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THE NEXT GREAT BATTLE OVER HOTEL DISTRIBUTION

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The battle for control of the customer is heating up between hotels and intermediaries. With annual revenues from online hotel bookings in the $35 billion range, it's definitely a prize worth fighting for. Currently, nearly half the bookings come through third-party intermediaries, which retain 15-30% of the price of the room. Hotels see the opportunity to increase direct bookings and, thereby, to increase revenues and margins and, importantly, to collect more information about the customer. But to do so, they need to shift from a wholesale to a retail mindset, and improve the value proposition to the consumer.

MARSH & McLENNAN COMPANIES

In the 1990s and early 2000s, the emergence of hotel web sites and online travel agencies (Travelocity, Expedia, etc.), along with more opaque shopping sites (Hotwire, Priceline, etc.), upset the traditional travel-agency business. Post 9/11, when travel slowed to a crawl, travel merchants upset the business again by scooping up hotel rooms at large discounts and reselling them at 20% margins. The last five to seven years have been relatively calm, with an uneasy truce of rate parity achieved between hotel companies and the online travel agencies (OTAs), but now internet search-based and shop-based "meta-mediaries" (such as Google and Kayak) have inserted themselves into the travel-distribution chain upstream from the traditional intermediaries, and they are looking to play an important role in booking hotel rooms. Airlines are also muscling into this space, hoping to improve their thin margins by booking hotel rooms along with flights. And finally, recent consumer litigation[1] may disrupt the rate parity détente that has forestalled all-out war between the large brands and the large OTAs.

This turbulence in hotel-room distribution has two major points of tension. The first is large hotel chains vs. intermediaries—such as global distribution systems (GDSs), travel agents, and hotel aggregators—that distribute rooms to travelers. The second is traditional travel-agent intermediaries vs. meta-mediaries, which are both fighting to control the top of the funnel, where consumers enter the booking chain.

The winners of these two battles will determine the future hotel-distribution landscape, with the possibility of different scenarios depending on region and type of inventory. This paper looks at the dynamics of these two battles and possible outcomes, and recommends actions that hotel companies can take to control their own destiny.

BATTLE #1: LARGE HOTEL CHAINS VS. INTERMEDIARIES

Hotel companies have historically embraced third-party distributors as convenient sources of incremental demand. Global distribution systems have broadened their reach to the business traveler, while online travel agencies have done so with leisure segments. However, as GDS fees have steadily climbed, and as merchant model distribution has grown in importance (and along with it, the OTAs' slice of the revenue pie), hotel companies have, like their airline "neighbors," become increasingly concerned with managing distribution costs. Moreover, many of them have set their sights on the sorts of ancillary revenues the airlines have been able to generate when they control the booking dialog with the consumer. If hotel companies can seize control of the booking dialog from the intermediaries, they reason, it could be an important source of margins for them as well.

