is likely to be:

- 1) I'm going to Atlanta.
- 2) Is there a Marriott there?
- 3) Let me go to their Web site and find out.
- 4) Yes, there is.
- 5) Good, let me book it so I can earn my points.
- 6) I'm only 2,000 points shy of that Hawaiian vacation.

In this customer's mind, the points and time saved outweigh the search costs and the possible \$10-\$20 a night he might save if he shopped around and chose the Sheraton or Hilton. As such, the one-stop shopping and price comparison features offered by third-party merchants are not likely to appeal to this customer if it means losing loyalty points.

**VALUE-ORIENTED
CUSTOMERS**

On the other hand, we have found that there is an equally large group of customers who are more price-sensitive, more flexible about travel plans, not brand loyal, and prefer shopping for deals. This group is the natural constituency for the online travel agencies and merchants. Similar to how consumers prefer the multiple brands and pricing structures offered by offline retailers as diverse as Wal-Mart and Circuit City, we believe a similar preference exists among a group of online travel shoppers. Shopping itself is entertainment to many Americans and frequently these shoppers get extreme satisfaction from "getting a good deal." Therefore, the discounted inventory that the online agencies' sites can offer more effectively than the suppliers' sites is attractive to this clientele. In addition, the rich content offered by many online agencies can also appeal to "researchers," or those customers who want to know everything they can about a purchase before they make it. With online travel guides, destination descriptions, maps, directions, seating charts, pictures, and even streaming video these sites are better equipped to "sell" the whole experience of a destination or trip, rather than just processing purchases of the component travel pieces (air, hotel, rental car, etc.).

Because there are different customer types with different shopping behaviors, there is ample room for several different travel-selling models in the online space. Brand-loyal customers are natural patrons of the supplier direct sites, whereas shoppers and more price-sensitive customers form a natural constituency for the online agencies. In our view, the Internet is big enough for both of them. We tend to believe that, in the near term, online travel bookings will be about evenly split between the brands' proprietary sites and the third-party sites.

**WHY HOTEL
COMPANIES WILL
NOT WIN THIS
BATTLE**

Much discussion in the industry lately has centered on the eventual balance in the online travel space between the hotel operators and the online agencies. One school of thought holds that once the suppliers get efficient at distributing their product on the Web, they will cut off available inventory and completely dis-intermediate all the agencies. The other holds that the inefficiencies in the distribution system are so

endemic that even a perfectly functioning electronic marketplace won't lead to 100% direct distribution. It is our belief that whether the travel agency, consolidator, or wholesaler is on-line or not, hotel operators will always look for alternate distribution channels to fill otherwise vacant rooms.

Hotel companies have historically benefited from the sale of rooms over the Internet, using it to sell excess inventory, whether it was the last few rooms during peak business demand periods or as much as half of their room inventory during slower weekend or holiday periods. However, the slow economy combined with the increasing popularity of researching and now booking travel on-line has completely reshaped the relationship between the hotels and the online distributors.

A CLOSER LOOK

The typical relationship between hotel operators and third-party distribution channels used to be that as demand decreased at a property, management would look to third-parties to sell a greater portion of their inventory, resulting in increased commissions to agencies and lower returns for the hotels due to the discounts given to travel merchants. As demand returned, operators would begin to scale back the amount of rooms allocated to outside organizations, thereby decreasing commissions and reducing the profit made by other parties.

With the proliferation of Internet travel sites, we believe that this relationship has been forever altered. While lodging companies may pull back inventory from the traditional bricks-and-mortar travel agencies and merchants in periods of increased demand, it will remain important for operators to maintain a presence on both their own proprietary Web sites and on third-party sites as well. One primary benefit of researching and booking travel on-line is the ability to compare rates at competing hotels very quickly. Therefore, it stands to argue that hotel companies will want to maintain a presence on third-party sites, but will increase or decrease the allocations that they offer third-parties and will modify their pricing depending on their projected occupancy levels.

When demand for hotel rooms is low (the conditions that exist today), hotel companies look for as many distribution sites as possible and allow them access to a large percentage of their inventory. Once the inventory is in the hands of an online merchant, hotel companies lose control over the pricing of the room and can no longer control the rate that is ultimately paid by the consumer. As room demand increases, the rooms provided to third-parties decreases and, on average, ADR begins to increase. Lastly, once demand has increased substantially, fewer rooms are allocated to organizations outside of the hotel company's own distribution system (Web site, call center, hotel direct sales, etc.) and companies are able to maximize ADR.

