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## Hilton HHonors Worldwide: Loyalty Wars

Jeff Diskin, head of Hilton HHonors® (Hilton's guest reward program), opened *The Wall Street Journal* on February 2, 1999, and read the headline, "Hotels Raise the Ante in Business-Travel Game." The story read, "Starwood Hotels and Resorts Worldwide Inc. is expected to unveil tomorrow an aggressive frequent-guest program that it hopes will help lure more business travelers to its Sheraton, Westin and other hotels. Accompanied by a \$50 million ad campaign, the program ratchets up the stakes in the loyalty-program game that big corporate hotel companies, including Starwood and its rivals at Marriott, Hilton and Hyatt are playing."

Diskin did not hide his concern: "These guys are raising their costs, and they're probably raising mine too. They are reducing the cost-effectiveness of the industry's most important marketing tool by deficit spending against their program. Loyalty programs have been at the core of how we attract and retain our best customers for over a decade. But they are only as cost-effective as our competitors let them be."

### Loyalty Marketing Programs

The idea of rewarding loyalty had its origins in coupons and trading stamps. First in the 1900s and again in the 1950s, America experienced episodes of trading-stamp frenzy that became so intense that congressional investigations were mounted. Retailers would give customers small adhesive stamps in proportion to the amount of their purchases, to be pasted into books and eventually redeemed for merchandise. The best-known operator had been the S&H Green Stamp Company. Both episodes had lasted about 20 years, declining as the consumer passion for collecting abated and vendors came to the conclusion that any advantage they might once have held had been competed away by emulators.

Loyalty marketing in its modern form was born in 1981 when American Airlines introduced the AAdvantage frequent-flyer program, giving "miles" in proportion to the miles traveled, redeemable for free travel. It did so in response to the competitive pressure that followed airline deregulation.

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<sup>1</sup> *The Wall Street Journal*, February 2, 1999, p. B1.

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Professor John Deighton of Harvard Business School and Professor Stowe Shoemaker of the William F. Harrah College of Hotel Administration, University of Nevada, Las Vegas, prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management. The case reflects the status of Hilton Hotels Corporation and Hilton HHonors Worldwide as of January 1999. Hilton has made numerous changes since that time, including Hilton Hotels Corporation's acquisition of Promus Hotel Corporation.

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The American Airlines program had no need of stamps, because it took advantage of the data-warehousing capabilities of computers. Soon program administrators realized that they had a tool that did not merely reward loyalty but identified by name and address the people who accounted for most of aviation's revenues and made a one-to-one relationship possible.

Competing airlines launched their own programs, but, unlike stamp programs, frequent-flyer programs seemed to survive emulation. By 1990, almost all airlines offered them. In the late 1990s, Delta Air Lines and United Airlines linked their programs together, as did American and US Airways in the United States. Internationally, United Airlines and Lufthansa combined with 11 other airlines to form Star Alliance, and American, British Airways, and four others formed an alliance called Oneworld. In these alliances, qualifying flights on any of the member airlines could be credited to the frequent-flyer club of the flyer's choice.

As the decade ended, computer-based frequency programs were common in many service industries, including car rentals, department stores, video and book retailing, credit cards, movie theaters, and the hotel industry.

## The Hotel Industry

Chain brands were a major factor in the global hotel market of 13.6 million rooms.<sup>2</sup> The chains supplied reservation services, field sales operations, loyalty program administration, and the management of hotel properties under well-recognized names such as Hilton and Marriott. (See **Exhibit 1** for details of the seven largest U.S. hotel chains competing in the business-class hotel segment.)

While the brands stood for quality, there was less standardization of operations in hotel chains than in many other services. The reason was that behind a consumer's experience of a hotel brand might lie any of many methods of control. A branded hotel might be owned and managed by the chain, but it might be owned by a third party and managed by the chain, or owned by the chain and managed by a franchisee, or, in some cases, owned and managed by the franchisee. Occasionally chains managed one another's brands, because one chain could be another's franchisee. Starwood, for example, ran hotels under the Hilton brand as Hilton's franchisee. Information about competitors' operating procedures therefore circulated quite freely in the industry.

### *Consumers*

For most Americans, a stay in a hotel was a relatively rare event. Of the 74% of Americans who traveled overnight in a year, only 41% used a hotel, motel, or resort. The market in which Hilton competed was smaller still, defined by price point and trip purpose and divided among business, convention, and leisure segments.

The **business** segment accounted for one-third of all room nights in the market that Hilton served. About two-thirds of these stays were at rates negotiated between the guest's employer and the chain, but since most corporations negotiated rates with two and sometimes three hotel chains, business travelers had some discretion to choose where they would stay. About one-third of business travelers did not have access to negotiated corporate rates and had full discretion to choose their hotel.

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<sup>2</sup> World Trade Organization.

The **convention** segment, comprising convention, conference, and other meeting-related travel, accounted for another third of room nights in Hilton's competitive set. The choice of hotel in this instance was in the hands of a small number of professional conference organizers, typically employees of professional associations and major corporations.

