# CHAPTER 5. HAS INNOVATION BECOME A ROUTINE PRACTICE THAT ENABLES COMPANIES TO STAY AHEAD OF THE COMPETITION IN THE TRAVEL INDUSTRY?

This text has been drafted by Martin Brackenbury, Former President of the International Federation of Tour Operators (United Kingdom).

## Abstract

Since innovation is at the heart of any successful company's agenda its role in ensuring competitiveness deserves our full attention. This paper attempts to examine the ways in which tour operators, who assemble packages that include travel and accommodation, approach innovation and competitiveness. It looks in particular at groups which have achieved the complete vertical integration of travel agents, tour operators, airlines, incoming tour operating ground handlers, and accommodation including hotels, apartments and cruise ships. In addition it focuses on the practical, structural and operational challenges faced by companies competing in this sector of tourism.

## Innovation and Economic Growth

Why has capitalism produced economic growth that is so much greater than can be achieved through other systems? Is it simply that price competition drives down the cost of goods and services and the savings is passed on to consumers as lower prices?

The answer is a clear "no". Price is not a sufficient explanation. No one 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. Moreover cars are not just functional tools. They also meet emotional and social needs. People identify themselves with their cars in the same way as they do with their clothes, shoes, hairstyles, and holidays.

Companies that do not produce new products that better satisfy emotional and social as well as practical needs will disappear. As a general rule companies in any sector that fail to replace 10 per cent of their revenue stream annually with



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innovative new products will go out of business in five years, unless they are suppliers of simple products like cement.

If new products are important for economic growth and survival, what about processes? The companies that survive are those that manage 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 innovation, which may at times be virtually invisible, at least to the consumer.

As might be expected innovation has been researched by a number of distinguished academics. William Baumol[39] stresses that large companies rely on systematic innovative activity within the firm as a competitive weapon. However, innovation carries with it significant risks. We tend only to remember the individuals who have been singularly successful at creating new economic and intellectual wealth for the rest of us to enjoy. The sad fact is that many innovations fail.

Carl Franklin in his book, '*Why innovation fails*'[40], 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 only moderately new to the market.
- They were based on tried and tested technology.
- They saved money.
- They met customers' needs.
- They supported existing practices.

39. BAUMOL, William J. (2002) *The Free-Market Innovation Machine:Analyzing the Growth Miracle of Capitalism*. Priceton University Press.

40. FRANKLIN Carl (2005) Why Innovation Fails: Hard-won Lessons For Business. Spiro Press.

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.

Particularly interesting is their list of ‘Idea Factors’[41] establishing where the ideas for the innovations came from and how they determined the success or otherwise of the ensuing products. I have seen all of these factors at work 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 lowest success rates went to ‘trend following’ and ‘mental inventions’ with 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. The winner was ‘random events’ which produced 13 more successes than failures.

41. GOLDENBERG Jacob, LEHMANN Donald R., MAZURSKY David (2001) *The Idea Itself and the Circumstances of Its Emergence as Predictors of New Product Success.* Management Science Volume 47, Issue 1, pp. 69 – 84.

It seems that firms face a dilemma – they must innovate or perish. But by innovating 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 and licensing arrangements. Innovation thus becomes 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 feels 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 often understood.

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

**Background**

Before answering this question, some background information 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.

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

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

What, you might ask, has happened to the small independent tour operator? In Sweden there are virtually none, while 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.* bird watching, walking or sailing) tour operators arrive on the scene to satisfy that need. This suggests that barriers to entry are low, and indeed they are. However the economic model for the small independent tour operator (low risk, low commitment, high flexibility) is completely different from that of the large, fully integrated group (higher risk, high commitment, very limited flexibility within any seasonal time frame).

According to the International Air Transport Association (IATA) there are 771 charter aircraft in Europe operated by 26 companies some of which are fully integrated flying divisions of the major companies. These charter companies operate modern fleets (average age 4.5 years) with very high fuel efficiency, at high intensity (circa 4 200 hours per year) and with very high load factors (>90 per cent). Charter fleets were the first low cost carriers. In 2002 they operated more that 1 million flights to 561 airports worldwide and carried 1 18 million passengers. They have been instrumental in opening up originating source 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 per cent of their production, with the rest supplied by other airlines. These charters and the low cost (no frills) carriers have operating costs that are roughly half those of the main network scheduled carriers, and this is reflected in the prices charged to consumers. It should be noted that these operating costs exclude any contentious contributions from airports.

The tour operators sell their products in packages – flights, accommodation and transfers – or as individual elements, either directly via direct mail and the Internet or through travel agents. Although the major companies have their own distribution channels they still rely on independent travel agents for part of their distribution. The structure of this distribution varies from one national market to another. For example Sweden is almost all-direct selling while the United Kingdom is about 60 per cent through travel agents. In no European market does the Internet account for more than 10 per cent of package holiday sales. It is worth noting that low cost carriers sell more than 80 per cent online.

