Frequent Flyer Programs, Part 2: An International Perspective on Loyalty Programs and Spin-offs

November 6th, 2017

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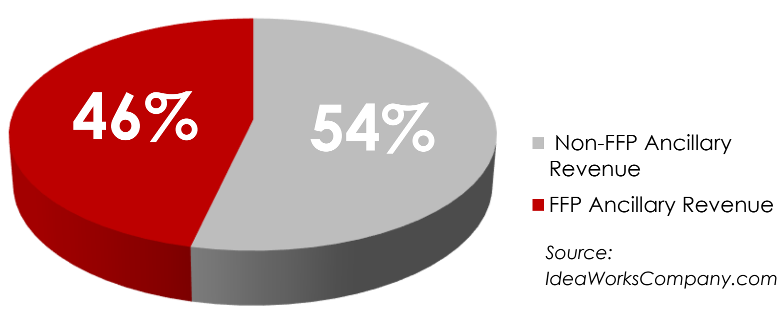
In part one of mba's series of articles about the hidden value of airline frequent flyer programs (FFPs), we discussed the impact these programs have on airline profitability, a brief history of how the FFP business has evolved, and how changes to these programs will affect carriers and customers. Although FFPs are considered intangible assets, the amount of revenue that they contribute to the airlines' bottom lines can be enormous; in some cases, 50% of an airline's profits can come from the sale of FFP points or miles to their business partners (often credit card issuing large banks).[i]

This article will explore the global FFP business environment and explore ways that various airlines have attempted to unlock the value of their programs. Some FFPs are managed internally by their respective carriers, some are programs operated as separate business units, some airlines' FFPs are subsidiary business units that are partially floated to outside entities, and others have spun off their loyalty programs altogether. We will look at some specific cases of each of those management options and examine the advantages and disadvantages of each approach.

Frequent Flyer Programs: Cash Cows with Hidden Values

It is not easy to determine the exact total value of FFPs. Because they are considered intangible assets, the revenues generated are often lumped into the "other income" line on airline's balance sheet; as such, these profits tend to escape the notice of all but the savviest of investors. The effect of FFPs on the airline's profit picture may soon become more visible to investors. The Financial Accounting Standards Board (FASB) has instituted new revenue accounting standards that will become effective in 2018. Among other changes, the new rules will require airlines to adjust their method of determining the standalone selling price for mileage credits, determine what status perks constitute material customer rights, and possibly change the way that they recognize co-branding revenues. The primary driver of these changes appears to be a desire on the part of the FASB to maximize the observable inputs to the numbers on the balance sheet.

2016 Total Ancillary Revenues - Top 10 Airlines



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Big Banks and Big Money

As was explained in mba's previous article dealing with this subject, most of the profits derived from FFPs come from the bulk purchases of miles or points made by large banks, hotels, car rental companies, and other associated businesses. Subsequently, these points are used by the banks' loyalty programs to reward their customers. The amount of money spent by large credit card issuing financial institutions on miles is astounding. For example, American Airlines stated in their July 2016 8-K filing that their most recent deal with Citi, Barclaycard, and MasterCard is expected to net $800 million in additional pre-tax incomes in 2018.[ii] Since these sorts of arrangements between airlines, major banks, and other businesses have become commonplace, it is logical to assume that the total value of FFPs globally has potential to reach hundreds of billions of dollars in aggregate.

While the sale of points and miles to financial institutions represents the largest piece of the FFP revenue pie, there are other ways in which these programs generate cash flow. FFPs are an effective way to promote the carriers' high-margin premium class products, they provide significant distribution cost savings, they are outstanding customer relationship management tools, and the customer data itself is a valuable and saleable product.[iii] Additionally, many of the miles and points that are awarded to the clients of the large banks ultimately go unused. In these cases, revenue gained by the airlines represents nearly 100% profit. All of these benefits make FFPs a lucrative and recession resistant profit vehicle for air carriers. Over the past ten years, the struggle for airlines has been how to manage these programs best to realize their FFPs true financial potential.