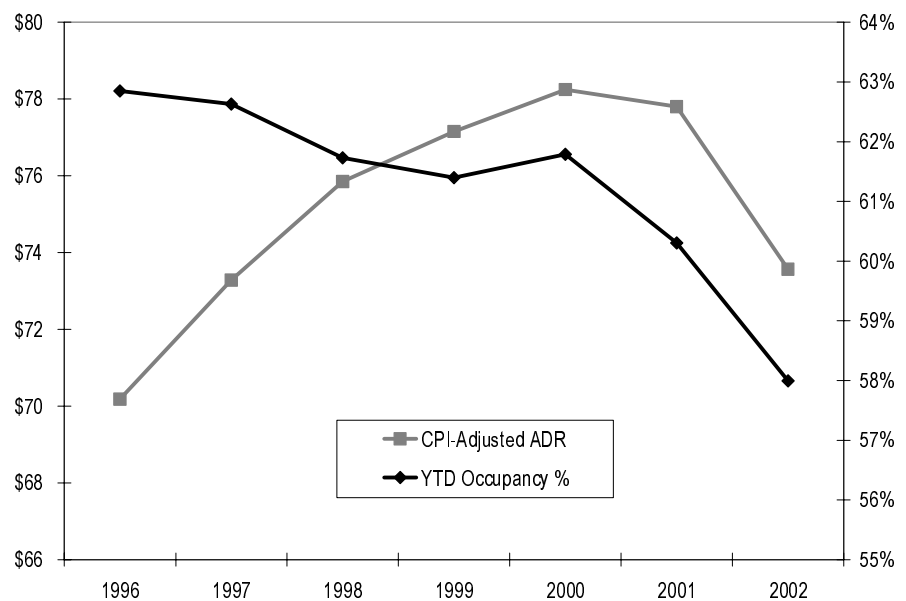
In recent months, hotel companies have been public about how they are not overly concerned by the emergence of online travel agents and merchants, illustrating the above example and stressing that room rates will quickly return to normal once individual business travelers return to the marketplace. In our discussion with industry insiders, we have found that this is not truly the case. Based on our research, hotel executives have recently been strategizing over how to regain control over their rates even when business travel resumes. The fear is that the business traveler will quickly adapt to the rate transparency that has been created by the Internet and will begin booking their rooms on-line.

**WHY IS THE
LANDSCAPE
CHANGING?**

The health of the lodging industry has often been said to be a leading indicator going into a recession and a lagging indicator once the economy returns, as corporations are quick to slash the travel budgets when their earnings fall and are hesitant to restore funding until a clear economic rebound has been established. This has proven to be true over the past 12-18 months as the economy slid into a recession, prompting companies to cut down on travel expenses, which have yet to return to previous levels even after the recession technically ended.

Exhibit 10 offers further evidence of the decline in travel, highlighting the recent increases in occupancy and ADR levels from 1996-2000 and the subsequent declines beginning in early 2001. Note that we have only used the period of January-May in each year to eliminate the seasonality of the rates and all dollar amounts have been adjusted according to the CPI increases during the same periods.

Exhibit 10. U.S. Industry-wide ADR and Occupancy Trends (January-May)



Source: Bear, Stearns & Co. Inc. estimates; Jupiter Research; Bureau of Labor Statistics.

**WEEKDAY REVPAR
DECLINES SHARPLY**

By and large, the hotel industry has typically made its earnings during the weeknights (Sunday-Thursday) and revenues over the weekend (Friday-Saturday) have been seen as icing on the cake. Room rates were generally higher during the week as travel planners struggled to find rooms at any price for their employees and discounted rates over the Internet were virtually non-existent. By contrast, weekend travel was relatively slow and hotels were more willing to negotiate on rates, offer rooms for sale via the Internet, and contract with wholesalers to arrange package deals for prospective guests.

For the hotel industry, the months of September through November are when the majority of corporate negotiated rates are determined for the upcoming year. In our opinion, it will be very challenging for the hotel operators to maintain, much less increase, their rates from 2002 levels as ADR and occupancy have both fallen roughly 6% from 2000 levels and corporate travel planners have become increasingly aware of the rates that are being offered over the Internet.

