HAS INNOVATION BECOME A ROUTINE PRACTICE THAT ENABLES COMPANIES TO STAY AHEAD OF THE COMPETITION IN THE TRAVEL INDUSTRY?

by Martin Brackenbury
President of the International Federation of Tour Operators,
Chairman of the World Tourism Organisation Business Council
Chairman of the Federation of Tour Operators (UK)

Abstract

Innovation is at the heart of any successful company's agenda so it is very worthy of discussion on the role that innovation plays in securing competitiveness. This paper attempts to examine the ways in which tour operators – that is to say the assemblers of packages of travel and accommodation – have approached the issue of innovation and competitiveness. It also reviews, in particular, the fully vertically integrated groups involving travel agents, tour operators, airlines, incoming tour operating ground handlers, and accommodation (hotels, apartments and cruise ships). In addition this paper focuses on practical, structural and operational issues encountered by companies competing in this part of the tourism sector.

Innovation and Economic Growth

Why has capitalism produced economic growth that so much exceeds that which has been achieved through other systems? Is it simply that price competition drives down the costs of goods and services and these are then passed on as lower prices to consumers?

The answer is clear. Price is not sufficient. None of us would buy a new car that was designed 30 years ago, such as a Trabant, whatever the price. New products have emerged to better satisfy the needs of current consumers. Cars that are faster, safer, more reliable, more comfortable, more economical and less polluting. In addition cars are designed as emotional and social purchases as well as functional tools. People identify themselves with their cars, as they do with their clothes, shoes, hairstyles, and holidays.

Without new products that better satisfy current emotional, social and practical needs companies will die. As a rule of thumb, companies in any sector that fail to replace 10% of their revenue stream annually through innovative new products are likely to be out of business in five years, unless they are simply suppliers of products like cement.

If new products are important for economic growth and survival, what about processes? Companies that have survived have managed to be profitable despite relentless price competition. To achieve this requires a complete re-examination of all processes, structures and product components from sub-contracted suppliers. These transformations are not achieved without significant, if sometimes virtually invisible innovation, at least to the consumer.

As might be expected innovation has been researched by a number of distinguished academics. William Baumol stresses that large firms use innovation as a competitive weapon, a compound of systematic innovative activity within the firm. However, innovation carries with it significant risks. We tend to remember the individuals who have been singularly successful at creating new economic and intellectual wealth for the rest of us to enjoy. Unfortunately many innovations fail.

Carl Franklin in his book 'why innovation fails' quotes a study by three academics – Donald Lehmann, Jacob Goldenberg and David Mazursky – in which they looked at 197 product innovations of which 111 were successes and 86 were failures.

What they found was that the successful innovations had some, or all of the following features:

– They were moderately new to the market.

– They were based on tried and tested technology.

– They saved money.

– They met customers' needs.

– They supported existing practices.

The products that failed:

– Were based on cutting-edge or untested technology.

– Were created with no defined solution in mind.

– Followed a 'me-too' approach.

What is interesting is their list of 'Idea Factors' establishing where the ideas for the innovation came from and how they determined the success or otherwise of the ensuing innovation. All of which I have encountered in the tourism sector.

They categorised these 'idea factors' as:

– Market research.

– Trend following.

– Need spotting – looking for an answer to a known problem.

– Solution spotting – Finding a new way of using an existing piece of technology, such as computers and lasers.

– Mental inventions.

– Random events – innovators stumbling upon something of significance.

They then plotted the success to failure rates of the six different idea factors. The two worst were 'trend following' and 'mental inventions' (three times as many failures as successes). 'Need spotting' and 'solution spotting' produced twice as many successes as failures. 'Market research' produced four times more successes than failures. However the winner was 'Random events' which produced 13 more successes than failures.

It seems that firms face a dilemma – they must innovate or they die but to innovate they run a considerable risk of failure.

William Baumol notes that firms faced with costly innovations that might well be rendered obsolete by their competitors participate in technology sharing arrangements and licenses thus making innovation a routine feature of economic life.

Clearly the competition authorities need to be convinced that such arrangements are not going to be used to create market power and thus artificially raise prices to consumers. Baumol considers that this mechanism of collaboration helps to account for the unparalleled growth of modern capitalist economies, enabling firms to come far closer to economic efficiency than is typically understood.

So what evidence do we find of innovation in products and processes in the larger leisure travel groups in Europe in particular and in travel agents (tour operators / airline / accommodation / hotels / apartments and cruise ships)?

