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How airlines can win the hearts, minds, and wallets of Chinese travelers

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China, the home of the world's most connected shoppers

China has the world's largest e-commerce market. Chinese consumers are expected to spend over $550 billion online in 2016, outstripping the around $350 billion spent in the U.S. China's e-commerce spending continues to grow at over 10 percent annually.

Chinese consumers are also highly tech savvy. McKinsey's iConsumer survey[1] revealed that 84 percent admit to using mobile devices to research products, read reviews, and make in-store recommendations. Over 60 percent of consumers have made purchases through mobile devices.

China's internet giants have innovated beyond their U.S. and European peers. Chinese consumers are used to social networking, commerce and online payments seamlessly linking together. Ninety-three percent of tier-one city dwellers have WeChat accounts. Eighty-three percent of them have WeChat Pay wallets and have purchased goods online.

This preference for electronic channels spills over to travel as well. Consumers prefer to book reservations and make transactions online. The key driver initially – as expressed by the consumers in our research – is to find lower prices. 59 percent of consumers expect prices to be lower online. Yet, interestingly, consumers' spending on travel actually *increases* once they get online. Tempted by special offers, packages and exciting destinations, 77 percent of consumers end up spending more.

Shoppers increasingly buying air travel online … but not with the airlines

Given the tech-savvy nature of Chinese shoppers, it is no surprise that they are increasingly booking air travel online. After a slow start, China's share of online booking is now over 58 percent of all bookings, surpassing the U.S. and Europe.

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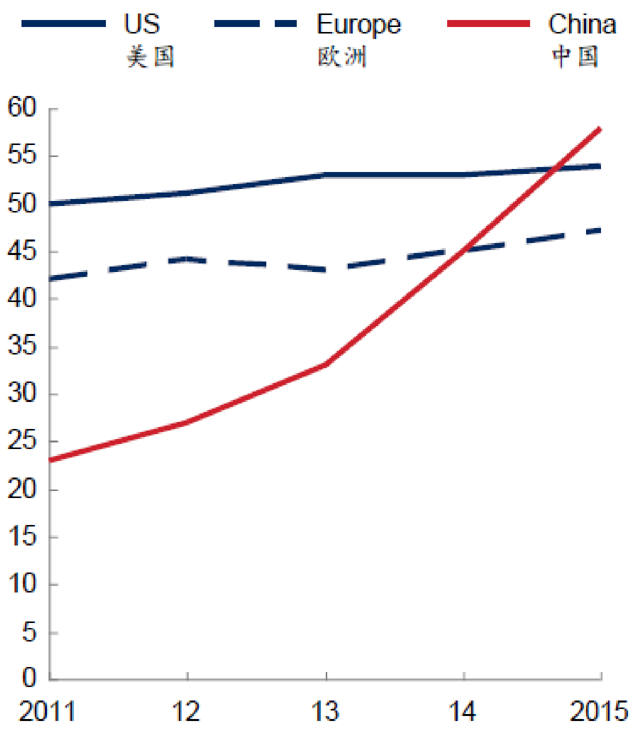
[1] McKinsey iConsumer Survey 2015: http://www.mckinseychina.com/how-savvy-social-shoppers-are-transforming-e-commerce/

Air ticket sales online penetration rate, 2010-2015



Source: Phocuswright, iResearch

The challenge for the airlines is that this online share is mostly not being won by them. Only around 25 percent of bookings are with the airlines' own web and mobile channels: the remainder are with online travel agencies (OTAs), led by the runaway market leader, C-trip.

The shift toward booking with OTAs continues: research shows that OTAs are gaining – and expected to continue to gain – share of online bookings: from today's 52 percent to over 60 percent by 2020 [2].