**CORPORATE TRAVEL
PLANNERS ARE NOT
BLIND**

Corporate travel planners know that hotels are struggling for business and have been discounting rates over the Internet to attract new customers and lure the still strong leisure market into their beds. Travel planners have seen that they have been consistently paying more for their “corporate negotiated rates” than they would have paid had they booked rooms over the Internet. In the past, there were always occasions where a reservation may have been cheaper over the Internet, but more times than not, rooms were not available over the Internet when businesses needed to book travel or were listed at a premium to their negotiated rate.

This occurred because demand for hotel rooms was strongest Tuesday through Thursday and rooms in many markets were scarce. Companies with significant volume were able to negotiate discounts to the “corporate” rate (typically a 10%-15% discount from rack) and companies without these preferred rates typically booked directly through the property and received the corporate rate or, in some cases, rack rate. Most hotel companies saw little need to sell rooms to online merchants and those listed on agency sites were posted there strictly to gain visibility to additional consumers but were not necessarily discounted. Now, with business travel lagging, hotel operators have been expanding their use of non-proprietary channels and sometimes find themselves discounting room rates to levels below those of their better corporate clients.

**NO RATE INCREASES
IN 2003?**

Our conversations with corporate travel planners have helped us develop our position that corporate-negotiated room rates will be flat to slightly down in 2003 and will increase only slightly in 2004. We spoke with travel planners at several *Fortune* 500 companies and each indicated that they have begun the fall negotiation season with the following goals in mind:

- no increase in room rates in 2003 from 2002 levels (each received substantial discounts from 2001 levels post-9/11); and
- two-year contracts that provide for only a 3%-5% increase in 2004.

It is important to note that most hotel companies develop their budgets based on a 3%-5% annual increase in rate. Going into 2002, many hotels and their corporate clients agreed to either discounted room rates or held them flat to 2001. What we are hearing from the corporations now is that they will see no increase again in 2003 and will resume their traditional annual increases in 2004, essentially equal to a cumulative average growth rate of 0.5%-1.5% for the 2001-04 period.

**BRANDS CONCEDE
THAT CORPORATE
RATES WILL NOT
INCREASE IN 2003**

These projections for increases in corporate negotiated rates were substantiated in conversations with directors of national sales at major hotel companies, including Hilton Hotels and Wyndham International. Representatives from both of these hotel companies indicated that they are building their budgets for next year with no increase in their corporate-negotiated rates. The only twist that they added is that each will see increases in overall ADR at their hotels despite holding corporate rates flat. The increase will come from a shift in the mix of business as corporate travel resumes in the latter half of 2003. In addition, assuming the economy improves in 2003, we think that many hotel operators may pull a significant portion of their rooms from non-proprietary travel Web sites, especially online merchants, and focus more on corporate

and group business rather than the leisure business that has currently been supporting their occupancy levels.

So, When Can Hotels Cut Off the Third-Party Travel Sites?

Inventory management in the travel industry is a very imprecise science. While manufacturers can quickly alter production and adjust inventories to meet demand, the travel industry has no such mechanism. Hotels take a long time to build and they just can't be taken in and out of service to meet the normal weekly and seasonal ebbs and flows of volume. The travel industry needs to be geared to handle maximum occupancy. A hotel needs enough rooms to satisfy peak midweek demand, but is often stuck with empty rooms on Saturday and Sunday night. As a result, U.S. hotels have an average occupancy of 63%-64% over the past ten-year period. Put another way, approximately 36%-37% of hotel rooms go unsold.

We think this fact will keep the non-supplier-direct distribution channels open in the near term. No respectable hotel company will be content to run 55% occupancy. To boost these numbers, the suppliers need to take market share from their competitors. Therefore, the hotels are doing everything in their power to take increase distribution and share. It is this search for a competitive edge that, in our view, will keep multiple supply channels open. If a hotel can boost occupancy by five points and squeeze out more profits by lowering the rate on some rooms by 20%, it will do so. It probably does not want to put a sign in front of its hotel saying "Rooms 20% Off" because then all the customers will want that deal. However, it may make sense to offer those rooms through an alternative distribution channel (a discounter, a wholesaler, or online auction) where the hotel can gain incremental revenues from selling them without disrupting its normal retail pricing strategy. That hotel may not be adept at finding guests who will stay at their hotel only if the rooms are 20% cheaper, but the experienced seller of discount rooms might have a captive audience of price-minded customers who would be willing buyers.