The **leisure** segment accounted for the final third. Leisure guests were price sensitive, often making their selections from among packages of airlines, cars, tours, and hotels assembled by a small group of wholesalers and tour organizers at rates discounted below business rates.

Although the chains as a whole experienced demand from all segments, individual properties tended to draw disproportionately from one segment or another. Resort hotels served leisure travelers and some conventioners, convention hotels depended on group and business travel, and hotels near airports were patronized by guests on business, for example. These segmentation schemes, however, obscured the fact that the individuals in segments differentiated by trip purpose and price point were often the same people. Frequent travelers patronized hotels of various kinds and price segments, depending, for example, on whether a stay was a reimbursable business expense, a vacation, or a personal expense.

### *Competition*

Four large global brands dominated the business-class hotel market (**Table A**). Each competed at more than one price point. (**Exhibit 2** shows the price points in the industry, and **Exhibit 3** shows the distribution of brands across price points.)

**Table A**

Marriott International	339,200 rooms
Starwood Hotels and Resorts	212,900 rooms
Hyatt Hotels	93,700 rooms
Hilton Hotels	91,100 rooms
Hilton International	62,900 rooms

Source: Company records.

**Starwood** Beginning in 1991, Barry Sternlicht built Starwood Hotels and Resorts Worldwide from a base in a real estate investment trust. In January 1998, Starwood bought Westin Hotels and Resorts, and a month later it bought ITT Corporation, which included Sheraton Hotels and Resorts, after a well-publicized battle with Hilton Hotels Corporation. By year-end, Starwood had under unified management the Westin, Sheraton, St. Regis, Four Points, and Caesar's Palace brands. Starwood had recently announced plans to create a new brand, *W*, aimed at younger professionals.

**Marriott** Marriott International operated and franchised hotels under the Marriott, Ritz-Carlton, Renaissance, Residence Inn, Courtyard, TownePlace Suites, Fairfield Inn, SpringHill Suites, and Ramada International brands. It also operated conference centers and provided furnished corporate housing. A real estate investment trust, Host Marriott, owned some of the properties operated by Marriott International, as well as some Hyatt, Four Season, and Swissotel properties.

**Hyatt** The Pritzker family of Chicago owned Hyatt Corporation, the only privately owned major hotel chain. Hyatt comprised Hyatt Hotels, operating hotels and resorts in the United States, Canada, and the Caribbean; and Hyatt International, operating overseas. Hyatt also owned Southern

Pacific Hotel Group, a three- and four-star hotel chain based primarily in Australia. Although the companies operated independently, they ran joint marketing programs.

The 1990s had been a time of consolidation and rationalization in the lodging industry, partly due to application of information technologies to reservation systems and control of operations. Diskin reflected on the trend: “Historically, bigger has been better because it has led to economies of scale and bigger and better brands to leverage. Historically, big players could win even if they did not do a particularly good job on service, performance, or programs. Now [after the Starwood deal] there's another big player. It would have been nice if it had been Hilton that was the largest hotel chain in the world, but biggest is not the only way to be best.”

## Marketing the Hilton Brand

The Hilton brand was controlled by two entirely unrelated corporations, Hilton Hotels Corporation (HHC), based in Beverley Hills, California, and Hilton International (HIC), headquartered near London, England. In 1997, however, HHC and HIC agreed to reunify the Hilton brand worldwide. They agreed to cooperate on sales and marketing, standardize operations, and run the Hilton HHonors loyalty program across all HHC and HIC hotels. At the end of 1998, HHC divested itself of casino interests and announced “a new era as a dedicated hotel company.”

The exit from gaming, the reunification of Hilton’s worldwide marketing, and the extension of the brand into the middle market under the Hilton Garden Inns name were initiatives that followed the appointment in 1997 of Stephen F. Bollenbach as president and chief executive officer of Hilton. Bollenbach had served as chief financial officer of Marriott and most recently as chief financial officer of Disney, and he brought to Hilton a passion for branding. To some members of the Hilton management team, the focus on brand development was a welcome one. “Hilton's advantage has been a well-recognized name, but a potentially limiting factor has been a widely varying product and the challenge of managing customer expectation with such a variety of product offerings. Since Hilton includes everything from world-renowned properties like The Waldorf-Astoria and Hilton Hawaiian Village to the smaller middle-market Hilton Garden Inns, it's important to give consumers a clear sense of what to expect from the various types of hotels,” observed one manager.

In mid-1999, the properties branded as Hilton hotels comprised:

1. 39 owned or partly owned by HHC in the United States
2. 207 franchised by HHC to third-party managers in the United States
3. 16 managed by HHC in the United States on behalf of third-party owners
4. 10 managed internationally under HHC's Conrad International brand
5. 220 managed by HIC in over 50 countries excluding the U.S.

The executives at Hilton HHonors worked for these 492 hotels and their 154,000 rooms. The previous year had been successful. Revenues had been in the region of \$158 per night per guest, and occupancy had exceeded break-even. Hotels like Hilton’s tended to cover fixed costs at about 68% occupancy, and 80% of all revenue at higher occupancy levels flowed to the bottom line. Advertising, selling, and other marketing costs (a component of fixed costs) for this group of hotels were not published, but industry norms ran at about \$750 per room per year.<sup>3</sup>

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<sup>3</sup> For the purpose of consistency in calculation among class members, assume an occupancy of 70%. The information in this paragraph has been masked. No data of this kind are publicly available, and these data are not to be interpreted as indicative of information private to either HHC or HIC.