The Frequent Flyer Program Management Options

In the universe of FFP management options, there are four general methods in use at airlines today: simple internalized FFPs, FFPs that are separate business units (which may be separately listed on a stock exchange), partially floated FFPs, and fully spun-off entities. Globally, the sizable percentage of airline loyalty programs are relatively underdeveloped. These internalized programs have not yet matured past a stage that focuses purely on passenger loyalty as a way to enhance an air carrier's traditional business. The advantage of these relatively simple programs is that they are fairly inexpensive to manage and can exist in an environment of limited resources. The principal disadvantage of these limited scope FFPs is that they don't directly produce revenues; since they are focused purely on organic growth, it is difficult for internalized FFPs to attract partners that can provide additional ancillary revenue streams.[iv] It is worth noting that IATA predicts that global air traffic will double over the next 20 years;[v] it is likely that many of these airlines will be looking to enhance the structure of their FFPs to realize more stable streams of revenue.

Frequent Flyer Programs As Separate Business Units

Running FFPs with the goal of producing additional revenue pathways is currently the dominant management mode used by most large network airlines globally. These FFPs are operated as business entities that are substantially

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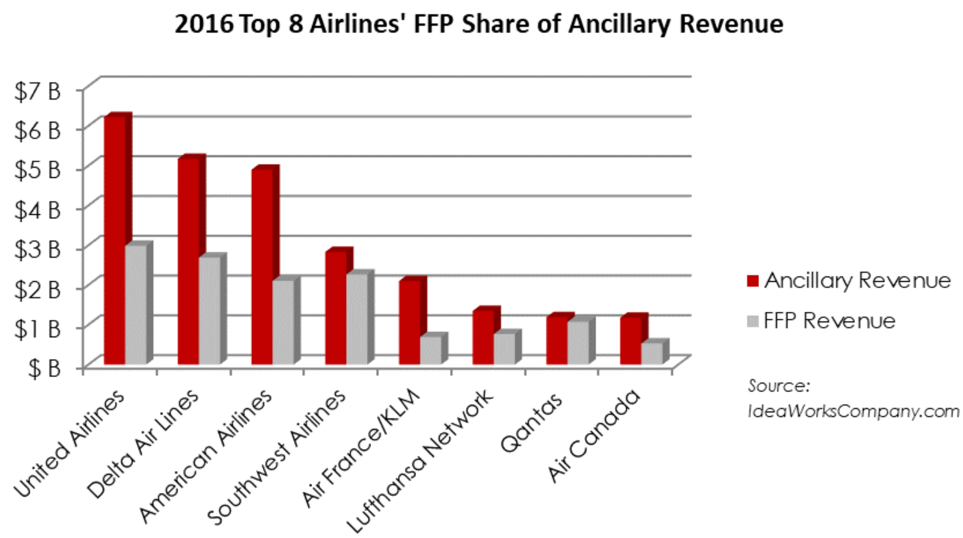
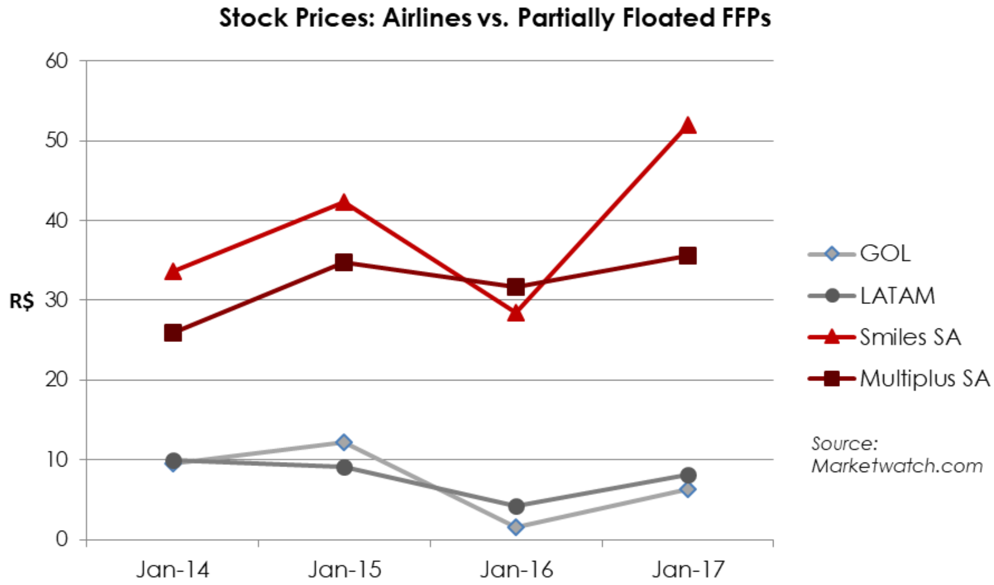
separate from the airlines' traditional line of business, the providing of air transportation. Operating FFPs as separate business units that have a degree of decision-making and budgeting autonomy allows for the formation of third-party relationships and the sale of miles or points as a commodity. The numbers bear out the revenue-generating power that this can harness for an airline. The top ten airlines globally earned an estimated $28.3 billion in ancillary revenues in 2016; FFP revenues accounted for $13.1 billion, or 46%, of those revenues.[vi] There is one disadvantage to this internal separate business unit model of management; because the value of the FFPs are considered intangible and are not easily discerned, attracting investment based on the performance of this line of business can be difficult.



