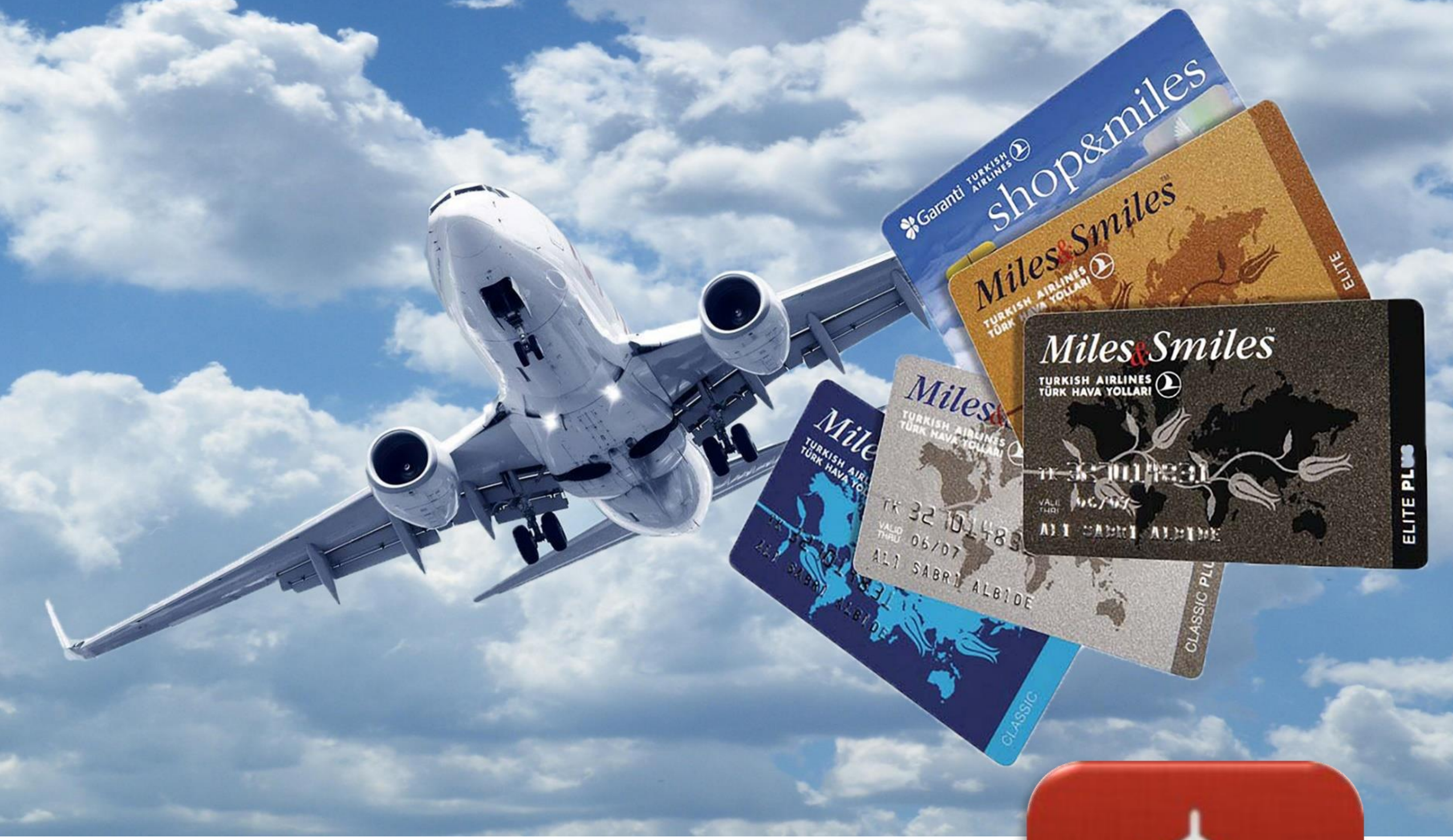

Frequent Flyer Programs, Part 1: Valuable Intangible Assets and the Effects of Spend-Based Programs

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One of the most valuable assets an airline possesses is its frequent flyer program (FFP). The fiscal impact of these loyalty programs often goes underappreciated; FFPs have grown beyond their original purpose as marketing tools and have become separate business units that contribute billions of dollars to airlines' coffers annually. While they do still serve to promote each air carrier's brand identity and to modify customer behavior, the primary purpose of FFPs has become to generate revenue. Since these revenues are often lumped into the "other income" line on the balance sheet, the impact of FFPs isn't readily apparent to investors. Even so, the revenues earned from these programs are enormous; in some cases, they represent half of an airline's profits[i]. In this series of articles, we'll demystify the complex relationships and structures that have turned FFPs from mere customer loyalty products into powerful financial instruments, and discuss some of the changes that may affect these programs' values in the future.

