Demystifying the Digital Marketplace: Executive Summary

Traditional hotel performance evaluation using calculations of supply and demand has evolved with the digital marketplace into a new approach. The landscape of the digital marketplace is made up of many channels of distribution along with a variety of market segments and rate types. These new intricacies of digital distribution call for a deeper dive and broader understanding into what drives business.

Traditional hotel performance evaluation using calculations of supply and demand has evolved with the digital marketplace into a new approach. The landscape of the digital marketplace is made up of many channels of distribution along with a variety of market segments and rate types. These new intricacies of digital distribution call for a deeper dive and broader understanding into what drives business.

A key factor impacting hotel performance in the new digital marketplace is the rising cost of customer acquisition. Growth in the digital distribution market for hotels has come along with the consolidation of several large intermediaries. Increasing market share of third-party intermediaries has caused distribution costs to rise quickly. These distribution costs, or customer acquisition costs, have risen from 5% – 10% of Guest-Paid Revenue in the 1990s to 15% – 25% in the U.S., or higher in other regions, in 2016. Customer acquisition cost is second only to labor costs in growth rate and is very difficult to manage. There are a myriad of vendors providing sales and technical services supporting hotel distribution with various fee and compensation structures that cause costs to be scattered across the Profit & Loss statement or not shown in accounting records. Even the most sophisticated operators struggle to quantify and manage customer acquisition costs in a routine way.

Navigating a virtual spaghetti bowl of players in the rapidly changing distribution ecosystem challenges those in the industry to understand the levers available to them that can affect improvement.

Part 2 of *Demystifying the Digital Marketplace* has taken hotel production data and associated costs for 25,000 hotels from 2014-2016, broken into 12 month periods ending in June of each year, to examine the patterns of performance by hotel type over time. Much of the analysis looks at three types of revenue or ADR: **Guest-Paid Revenue or ADR** includes everything paid to a hotel or third-party to account for Merchant (Net) rates; **Hotel-Collected Revenue or ADR** reflects the revenue the hotel collects and shows on the P&L statement; and **COPE Revenue or ADR** (Contribution to Operating Profit and Expense) which reflects the **Guest-Paid Revenue** after removing all direct acquisition costs such as commissions, transaction fees and channel costs. At the U.S. aggregate level, the study examines **Net Revenue** which additionally removes Sales and Marketing expense.

Part 3 will offer up methods for hotel brands, owners, and operators to analyze and act in the current market environment.

UPPER TIER = LUXURY, UPPER UPSCALE, UPSCALE

MIDDLE TIER = UPPER MIDSCALE

LOWER TIER = MIDSCALE AND ECONOMY

WHAT YOU NEED TO KNOW

There are five major themes that emerged from the review of data from June 2014 through June 2016.

1

Dynamic Hotel Demand and Cost of Customer Acquisition

Hotel demand is strong and revenue growth has been healthy. This theme is encouraging and reinforces the strength of industry fundamentals. More consumers are traveling and staying in hotels for business, leisure and meeting purposes. On the cost side, hotels continue to pay third parties to deliver more and more business each year. On average, hotels will pay 16-18% of guest-paid revenue in customer acquisition costs, but this ranges from about 15-25% with some hotels as high as 35-40%. The makeup of these costs is split roughly with half being internal direct Sales and Marketing expenditures and half spent externally. The third party payments generally run 7-15% of Guest-Paid Revenue with the costs incurred for internal Sales and Marketing costs making up the remaining 7-10%.

2

The Role of Third Party Intermediaries

The traction in the market by third party intermediaries is becoming more pronounced over time. Within the OTA segment, two companies and their affiliates represent about 96% of consumer demand on a room night basis. The OTA share of total room nights is up 28% from 2014-2016 to an average of 12.4% of demand while Brand.com grew 9% to reach an average of 20%. As a relatively small number of aggregators attract a growing portion of consumer demand, it drives higher total costs for those who want to tap into the demand flow, even as commission fee percentages come down. Metasearch is gaining share in the third party intermediary space and while it is often charged through auction models and media fees rather than commissions, these costs are rising quickly. In fact, meta search players are adding to the overall market costs pitting the OTAs against brands and individual hotels for position in search results.