### *Hilton HHonors Program*

Hilton HHonors was the name Hilton gave to its program designed to build loyalty to the Hilton brand worldwide. Hilton HHonors Worldwide (HHW) operated the program, not as a profit center but as a service to its two parents, HHC and HIC. It was required to break even each year and to measure its effectiveness through a complex set of program metrics. Diskin ran the limited liability corporation with a staff of 30, with one vice president overseeing the program's marketing efforts and one with operational and customer service oversight. (**Exhibit 4** shows the income statement for HHW.)

Membership in the Hilton HHonors program was open to anyone who applied, at no charge. Members earned points toward their Hilton HHonors account whenever they stayed at HHC or HIC hotels. When Hilton HHonors members accumulated enough points in the program, they could redeem them for stays at HHonors hotels, use them to buy products and services from partner companies, or convert them to miles in airline frequent-flyer programs. (**Exhibit 5** shows how points in the program flowed among participants in the program, as detailed in the text that follows.)

There were four tiers of membership—Blue, Silver, Gold, and Diamond. The program worked as follows at the **Blue** level in 1998.

- When a member stayed at a Hilton hotel and paid a so-called business rate,<sup>4</sup> the hotel typically paid HHW 4.5 cents per dollar of the guest's folio (folio is the total charge by the guest before taxes). HHW credited the guest's Hilton HHonors account with 10 points per eligible dollar of folio.
- Hilton guests could earn mileage in partner airline frequent-flyer programs for the same stay that earned them HHonors points, a practice known as Double Dipping®. (Hilton was the only hotel chain to offer double dipping; other chains with frequency programs required guests to choose between points in the hotel program or miles in the airline program.) If the member chose to double-dip, HHW bought miles from the relevant airline and credited the guest's airline frequent-flyer account at 500 miles per stay.
- If the guest used points to pay for a stay, HHW reimbursed the hosting hotel at more than the costs incremental to the cost of leaving the room empty but less than the revenue from a paying guest. The points needed to earn a stay depended on the class of hotel and fell when occupancy was low. As illustration, redemption rates ranged from 5,000 points to get 50% off the \$128 cost of a weekend at the Hilton Albuquerque, to 25,000 points for a free weekend night at the \$239 per night Hilton Boston Back Bay. A number of exotic rewards were offered, such as a two-person, seven-night diving adventure in the Red Sea for 350,000 points, including hotel and airfare.
- Members earned points by renting a car, flying with a partner airline, using the Hilton Credit Card from American Express, or buying products promoted in mailings by partners such as FTD Florists and Mrs. Field's Cookies. Members could buy points at \$10 per thousand for up to 20% of the points needed for a reward.
- Members had other benefits besides free stays. They had a priority-reservation telephone number. Check-in went faster because information on preferences was on file. Members were favored over nonmembers when they asked for late checkout. If members were

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<sup>4</sup> Hilton distinguished three kinds of rate. "Business rates" were higher than "leisure rates," which in turn were higher than "ineligible rates," which referred to group tour wholesale rates, airline crew rates, and other deeply discounted rates.

dissatisfied, they were guaranteed a room upgrade certificate in exchange for a letter explaining their dissatisfaction. Points could be exchanged for airline miles and vice versa and to buy partner products such as airline tickets, flowers, Mrs. Field's Cookies products, Cannondale bicycles, AAA membership, Princess Cruises trips, and car rentals.

Members were awarded **Silver VIP** status if they stayed at HHonors hotels four times in a year. They earned a 15% bonus on base points, received a 5,000-point bonus after seven stays in a quarter, and received a 10,000-point discount when they claimed a reward costing 100,000 points. They were given a certificate for an upgrade to the best room in the hotel after every fifth stay.

Members were awarded **Gold VIP** status if they stayed at HHonors hotels 16 times or for 36 nights in a year. They earned a 25% bonus on base points, received a 5,000-point bonus after seven stays in a quarter, and received a 20,000-point discount when they claimed a reward costing 100,000 points. They were given a certificate for an upgrade to the best room in the hotel after every fifth stay and were upgraded to best available room at time of check-in.

The top 1% of members were given **Diamond VIP** status. This level was not mentioned in promotional material, and no benefits were promised. Diskin explained, "Our goal at the time was to underpromise and overdeliver. If you stay a lot, we say thank you, and as a reward we want to give you Diamond VIP status. We get a lot more bang, more affinity, more vesting from the customer if we do something unexpected. As an industry, we should never overpromise. It leads the public to decide that this is all smoke and mirrors, and it makes it harder for us to deliver genuine value." **Table B** shows HHW's member activity in 1998.