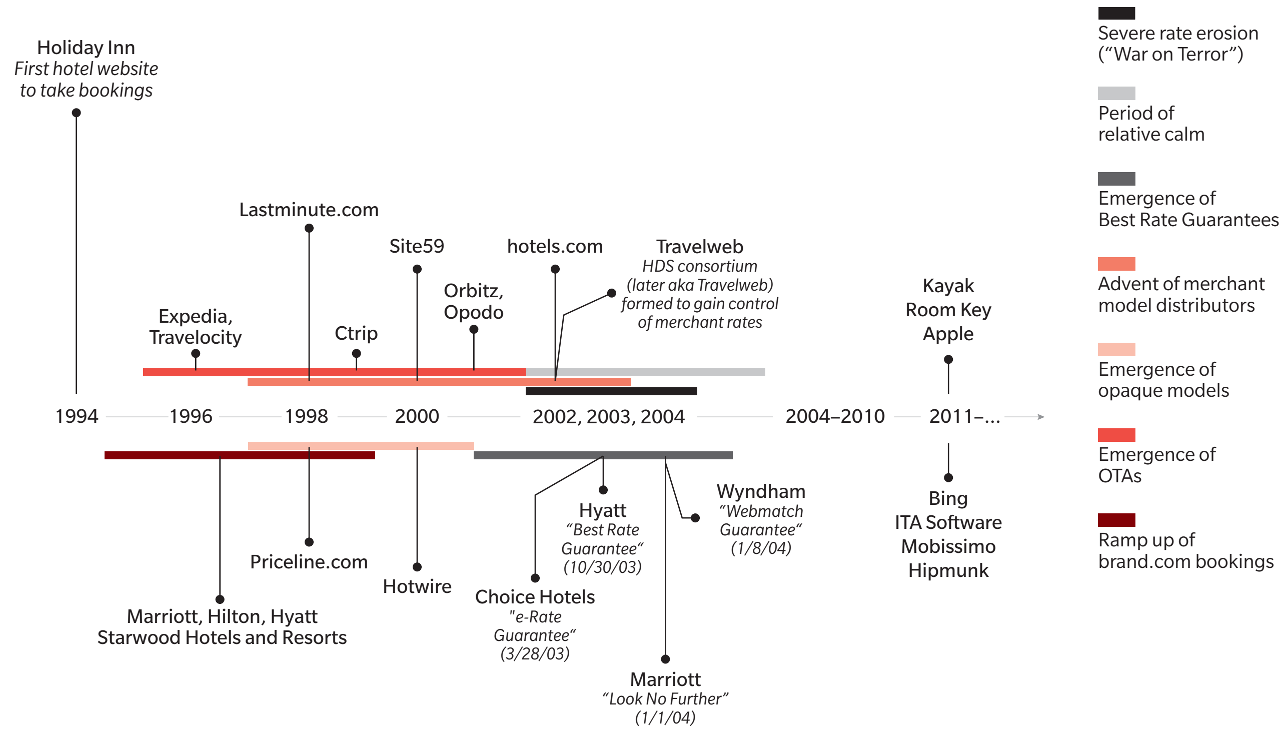
We have the makings of a classic battle, as both sides have leverage: Hoteliers provide rate and availability content to intermediaries, while intermediaries provide hotels with a crucial source of customers. The balance of power shifts with demand and brand recognition. During times of high demand or in markets

1 James Smith v. Orbitz Worldwide, Inc., Expedia, Inc., Hotels.com LP, et al., class action complaint filed in US District Court, Northern District of Texas, August 21, 2012.

EXHIBIT 1: HOTEL DISTRIBUTION REVOLUTION

Starting in 1994 with the launch of HolidayInn.com, the internet unleashed a decade of chaos in the hotel-distribution system. After a brief respite, a new era of upheaval is on tap, as hotels look to keep a larger share of their room revenues from both old and new adversaries.

HOTEL DISTRIBUTION EVOLUTION
1994 TO PRESENT



Source: TravelCLICK Hotel Bookings by Channel (2006-2010), Oliver Wyman analysis

with strong brand recognition, hotels rely less heavily on intermediaries. But during times of low demand or in markets where their brand image is not well established, hotels depend on intermediaries to boost occupancy.

The balance of power also varies with the size of the hotel chain. Smaller chains or boutique hotels are less able to afford sophisticated reservation systems and interfaces to distribution channels—and are thus more dependent on intermediaries to sell rooms.

As a result, small hotel chains and independents may benefit if intermediaries win the battle against large hotel chains.

Whether customers adopt direct channels or intermediaries depends on how successful each player is at attracting them with a smooth and simple internet experience. Today, hotels often offer better content—both rich digital content and local area information. Hotels can also provide a more refined ability to book a specific room type, be it one with a garden view or one that's far from the elevator bank, just as airlines let travelers choose their exact seat. Both capabilities provide incentives for customers to book direct. (For example, most hotels do not offer loyalty program points on merchant model bookings and most group rates can only be negotiated and committed through direct channels.)

For their part, intermediaries (both traditional agents and search-and-shop meta-mediaries) offer customers the ability to compare options from different hotel chains. Many intermediaries display reviews and ratings, which can make it easy to compare seemingly similar hotels. And some intermediaries bundle packages of flights, hotels, and rental cars, reducing the hassle of planning a trip.

In today's travel ecosystem, such bundling is the ticket to increased revenues and margins in a low-margin business. In this regard, airlines are ahead of hotels and are now looking to book entire trips or vacation packages, rather than just flights. One airline, in fact, Allegiant, has positioned itself not as an airline but as a travel company (see the sidebar, "Allegiant: Travel Is Our Deal").