Hotels, being downstream of the aggregated demand, are experiencing a decline in the amount they can capture of Guest-Paid Revenue growth. That differential varies by hotel segment with some able to capture more of the value in the market than others. Across all U.S. hotels in the timeframe of the study, Guest-paid Revenue grew 4.6% while Net Revenue* only grew 4%. Even in a period of robust economic growth, this gap has widened over time as third parties are sharing in a higher proportion of the incremental value coming into the market.

*Net Revenue accounts for commissions, transaction and channel costs as well as total Sales and Marketing expenses.

3

The Imperative to Manage Revenue Capture

Revenue Capture is the percentage a hotel keeps of Guest-Paid Revenue once all acquisition costs are paid. Managing Revenue Capture is an imperative to sustain profitability in the digital marketplace. The 2014-2016 data trends examined in this analysis bring into sharp focus the fact that a traditional top line view of revenue performance has masked a weakness in true hotel profitability driven by unrelenting growth of acquisition costs. In the period from 2014-2016, OTA commissions rose at three times the rate of growth of Guest-Paid Revenue. Metasearch costs are still small in absolute terms but are a growing component of customer acquisition. When a rising tide of Guest-Paid Revenue does not result in a corresponding rise in profit contribution to hotels, owners and operators are constrained in their ability to reinvest in property improvements and staffing.

4

Diversity of Business Mix and Impact on Profit Contribution

There remains a wide range of channels and segments through which hotels receive their business, and this diversity is important for hotels to leverage as they deploy resources to acquire their customers. There have been shifts in this mix of channels and segments that have had direct implications for profit contribution. The most notable is the transfer of bookings from Property Direct (drive-in, call-in), to the OTA channel. That change is particularly evident in the Middle and Lower Tier hotels, or Upper Midscale, Midscale and Economy chain scales, causing a reduction in Revenue Capture. On the other hand, Upper Tier hotels, or Luxury, Upper Upscale and Upscale chain scales, managed to shift within the OTA channel to improve profit contribution by dramatic reductions in Opaque OTA business while growing the Brand.com business yielding higher Revenue Capture.

Managing this diverse mix is at the root of what hotels can do to improve their profit contribution. Each hotel has a wide range of channels and segments available in its market and can tap this to get a healthy balance of business at the lowest cost possible. This target, based on each hotel's market situation is referred to as the hotel's unique Optimal Business Mix and achieving that objective will be explored in detail in Part III of *Demystifying the Digital Marketplace*.