**Table B** Members' Paid Activity in 1998

	Members (000)	Members active in 1998 (000)	Stays for which members paid (000)	Nights for which they paid (000)	Spending on which they earned points (\$000)	Stays per active member in 1998	Nights per active member in 1998	Reward nights claimed by members
Diamond	24	20	310	521	\$62,000	15.5	26.1	27,000
Gold	220	84	1,110	1,916	\$266,000	13.2	22.8	34,200
Silver	694	324	1,023	1,999	\$341,000	3.2	6.2	70,200
Blue	1,712	992	1,121	2,579	\$439,000	1.1	2.6	48,600
Total	2,650	1,420	3,564	7,015	\$1,108,000	2.5	4.9	180,000

Source: Company records (certain competitively sensitive information has been masked).

A further 712,000 stays averaging 2.4 nights were recorded in 1998 for which no Hilton HHonors membership card was presented but instead airline miles were claimed and airline membership numbers were captured, so that the guest could be given a unique identifier in the Hilton database. Spending on these stays totaled \$327 million.

Guests identified by their HHonors or airline membership numbers occupied 22.5% of all the rooms occupied in the Hilton Hotels and Hilton International network in a year. They were a much smaller proportion of all the guests who stayed with Hilton in a year because they tended to be frequent travelers. Hilton's research found that Hilton HHonors members spent about \$4.6 billion on accommodation per year, not all of which was with Hilton. The industry estimated that members of

the frequent-stayer programs of all the major hotel chains represented a market worth \$11.1 billion and that the average member belonged to 3.5 programs.

### *Rationales for the Program*

#### **1. Revenue and yield management**

Hotel profitability was acutely sensitive to revenue. A trend in the industry was to appoint a “revenue manager” to each property to oversee the day-to-day decisions that affected hotel revenue. Yield management models were probabilistic algorithms that helped this manager set reservations policy. He or she used past history and other statistical data to make continuously updated recommendations regarding hotel booking patterns and what price to offer a particular guest. Simulation studies had shown that when booking was guided by a good yield management model, a company’s revenue increased by 20% over a simple “first come, first served, fixed price” policy.

In the hotel industry, effectively managing yield meant utilizing a model to predict that a room was highly likely to come available due to cancellation or no-show, as well as driving business to higher-paying or longer-staying guests. Variable pricing meant that the rate charged for a room depended not only on its size and fittings but also on the day of booking, the day of occupation, the length of stay, and customer characteristics. Of these factors, customer characteristics were the most problematic.

Customer characteristics were needed by the model to estimate “walking cost,” the cost of turning a customer away. That cost in turn depended on the customer’s future lifetime value to the chain, a function of their willingness to pay, and past loyalty to the chain. These were considered “soft” variables, notoriously difficult to estimate. The better the historical information on a customer, however, the better the estimate. As Adam Burke, HHonors’ senior director of marketing for North America, put it, “Who gets the room—the person paying \$20 more that you may never see again, or the guy spending thousands of dollars in the system? If we have the right data, the model can be smart enough to know the difference.” Some in the hotel industry argued that a benefit of a frequent-guest program was to let the reservations system make those distinctions.

#### **2. Collaborating with partners**

HHW partnered with 25 airlines, three car rental firms, and a number of other firms. Burke explained, “Why is Mrs. Field’s Cookies in the program? We have several objectives—regional relevance to consumers, access to partners’ customers, making it easier for members to attain rewards. A franchisee may say, ‘Why are we doing something with FTD Florists?’ We point out that their investment keeps costs down and gives a broader range of rewards to our members.”

Burke explained why Hilton offered double dipping: “We have 2.5 million members. The airline frequent-flyer programs have 20, 30, 40 million members who aren’t HHonors members and do travel a lot. Airlines don’t mind us talking to their members because—through double dipping—we don’t compete with their programs. In fact, we complement them by allowing our joint customers to earn both currencies.”

#### **3. Working with franchisees**

The Hilton HHonors program was a strong factor in persuading hotel owners to become Hilton franchisees or give Hilton a management contract to run their property. Franchisees tended to be smaller hotels, more dependent on “road warrior” business than many of Hilton’s convention hotels, resort hotels, and flagship properties. They saw value in a frequent-guest program to attract

business, and HHW's program cost was comparable with or lower than its competitors'. The program's ability to drive business, however, remained its biggest selling point. Diskin elaborated, "Seven or eight years ago some operators were concerned about the cost of the program. We took a bunch of the most vocal, critical guys and we put them in a room for two days with us to discuss the importance of building long-term customer loyalty, and they came out saying, 'We need to spend more money on the program!'"

#### **4. Relations with guests**

The program let the most valuable guests be recognized on-property. Diskin explained:

In a sense, the loyalty program is a safe haven for the guest. If there is a problem and it is not taken care of at the property level, the guest can contact our customer service team. It's a mechanism to make sure we hear about those problems. We also do outbound after-visit calling, and we call HHonors members because they're the best database and the most critical guests we have. They have the most experience and the highest expectations. We do feedback groups with members in addition to focus groups and quantitative research. We invite a bunch of members in the hotel down for dinner, and we say we want to talk about a subject. I get calls from people that are lifelong loyalists, not because of any changes we've made, but because once we invited them and asked them their opinion. People care about organizations that care about them.