BATTLE #2: AGENT INTERMEDIARIES VS. META-MEDIARIES

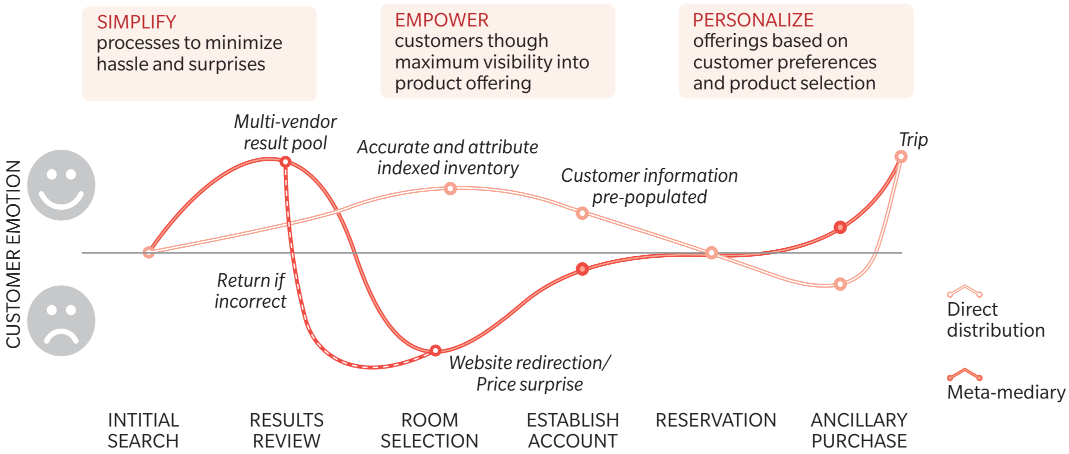
Traditional and online travel agents use data provided by hoteliers (usually via a switch or a GDS), while meta-mediaries typically scrape data from hotel websites (or acquire equivalent information through specialized interfaces, such as HTNG or Open Travel). These two groups are competing for the customers where they first enter the travel-distribution ecosystem.

Most meta-mediaries provide search or shopping services without letting customers actually book a room or flight. But that is changing. Kayak, for example, which used to push buyers onto airline, hotel, or OTA sites like Priceline, now makes bookings itself. The meta-mediary's value derives from its superior searchability, slick interface, value-added information layers (e.g., neighborhood highlights for dining or nightlife in the case of Hipmunk) and complex algorithms for building products and checking availability.

However, as giants Google (Hotel Finder) and Apple (iTravel app) enter the fray, they could really shake up the space. (Google bought ITA Software, used by many air carriers for low-fare searches on their own websites, for $700 million; Apple has filed patents for its iTravel app.)

Neither traditional intermediaries nor meta-mediaries have won control over the top of the customer funnel because neither has yet figured out how to make the customer experience hassle-free. (For a closer look at the hassles involved with booking a hotel room, see Exhibit "Customer Booking Hassle Map.") And many of the hassles that remain can only be solved by strengthening relationships with hotels and getting access to their data and rich media content. Of course, hotels are less interested in fostering these relationships, which cuts into their margins, than in direct-connect bookings that they control.

EXHIBIT 2: CUSTOMER BOOKING HASSLE MAP



Source: Oliver Wyman

FOUR POSSIBLE SCENARIOS

The outcomes of the two battles are far from decided. The main determinants are how well hotels can connect with consumers, how well global internet giants perform in a whole new business arena, and how well each can do these things while simultaneously making life easier for the hotelier at the property level. We can organize the potential outcomes by imagining two axes, one representing the outcome between suppliers and intermediaries, and the other representing the outcome between intermediaries and meta-mediaries. The two possible winners in each battle suggest four main scenarios with multiple variants. (See Exhibit 3, "Distribution Market Scenarios.")