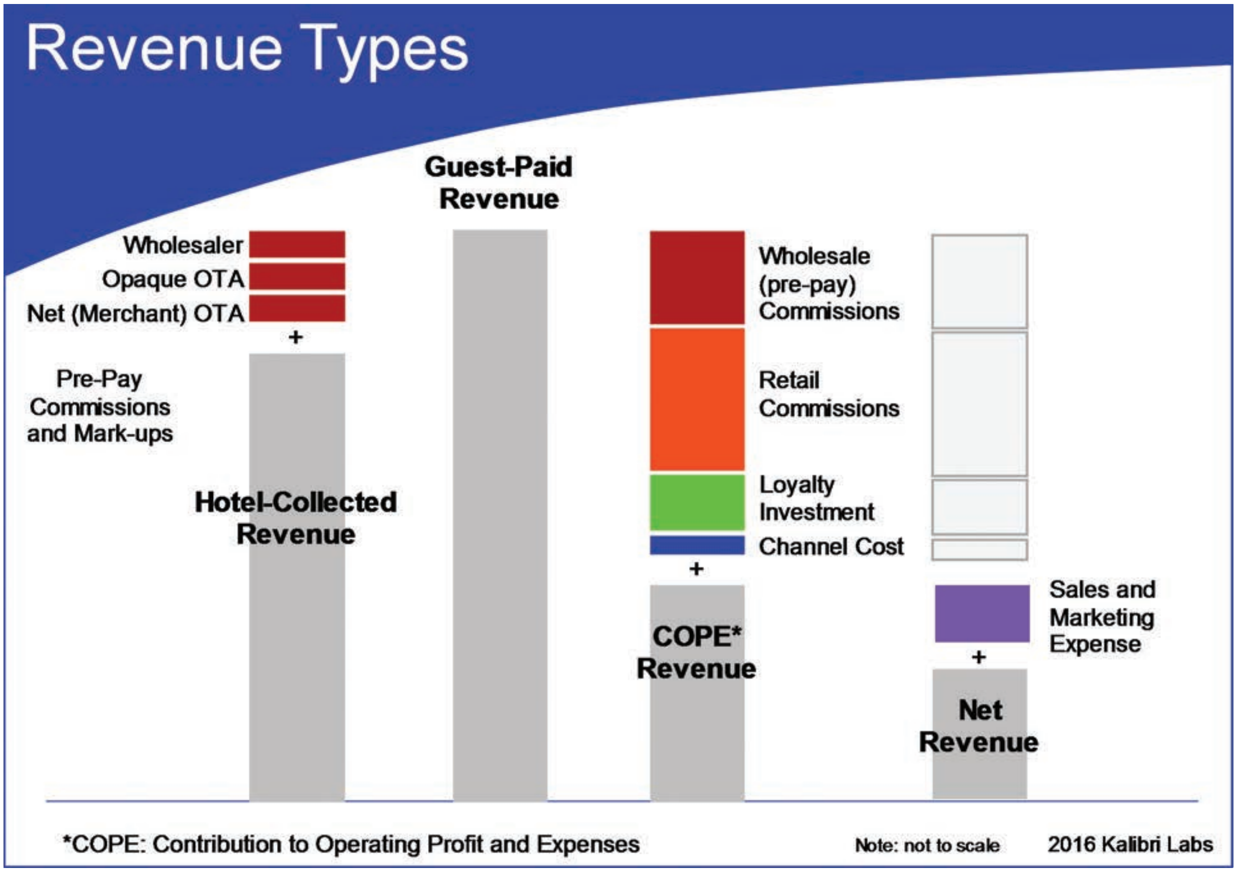
5 Customer Acquisition Techniques— Loyalty, Leisure and Profit Contribution

