PRICEWATERHOUSECOOPERS

Hospitality Directions Europe Edition*

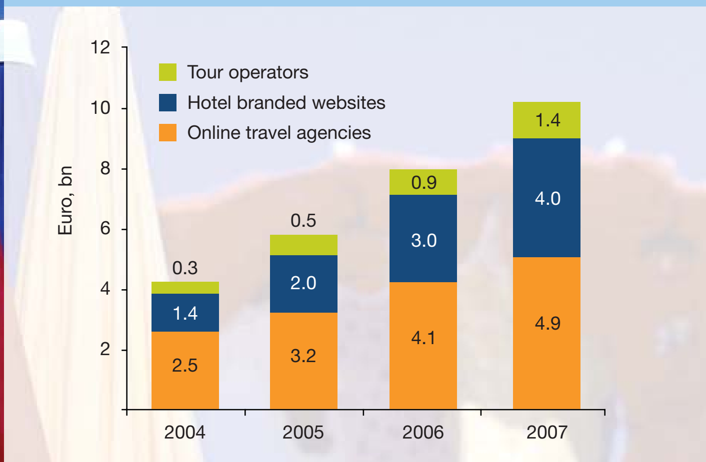
Briefing Paper November 2007

The distribution revolution

The growth of supplier-only sites has been at the expense of the online aggregators

Against a backdrop of fast-growing internet purchasing activity, the online travel market is experiencing a profound evolution. As we predicted a year ago, online travel agencies have seen the balance of power shift away from them in the last 12 months. Consumers and suppliers are fighting back. The surge in high-speed broadband penetration, coupled with suppliers' ability to take control of their own inventories, has blunted the competitive edge that online travel agencies once enjoyed. Price and convenience – the two principal drivers of internet usage – continue to be the crucial differentiators in online travel purchasing. In this paper, we map three principal influences behind these developments in greater depth, as well as examining the strategies that will determine success in the year ahead.

European online hotel bookings by channel, 2004-2007



Source: PhoCusWright European Hotels: Managing Hospitality Distribution, 2007

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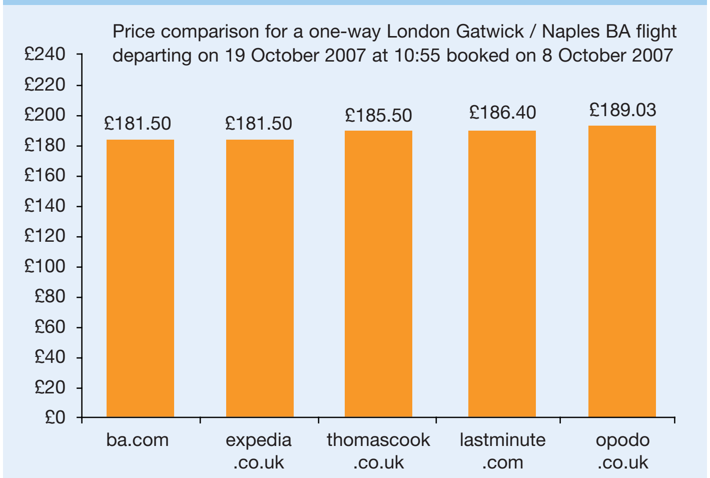
Is content king?

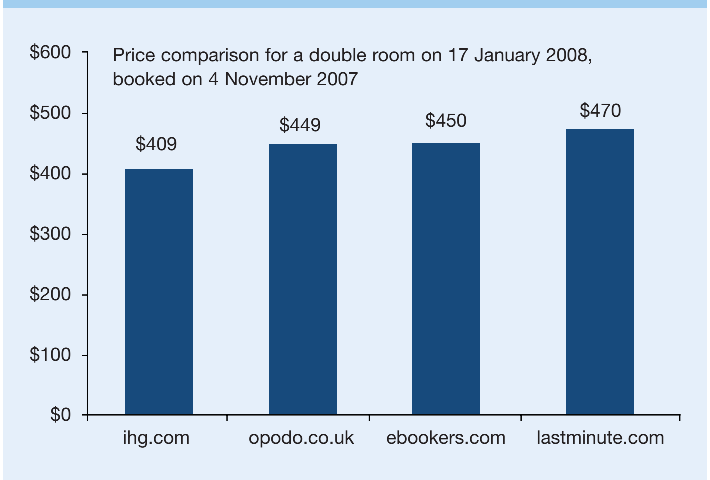
Airlines and hotel owners are in a strong position. As the 'content' owners – whether planes or hotels – they control the underlying assets. By contrast, the online intermediaries (the aggregators) own little. This dynamic has taken time to make itself felt; however, with airlines and hotel chains now having much greater control over the pricing of their inventories, a dramatic change has been taking place. The suppliers have been ensuring that their sites provide the lowest-cost bookings – something which was often not the case before. Because of this trend, the growth of supplier only sites has been strong in the past couple of years.

