November 10, 2003

The Billion Dollar Leak - The Impact of The Merchant Model on US Hotel Profits

By Bobby Bowers, SVP, and Jan D. Freitag, Director, Smith Travel Research

The impact of third party Internet sites on hotel reservations is the focus of intense debate in the hotel industry today. This article will attempt to quantify the financial impact of third party sites on U.S. hotel industry room revenues and profits. While many hotel operators believe these sites have a beneficial effect on their occupancy we feel it is important for hotel operators to identify the potential impact that third party Internet retailers can have on their revenues and more importantly, on profits. This article, we believe, can shed some light on this topic.

In the "merchant model" transaction, the hotel receives the net rate previously negotiated with the retailer. Guests booking rooms via third party sites pay the amount posted by the Internet retailer and do not know or care what percentage or dollar amount the hotel ultimately receives for the services. The Internet retailer keeps the difference between the consumer's final price and the hotel's net rate. The Internet retailer assumes no risk and incurs no cost if the allocated inventory goes unsold.

Based on the financial disclosures of publicly traded companies and STR's estimates of total industry revenues we have estimated the merchant model room revenue share of total online hotel sales. From there we then extrapolate an industry-wide merchant revenue figure commonly referred to as "leakage" (i.e. revenue "leaked" from the hotel industry to third party sites).

Total Merchant Model "Leakage" Figure:

PhoCusWright estimates that 49% of the $6.3 billion in online hotel sales in 2002 are generated by online travel agencies. 75% of this revenue is generated through the merchant model. Based on this data, total merchant model sales were estimated to be over $2.3 billion in 2002.

(all $ in millions)

2002		
Online Hotel Sales	100%	$ 6,300
Online Travel Agencies	49%	$ 3,087
Hotel Web Sites	51%	$ 3,213
Gross Merchant Model Sales as % of Online Agency Sales	75%	$ 2,315

Source: PhoCusWright

The $2.3 billion is gross merchant model revenue and requires adjustment for certain costs to reflect net proceeds from the merchant model. Based on publicly available information and industry research reports we derive a total industry merchant model leakage figure

Estimated Total Merchant Model Leakage

(in millions)

Year	2001	2002	2003E	2004E
Gross Merchant Model Sales	$ 917	$ 2,315	$ 3,375	$ 4,875
Total Leakage from the Merchant Model	$ 296	$ 676	$ 1,013	$ 1,314

Source: Smith Travel Research

We estimate that third party merchant sales leakage from the U.S. hotel industry was about $676 million in 2002 and that number is expected to increase to over $1 billion in 2003.

Hotel Industry Impact:

Despite recent difficulties in the U.S. hotel operating environment, the industry has been profitable for the last 10 years. The table below details industry revenues and profits for the last two years and our forecast for 2003:

Estimated US Hotel Industry Performance

(all $ in billions)

Year	2001	2002	2003E
Rooms Revenue	$ 79.6	$ 78.9	$ 81.3
Total Revenues	$ 103.5	$ 102.6	$ 106.5
Profits	$ 16.2	$ 14.2	$ 16.0

Source: Smith Travel Research

To appreciate the full financial impact of merchant model leakage, we have also estimated the impact on industry profits. In an article recently published by the investment bank Bear Stearns, the argument was made that an incremental dollar generated through an occupancy gain increases profits by $0.60 because of the increased variable costs associated with filling the room (e.g. labor, utilities, laundry, etc,). However, a dollar gained purely through an ADR increase flows to the profit line with only a 5% expense. Adding to this logic, it can be assumed that revenues leaked to third party sites if realized by hotel companies, would have almost completely impacted the bottom line. Revenue given up to third party sites can be considered "incremental" revenue to the hotel operator, i.e. dollars the guest actually paid that go to the third party site instead of the hotel. Based on these assumptions we estimate the potential profit impact of merchant model leakage as shown below:

Estimated US Hotel Industry Results and Leakage Percentage

US Hotel Industry Revenues (all $ in millions)			
Year	2001	2002	2003E
Industry Room Revenue	$ 79,600	$ 78,900	$ 81,300
Industry Profits	$ 16,200	$ 14,200	$ 16,000
Room Revenue Leakage	$ 296	$ 676	$ 1,013
Percent of Rooms Revenue	0.4%	0.9%	1.2%
Profit Leakage	$ 281	$ 642	$ 962
Percent of Industry Profits	1.7%	**4.5%**	**6.0%**

Source: Smith Travel Research

Given the industry room revenue figure in 2002 was $78.9 billion, the roughly $676 million in estimated leakage revenue equates to less than 1% of total room revenues, which may not seem much. However, applying the leakage figure to industry profits shows a different picture. The industry gave up an estimated 4.5% of profits by shifting pricing power to the Internet retailers. We assume that this number will likely increase, to around 6% in 2003.

Assuming the industry is poised for further recovery in 2004, the impact of the merchant model on industry profitability should not be underestimated. The primary argument of the third party merchants is that they help generate incremental bookings the hotel would have not captured without the help of this distribution channel. But hotel management should carefully evaluate the cost/value equation that third party retailers propose. By subscribing to the merchant model, hotel managers are shifting at least some of their pricing leverage to the third party sites. If lodging demand increases in 2004, there is potential for increased room rates. Hotel managers locked into wholesale arrangements may not fully benefit from rate increases which, in turn, can impact profitability. In most cases the amount of room inventory allocated to Internet merchants is probably relatively small. But, as we have tried to show on a macro level, leaked revenues can impact profits which then can impact owners' returns and company stock prices. Third party distribution sites have their place, hotel operators just have to make sure they understand the full implications of the collaboration.

Conclusion:

The figures presented here are based on a number of assumptions. However, the underlying fact is that the third party players are a force to be reckoned with and that their actions can impact hotel industry profitability. Every hotel operator should understand the costs and opportunities that third party merchant sites present. The third party sites are here to stay. Using them to form a mutually rewarding relationship is in the hotel operators' hands.

For more information please contact Smith Travel Research:

Bobby Bowers	Mr. Jan D. Freitag
Tel: 615-824-8664, x321	Tel: 615-824-8664, x352
bobby@smithtravelresearch.com	jan@smithtravelresearch.com

About Smith Travel Research:

Smith Travel Research is the recognized leader for US Lodging Industry benchmarking. For over 18 years, STR has collected monthly and daily operating data and reported on the state of the U.S. lodging industry, maintaining one of the world's largest lodging industry databases and publishing an array of valued industry research.

For more about STR and its services, visit the web site www.smithtravelresearch.com .