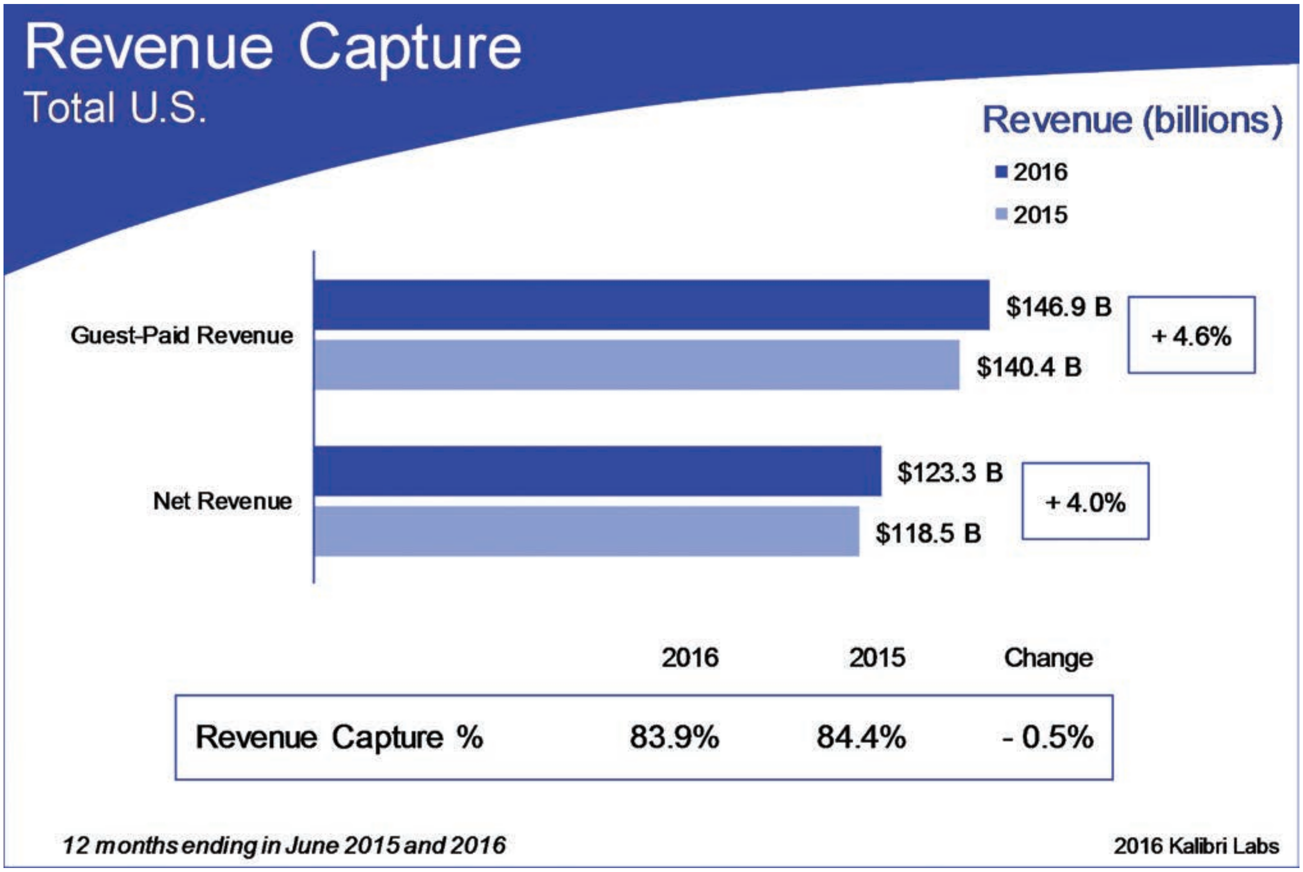
As the U.S. market is dominated by chain hotel companies, their brand loyalty programs seem to be at the heart of many acquisition strategies. Results from the recent wave of campaigns by most chains have proven that consumer behavior can be influenced by these member programs. For the first time in five years, Brand.com grew more quickly than OTAs corresponding with the introduction of Book Direct/Member Rate campaigns to the market. Additionally, the proportion of room nights booked by loyalty members is at an all-time high, well beyond the traditional strength in the business travel segment. In 2016, the incentive offered to prospective members was discounted rates which may have limited the profit contribution for the hotels in the short term with the longer term objective of engaging them as recurring customers. Incentives to book on Brand.com that do not incur direct costs would prove even more beneficial to hotels. Overall, Brand.com delivers higher Net ADRs for the hotels when compared to the Net ADRs they would receive through any other channel.

Acquiring guests through OTAs appears to be most effective during typical leisure periods. However, no hotel can expect to receive all their business through any one channel and learning optimization techniques to attract consumers through a mix of low-cost channels will always be the best path to higher profit contribution.