In almost all cases, ba.com offers the cheapest BA flights



Source: ba.com, agencies websites

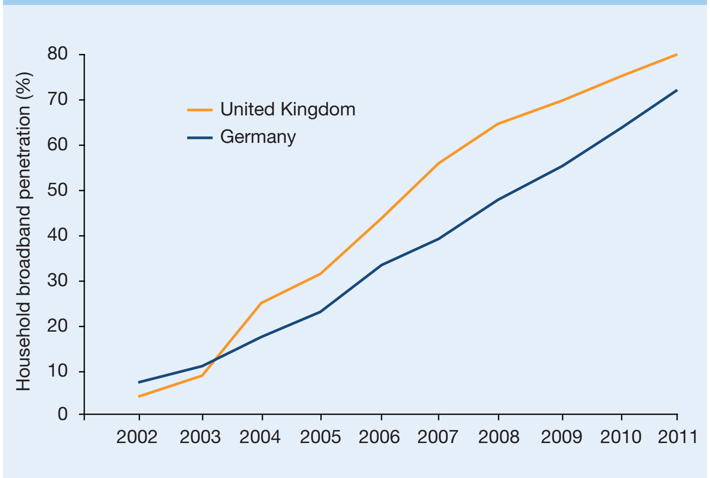
In almost all cases, ihg.com offers the cheapest IHG rates



Source: ihg.com and agency websites

The rapid growth in broadband speed and penetration has fuelled this trend. Because consumers can now open multiple sites at the same time, they are able to quickly and conveniently organise their own travel schedules –

Broadband penetration 2001-2011



Source: Global Entertainment and Media Outlook, PricewaterhouseCoopers LLP, Wilkofsky Gruen Associates

checking price and availability themselves, instead of having to rely on online intermediaries to perform this function for them.

Of course, whilst large suppliers (particularly hoteliers) can promote and rely on their own sites for an ever increasing proportion of their bookings, the small niche or boutique players do not have such a window on the world. As a growing proportion of bookings migrate to the web, these smaller operators need an aggregator to promote them to would-be customers and this factor goes far towards explaining the meteoric rise of online bedbanks over the last couple of years.

There is growing evidence that those suppliers that have sufficient scale will continue to see more and more bookings going directly to their own sites, using aggregators purely for their own yield-management strategies. Whereas the smaller players will become more reliant on the aggregators for their distribution as the internet becomes the channel of choice. Content will be king – and for the aggregators the battle will be over getting differentiated and exclusive content to gain the same benefits that the large content providers currently enjoy.

Customer acquisition – at what cost?

As a general rule, repeat business in the online travel world is low. And because customer loyalty is in short supply, the cost of customer acquisition is high.

For instance, sales and marketing costs at Priceline have risen in ten of the last thirteen quarters and at Expedia now account for 35 per cent of the net margin – far in excess of typical industry norms. This raises the question,

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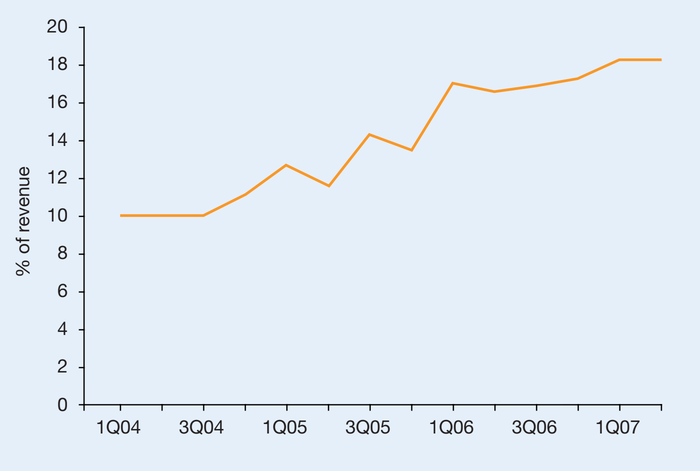
Priceline sales and marketing costs* Q104-Q207



Source: Priceline quarterly earning statements

what can be done to improve customer retention? Obviously, loyalty schemes are a key mechanism – and this is proving to be another area where the suppliers can wield an advantage over the aggregators. For airlines, reward points represent a persuasive means of cementing customer loyalty – they are also extremely cost-effective. After all, they are giving away something (seats) that would not otherwise be taken. The cost to an airline of this offering is marginal. In contrast, the benefit to the customer is enormous.

But how can an online aggregator create the same degree of loyalty? In the old 'off-line' world of high-street agents, loyalty was generated through good old-fashioned customer service. But in a faceless, web-enabled world this is proving much harder to achieve and, to compound matters, they have nothing to give away, after all. Their only recourse is to offer discounts – and these come directly off the bottom-line. If they want to give away a free flight, they have to buy that flight from the supplier. Until now, very few sites have managed to tackle this issue effectively. Outside of the online travel world, there are examples of successful schemes being used – Amazon, for instance, fosters loyalty by providing its users with recommendations for other follow-on purchases (based on its enormous database of individual user preferences). It remains to be seen what tactics will be adopted. But whatever emerges, an innovative service-led solution will be needed to match suppliers' pulling-power in this respect.