SCENARIO I: BACK TO THE FUTURE

Hotel chains emerge victorious, although intermediaries continue to participate on a limited scale. Hotel chains steadily increase the portion of bookings made through their own direct channels by offering compelling content and packages. Traditional agents, for their part, lose their battle with hotels but win against the meta-mediaries. The travel-management company model persists for business travel, but leisure travelers increasingly book directly through hotel websites. A few consolidated low-cost online travel agencies survive to liquidate distressed inventory or market special promotions. The Roomkey.com reservation service, offered by Intercontinental, Choice Hotels International, Hilton Worldwide, Hyatt, Wyndham, and Marriott, shows that hotels are serious about claiming the "meta" direct-connect channel. The site offers clear cost comparisons between founder hotels and, more recently, res99.com (a Travelocity affiliate) inventory, consolidated TripAdvisor content per hotel, and direct links to hotel websites for more information or booking.

EXHIBIT 3: DISTRIBUTION MARKET SCENARIOS

With all the uncertainty in how these battles will be resolved, one can easily imagine four or more major scenarios for the future, each with its own implications for success.

Agent

BACK TO THE FUTURE

- No analog of "full content agreement" emerges in hotel arena
- Hotel chains gradually increase their share of direct distribution by offering more compelling content and/or packages through direct channels
- TMC model persists for corporate bookings and TOs persist for European package, but leisure moves mostly through brand.com or through low-cost, direct-connected on-line leisure agencies

THE (INTERMEDIARY) EMPIRE STRIKES BACK

- Increasing number of direct-connect requests swamps TMCs and OTAs; industry determines that the direct-connect model is not scalable
- Consumer protection legislation limits the complexity and unbundling of airline and hotel offers
- GDSs enjoy resurgence in popularity and leverage airline and hotel consolidation to become the definitive source of travel industry content

Suppliers ← → Intermediaries

META-FRIENDS WITH BENEFITS

- Hotel chains collaborate with meta-shoppers, marginalizing OTAs and tap aggregators as a source
- New intermediaries/OTAs are viewed as "supplier-friendly," only charging on a cost-per-click basis and handing off the traveler to the supplier for final transaction
- Google/ITA offers corporations a self-booking tool, which many readily incorporate into their corporate intranets; Microsoft counters with bing/farecast/powered tool

FULL META-(STRAIGHT) JACKET

- Search engines and meta-shoppers marginalize OTAs, but then move into the transaction world (as Kayak has)
- TMCs adopt white label versions of these tools, integrate them with proprietary FOS, and begin to wean themselves from GDS technology
- New intermediaries aggressively steer customer behavior and attempt to capture ancillary revenues and commissions for themselves

Search/
Shop

Source: Oliver Wyman

(By contrast, airlines launched Orbitz.com way back in 1998 as a response tactic to regain control from online travel agents.)

SCENARIO II: THE (INTERMEDIARY) EMPIRE STRIKES BACK

As an increasing number of direct-connect requests swamps travel-management companies, travel agents, and online travel agents, the industry concludes that the direct-connect model is not scalable and falls back to a wholesale approach. At the same time, consumer-protection legislation limits the complexity and unbundling of airline and hotel offers. Agent intermediaries push for a return to the old distribution method, with room reservations delivered by GDSs (rather than hotels directly), which marginalizes meta-mediaries. Under these circumstances, GDSs enjoy a resurgence and leverage airline and hotel consolidation to become the definitive source of travel industry content.

SCENARIO III: META-FRIENDS WITH BENEFITS

Large hotel chains seize control of the top of the funnel by collaborating with meta-mediaries. Their partnership powers both players to victory in their battle against traditional agents. Bookings for leisure travel are concentrated through direct channels, as hotel chains develop an effective internet strategy and approach to search-term optimization and marketing. OTA intermediaries are forced to adopt a cost-per-click (CPC) model because hotels no longer make inventory directly available to them. The decline of these intermediaries might have a negative impact on small hotel chains, especially if they are unable to rise to the level of the large chains in their search-engine marketing and optimization capabilities.

SCENARIO IV: FULL META-(STRAIGHT) JACKET

Meta-mediaries leverage their control over the top of the funnel to move into bookings (as Kayak has done) and marginalize online travel agents. Meta-mediaries incorporate dynamic software to package vacations and bundle ancillaries, such as airline and car-rental reservations. New entrants (possibly Google and Apple) aggressively start negotiating their own branded merchant-model distribution deals with hotels. Essentially, the meta-mediaries move into the booking and ancillary revenue business themselves, diminishing suppliers' abilities to control the customer interaction.