HIGHLIGHTS

- Revenue Capture, or the percentage of revenue hotels retain after all customer acquisition costs are paid, has declined from 84.4% in the 12 months ended June 2015 to 83.9% in the same period 2016. This represents $729 million that U.S. hotels could have retained and put towards operating expenses and improvements.
- The average range for customer acquisition costs is between 16%-18% of Guest Paid Revenue but many hotels still pay over 25%.
- Brand.com is approximately 20% of room night demand in the year ending June 2016. This compares to OTA at 12.4%, GDS at 9.5% and Voice at 8.1%. Group is 14.2% and Property Direct is 34.3%.
- Brand.com has a COPE ADR that is 27% higher than the OTA COPE ADR even when the costs of loyalty programs as well as discounts related to corporate and other negotiated rates are included.
- The OTA commissions paid by the U.S. industry have grown from 2014-2016 at three times the growth rate of Guest-Paid Revenue. Retail Commissions paid to non-OTA travel agents are growing at a similar rate to Guest-Paid Revenue.
- The proportion of business delivered by loyalty members has increased in all hotel types over the past three years. The Upper and Middle Tier hotels generate over 50% of their business from loyalty members and those figures have grown from 2014 to 2016 by 6.5% and 7.4% respectively. Lower Tier hotels have roughly 25% loyalty penetration in their business but grew that figure 17% from 2014 to 2016.





OVERALL INDUSTRY VIEW—SUMMARY OF FINDINGS

- Hotel-Collected ADR (or traditional ADR) growth during the current cycle, beginning in 2009, has been surprisingly low. ADR growth has been well below prior cycle peaks despite the strongest supply/demand relationship and the highest industry occupancies of the past 40 years.
- COPE Revenue is not growing as quickly as Guest-Paid Revenue or Hotel-Collected Revenue. Meaning that as consumer demand increases and as guests pay more, hotels are not always capturing that incremental value due to added customer acquisition costs. If hotels benefited proportionally from increases in revenue paid by guests then the growth in COPE Revenue would equal the growth in Guest-Paid Revenue.
- If COPE Revenue had only grown at the same rate as Guest Paid Revenue (4.6%) from 2015 to 2016 the industry would have retained approximately $440 million in incremental profit contribution. Over many years this "sieve effect" may undermine the hotels' ability to control the levers of customer acquisition.
- Industrywide, Revenue Capture, or the percentage of Guest-Paid Revenue that hotels retain after all customer acquisition costs are paid including Sales and Marketing expense, declined 0.5% from 2015 to 2016. If the Revenue Capture percentage had remained steady year over year, hotels would have retained $729 million more. This reflects in a $9 billion erosion of asset values (using an 8% capitalization rate). For every tenth of a point that Revenue Capture percentage declines, asset values are reduced by $1.8 billion.
- Bookings through the OTA, GDS and FIT/Wholesale channels (Indirect Sources of Business), are an increasing percentage of total transient bookings. The Transient Direct-to-Indirect Ratio measures the number of Direct Bookings, defined as bookings through Brand.com, Voice or Property Direct Sources of Business, for every one Indirect Booking. This ratio has declined from 4.3 in 2011 to 2.7 in 2016 meaning that in 2016 there were only 2.7 Direct Bookings for each Indirect Booking. This decline in Direct Bookings reflects the increasing market share of third-party intermediaries.
- Digital channels now account for 42% of total room nights. Growth in Brand.com, OTA and GDS comes at the expense of more traditional Sources of Business such as Property Direct and Voice.
- The difference between Guest-Paid and Hotel-Collected Revenue has grown to over $3.5 billion in the 12 months ending in June 2016. This difference is made up of Merchant (Net), Opaque and Wholesale commissions. Currently reported Hotel-Collected ADR numbers at the total U.S. level are understated by about $3 dollars and do not reflect actual customer spend as they do nor account for rates paid directly to third parties.