Background

Before doing so, some background is necessary. Vertical integration and consolidation began among tour operators in the 1960s in the UK when Riviera, Luxitours and Gaytours were consolidated into Thomson Holidays. Since then Tour Operator Brands have been acquired, often retaining their original identity, sometimes being absorbed and re-branded. The same process occurred in Germany, the Scandinavian and Benelux countries, France, Italy and Spain.

Figure 1. Clear European market leadership

Source: TUI.

Europe now has six very large companies TUI (Germany), Thomas Cook (Germany), Rewe + LTU (Germany), MyTravel (UK), First Choice (UK), Kuoni (Switzerland). (Figure 1.)

TUI is by far the biggest, with 22 milion customers, 81 brands, 89 aircraft, 3 715 travel agents and 287 hotels (with 153 000 beds) and 32 incoming agencies. (Figure 2)

Figure 2. Vertical integration

Source: TUI.

What, you might ask, has happened to the small independent tour operators? In Sweden there are virtually none, however in the United Kingdom the number of licensed tour operators continues to grow (currently 1 440). These companies can thrive and prosper in highly differentiated market niches. It does appear that where there are customers with highly differentiated requirements (*e.g.* birdwatching, walking and sailing) the tour operators appear in order to satisfy that need. This suggests that barriers to entry are low and they are. However the economic model for the small independent tour operator (low risk, low commitment, highly flexible) is completely different from that of the large, fully integrated groups. (Higher risk, high commitments, very limited flexibility within any seasonal time frame.)

Within IACA in Europe, there are 771 charter aircraft operated by 26 companies some of which are fully integrated flying divisions of the major companies. These charter companies operate very highly fuel efficient, modern fleets (average 4.5 years old) and operate very intensively (circa 4 200 hours per year) at very high load factors (90%+). The charter fleets have been the original low cost carriers. In 2002 they operated more that 1 million flights to 561 airports world-wide and carried 118 milion passengers and have been instrumental in opening up originating markets – through the use of local airports – flying direct to holiday destinations. The major tour operators typically have in-house fleets that account for around 80% of their production – the rest comes from other airline suppliers. These charters and the low cost (no frills) carriers have operating costs that are around 50% of the main network scheduled carriers, and this is reflected in prices charged to consumers. [Note that these operating costs exclude any contentious contributions from airports.]

The tour operators sell their products (packages – flights, accommodation and transfers – or individual elements) either directly (Direct mail, Internet) or through travel agents. The major companies have their owned distribution channels but still depend upon independent travel agents for some of their distribution. The structure of their distribution varies from national market to national market (Sweden is almost all direct) while the United Kingdom is about 60-40 in favour of travel agent distribution. In no European market does the Internet account for more than 10% of package holiday sales. [Note the low cost carriers sell more than 80% online.]

Customers from each country have different needs and perceptions as does each segment within a country. European homogenisation has not occurred. Markets have continued to be national and idiosyncratic. It is this fact above all others that make destination suppliers – hotels and other accommodation owners – make use of tour operators. The tour operators know their customers.

At the simplest, broadest level there are very marked differences in preferred accommodation types. In Scandinavia about 90% prefer apartments to hotels, in Germany 80% prefer hotels to apartments; in the United Kingdom it is about 50/50. Note that Turkey – a key non-EU competitor has decided to invest almost 100% in hotels – thus cutting themselves off from half the market. Not surprisingly, they do particularly well from Germany.

In the early 1980s there were initially no hotel chains in the leisure sector of any size. Since then a number of independent resort chain hotels have emerged, mostly through acquisition, but also from direct investment or franchising. The most obvious example has been Sol Melia based in Mallorca. The major integrated groups have also entered the hotel sector. First Choice with Barcelo, MyTravel with the Sunving Group, TUI with hotels branded for different segments.

However, typically, owned hotels do not account for more than 10-15% of their capacity. The other 85-90% of hotel capacity is provided through contracts with thousands of independent hotels and other accommodation suppliers.

More recently some of the major operators have decided to acquire their own local ground-handling agents in the destination, to provide transfers and excursions. For the most part these are contracted out to a plethora of local suppliers.

Motivations for consolidation and vertical integration

As a small operator it is possible to grow at a very rapid rate for a limited period. Then, as the overall market is growing relatively slowly further growth is manifestly at the expense of other tour operators. A customer that would have gone with company A is induced to go with company B. Competitive responses, generally to the advantage of consumers, through lower prices, mean that the growth of the individual firm is then constrained. (Although overall growth in the market is likely to have been accelerated through price competition). One option for shareholders is merger or acquisition to secure continuing growth.

Of course, along the way many difficult and important decisions are encountered within the business.