The most likely outcome may actually be a combination of these scenarios, especially if neither of the two battles has a decisive winner. If that's the case, we might expect meta-mediaries to share the top of the funnel with the strongest online travel agents. Weaker online travel agents will struggle to survive under pressure from reductions in merchant model margins. Meta-mediaries will forward customers to direct channels and online travel agents. Direct sales will continue to migrate from offline to online. Travel-management companies will maintain their position as leaders in the business segment, but will face competition from online travel agents, who will redirect their offerings to the business segment. All players will look to bundle—in other words, to sell complete travel packages rather than just hotel rooms or airline seats.

CAN HOTELS WIN THE RETAIL CONSUMER?

To win the industry battle, hotel companies must win the hearts of customers by simplifying the reservation process and giving travelers more flexibility and choice. At the same time, the chains must avoid burdening hoteliers with time-consuming additional tasks and responsibilities. Complete strategies must reduce both customer and hotelier hassles that waste time, energy, or money, while allowing distribution systems to remain nimble enough to adapt to changing competitive conditions.

SIDEBAR: ALLEGIANT—TRAVEL IS OUR DEAL

Under intense competition from rival airlines, Allegiant Airlines has adapted its business plan to take advantage of customer demand for package offers. Rather than advertise itself as an airline, it has positioned itself as a travel company. This is reflected in its slogan: "Travel is our deal."

Before customers search for a flight on Allegiant's website, they are reminded that they will save money if they book their flight and hotel (and car) together. After selecting flight dates, customers are automatically taken to a page that allows them to book a hotel for the nights of their visit, unless they specifically opt out. They are then shown options for renting a car. Finally, when the transaction is complete, customers are recommended attractions near their destination.

Up to one third of Allegiant's revenues come from hotel and rental car bookings. During difficult times for the airlines industry, Allegiant's focus on addressing an unmet customer need has been central to its success.

ALLEGIANT AIRLINES

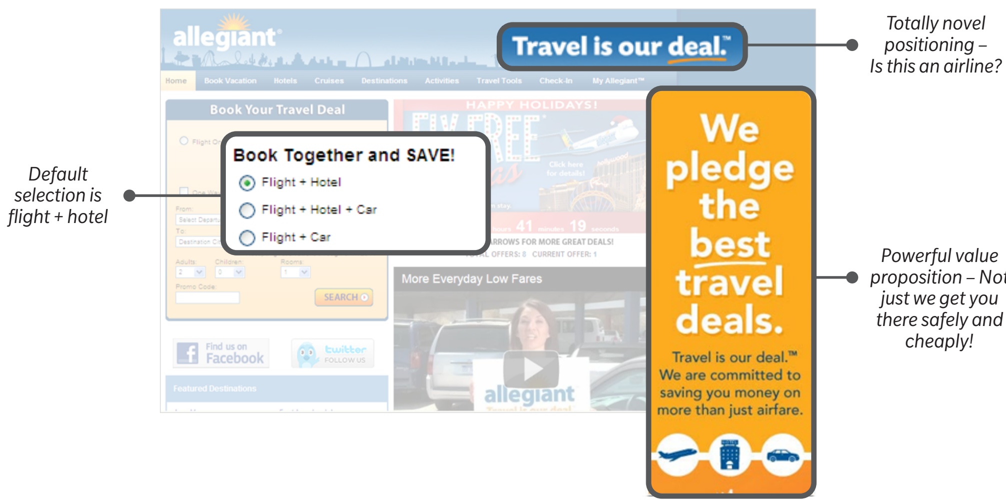
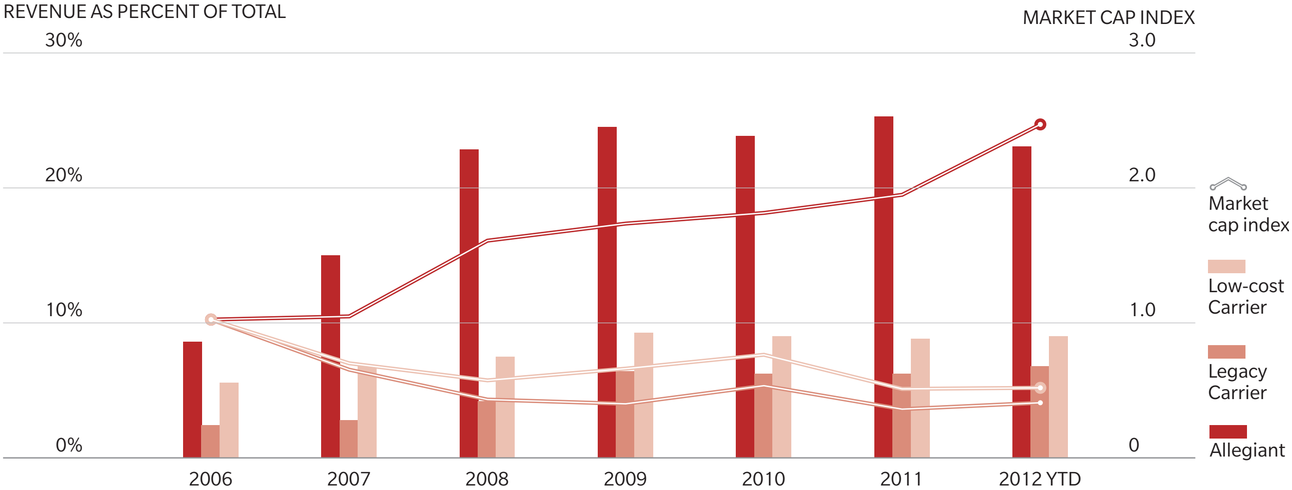