- The Brand.com room night share of the total U.S. market for the year ended June 2016 was 20.0% while OTA was 12.4%; GDS was 9.5%; Voice 8.1%; Group 14.2%; FIT 1.4%; and Property Direct was 34.3%.
- While OTA room night growth was most dramatic over the period of 2014 to 2016 at 28%, it was on a much smaller base than Brand.com which rose 9% while GDS gained 6.5%. Property Direct's decline was the largest at 12.8%. Modest changes were in Group with a 0.2% gain and FIT Wholesale with a 0.9% decline.
- The OTA business is dominated by Expedia and Priceline/ Booking.com with those two parent companies comprising roughly 96% of the OTA business in the U.S. The mix of business models within the OTA channel has shifted dramatically from 2014 to 2016. Opaque business has declined by almost 10% while the Retail models of Expedia Traveler Preference and Booking.com had the most significant increase of 108% and the Merchant (Net) model rising by 23.7%.

Costs

- Bookings made directly with the property or brand are more profitable than those made with an intermediary. Indirect bookings contain commissions in addition to channel fees and are likely to be discounted rates. As a percentage of Guest-Paid Revenue, OTA costs are approximately 2.5 times those of Brand.com.
- OTA commissions, other retail commissions, and loyalty fees are outpacing the growth rate of Guest-Paid Revenue. OTA commissions are growing at nearly 3 times the rate of Guest-Paid Revenue and 2 times the rate of loyalty fees. All customer acquisition costs have increased over the 2014-2016 period.
- As Indirect demand rises, there will be a negative and disproportionate impact on COPE Revenue due to the significantly higher costs associated with Indirect business.

Loyalty

Third party intermediary marketing budgets dwarf those of hotel brands with Expedia and Priceline reported as spending $6 billion in Google search alone. However, the penetration of hotel brand loyalty programs clearly convey a powerful value proposition to consumers. Hotel brands have a strong hold on certain segments of the market, such as business travel and government due to loyalty programs while OTAs dominate amongst non-loyal consumers buying leisure products.

The share of room nights associated with loyalty member bookings was over 50% for the Upper and Middle Tiers and about half that for the Lower Tier. The Tiers, discussed further below, break U.S. hotels into groupings based on their rate performance and business profiles. Growth rates for Brand.com loyalty penetration from 2014 to 2016 are strong within the Upper Upscale chain scale at 8.5%, followed by the Midscale and Upper Midscale chain scales at 7.6% and 7.4% respectively. The Economy chain scale had the strongest loyalty penetration growth, 32.6%, but was building on a smaller base at roughly half of the loyalty penetration of other chain scales.

HIGHLIGHTS BY TIER

This study examines three tiers of hotels grouped based on having similarity in their rate performance and business profiles. The **Upper Tier** contains the Luxury, Upper Upscale and Upscale chain scales, the **Middle Tier** contains the Upper Midscale chain scale and the **Lower Tier** contains the Midscale and Economy chain scale hotels.

The Direct-to-Indirect Ratio decline was more severe in the Middle and Lower Tier hotels largely due to the rapidly shrinking Property Direct Source of Business. Much of that business shifting away from Property Direct appears to be powering the OTA growth in those chain scales. The Upper Tier had a much smaller decline in its Direct-to-Indirect Ratio due to a smaller uptick in OTA business combined with a larger increase in Brand.com room night share.

Upper Tier
(Luxury, Upper Upscale and Upscale chain scales)

- From 2014 to 2016, Upper Tier properties managed costs better than those in the Middle and Lower Tiers with COPE ADR growth of 7.1%, which is only slightly less than Guest-Paid ADR growth of 7.4%. Growth was accomplished largely through a shift in the OTA channel from Opaque to Merchant and Retail along with a healthy increase in Brand.com.
- The COPE ADR for Brand.com is 11% higher than the COPE ADR for the OTA channel. The OTA COPE ADR improved almost 10% from 2014 to 2016 largely driven by a reduction in Opaque rates and improvement in the Merchant (Net) model rates; Brand.com rates improved 6.2% for the same period.
- In absolute terms, OTA and GDS COPE ADRs have performed relatively similarly over the past two years although OTA business is concentrated on the weekends while GDS business typically comes mid-week.
- Opaque OTA demand share dropped from 2014 to 2016 in the Upper Tier more sharply than the overall U.S. market, -24.7% compared to -9.6%. OTA Retail model

business, at 48.4% of OTA demand, grew at roughly half the rate of the U.S. as a whole. The Merchant (Net) model gained about 15.8% compared to the national average of 23.7%.