Hilton customized a guest's hotel experience. Diskin explained, "We build guest profiles that keep track of preferences, enabling the hotel to provide customized services. For instance, consider the guest that always wants a room that is for nonsmokers and has a double bed. This information can be stored as part of the member's record so that when she or he makes a reservation, the guest will receive this type of room without having to ask, no matter where the guest is staying."

HHW used direct mail to cultivate the relationship between members and the Hilton brand. Diskin explained, "Certainly you want to focus much of your effort on your highest-revenue guests, but there are also opportunities to reach out and try to target other customer segments. For example, we worked with a nontravel partner to overlay data from their customer files onto our total membership base and identified segments that might like vacation ownership, others who would be great for the casinos, and some that might like the business and teleconferencing services we offer."

Diskin was concerned that some travelers spread their hotel patronage among several chains and did not receive the service to which their total expenditure entitled them. He noted, "Our research suggests that a quarter of the frequent travelers are members of loyalty programs but don't have true loyalty to any one brand. They never get to enjoy the benefits of elite-program status because they don't consolidate their business with one chain. They typically don't see the value in any of the loyalty schemes because they haven't changed their stay behavior to see the benefits."

#### **5. Helping travel managers gain compliance**

A significant proportion of Hilton's business came from contracts with large corporate clients. Hilton offered discounted rates if the corporation delivered enough stays. Burke explained:

If you are a corporate travel manager, you want employees to comply with the corporate travel policy. You negotiated a rate by promising a volume of stays. While some travel managers can tell employees that they have to follow the company policy if they want to get reimbursed, many others can only recommend. What if someone is a very loyal Marriott customer, yet Marriott is not one of that company's preferred vendors? A travel office is going to have a real hard time getting that guy to stay at Hilton if they can't mandate it.

We respond with a roster of offerings to give that Marriott traveler a personal incentive to use us, the preferred vendor. Our overall objective is to use the program as a tool that can help the travel manager with compliance to their overall travel policy.

### *Member Attitudes*

HHW made extensive use of conjoint analysis to measure what members wanted from the Hilton HHonors program. Burke explained:

Members come in for an hour-and-a-half interview. They're asked to trade off program elements, including services and amenities in the hotel, based on the value they place on those attributes relative to their cost. The results help us determine the appropriate priorities for modifying the program. We find that different people have different needs. Some people are service oriented. No amount of miles or points is ever going to replace a warm welcome and being recognized by the hotel as a loyal customer. Other people are games players. They go after free stays, and they know the rules as well as we do. We've been in feedback groups where these people will educate us on how our program works! And, of course, many people are a combination of both.

Using a sample that was broadly representative of the program's upper-tier membership categories, program research found that Hilton HHonors members had an average of over 30 stays in all hotel chains per year, staying 4.2 nights per stay. Between 1997 and 1998, Hilton experienced a 17.5% increase in member utilization of HHonors hotels globally. Despite this improvement, more than half of HHonors member stays went to competing chains annually—this was primarily attributable to Hilton's relatively limited network size and distribution. The conjoint analysis suggested that roughly one in five HHonors member stays were solely attributable to their membership in the program—making these stays purely incremental.

The study found that the most important features of a hotel program were room upgrades and airline miles, followed by free hotel stays and a variety of on-property benefits and services. Members wanted a streamlined reward-redemption process and points that did not expire. These findings led to refinements in the terms of membership for 1999, but Diskin was exploring more innovative approaches to the rewards program.

Diskin recognized that in their market research studies, consumers tended to describe an ideal program that was simply a version of the programs with which they were familiar. He was looking for more radical innovation:

Hilton and Marriott tend to attract "games players." We want to compete effectively on the reward elements but also introduce them to the more high-touch, high-feel kind of guest experience as well. The customer base that we have accumulated comprises games players primarily. So we've got to deliver that benefit but still go further.

We've been on a mission to dramatically improve the stay experience for members of the upper-tier ranks of the program. That is the key to competitive distinctiveness. That's not something that anybody can imitate. We want our best customers to feel that when they go to Hilton, they know Hilton knows they're the best customer and they're treated special. We want them to think, "I'm going to have the kind of room I want, I'm going to have the kind of stay I like, and if I have a problem, they're going to take care of it." We want the staff to know who's coming in each day and make sure that these guests get a personal welcome. Our new customer reservation system will get more information down to the hotel. We'll know a lot

more about our incoming guests. We will have a guest manager in the hotel whose job it is to make you feel special and to address any concerns you may have.

## The Starwood Announcement

*The Wall Street Journal* of February 2, 1999, announced the birth of the Starwood Preferred Guest Program, covering Westin Hotels Resorts, Sheraton Hotels Resorts, The Luxury Collection, Four Points, Caesar's, and Starwood's new W brand hotels, representing more than 550 participating properties worldwide. It became clear that Starwood was adding program features that might be expensive to match. Four features in particular were of concern.