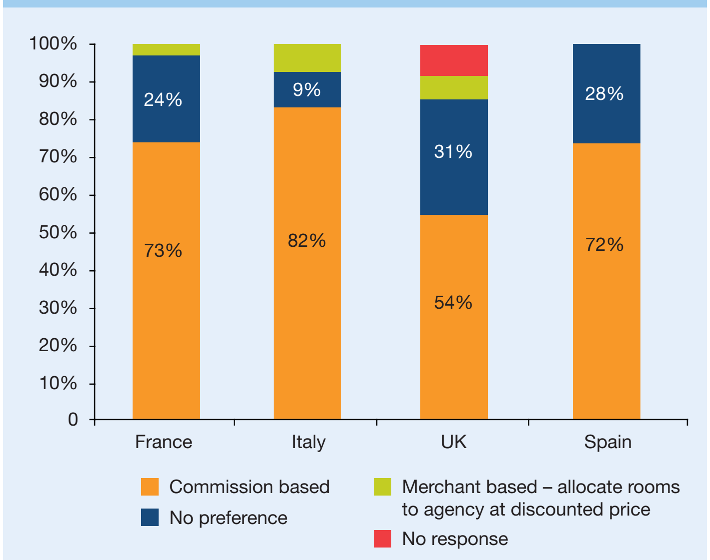
Who pays for the cost of distribution?

Ten years ago, the travel industry was driven by commission. Travel agents were seen by suppliers as distributors of their product – it was that uncomplicated.

However, that began to change – and when it did, momentum picked up rapidly. Airlines were the first to catch on – the commissions they paid to intermediaries were progressively whittled down, to a point where now zero commission is the norm. For example, BA began to cut commissions paid to agencies in 2003 – and by 2006, it was down to zero per cent. As a consequence, travel agents – as service providers – had no alternative but to charge their customers a fee for these services. The same trend can be seen in the corporate travel sector – most large organisations book all travel requirements through one agent and, in the last few years, they have moved to charging fees net of commissions and other incentives received. Once again, the agents serving this sector have been forced to become genuine service providers.

The alternative to the commission model in the travel sector has long been the so-called 'merchant model', whereby suppliers provide flight and hotel allocations to distributors at a net rate – a rate which the distributor is then at liberty to mark up at their discretion (and to mark down, where appropriate, but only to an agreed threshold).

Which type of contract do hoteliers prefer?



Source: PwC primary research

As a rule, suppliers prefer the commission model. For them, the merchant model allows aggregators to interpose an additional management structure on top of their own, complicating the yield management and pricing structure. It is interesting to see how the online agents have balanced their businesses. Expedia, for example, has maintained a broadly equal split between its commission and merchant business. By contrast, Priceline has significantly shifted its business to be commission-based. And, whether it is a coincidence or not, its market share has expanded significantly in the last ten years.

Summing up – where next?

Looking ahead, we believe that all players in this space will need to stay focussed on meeting the customer's preference for 'dynamic packaging' – that is to say, bundling together various discrete elements of product offerings in a more flexible way than the traditional package.

We are seeing a rush to develop better technical solutions in this space, often offering consumers local ground services unrelated to their basic travel plans (eg theatre tickets, restaurant bookings and theme park entry). By providing such an inclusive service, online players are actively encouraging consumers to stick with their sites – especially where the add-on services they offer would otherwise be more difficult to obtain direct before arrival.

By bundling multiple products together, online agents have been able to generate higher revenues per booking, helping to offset fast-growing customer acquisition costs. And with commissions on flights now virtually non-existent, margins on hotel sales of 15-20 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. From now, in line with the trends we are seeing in the marketplace, we expect to see an increasing number of large suppliers selling their product direct. And we also expect to see them taking strides towards similar dynamic packaging of product via their own sites. Tour operators are following this trend too, blending a mix of proprietary and 'bought-in' content to provide consumers with a more flexible and comprehensive package offering.

Each has their own type of content, and as they continue to develop, will encroach on the others' space. It remains to be seen how long it will be before supplier sites, such as airlines, manage to offer the same range of packaged product as the online agents – but they are already moving in this direction and undoubtedly have the resources to make up lost ground. That said, the online agents continue to enjoy a technology advantage and they will use this to develop better site functionality.

We began this paper by asking whether content would prove to be king. And we conclude with the same question. Whether the content is the actual end product (the planes and hotels that suppliers own), whether it is contracted content (exclusive or otherwise) that they choose to use to achieve differentiation, or whether it is the technology deployed on the site, it looks as though the future of the online travel market will be shaped by "content". It remains to be seen, for the moment at least, which camp will deploy content to the best effect – but the fact that they will seek out new ways of doing so cannot be in doubt.

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