Even though FFPs are considered intangible assets, it is important to realize that they do have a quantifiable value. The value of an FFP can be used by an airline as leverage to raise additional capital to invest in growth. Understanding the value of an FFP is critical when measuring the financial health of an airline. For example, in 2015, Delta Air Lines noted that a hypothetical 10% increase in the value of their FFP customers' accrued points would have resulted in a decrease in revenue of $48 million[ii].

A Brief History of Loyalty

It is useful to understand the evolution of FFPs in order to appreciate the considerable impact these programs have on airline profitability. FFPs aren't new; in fact, the modern concept of the FFP is rapidly approaching its 40th birthday. American Airlines was the first carrier in the post-deregulation period to institute an FFP-type loyalty program back in 1981 with its AAdvantage® program. In the intensely competitive post-deregulation environment, other airlines quickly saw the rationale of compelling customer loyalty through FFP programs and followed American Airlines' lead. Four years later, to lure additional business and gain product visibility, the first mileage accrual relationship was formed between a credit card company and an airline. More intercorporate relationships followed; hotel stays to FFP miles conversions, rental car conversions, credit card co-branding, and other schemes created deeper symbiotic relationships between airlines and non-aeronautical companies.

These developments caused the mileage balances of airline FFPs to grow exponentially. In the late 1980's, United Airlines realized the potential liability of high mileage balances and became the first carrier to institute an expiration date on miles accrued. According to *The Economist*, by 2005 the total value of airline points collected by customers reached more than $700 billion[iii]. Today, there are more than 300 million people enrolled in FFPs managed by the major U.S. airlines. Travel purchased using awarded points or miles accounts for seven percent of all miles flown by U.S. carriers[iv].

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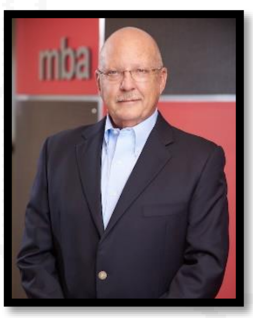

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Big Banks and Big Money

The relationships between the airlines and their credit card issuing bank partners have grown beyond the brand enhancing arrangements originally conceived in the 1980s into vital transactions worth billions of dollars annually. In the competitive banking sector, large financial institutions are continuously improving their credit card products to attract the customers that they most value. The opportunity for their clients to earn airline miles through credit card and other purchases has proven to be a valuable marketing strategy, compelling these companies to buy billions of miles from the airlines each year. One estimate by Stifel Financial Corporation indicates that the banks spend between 1.5 and 2 cents per mile that they purchase. The income generated from the sale of these miles represent airline revenue streams that aren't sensitive to the factors that threaten their traditional business activities, such as the price of oil, severe weather, and world events that impact discretionary spending.

These purchases of miles, primarily by big banks, have an enormous upside for the airlines; this income is virtually cost free. The airlines are receiving payment for seats up front and long in advance of actually having to deliver a product to a flying passenger. These purchased blocks of miles represent a significant time value of money benefit; funds that would traditionally not be available until tickets are sold are instead immediately accessible to the airlines for use. While unredeemed miles and points do represent a liability (known as a "debt of miles") on a carrier's balance sheet, the cost of flying a passenger traveling on the award miles purchased by other companies is almost incidental. In fact, the negotiated price at which the airlines sell their miles is as much as three times the cost of providing a flight to the customer[v]. Of course, many of the miles purchased by large financial institutions and other businesses go unused or expire. These miles represent pure profit for the selling airline since they are intangible assets that cost next to nothing to produce.

Changing Accrual Schemes: Rewarding the Highest Value Customers

There have been some changes in FFPs that could radically affect program values. While billions of miles are purchased by financial institutions, it is still true that a significant portion of the mileage and points balances held within FFPs are earned by passengers who are buying tickets directly on the airlines. By 2015, some airlines in the United States began to realize that FFPs based purely on geographic distance traveled were not necessarily attracting the high spending clients that they value most. Points accruals based only on total mileage can actually penalize the customers who tend to contribute the greatest value to an airline's bottom line— the short haul, short notice, high fare business travelers. As they looked for ways to increase the overall value of their FFPs, airlines began to reevaluate their award accrual schemes to attract the customers that the institutions buying their miles find most attractive to target.

The changes that resulted from that re-evaluation have given rise to two different FFP mileage/points accrual systems: mileage-based and spend-based. Mileage-based programs exactly are what they say they are—a system of accumulation based on the distance of travel between cities, usually on a per segment basis and often with a guaranteed minimum accrual per flight. Spend-based FFPs are also relatively easy to understand; these programs reward

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customers based on the amount of money that they pay for each ticket. The analysis of industry FFP trends can become somewhat convoluted when one considers differences in terminology between airlines. For instance, Delta Air Lines' SkyMiles® program uses "miles" as the unit of reward, but those miles are awarded based upon the price of the ticket (at least five miles for every dollar spent[vi]).