We don't believe that any one entity has enough distribution capabilities, either in the online or offline world, to put their product (priced properly) in front of all potential buyers. Multiple channels and strategies are required. Right now — in the travel business — the online agencies, discounters, wholesalers, and auctions expand distribution capabilities and can drive incremental business to those suppliers willing to tap these channels. We find it hard to imagine any supplier unilaterally disarming and removing themselves completely from these channels, particularly if their competitors are utilizing them. Moreover, the highly competitive nature of the travel business leads us to believe that any concerted effort to collectively limit the inventory made available to alternative distribution channels would not be sustainable.

OPERATORS MUST LIMIT ONLINE MERCHANTS

Where we do see an opportunity for hotel operators to increase the rates that they receive via online channels is by shifting the mix of bookings away from online merchants. The online merchant model typically cuts deeper into the pockets of hotel operators than online merchants and has the potential to tie-up rooms on nights near full occupancy until shortly before check-in. As such, successfully moving rooms back into the hands of agencies will likely benefit hotel operators in the long run.

From a profitability standpoint, online merchants cause hotel operators to leave money on the table by buying rooms at a discount and often selling them at comparable prices to what the hotel operator is offering them through competing distribution channels. For example, online merchants might secure the rooms at a 25%-30% discount and mark the rooms up 20%-25%, thus making a healthy profit and enabling them to sell the rooms at a slight discount to the hotel's proprietary site. Under the agency model, hotels dictate pricing and the agent works strictly on a commission basis (around 10%). Therefore, on a \$100 hotel room, a hotel might receive \$75 from a merchant who sells the room at \$90-\$95, whereas it could have sold the room through an agent for \$90 and received \$82 for the same room.

Another downside to the merchant model from an operator's perspective is that once the rooms have been allocated to a merchant, it is difficult to get the rooms back before the deadline when the merchant must commit to paying for every room it has been allocated or return the unsold inventory (often 24 hours before check-in). This presents itself as a problem when the hotel has sold out of its available inventory in advance of a given night, yet the merchant still has rooms to sell. Requests for additional rooms must be directed to the merchant and the property loses the upside that it could have earned.

At this point in time, we believe that hotel operators are not in a position of strength when negotiating with online merchants because of the pressure to fill their hotel rooms despite depressed levels of business demand. As the market rebounds and transient business travelers return, hotel operators will be in a better position to pick and choose their online travel partners and, it is our opinion, that the merchants will be the first to feel pressure. As such, we do not expect this to occur until late 2003 or early 2004.

What? You've Never Heard of Reverse Online Auctions?

A new trend in online bookings is emerging that has the potential to reshape the way the majority of corporate travel is booked, known as reverse online auctions. The premise is simple: Invite several competing hotels to “bid” on your business whether it is for a onetime meeting or for all of the company’s transient business in a particular location. The competing hotels know who they are competing against, but do not know which bid belongs to which competitor, and this anonymity helps to create the competitive atmosphere that companies believe will drive their room rates down.

We suspect that if you have not already heard of reverse online auctions, you will soon find yourself paying attention to this new trend. Reactions from hotel staff who have participated in auctions have been mixed: Some say that they will sell their products anyway that the customer demands, others say that auctions put them at a disadvantage as they try to sell the “benefits” of their property. Regardless of whether hotels like reverse online auctions or not, we believe that over the next few years, a large percentage of corporate travel will be auctioned to the lowest bidder and the effect will place downward pressure on corporate negotiated hotel rates.

HOW DOES IT WORK?

The process usually begins once a company has identified a need for lodging for a particular event or on a recurring basis over the course of a year. In either scenario, the company develops a Request for Proposal (RFP) outlining variables such as number of rooms, meeting space requirements, Internet connectivity, etc., and sends the list electronically to several competing hotels. Each hotel knows the names and locations of the other hotels that have been invited to bid on the business and can decide whether or not to participate. Those that choose to participate are invited to formulate their strategy and decide on their initial bids by a certain time. Before the auction begins, the names of the hotels are hidden so that each property knows who they are competing with, but not which bid belongs to which property. Once the bidding begins, each hotel can modify any of its variables (room rate, charges for parking, Internet access, phone calls, dry cleaning discounts, etc.) until the time limit expires. Our research indicates that the auctions can be as short as 15-30 minutes or as long as a couple of hours depending on the company, but typically, most of the activity takes place in the final five minutes, with each hotel jockeying for position when the time expires.

