

Owners at Risk of Losing \$2.1B in Asset Value: An Analysis of the New Expedia Traveler Preference Program

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The new "Expedia Traveler Preference Program," is in the process of being rolled out. This new "retail model" will allow guests to pay the hotel at check out, as opposed to the current "merchant model" where guests pre-pay directly to Expedia. While the change in structure will not affect what the guest pays in rate, it could have a negative impact on US hotel ownership to the tune of \$2.1 billion in real estate value unless concessions by Expedia, brands and managers occur.

- **Expedia benefits by reducing its annual expenses by roughly \$50M.**
- **Management companies and brands will benefit from increased fees by \$81M.**
- **Consequently, hotel owners' profits will decrease by this same combined amount.**

The issue is not that Expedia is switching to a retail model; rather the controversy revolves around the fact that the new model increases the cost to a hotel to acquire the same business and that the entire burden of this added cost falls on ownership, while Expedia and the hotel brands and management companies (the two constituents that negotiated the agreement) benefit from the change. **A lower Expedia commission structure, more consistent with brick & mortar travel agents and/or manager and brand concessions would make this transition "cost neutral."** At this time, we understand that Expedia will not be altering the commission levels with the majority of properties, although it has reduced commissions with some of the large brands for its retail model. However, concessions are not sufficient to render the change "cost neutral."

--This new program will cost hotel owners up to an additional \$4.00¹ for every \$100.00 that goes through Expedia under the new retail model. Of this, \$2.20 will be shifted from Expedia to owners by way of credit card fees (or \$0.44 if a hotel already uses the Expedia credit card program), and the remaining \$1.80 will be remitted to operators and brands.

-- The new program could result in further hotel value erosion in a share shift from lower cost channels (including diversion of bookings from brand.com).

--- If brands and managers renegotiate similar agreements with the other merchant model agents, there will be further hotel value erosion.

¹ For the 62% of hotels that currently use the Expedia credit card program to expedite the collection of payment, the new program will cost hotel owners an additional \$2.24. Of this \$.44 will be shifted from Expedia to owners by way of additional credit card fees. This calculation is based on a hotel paying credit card fees on 80% of the rate net of Expedia commission, whereas hotels will now pay credit card fees on 100% of the rate. The remaining \$1.80 will be remitted to operators and brands.

--One rationale for a recent renegotiation of a new Expedia agreement claimed anti-trust risk to owners & managers (despite the argument that risk belongs to Expedia) and did not allow owners to weigh the impact of litigation risk versus value impairment.

The Analysis:

	Current Merchant Model	Future Retail Model
Description	-Guest pre-pays Expedia directly at the time of reservation. -Hotel invoices Expedia for payment. -Expedia pays Hotel less commission.	-Guest makes reservation on Expedia. -Guest pays hotel directly at check out. -Expedia invoices hotel for commission. -Hotel pays commission to Expedia.
Credit Card Fees for entire payment	- Paid by Expedia - For the 62% of hotels that participate in the Expedia credit card program (to expedite payment), the hotel pays fees on 80% of rate which is net of Expedia commission.	- Paid by Hotel
How is Expedia revenue recorded at Hotel?	Rooms Revenue is recorded at the hotel net of commission. <u>Example:</u> If rate is \$100 and Expedia commission is 20%, then the hotel records \$80 of rooms revenue.	Rooms Revenue is recorded at the hotel and the Expedia commission is a Rooms expense. <u>Example:</u> If rate is \$100 and Expedia commission is 20%, the hotel records \$100 of revenue and \$20 is in the commission line item under the Rooms department expenses.
Affect of Fees (Management, Brand and Marketing)	In the example above, the hotel pays its brand, manager and other variable fees on \$80 of revenue recorded at hotel level.	In the example above, the hotel pays its brand, manager and other variable fees on \$100 of revenue recorded at hotel level.

For this analysis, we assume 70% of Expedia US Hotel Room Revenue could be affected by the new Traveler Preference program. This excludes Advance Purchase, Packages and Opaque which will remain in the Merchant model and transactions already in the Retail model. Of the revenue that could potentially be affected, we assume 90% will switch from the Merchant model to the Retail model. While Expedia is initially offering a choice to guests, excluding advanced purchase products, there is no incentive for a guest to pre-pay via the Merchant model. The following analysis assumes no change to the commission rate paid to Expedia.