- No blackout dates** All frequent guest and airline programs until now had ruled that members could not claim free travel during the very height of seasonal demand and when local events guaranteed a hotel full occupancy. Starwood was saying that if there was a room to rent, points were as good as money.
- No capacity control** Programs until now had let hotel properties limit the number of rooms for free stays. Starwood was telling hotels that all unreserved rooms should be available to guests paying with points.
- Paperless rewards** Guests had had previously to exchange points for a certificate and then use the certificate to pay for an authorized stay. Under Starwood's system, individual properties would be able to accept points to pay for a stay.
- Hotel reimbursement** Now that blackout dates were abolished, a property, particularly an attractive vacation destination, might have to contend with many more points-paying guests than before. Starwood therefore raised the rate at which it reimbursed hotels for these stays. To meet the cost, it charged participating hotels 20%–100% more than its competitors on paid stays.

Starwood was pledging to invest \$50 million in advertising to publicize the program—significantly more than HHW had historically spent on program communications. (**Exhibit 6** compares the loyalty programs of the four major business-class hotel chains after the Starwood announcement.)

### *Diskin's Dilemma*

Without any doubt, Starwood had raised the ante in the competition for customer loyalty. Diskin had to decide whether to match or pass. He mused:

Do we have to compete point for point? Or do we want to take a different positioning and hold on to our loyal members and differentiate HHonors from Starwood and other competitors? We're in a cycle where for 10 years the cost to our hotels of our frequent-guest program as a percent of the folio has been cycling down. Yet activation, retention, and member spend per visit all have improved. If we can deliver the same amount of business to the Hilton brand and it costs less, Hilton makes more margin. That attracts investors, franchise ownership, new builders. That's another reason why they buy the Hilton flag.

As Diskin saw it, Starwood's Preferred Guest announcement was a solution to a problem Hilton did not have, arising from its recent purchases of the Sheraton and Westin chains:

They are trying to develop the Starwood brand with the Starwood Preferred Guest Program. They are targeting the most lucrative part of the business, the individual business traveler, where Sheraton and Westin independently have never been as effective as Marriott, Hyatt, and Hilton. Sheraton's frequent-guest program wasn't very effective. They changed it every few years; they used to have members pay for it. Westin never had enough critical mass of properties for it to be important for enough people. So now, together they can address Westin's critical-mass problem and Sheraton's relevance.

But if frequent-guest programs were a good idea, perhaps bigger programs were an even better idea. Diskin reflected: "Hotel properties routinely pay 10% commission to a travel agent to bring them a guest. Yet they continually scrutinize the cost of these programs. Of course, they're justified in doing so, but the return on investment clearly justifies the expenditure. And our competitors certainly seem to see a value in increasing their investment in their programs."

Diskin tried to predict Hyatt's and Marriott's response to the Starwood announcement. The industry was quite competitive enough. He thought back to his early years at United Airlines and recalled the damage that price wars had done to that industry.

**Exhibit 1** The U.S. Lodging Industry

	<i>Countries</i>	<i>Properties</i>	<i>Rooms</i>	<i>Owned Properties</i>	<i>Franchised Properties</i>	<i>Management Contracts</i>
Marriott International <sup>a</sup>	53	1,764	339,200	49	936	776
Bass Hotels and Resorts <sup>b</sup>	90	2,700	447,967	76	2439	185
Hilton Hotels Corp. <sup>c</sup>	11	272	91,060	39	207	16
Starwood Hotels and Resorts Worldwide, Inc. <sup>d</sup>	72	695	212,950	171	291	233
Hyatt <sup>e</sup>	45	246	93,729	NA	NA	NA
Carlson <sup>f</sup>	50	581	112,089	1	542	38
Hilton International <sup>g</sup>	50	224	62,941	154	0	70
Promus <sup>h</sup>	11	1,398	198,526	160	1,059	179

Source: World Trade Organization and company information.

<sup>a</sup>Includes Marriott Hotels, Resorts and Suites; Courtyard, Residence Inn, TownePlace Suites, Fairfield Inn, SpringHill Suites, Marriott Vacation Club International; Conference Centers, Marriott Executive Residences, Ritz-Carlton, Renaissance, Ramada International.

<sup>b</sup>Includes Inter-Continental, Forum, Crowne Plaza, Holiday Inn, Holiday Inn Express, Staybridge.

<sup>c</sup>Includes Hilton Hotels, Hilton Garden Inns, Hilton Suites, Hilton Grand Vacation Clubs, and Conrad International.

<sup>d</sup>Includes St. Regis, Westin Hotels and Resorts, Sheraton Hotels and Resorts, Four Points, Sheraton Inns, The W Hotels. Does not include other Starwood-owned hotels, flagged under other brands (93 properties for 29,322 rooms).

<sup>e</sup>Includes Hyatt Hotels, Hyatt International, and Southern Pacific Hotel Corporation (SPHC). Because it is a privately held corporation, it will not divulge the breakdown of rooms between ownership, franchise, and management contract.

<sup>f</sup>Includes Radisson Hotels Worldwide, Regent International Hotels, Country Inns and Suites.

<sup>g</sup>A wholly owned subsidiary of what was once known as the Ladbroke Group. In spring 1999, Ladbroke changed their name to Hilton Group PLC to reflect the emphasis on hotels.