Needs and perceptions differ not only from country to country but from one market segment to another within a given country. There has been no European homogenisation -- markets have remained national and idiosyncratic. It is for this reason above all that suppliers in destinations, such as hotels and other types of accommodation use tour operators, who know their customers.

At the most basic level one can see marked differences in accommodation preferences. In Scandinavia about 90 per cent prefer apartments to hotels, while in Germany 80 per cent prefer hotels to apartments and in the United Kingdom the



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ratio is about 50/50. It is interesting to note that Turkey, a key non-EU competitor, has decided to invest almost 100 per cent in hotels – thus cutting itself off from half the market. Not surprisingly, it does a brisk trade with Germany in this context.

In the early 1980s there were no sizeable hotel chains in the leisure sector. Since then a number of independent resort hotel chains have emerged, mostly through take-overs, but also by direct investment or franchising. The most obvious example is Sol Melia based in Mallorca.

The major integrated groups have also entered the hotel sector. First Choice with Barcelo, MyTravel with the Sunving spelling Group, and TUI with hotels branded for different segments. However in most cases owned hotels do not account for more than 10-15 per cent of the capacity of these groups. Thus 85-90 per cent 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**

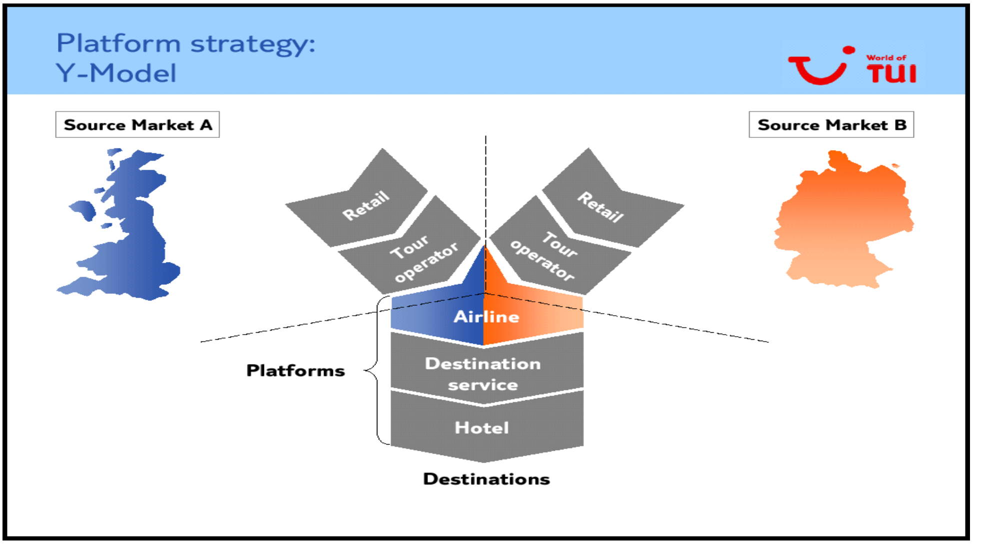
Small operators can grow at a very rapid rate for a limited period. Subsequently, since the overall market is growing relatively slowly any additional growth must be at the expense of other tour operators. A customer that would have opted for company A is induced to choose company B. An individual firm's ability to grow will be limited by competitive responses, which are generally to the advantage of consumers since they take the form of price reductions. This competition on price does however tend to accelerate overall growth in the market. Shareholders who wish to ensure continuous growth can always resort to mergers and/or acquisitions.

The road to growth involves many difficult and important decisions along the way. For example, when a tour operator reaches a certain size the lack of a guaranteed supply of charter seats raises the question of starting its own charter airline. The problem is that this solution means that the risk of not filling enough seats and thus not being able to pay the leaser lies with the tour operator.

So capturing the profit and exercising control are key motivations -- control over distribution through both travel agents and selling 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 4.1).

**Figure 4.1. Platform strategy: Y-Model**




*Source*: TUI.

This shows how source markets can be managed separately, creating synergies by using three platforms: the airline, destination service and the hotel.

This is an opportunity to guarantee quality, create synergies and develop a master brand 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. To some extent this has been the result of higher productivity across the entire value chain. Fierce competition in this sector has ensured that most of the cost savings has been passed on to consumers in the form of lower prices.



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Quality consistency has also improved. Customers can depend upon the promises made being fulfilled. Choice has been increased as tour operators seek to offer a wide range of innovative holidays to consumers.

### *For companies*

The larger companies thought that by growing geographically and integrating vertically they would reduce risks and increase profits. Smaller tour operators feared that the purchasing power of the larger companies and their own effective exclusion from distribution channels would make it impossible to compete.

The actual picture looks very different however. The larger companies have an in-built lack of flexibility, particularly on the airline side, and have found it difficult to cope with new circumstances. The smaller companies in contrast have been rapid and flexible in their responses. As a result all the major companies have had to significantly downgrade profit expectations over the past 18 months. There is no evidence that the biggest tour operators are able to wield market power, *i.e.* to raise prices and make unwarranted profits.