Assumptions	
Current Average Expedia Merchant Model Commission Across all Properties	20.0%
Credit Card Fees**	2.2%
Mgmt /Brand/ Marketing Fees*	9.0%
*Weighted Average between Independent and Branded Properties	
** Source: PKF	

TOTAL US Expedia Rooms Revenue via Merchant Model	
2012E Gross Expedia US HOTEL REVENUE*	\$7,202,000,000
% of US Expedia Hotel Rooms Revenue that could be affected by new program** (excludes Advance Purchase, Package, Opaque, and Retail)	70%
% of US Expedia Hotel Rooms Revenue that could be affected and will switch from Merchant Model to Retail Model**	90%
ESTIMATED TOTAL US EXPEDIA ROOMS REVENUE via MERCHANT MODEL**	\$4,537,260,000
*Source: Morgan Stanley Research October 8, 2012 (based on Expedia stating 5% share of Total US hotel revenue)	
**Unsupported estimate by hotelAVE as Expedia does not provide this data point	

Hotel Type	% of US Room Supply	Fees (as a % of Gross Operating Revenue)	Total Fees (as a % of Gross Operating Revenue)	Weighted Average
Independent	31.2%	Management Fees 3% Marketing Fees 1.5%	4.5%	1.4%
Branded	68.8%	Management Fees 3% Brand Fees= 3% Marketing Fees= 5%	11%	7.6%
Total Weighted Average of Mgmt/Brand/Marketing Fees				9.0%

Estimated Additional Fees based on new Expedia Traveler Preference Program	
Estimated Additional Credit Card Fees for Hotel (Based of Total US EXPEDIA Rooms Revenue- as hotel currently does not pay CC fees on Expedia bookings)***	\$50,309,139
Estimated Additional Mgmt /Brand/Marketing Fees (based only on change from net to gross revenue which is equal to the commission)	\$81,416,593
TOTAL ESTIMATED IMPACT on NOI assuming Expedia Commission is Unchanged	\$131,725,732
*** This calculation takes into consideration 62% of hotels participate in the Expedia credit card program. Note that these hotels are paying credit card fees on 80% of net revenue paid to property, whereas under the new program, the 62% of hotels will be now paying credit card fees on 100% of revenue.	

Total Estimated Effect on US Hotel Real Estate Value (based on 8% Cap Rate*) taking 4% FF&E Reserve into consideration	\$2,100,297,654
*Source: Based on 2010 and 2011 Hotel Transaction Cap Rate captured by RCA	

Total Estimated Effect on US Hotel Real Estate Value (in 000,000's) (based on 8% Cap Rate) taking 4% FF&E Reserve into consideration							
* Data points not provided by Expedia							
		% of US Expedia Hotel Rooms Revenue that could be affected by Expedia Traveler Preference Program (Excludes Advance Purchase, Package, Opaque, and Retail)					
		50%	60%	70%	80%	90%	100%
% of US Expedia Hotel Rooms Revenue that could be affected and will switch from Merchant Model to Retail Model under Expedia Traveler Preference Program	50%	\$ 833	\$ 1,000	\$ 1,167	\$ 1,334	\$ 1,500	\$ 1,667
	60%	\$ 1,000	\$ 1,200	\$ 1,400	\$ 1,600	\$ 1,800	\$ 2,000
	70%	\$ 1,167	\$ 1,400	\$ 1,634	\$ 1,867	\$ 2,100	\$ 2,334
	80%	\$ 1,334	\$ 1,600	\$ 1,867	\$ 2,134	\$ 2,400	\$ 2,667
	90%	\$ 1,500	\$ 1,800	\$ 2,100	\$ 2,400	\$ 2,700	\$ 3,000
	100%	\$ 1,667	\$ 2,000	\$ 2,334	\$ 2,667	\$ 3,000	\$ 3,334

To calculate a hotel's individual economic impact, we recommend contacting www.hamagroup.org to request its Merchant-to-Retail Cost Calculator Model.

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