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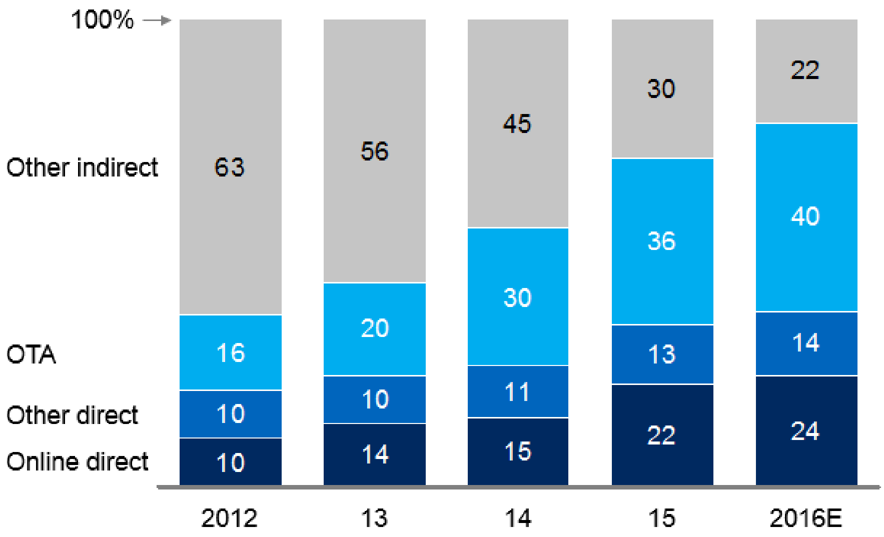
2 iResearch's "2016 China Online Travel Industry Monitor Report", McKinsey
http://report.iresearch.cn/content/2016/05/260893.shtml

Share of bookings by distribution channel
%



Source: Travelsky, iResearch

China is unusual in this regard: While OTAs are certainly prevalent in the U.S. and Europe, airline carriers have been more successful at attracting customers to visit their own websites. In 2015, airlines' own websites and apps contributed 42 percent of total sales for US carriers and 36 percent for European ones.

Why? China's carriers need to look inwards

The low share of direct e-commerce bookings of the major Chinese carriers has been driven by a few factors.

Firstly, many major carriers' own websites and mobile apps are poorly designed, functionality is limited (for example, many don't allow multi-stop routes or child bookings), and they suffer from frequent outages and errors. Some websites don't work on all browsers. Payments often fail. Customer service is poor; customers should not expect a timely response – or even a response at all – when things go wrong. And the Chinese carriers' foreign-language websites are even worse. It is no surprise that customers turn elsewhere.

Secondly, customers can often find cheaper prices on alternative channels. For example, a quick search on China Eastern's website prices a round trip flight from Shanghai to Singapore at CNY 2,810. Exactly the same flights are priced at CNY 2,673 at an OTA. If customers do not trust that they are going to get the cheapest price, they will look elsewhere.

Why is this happening? Some travel agencies are rebating part of the commission paid by the airline as a discount on the ticket. Other agencies actively decide to take a loss on the flight as a hook to attract the customer, after which they can cross-sell lucrative hotel and tour packages.

Thirdly, there is huge organizational inertia. The Chinese airlines each employ hundreds of sales people across China to develop and serve the traditional travel agencies. They set sales targets for these teams for agency sales. It is no surprise, therefore, that not everyone in the organization is pushing for more sales online.

Airlines should be worried

Having the customer go to an OTA instead of your own website means that customers see tickets offered by several other carriers, typically ordered by price. This makes an airline seat seem like a commodity: it's hard to communicate distinctive, differentiating features, such as more spacious seats, a better airport experience, or higher quality onboard service. Customers will shop around, making airlines subject to fierce price competition that only pushes down yields.

In addition, the airline does not get to 'own' the customer. The OTA develops the relationship and holds detailed information on customers. The airline usually only has access to the customer's name and ID number, but are not able to collect the additional contact information that would enable them to build a customer profile and target customers with personalized offers.

Finally, intermediaries are more expensive. Airlines pay global distribution system (GDS) fees, commissions, sales incentives or other fees on bookings. Many of the passengers coming through OTAs and travel agencies are lower yield passengers, for whom the airline can little afford to pay high distribution costs. Most of the future industry growth is likely to be in price-sensitive leisure segments.

Chinese carriers need to fight back and own their customers. It is possible: the Chinese low-cost carrier Spring Airlines succeeds in getting 80 to 90 percent of its bookings through their own online channels.

Three imperatives for the Chinese carriers

1. Design high quality web and mobile channels

The first step is for the airline to ensure it has well-designed and reliable web and mobile channels. This seems obvious, but the challenge is in making this happen.