Once the bidding period is over, the company evaluates the final bids, contacts the winner, and begins drawing up the contracts with very few items up for further negotiation.

WHAT ARE THE RESULTS?

Companies who have tried reverse auctions are standing by the results. ProcurePoint, one of the largest providers of reverse online auctions for major corporations, recently released a summary of the results of over 120 auctions involving 80 companies. They reported that their clients achieved the following savings:

- 3%-8% reduction in the dollar amounts of the bids during the course of the auction;

- 8%-12% savings through spend aggregation (guaranteeing a minimum number of room nights to the auction winner); and
- 3%-5% savings based on reducing the number of labor hours spent on the RFP process.

We independently verified this information with several of the companies who have been experimenting with reverse online auctions and they confirmed that they have been saving an average of 15%-25%.

SO HOW DID THIS EVOLVE?

Reverse online auctions are a relatively new trend in the hotel industry. Our contacts within the hotel industry reported that they began encountering the trend in late summer 2001 as the general business economy worsened and companies began to look internally at how they buy goods and services and how to reduce costs. We took the opportunity to speak to travel planners at several large U.S.-based companies who have begun to experiment with reverse online auctions for their lodging needs and they explained their motivation for testing this approach.

Although reverse online auctions have been widely used by corporate purchasing departments for sourcing such commodities as towels, sheets, trash bags, etc. for some time, control over selecting preferred hotels has not traditionally been a function of the “purchasing department.” As companies examined their internal processes, many in the procurement side of the business began to question whether or not reverse online auctions had a practical application in travel decisions.

In conversations with travel managers, many were skeptical at first about how well the systems that were in place for purchasing commodity items would handle an auction for hotel rooms. If you compare buying a bed sheet to buying a hotel room, it becomes clear that sophisticated software must be written to accommodate the multitude of variables that help determine the best hotel or hotels for a company’s employees. If you ask five reputable linen manufacturers for a price on a white, 200-thread count, king-size flat sheet, you can be reasonably assured that regardless of which company you select, the sheet will meet your specifications and your satisfaction. Furthermore, the likelihood that you would feel obligated to visit the factories that would be producing the product is fairly remote whereas it is routine for a corporate travel planner to visit each of the competing hotels in a particular city for a site visit to inspect the quality of the accommodations.

As corporate travel planners begin to experiment with reverse online auctions, they are realizing that this negotiating tool may have significant potential. The cost savings that corporations are realizing combined with the time savings that can be achieved are enticing travel planners to continue to test their pilot programs and hone their skills.

WHO WINS IN A COMPETITION LIKE THIS?

The competitive nature of the auction prices typically results in savings for the company acquiring the hotel rooms. This is not to say that the supplier is not also a winner, but to make this assumption, one needs to know whether or not the hotel ultimately displaced higher-rated business by selling the rooms in bulk at lower rates than it could have sold them to individuals or small groups. Many of the auctions have resulted in a frenzied under-bidding in the final moments, likely resulting in regret by the winner that they ultimately lost the competition, while other auctions

showed that the hotels exercised restraint and understood the point at which it no longer made sense to chase the piece of business being auctioned. If one participant does not have a good understanding of yield management, the other participants may end up suffering the consequences.

Surprisingly, the winner of the online bids is usually not the lowest bidder on room rate alone. Here is what we heard from some of the organizations contacted during our research:

- ProcurePoint indicated that “85% of the winning bids were not the lowest.” How is this true?
- Dell Computer substantiated this point, adding that “price is only one factor in our decision-making process; every company has different needs, and we place a high value on last-room availability, high-speed Internet access, and flat rates that don’t fluctuate between the peak and off seasons.”
- Charles Schwab indicated that the benefits of reverse online auctions are “driving value and streamlining the traditional RFP process.” Schwab plans to continue to experiment with online auctions in select markets and, if successful, may increase their use significantly over the next few years.

In our opinion, widespread use of reverse online auctions could result in the commoditization of the hotel industry. We further believe that companies offering large pieces of business to hotel companies would certainly gain an advantage by having the hotels bid for them in a rate-transparent environment.