EXHIBIT 4: ANCILLARY REVENUE GROWTH AT ALLEGIANT



Note: Ancillary revenue includes baggage, change fees and miscellaneous revenue, plus transportation revenue for LCCs. DAL indexed to Apr 2007 as Dec 31, 2006 not available. 2012 ancillary revenue data for Q1-Q2.
Source: Planestats Income Statement, Google finance

Consider the typical traveler's "hassle map" today. It starts as soon as you decide you need a hotel room. You know where you want to be (in Boston, say, near the convention center), but when you start searching online, you get an unwieldy list of options. How do you narrow down the list to the ones that best suit your needs? Trying to compare offers across hotel brands is both time-consuming and difficult, as the quality of information available varies widely by property. You can't help but wonder if the description is outdated, or if there are factors you'd like to know about that aren't mentioned (the elevator isn't working; there's a major renovation happening at the property next door; the only room left is next to the noisy ice machine). Customer reviews from user-generated content (UGC) sites like TripAdvisor offer some help, but they're not always available.

Once you choose a hotel, the hassles aren't over. A multi-step, one-size-fits-all booking process is time consuming—doubly so if you're using a mobile device. And who hasn't gotten a nasty surprise when the rate they thought was being offered suddenly jumped when they clicked "buy?" Loyalty programs, built to ease hassles, don't always work that way ("What's my password again?"). Then there's the actual room selection: You know you want to be away from the elevator bank, or on a low floor, but there's no way to guarantee that—the best you can do is type in a special request and hope for the best. After you push "submit," it's difficult to go back later to change your booking. Finally, you still need to book other trip components—flight, ground transportation, attractions, and the like—separately. That's a lot of frustrations—and opportunities—for hotels to improve the booking process.

HOTEL STRATEGIES FOR SUCCESS: CUSTOMER-FOCUSED

Hotel companies could better meet customers' needs by doing the following.

1. **Give shoppers greater product selection.** Travelers are being offered an increasingly flexible array of choices. National Car Rental's Emerald Aisle allows customers to choose a specific car. Timbuktu.com lets customers personalize and visualize nearly every element of their messenger bag. Virtually every airline online check-in process allows customers to select their seats. Meanwhile, most hotels can't even guarantee rooms away from the ice machine. Greater flexibility and fluidity in inventory management is a must.
2. **Customize the shopping experience.** Customers are seeing more targeted offers customized to their preferences, behaviors, and even location. But hotels have been known to advertise a vacation package to a frequent business traveler who had stayed at the very same hotel every other week for a year. Clearly an opportunity exists for hotels to use customer information to provide a much more personalized shopping experience. Customization is a way to increase loyalty and engagement of high-value customers.
3. **Go mobile.** The prevalence of smartphones has created a new channel for interaction.