Chinese carriers struggle to attract the technology talent they need. As much as they want to, Chinese airlines cannot compete for leading IT graduates with the fast-growing internet companies such as Alitrip. As state-owned enterprises, they offer much lower salaries and a culture that is less entrepreneurial and hence less attractive than the internet firms.

While Chinese carriers can and do consider outsourcing development to third parties, they usually don't allocate enough budget to create a truly distinctive online or mobile experience for their customers. But they must spend more. Delta, with arguably the world's best online experience today, invested $140 million to get to the position it is in. Chinese carriers need to substantially increase the budgets they allocate to building their online and mobile presence, an investment that will quickly pay for itself in saved commissions and fees once they start winning back customers.

In the meantime, many carriers are turning to the OTAs themselves to develop a store for them. Most Chinese carriers have launched branded 'flagship stores' on Alitrip, C-trip and others. While these solutions have some advantages, such as showing only the carrier's fares, they are not a long-term substitute for creating channels that airlines control directly themselves.

Exhibit: Air China’s flagship store in Alitrip

2. Migrate customers

Once they’ve established well-designed and reliable mobile and web channels, Chinese carriers need to migrate customers to them. Airlines should:

- *Offer special features only available on e-commerce channels*. This can be as simple as offering discounted fares or bonus frequent flier miles for direct bookings. More advanced differentiation would be to provide exclusive features on their own channels, which are not available for OTAs. We have seen some carriers allow seat selection at the time of purchase only on their own websites. They could also allow earlier check-in, for example 48 hours ahead of departure time, for their own-channel customers.
- *Reduce commissions to zero in home markets, to ensure that agencies cannot rebate part of this to the customers*. The U.S. was the first to go down this path; China has recently followed. Chinese airlines reduced the up-front commission on domestic tickets to zero in June 2015 and on international tickets in early 2016. Recently, they have further changed the “after-sale rebate” model from charging a percentage (usually 1.5% – 3%) based on the sales price of the ticket, to charging a fixed price (e.g. RMB 5 per discounted domestic ticket). Some of the Chinese carriers acknowledge that their share of OTA sales actually *increased* after they switched to the new model. So while the airlines are succeeding at shifting business away from traditional agencies to online channels, this business is not going toward their own online channels.

- *Clamp-down on agencies offering fares below published fares*. Agency contracts should not permit agencies to sell tickets below the list price. While many Chinese carriers have this clause, they do not enforce it. U.S. carriers came down hard on the illicit discounting of tickets, blacklisting agencies that didn't follow their terms and conditions. Chinese carriers need to follow.
- *Integrate offline and online channels*. For example, some airlines have replaced city ticket offices with internet cafes. In markets where few customers have bank accounts or credit cards, carriers allow online booking but offline payment at convenience stores.
- *Ensure a "best rate guarantee" for bookings through the website*. This typically is not a perfect guarantee, but for example "if you find the same flights cheaper elsewhere, we will pay you double the difference." This not only reassures the customer, it also acts as a good check on compliance, allowing airlines to quickly identify agencies that are undercutting them.

3. Build customer profiles

Once customers start coming to their website or app to book a ticket, airlines need to build up customer profiles. They need to track and save browsing and purchasing behavior, and use this information to customize offers and cross-sell products, such as hotel accommodations, rental cars, bus transfers, tours, and restaurants. In providing these additional services, airlines can go beyond their traditional role as air carriers and assume a much broader travel advisory role.

Such a shift is possible. Using this three-step approach, one Latin American carrier boosted its share of online transactions from 15 percent to 60 percent.

Whither the intermediaries

While we believe it is important for airlines to own their customers, there is and will remain a role for the travel agency or OTA. Many customers are infrequent travelers, and thus agencies play a valuable role in educating them on available travel options and helping them make bookings. For their part, agencies will over time need to move up the value chain, specializing in providing more personalized advice and higher value-added package of vacations.

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China’s carriers operate in the world’s most exciting e-commerce market. Yet, they risk missing out on the wealth of value opportunities this provides. Airlines should strive to win back their customers, drive up their share of online transactions, and capture more value in China’s rapidly growing travel market.

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