<sup>h</sup>Includes such brands as Doubletree, Red Lion, Hampton Inn, Hampton Inn & Suites, Embassy Suites, and Homewood Suites.

**Exhibit 2** Price Segments in the Lodging Industry

- **Luxury:** Average rack rate over \$125, full-service hotels with deluxe amenities for leisure travelers and special amenities for business and meeting markets. Chains in this segment include Four Seasons, Hilton, Hyatt, Inter-Continental (a Bass Hotels and Resorts brand), Marriott Hotels and Resorts, Renaissance (a Marriott International brand), Ritz-Carlton (also a Marriott International brand), Sheraton (a Starwood Hotels and Resorts brand), and Westin (also a Starwood Hotels and Resorts brand).
- **Upscale:** Average rack rate between \$100 and \$125, full-service hotels with standard amenities. Includes most all-suite, non-extended-stay brands. Crowne Plaza (a Bass Hotels and Resorts brand), Doubletree Guest Suites (a Promus Hotel Corp. brand), Embassy Suites (also a Promus Hotel Corp. brand), Radisson (a Carlson Worldwide Hospitality brand), Hilton Inn, and Clarion (a Choice Hotels brand) are all examples of chains in this segment.
- **Midmarket with food and beverage (F&B):** Average rack rate between \$60 and \$90, full-service hotels with lower service levels and amenities than the upscale segment. Examples include Best Western, Courtyard (a Marriott International brand), Garden Inn (a Hilton brand), Holiday Inn (a Bass Hotels and Resorts brand), and Howard Johnson (a Cendant brand).
- **Midmarket without F&B:** Average rack rate between \$45 and \$70, with limited-service and comparable amenities to the midmarket with F&B segment. Examples of chains in this segment include Hampton Inns (a Promus brand), Holiday Inn Express (a Bass Hotels and Resorts brand), and Comfort Inn (a Choice Hotels brand).
- **Economy:** Average rack rate between \$40 and \$65, with limited service and few amenities. Fairfield Inn (a Marriott International brand), Red Roof Inn, Travelodge, and Days Inn of America (a Cendant brand) are examples of economy chains.
- **Budget:** Average rack rate between \$30 and \$60, with limited service and basic amenities. Motel 6, Super 8, and Econo Lodge are the best-known chains in this segment.
- **Extended stay:** Average rack rate between \$60 and \$90, targeted to extended-stay market and designed for extended length of stay. Marriott International has the following two brands in this market: Residence Inn by Marriott and TownePlace Suites. Other chains include Homewood Suites (a Bass Hotels and Resorts brand), Summerfield Suites, and Extended Stay America.

Source: U.S. lodging chains segmented by RealTime Hotel Reports Inc., authors of the 1998 Lodging Survey.

**Exhibit 3** Segments Served by the Major Chains

	Luxury	Upscale	Mid-market with Food and Beverage	Mid-market without Food and Beverage	Economy	Budget	Extended Stay
Hilton	X	X	X	X			
Hyatt	X						
Marriott	X	X	X		X		X
Starwood	X	X	X				X

Source: Company records.

**Exhibit 4** Hilton HHonors Worldwide: 1998 Income Statement

(While these data are broadly reflective of the economic situation, certain competitively sensitive information has been masked.)

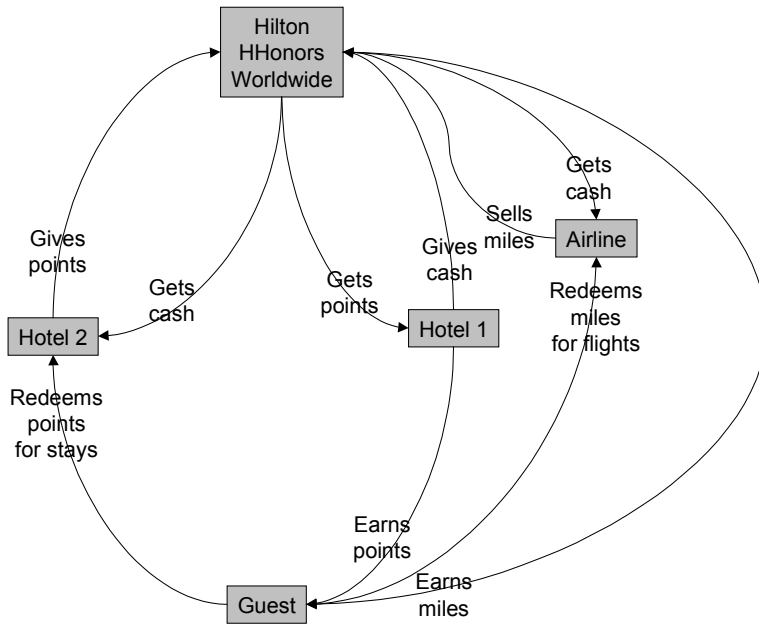
	\$ (thousands)
<b>Revenue</b>	
Contributions from hotels	
Domestic	\$39,755
International	\$10,100
Strategic partner contributions	\$18,841
Membership fees <sup>a</sup>	\$1,141
<b>Total</b>	<b>\$69,837</b>
<b>Expense</b>	
Redemptions	
Cash payments to hotels	\$12,654
Deferred liability <sup>b</sup>	\$9,436
Airline miles purchases	\$17,851
Member acquisition expenses	\$7,273
Member communication expenses	4,236
Program administration expenses	\$17,988
<b>Total</b>	<b>\$69,438</b>
<b>Net Income</b>	<b>\$399</b>

Source: Company records (masked). For purposes of consistency in calculation among class members, assume an average nightly revenue of \$158 per room. Assume that airline miles are purchased from the airline by Hilton at 1 cent per mile.