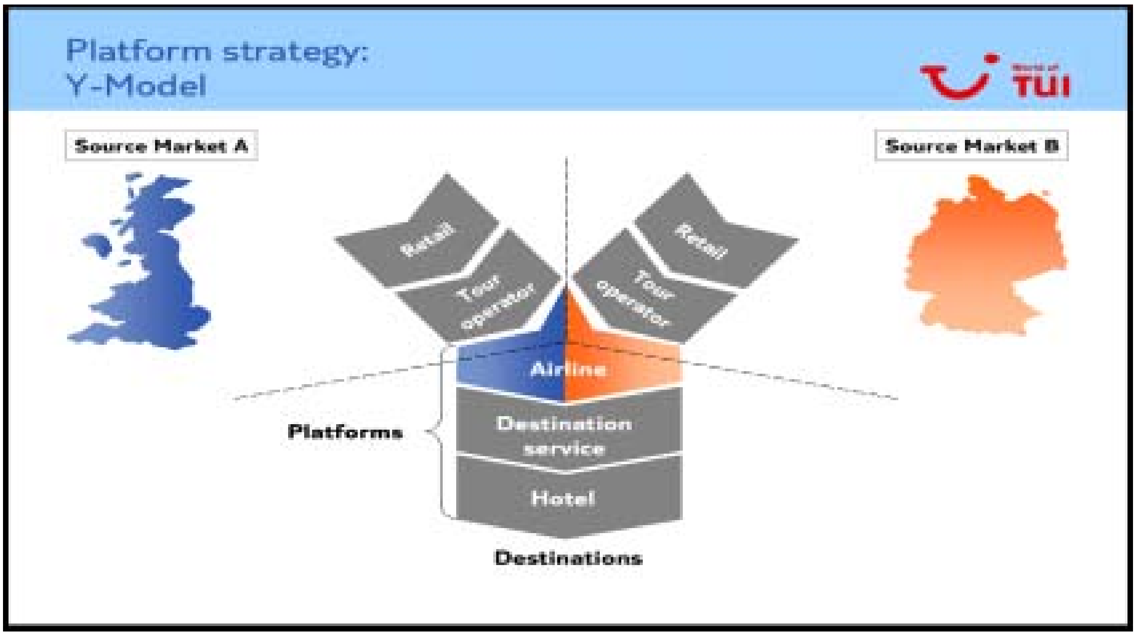
For example, when a tour operator reaches a certain size the lack of a guaranteed supply of charter seats leads to the question of whether starting their own charter airline would be a good idea. The problem is that a guaranteed source of supply of seats, and the quantum of profit per passenger to go with them, has the consequence that the risk of not filling the aeroplane and not being able to pay the leaser lies with the tour operator.

The clincher in favour of starting a charter airline is the extra profit – the rationalisation of the extra risk incurred is made through saying that seats were already committed before but no extra profit accrued.

So capturing the profit and exercising control are key motivations. Control over distribution through both travel agents and direct to consumers. And control of airline seats and (to some extent) beds and incoming agencies.

To illustrate this TUI have, what they call, the 'Platform Strategy Y-Model'. (Figure 3)

Figure 3. Platform strategy: Y-Model



Source: TUI.

This is a useful description for showing how source markets are managed separately. Then synergies are created by using three platforms – airline / destination service / hotel.

The opportunity is to guarantee quality, to create synergies and to create a masterbrand as a basis for group identification.

The results of consolidation and vertical integration

For consumers

Consolidation and vertical integration have brought about lower costs – particularly in the airline sector, but to some extent through higher productivity throughout the entire value chain. The ferocious competition in the sector has ensured that consumers have captured most of these lower costs in lower prices.

Consistency of quality delivery has also improved so that customers can depend upon the promises made being delivered. Choice has been increased as tour operators seek to offer a wide and innovative selection of holidays to consumers.

For companies

The large companies thought that by growing geographically and integrating vertically risks would be less and profits would be larger. Smaller tour operators thought that they would be unable to compete with the large companies because of their buyer power and through effective exclusion from distribution channels.

Currently, the picture looks very different. The large companies have in-built inflexibilities, particularly on the airline side and have found it difficult to react to recent circumstances. Smaller companies have been swift to react and flexible in their response. As a result all the very large companies have had to announce significant adjustments to profit expectation over the past 18 months. There is no evidence among the large tour operators of market power, *i.e.* the ability to raise prices to consumers and make unwarranted profits.