The ultimate goal of any FFP is to attract high-value customers: those that spend proportionally more on a per ticket basis, fly frequently, have a high net worth that would make them attractive to airlines' FFP business partnerships or data buyers, or some combination of all three. Some airlines have found it necessary to change their accrual schemes to reward better those customers who spend the most money. In the early days of FFPs, the number of miles that a passenger flew was considered the best measure of a customer's value to an airline.[vii] With the advent of improved customer tracking tools, airlines are discovering that the passengers that fly the most geographic miles are often not the clients of highest value to them or their FFP partner businesses. These carriers view the move from mileage-based FFPs to spend-based programs as not only a just way to reward their highest spending passengers but to increase the available pool of valuable customers to their FFP business partners as well.

The Current State of U.S. Frequent Flyer Program Accrual Schemes

As attitudes about FFPs and their value to both the airlines and consumers evolve, the industry finds itself in a situation where the miles/points accumulation systems are different at each airline company. Delta Air Lines and United Airlines led the way among the legacy carriers in switching their FFPs to spend-based programs. The major low-cost airlines also tend to prefer spend-based programs, though this attitude is not universal. It is important to note that, even at those carriers that retain mileage-based FFPs, award levels are typically higher for those passengers who opt to either spend more for a ticket or travel in a higher class of service. The reality is that many FFPs are not purely spend-based or mileage-based; hybrid programs are more the rule than the exception. The below chart is a summary of the FFP accrual schemes at nine U.S. carriers.

Frequent Flyer Program Mileage Accrual at Major U.S. Airlines

Spend-Based FFPs			
Airline	**FFP Name**	**Unit**	**Base Accrual Scheme***
American Airlines	AAdvantage®	Miles	5 miles per USD spent[viii]
Delta Air Lines	SkyMiles®	Miles	5 miles per USD spent[ix]
United Airlines	MileagePlus®	Miles	5 miles x base fare[x]
Southwest Airlines	Rapid Rewards®	Points	6 points x base fare[xi]
JetBlue	TrueBlue®	Points	3 points x base fare[xii]
Mileage-based FFPs			
Airline	**FFP Name**	**Unit**	**Base Accrual Scheme***
Spirit Airlines	Free Spirit™	Miles	50% of miles flown[xiii]
Frontier Airlines	EarlyReturns®	Miles	Distance between airports[xiv]
Alaska Airlines	Mileage Plan™	Miles	100% of miles flown (500 min.)[xv]
Hawaiian Airlines	HawaiianMiles™	Miles	100% of miles flown (500 min.)[xvi]

*Base schemes are those accruals that require the minimum level of program membership. Most airlines provide tiered programs that provide greater award accruals at higher levels of program membership.

How Changing Frequent Flyer Programs Affects Customers

The airlines' FFP mileage or points accumulation systems have the power to change consumer behavior significantly. Because spend-based programs reward the customers who pay the most for their tickets, these sorts of FFPs have a disproportionately negative impact on the accumulation of mileage or points by leisure travelers. Conversely, spend-based FFPs have a significant positive impact on the frequent business traveler's potential to accumulate a sizeable mileage or points balance. In fact, because of the direct relationship between ticket price and earned program points or miles, it is conceivable that the highest FFP earnings may occur on short, low competition segments. This situation is particularly the case for customers who buy short notice tickets or walk-up fares, which is precisely the sorts of purchases that valuable business travelers tend to make.

Because many airline customers are neither purely business nor leisure travelers, the total long-term impact on consumer behavior is yet to be determined. PricewaterhouseCoopers estimates that in spend-based programs 40% of customers are better off, 45% experience lower award potential, and 15% see little or no change in their FFP accruals[xvii]. It is evident that the polar ends of the passenger spectrum will see the greatest advantages or disadvantages. High fare paying business travelers, especially those who fly many short segments, stand to gain the most from spend-based loyalty programs. Leisure travelers will see little to no advantage in FFP membership in this scheme; their spending patterns tend to bias toward discount tickets purchased long in advance, limiting their revenue potential to the airlines. The establishment of spend-based FFPs will likely please business clients and encourage their continued loyalty. Vacation customers who fly much less frequently will probably not find the presence of a spend-based FFP a compelling reason to select one carrier over another.

Conclusion

The FFP concept has truly come of age. From their humble roots as products intended to compel customer loyalty, FFPs have evolved into complex and valuable assets that contribute up to one-half of an airline's total profits. FFPs represent recession resistant income for airlines; major financial institutions purchase billions of miles each year for use in their loyalty programs, and the cost to the airlines of providing award travel is far below the price at which the miles are sold. Thus, the revenues from the sale of miles or point by the airlines to banks and other companies are nearly immune to the variables that have made the airline industry so volatile in the past. Some airlines have recently changed their FFP programs to provide greater rewards to those customers who spend the most amount of money with the airline. These changes could have an impact on the total value airline FFP programs.

In part two of this frequent flyer program series, we'll dive deeper into the value of these programs by examining the impact of airline alliances on program value, and we'll consider the benefits and drawbacks of spinning off FFPs to outside entities.

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