**GRASSROOTS
RESEARCH**

During the second-quarter earnings season, we have heard hotel executives acknowledge that online auctions are growing in usage. Some have said that it is such as a small percentage of their overall business that it is of little concern to them, while others have said that they will sell their hotel rooms however their customers would like to buy them. However, after speaking with property-level sales managers who have participated in online auctions, we have discovered that hotel companies are concerned about this growing trend. The common theme was that it doesn’t allow the hotels to sell their benefits such as pleasant staff, clean rooms, prompt and accurate billing/accounting systems, etc., and instead forces hotels to compete strictly on less qualitative measures like room rate and last-room availability. In addition, the majority of those we polled believed that online auctions will become more prevalent in the months to come.

One saving grace for the industry, however, is that many travel planners are hesitant to use online auctions in the markets where they book the most travel and in their own backyards. At Bear Stearns, for example, our travel department indicated that the relationships with preferred hotels in New York City, cultivated over approximately the past five to ten years, might suffer if the company decided to employ online auctions in New York City, where the bulk of our hotel demand is generated. Corporate travel planners and their counterparts at the local hotels see each other often at industry events and develop a rapport that generally yields mutually-beneficial results when rates are being established for the following year. Each understands the others’ needs and they work to create pricing strategies that ensure both parties are

satisfied. While auctions continue to increase in popularity, we believe that they will be rolled out first in the smaller markets that a company does business and that it will take time for auctions to gain popularity in the cities where long-standing personal relationships exist.

It is our opinion that reverse online auctions are a trend that should be monitored over the next 12-18 months as hotel operators and corporate travel planners continue to experiment with this method of negotiating room contracts.

So What Does This All Mean?

Over the last few years, we've seen the volume of online bookings in the hotel and airline industries explode. Practically across the board, consumers have readily adopted this medium as an efficient tool for researching and booking travel, and we agree with the consensus view that this trend will continue to grow exponentially in the years to come. In fact, we believe that by the end of 2005, online lodging revenue will have more than tripled the \$3.8 billion generated in 2000. The industry began as a mechanism to entice price-conscious leisure travelers to fill otherwise unsold hotel rooms, but more recently, as the effects of a recession have caused further tightening in corporate travel policies, both small businesses and large corporations alike have begun to explore the Internet as a means to reduce costs.

In our opinion, travelers will continue to increase their use of the Internet to research and book travel online. This trend will cause continued pressure on hotel rates even as the economy rebounds and demand for lodging increases. Despite the traditional supply and demand curves that historically have caused prices to rise and fall, the rate transparency caused by quick access to competing hotels' rates and availability has introduced a third variable that will limit hotel operators' ability to rapidly increase prices as demand rebounds.

We believe that while commoditization of the hotel industry will likely never reach the same extent that the airline industry has experienced, hotels will be forced to compete increasingly based on rate. To succeed in this evolving environment, hotel companies will need to develop strong brand loyalty to drive customers to their own proprietary or consortium sites and deter consumers from becoming loyal to online agencies and online merchants. Winning this battle will play a major role in determining how hotel companies will be able to exert upward pressure on rates.

While hotel companies battle for consumers with third-party Web sites, they will need to be mindful of the companies who constitute the bulk of their business, the individual business traveler. Increasingly, companies are under pressure to reduce their travel expenditures, and we believe that many will experiment with new techniques, such as reverse online auctions, to streamline their procurement of hotel rooms. The extent to which reverse online auctions will take hold is yet to be seen, but it has the potential to reshape the relationship between hotels and their customers and shift pricing leverage out of the hands of hotel operators.

We feel that it is important for investors in lodging stocks to consider the potential effects that the growing online travel market could create. In our opinion, the ability of the lodging industry to yield-manage its room inventory between traditional distribution channels as well as the evolving online travel channels will determine the level of profitability of the sector going forward.

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1. Buy — Expected to outperform the local market by 20% in the next 12 months. Strong conviction and typically accompanied by an identifiable catalyst. Sectors with less volatility would anticipate lower total returns.
2. Attractive — Expected to outperform the local market by 10% or more in the next 12 months, it is usually more difficult to identify the catalyst.
3. Neutral — Expected to perform in line with the local market in the next 12 months.
4. Unattractive — Expected to underperform the local market in the next 12 months.
5. Sell — Avoid the stock.

For important disclosure information regarding the companies in this report, please contact your registered representative at 1-888-473-3819, or write to Uzi Rosha, Equity Research Compliance, Bear, Stearns & Co. Inc., 383 Madison Avenue, New York, NY 10179.