For suppliers

The ferocious competition in the source markets / originating countries has led to significant pressure on all parts of the value chain to deliver quality at lower prices. Wherever there is an excess supply of beds prices have been adjusted downwards. Where beds have been in short supply the response of the hoteliers has been either to raise prices - thus risking uncompetitive prices – or, they have sought to move the risk of filling the hotel to the tour operator. Or, in some cases, they have sought a mixture of the two. Some accommodation owners have updated their products making them much more desirable and competitive.

The contribution of innovation to survival and success

Within Europe the large integrated tour operators have depended upon technological innovation, apart from the social innovation of paid holidays. The main technological advances were the advent of highly reliable and economical commercial jet aeroplanes for short haul travel, particularly Boeing 737s. Long haul travel became accessible to consumers after twin-engined aeroplanes were considered so reliable that they could fly over water for extended periods. This brought prices down significantly for example to the Caribbean from Europe for medium-sized aircraft (Boeing 757s & 767s). Further technological developments have delivered efficiency gains in aviation so that prices have fallen and are expected to fall further. The other main external developments have been the huge technological advances in telecommunication and computers. Without clever applications within companies there would be no way of keeping track of millions of transactions and pieces of information at a reasonable cost. The Internet has passed power to consumers – the transparency of comparative prices and information – and is likely to reduce the profitability of the sector over time.

Innovations have occurred in company structures primarily to take cost out of the business, as illustrated with the TUI structure.

Attempts at collaboration have been explored in distribution, computer systems and aviation as well as on health and safety and the development of tools for sustainable development.

Dr. Frenzel, the CEO of TUI argued recently in Vilamoura at the WTTC Tourism Summit that the middle market ground (hitherto the main market for tour operators) – concerned with quality and reassurance, at a price, is giving way to a degree of polarisation: The highly price sensitive and the affluent catered for through niche products. In addition the wish of consumers to assemble their own package had increased significantly and plans were well advanced to enable consumers to fulfil their wishes. In his view the classical tour operator is set to disappear.

What these examples illustrate is that, just as Baumol argues, innovation in products and processes is a routine part of economic life within companies, particularly those subject to ferocious competition as encountered in the vertically integrated tourism businesses upon which I have focussed. However, because these businesses are not high-tech the scope for innovation is rather limited and easily copied. Is that why price competition and its consequences of productivity improvement and not product innovation, has occupied the minds of senior managers in this sector over the past ten years? Perhaps Dr. Frenzel is going to change all that.

But how much innovation has there really been in the sector that is visible and going to influence the consumer? Comparing brochures of Mediterranean sun and beach offers of 20 years ago – the language used is different now, the photos more honest but what about the experience? The airport experience is definitely much worse. On arrival, the hotel or apartment is likely to offer much more consistent quality now. Returning to the destination, of the things to see, do or buy little has changed, maybe more restaurants, discos, opportunities for sailing and diving but no real changes to the complementary offer. The same is true for skiing destinations – although snowboarding has been introduced.

We have seen successful niche products to suit the purpose of the tourism experience – sun and sea, to sail, to be entertained, to learn, to walk, to trek, to climb, to visit people, to rest and relax, to play games, to eat and drink, excitement and so on. The products offer different levels of quality/comfort and exclusivity. They cater for singles/couples/families – single families, young families, families with teenagers – offering special facilities for each category.

With this background it is perhaps not surprising that tour operators seek out new destinations in the developing world providing that they are safe. Increased variety is attractive to consumers – as well as lower prices. However travel agents and tour operators would like to see more innovation in the destinations. To that end the WTO Business Council is to organise a study on innovation. Looking not just at IT entrepreneurship and capacity building, but also into the processes of public/private partnerships and collaboration that are necessary to engage these actors and secure the innovations. What opportunities are there for improvements to productivity? – clearly more limited than in some other sectors. Higher levels of performance and technical skills are one resource – but once trained the hospitality sector tends to lose many staff to other sectors for higher pay. Another more promising area is in energy production and usage. We will see continuing cost reductions from aircraft purchases and operating costs – but those benefit long haul more than short haul traffic. Improving the travel experience through airports is critical as this is already constraining the willingness of people making short breaks. The terrorism threat has made a bad situation that much worse. To help regain consumer confidence we certainly need innovative solutions to contain terrorism not only at airports and in the air, but also in ground transportation, hotels, historic sites and wherever tourists congregate. Very little has been done to improve the awful experience at wonderful historic sites – much can be done through technology and good management. Tourism is uniquely vulnerable to terrorism. A low cost small terrorist act can lead to worldwide publicity, disrupt an economy and a regime, and kill infidels without any risk to the perpetrators.

In conclusion, we need innovation and we definitely need active public/private dialogue to find joint solutions.