Whether it's online check in, smart apps that allow the guest to arrange ground transportation or track a courtesy van's arrival at their terminal, or location-sensitive promotions that tell them about the great spa they're walking past at the property, hotels need to conquer the mobile channel before intermediaries do.

4. **Harness social media.** Customers now have access to a variety of UGC and social media sources (Facebook and TripAdvisor, for instance) with information and reviews from their friends and peers about many aspects of the travel process. Hotels need to manage the development of social media content and their response to UGC to promote engagement while carefully managing their brand across these sites.
5. **Enable advanced search.** As rate products and trip requirements become more complex, more advanced search capabilities are required to find the desired rate and availability match. There's no hotel product similar to ITA QPX, which stitches together itineraries from multiple fare products and multiple airlines. For example, it is not possible for a customer (or even easy for a reservation agent) to search and assemble a 4-night stay where the first two nights are single occupancy at the group rate and the following nights are double occupancy at a package rate that includes breakfast and golf daily.

HOTEL STRATEGIES FOR SUCCESS: HOTELIER-FOCUSED

The balancing act for hotel companies is to reduce customers' hassles without adding to hoteliers' hassles. We recommend the following:

1. **Improve the management of multi-attribute inventory.** The complexity of inventory management increases dramatically as customers are allowed to choose more specific hotel-room attributes. As hotels begin to offer customers more choices, hotel companies must provide hoteliers with powerful but easy-to-use inventory-management systems.
2. **Develop branded rate products.** A mainstay of airlines for several years, branded fare products differentiate between more and less price-sensitive customers. For instance, Air Canada offers Tango, Tango Plus, and Latitude fares for its economy cabin; each of these fare products offers a different combination of refundability/changeability, mileage accrual, seat selection, and priority handling benefits. Hotels need the analogous ability to support and maintain pricing for multiple room-rate products. They must make them easy to understand and differentiate so that consumers will voluntarily choose to buy the premium products.
3. **Master the art of multi-person, multi-payment, multi-segment bookings.** Customers are traveling in more flexible ways (think, for example, of business travelers with several trip segments, a tour group with several people to a room, or a large family requiring adjoining rooms with multiple bedding types.) Hotel companies need to transition to a new reservation concept with a many (products) to many (guests) construct.

4. **Enable smooth management of advanced content.** Hotels need to generate and publish rich digital content (videos of rooms and floor plans) and local information (restaurant recommendations.) Otherwise, meta-mediaries will fill the void. Hipmunk already allows customers to search based on factors such as nightlife concentration; Room 77 allows customers to evaluate the floor plan of and view from specific rooms at a hotel.
5. **Improve pricing and inventory management of ancillary products and packages.** Most hotels cannot fully profit from the sale of ancillary products and packaged travel because they do not have the systems required to dynamically price them. In addition, hotels lack systems that can guarantee the availability of ancillary products. They need capabilities to dynamically price packages and also price and check availability for ancillary products.
6. **Embrace globalization.** As hotel companies become increasingly global, the ability to intelligently support multiple languages and multiple payment types (credit cards, gift cards, vouchers, cash + points, layaway, etc.), both individually and in combination, is critical. Hoteliers require the flexibility to welcome visitors from these growth markets as readily as they do those from Europe and North America, but they currently struggle with language barriers and foreign payment methods.
7. **Support high-volume shopping/caching.** As online travel agents and meta-mediaries become more sophisticated and popular, the demand for rate and availability checking on hotel reservation systems will continue to increase. Hotels need to be able to efficiently handle these requests through streamlining direct connects and supporting caching protocols.

LOOKING FORWARD

As hotel bookings have shifted to the internet, hotels and traditional third parties have lost business and control to upstarts, just as the airline industry did. But the uncertainty and potential upheaval in the hotel-distribution ecosystem presents a major opportunity to harness the shifts in demand and offer a superior product and experience for their customers. Hotels have been focused on revenue-per-available-room (RevPAR). Those that successfully transition to direct-connect selling will find that they can instead maximize margin-per-available-room (MarPAR). Right now, hotels are losing the battle to intermediaries, both traditional and search-and-shop, which are using their internet savvy to skim billions in room-rate margins. To claw back, hotels need to switch from a wholesale to a retail mindset. The resultant new products are likely to streamline management for hoteliers, improving operational efficiency—and profits.

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