<sup>a</sup> From members of the Hilton Senior HHonors program only. The Senior HHonors program invited people over 60 to receive discounted stays in exchange for a membership fee. Regular HHonors members do not pay a membership fee.

<sup>b</sup> More points were issued than redeemed. From the outstanding balance a deferred liability was charged to HHW's income statement, based on estimating the proportion of points that would ultimately be redeemed.

Exhibit 5 How the Hilton HHonors Program Works



Source: Company.

**Exhibit 6** Membership Offerings of the Four Major Business-Class Hotel Chains in 1998

Chain	Membership Restrictions <sup>a</sup>	Point Value	Eligible Charges	New Member Bonus	Airline Mileage Accrual
Starwood	One stay per year to remain active—basic; 10 stays or 25 room nights per year—medium; 25 stays or 50 room nights	2 Starpoints=\$1 basic; 3 Starpoints=\$1 medium or premium	Room rate, F&B, laundry / valet, phone, in-room movies	Periodically	Starpoints earned can be converted to miles 1:1; cannot earn both points and miles for the same stay
Hilton	One stay per year to remain active—Blue; 4 stays per year or 10 nights—medium; 16 stays per year or 36 nights—premium; 28 stays or 60 nights—top	10 pts.=\$1—Blue; +15% bonus on points earned—medium; + 25% bonus on points earned—premium; + 50% bonus on points earned—top	Room rate, F&B, laundry, phone	Periodically	500 miles per qualifying stay in addition to point earnings
Hyatt	One stay per year to remain active—basic; 5 stays or 15 nights per year—medium; 25 stays or 50 nights per year—premium	5 pts.=\$1; + 15% bonus on points earned—medium; + 30% bonus on points earned—premium	Room rate, F&B, laundry, phone	Periodically	500 miles per stay; not available if earning points
Marriott	No requirements for basic; 15 nights per year—medium; 50 nights per year—premium	10 pts.=\$1; + 20% bonus on points earned—medium; +25% bonus on points earned—premium	Room rate, F&B, laundry, phone	Double points first 120 days	3 miles per dollar spent at full-service hotels; 1 mile per dollar spent at other hotels; not available if earning points

<sup>a</sup> Most programs run three tiers. For ease of comparison, the three levels are named basic, medium, and premium. HHonors has four tiers.

## Exhibit 6 (continued)

Chain	Affinity Credit Card Point Accrual	Point Purchase	Bonus Threshold Reward	Exchange Hotel Points for Airline Miles	Hotel Rewards
Starwood	1,000 hotel pts. first card use; 1 hotel pt.=\$1 spent; 4 hotel points=\$1 spent at Starwood hotels	NA	NA	1:1 conversion except JAL, KLM, Ansett, Qantas, Air New Zealand; 5,000 bonus miles when you convert 20,000 hotel points; minimum 2,000 Starpoints—basic; minimum 15,000—medium; no minimum for premium	5 categories; 1 free night category 1 is 3,000 Starpoints; 1 free night category 5 is 12,000 Starpoints
Hilton	5,000 hotel pts. for application; 2,500 hotel points first card use; 2 hotel pts.=\$1 spent; 3 hotel pts.=\$1 spent at HHonors Hotels	\$10=1,000 pts. up to 20% of the total points of the reward	2,000 pts.= 4 stays per quarter	10,000 pts.= 1,500 miles; 20,000 pts.= 3,500 miles; 50,000 pts.=10,000 miles; minimum 10,000 hotel points exchange, can also exchange airline miles for hotel points	5 categories: free weekend night 10,000 lowest; 35,000 highest
Hyatt	None	\$10=500 pts. up to 10% of the total points of the reward	None basic	3 pts.= 1 mile; minimum 9,000-point exchange	Weekend night no category: 8,000 pts.; if premium time there is an additional 5,000 pts.; come with partner awards
Marriott	5,000 hotel pts. first card use; 1 hotel pt.=\$1 spent; 3 hotel points=\$1 spent at Marriott Rewards hotels	\$10=1,000 pts. up to 10% of the total points of the reward	None basic	10,000 pts.=2,000 miles; 20,000 pts.=5,000 miles; 30,000 pts.=10,000 miles; minimum = 10,000 hotel point exchange	2 categories: 20,000 free weekend low category, and 30,000 high category

Source: Assembled by the casewriters from the promotional materials of each hotel chain in 1999.