### *For suppliers*

Fierce competition in the source markets in the 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 hoteliers has been either to raise prices, at the risk of being uncompetitive, or an attempt to pass the risk of filling beds to the tour operator. Some hoteliers have combined these two approaches. In some cases accommodation owners have significantly updated their products to make them more desirable and competitive.

## The contribution of innovation to survival and success

Leaving aside the social innovation of paid holidays, Europe’s main integrated tour operators have relied on technological innovation for success. One of the main technological advances has been the advent of highly reliable and economical commercial jet aeroplanes for short haul travel, particularly Boeing 737s. Long haul flights became attractive once twin-engined planes demonstrated their ability to fly reliably across the seas for extended periods to overcome seasonality. These innovations reduced prices significantly, for example to the Caribbean from Europe with medium-sized aircraft (Boeing 757s & 767s). Further technological improvements in the efficiency of air travel are continuing to bring prices down. The



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other main external developments have been the huge technological advances in telecommunications and computers. Thanks to intelligent applications by certain companies based on this new technology it is now possible to keep track of millions of transactions and pieces of information at a reasonable cost. The Internet has allowed comparison of prices and information thus increasing transparency and transferring power to consumers, a development which is likely to reduce the sector's profitability over time.

Innovations in company structures have been aimed primarily at eliminating costs, as illustrated by the TUI structure.

There have been attempts to collaborate at the level of distribution, computer systems, air travel, health and safety and tools for sustainable development.

It has been argued at a recent World Travel and Tourism Council' Summit that polarisation is occurring in the middle market, which has so far been the main market for tour operators concerned with quality: a highly price sensitive segment on the one hand and on the other affluent clients for whom niche products must be developed. In addition he noted a significant increase in the desire of consumers to assemble their own package. Plans that will enable them to do just that are already at an advanced stage. In his view the classical tour operator is set to disappear.

As with Baumol[42] these examples show that innovation in products and processes is a routine part of corporate practice, particularly in the case of the vertically integrated tourism concerns and the companies that face fierce competition on which I have focused my attention. However, since these are not high-tech businesses the scope for innovation is rather limited and in any case the innovations are easy to copy. Is that why price competition and its impact on productivity has been the main concern of management in this sector for the past ten years, rather than product innovation?

But how much visible innovation capable of influencing the consumer has there really been in this sector? If one compares the brochures advertising Mediterranean beach holidays 20 years ago with those of today, it is immediately clear that the language is not the same and the photos are more honest... but what about the experience itself? Although the airport experience is definitely worse, on arrival at the hotel or apartment one can be more certain of consistent quality today. As for the destination, little has changed when it comes to the things to see and do or buy.

42. BAUMOL William, op.cit.



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There may be more restaurants and discos or opportunities for sailing and diving, but there is no real change at the level of such complementary products and services. The same can be said of skiing destinations, despite the introduction of snowboarding.

So clearly successful niche products have been developed to provide a satisfying tourism experience enjoying sun and sea, sailing, being entertained, learning, strolling, trekking, climbing, visiting people, resting and relaxing, playing games, eating and drinking, finding new thrills and excitement and so on. The products offer different levels of quality and comfort as well as exclusivity. They offer special facilities for different categories: singles, couples, families, and in the latter case for single families, young families or families with teenagers.

It is perhaps not surprising in such circumstances that tour operators look for new destinations in the developing world, which must of course offer the required level of safety. Increased variety together with lower prices is a sure way to attract consumers. Travel agents and tour operators however would like to see more innovation in destinations. To that end the Business Council of the World Tourism Organization is planning a new study on innovation. As well as entrepreneurship in information technology and capacity building, it will also look at public/private partnerships and other forms of collaboration necessary to engage these actors and secure the innovations.

What opportunities are there for improving productivity in tourism? Clearly they are fewer than in certain other sectors of the economy. Improving performance and technical skills through training is one possibility, but the hospitality sector tends to lose newly trained staff to other sectors offering lure higher rates of pay. A more promising area is the production and use of energy in tourism. We will no doubt continue to see reductions costs for aircraft purchases and operating costs – but these will benefit long haul rather than short haul traffic. Improving the travel experience at airports is critical as this is already affecting people’s willingness to take short breaks. The terrorism threat has had a disastrous impact on an already bad situation. Innovative solutions must be found to deal with the terrorism threat wherever tourists are found -- at airports and in the air, in ground transportation, in hotels, at historic sites -- if we are ever to regain consumer confidence.

In conclusion, yes innovation is becoming a routine practice that can help companies to stay ahead of the competition. Equally important to meet the challenges of tourism today and find solutions satisfactory to all is active dialogue between the public and private sectors.



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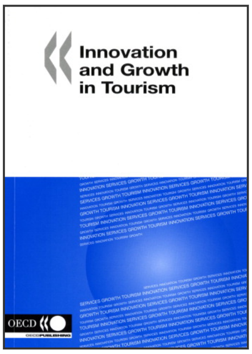


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