- In a close second to OTA room night share growth from 2014 to 2016 of 13.9%, Brand.com grew by a full 11.1% and on a much larger base with more than twice the beginning share compared to OTA.
- Within the Upper Tier, the Luxury chain scale shifted business to the OTA channel in a more pronounced way than the Upper Upscale and Upscale chain scales. For Luxury, the OTA Source of Business grew 2.3 points in room night share from 2014-2016 while Upper Upscale and Upscale grew only 1 and 1.4 points respectively.
- Although all chain scales in the Upper Tier had increases in their COPE ADR from 2014 to 2016, the growth was slowest for Luxury at 5.8% compared to 7.7% for Upper Upscale and 8.9% for Upscale.
- The COPE ADR for the Luxury chain scale was negatively impacted by a combination of a high proportion of OTA business, the room night share of which continues to grow, along with the costs associated with luxury consortia amenities, a cost category that mostly pertains to the Luxury chain scale.

Middle Tier
(Upper Midscale chain scale)

- COPE ADR growth was hampered compared to Guest-Paid ADR growth largely due to a shift from Property Direct to the OTA channel.
- Middle Tier COPE RevPAR growth of 3.2% from the 12 months ending in June 2015 compared to the same period in 2016 was stronger than that of the Upper Tier at 2.1% and of the Lower Tier at 3.1%. Growth can be partially attributed to increases in the COPE ADR of the Voice channel at 7.0% and of Brand.com at 6.7%. A limited growth in supply for the Middle Tier was also a contributor to improved occupancy, in turn driving stronger COPE RevPAR performance.
- Within the OTA Source of Business, the Middle Tier Opaque room night share declined by 17%, almost twice the industry-wide Opaque room night share drop, while the Opaque COPE ADR improved by over 12%. The Retail model COPE ADR declined by 0.5% and the Merchant (Net) model improved its COPE ADR by 7%. These shifts contributed favorably to the Middle Tier's COPE RevPAR performance.

Lower Tier
(Midscale and Economy chain scales)

- The Lower Tier had a similar but more dramatic shift than the Middle Tier from Property Direct to OTA bookings. This played out as a wide gap between the Guest-Paid Revenue growth and the COPE Revenue growth from 2014 to 2016. The decline in Property Direct room night share coupled with an increase in OTA and flat growth in Brand.com led to reduced ability to capture the value of increased Guest-Paid Revenue.
- The Midscale chain scale showed the strongest COPE RevPAR growth at 3.6%, from the 12 months ending June 2015 to the same period in 2016, of any chain scale in this analysis. The hotels in that chain scale grew COPE Revenue more efficiently than any other chain scale and managed to keep their acquisition costs more in line with rate improvement.
- The Economy chain scale, while it had the best improvement in Guest-Paid Revenue of all chain scales from 2014 to 2016, leads the industry in OTA growth at 44% over that same period. Additionally, it was the only chain scale that experienced share growth within the Opaque OTA model at 6.6% from 2014 to 2016; the industry as a whole showed a decline of 10%.
- In 2016, the Lower Tier had a premium of over 10% for Brand.com COPE ADR compared to OTA COPE ADR. This premium declined from the previous year's figure of closer to 15%. The GDS COPE ADR for the Lower Tier is 16% higher than that of the OTA COPE ADR, whereas for the Upper and Middle Tier hotels the GDS and OTA COPE ADRs are much more similar.

The following section will delve into the overall U.S. market performance in more detail as well as explore the specific performance of each of the Tiers described above.