There is one airline that has sought to break the mold and make the performance of its FFP more accessible to investors. In 2008, Qantas not only broke out its FFP as a separate division of the company but one that reported its earnings as a separate line item. This move has provided more investor visibility into Qantas' financial performance, and is a move that no other airline that internally manages their FFP has yet matched.

The Partial Float FFP

A twist that has been seen on the separate business model of FFP management has been the public offering of FFP shares to the public. In these cases, FFPs are partially spun-off; they are managed, sell stock, and report earnings separately from their respective carrier, but the airlines themselves retain a majority stake. Referred to as a partial float, this allows the airlines to raise additional capital via the markets while still retaining the ability to garner some revenue from their programs. Two airlines have been noteworthy in heading down this path: the Brazilian airlines TAM and GOL. TAM, which recently merged with Chile's LAN to create the LATAM group of companies, listed their Multiplus FFP as a separate company on Brazil's stock index in 2010, selling 27% of the available shares. GOL went even further with their Smiles program in 2013, retaining only a 57% total stake.[vii] While each airline was able to raise capital via a public offering, these arrangements mean that they cannot access the entirety of the profits from their FFP programs to use for growth or to cover expenses in an economic downturn. It is worth noting that the holding companies for the FFPs trade at consistently higher values than the airlines themselves.



To Spin or Not to Spin?

For the past ten years, some airline industry analysts have advocated for carriers to spin-off their FFPs entirely; realizing that there was inherent cash value in the programs, one view point was that spinning off FFPs could help the airlines access much needed operating capital. Air Canada did exactly that with their Aeroplan FFP in 2005, gradually selling stakes in their program until its ownership was completely under a separate company. The resulting company, called Aimia, Inc., acquired other loyalty programs and made monetizing those products its core business. While the sale of Aeroplan did allow Air Canada to access much-needed capital to stay afloat, it robbed them of the ability to use their FFP as a source of ancillary revenue. Realizing that this arrangement placed them at a significant competitive disadvantage, Air Canada recently announced that they will be ending their relationship with Aimia in 2020 and will replace Aeroplan with a new internally managed product. During lean economic times, there was a strong temptation for other airlines to follow Air Canada's lead; Aeromexico, in particular, was rumored to be considering spinning off their Club Premier® FFP to Aimia. As of this date, that has not occurred; Aimia currently owns a 29% share of the Club Premier program as a joint venture that is controlled by Aeromexico.[viii]

An example of a more fruitful and enduring FFP spin-off can be found in the relationship between Lufthansa and its Miles and More program. In 2014, Lufthansa split off its FFP unit to a separate entity that is still 100 percent owned by Lufthansa AG. Miles and More currently boasts a wide array of partners, including 40 airline partners and more than 270 non-airline associated businesses.[ix] While the Lufthansa/Miles and More transaction was not a spin-off to an entirely separate entity like the Air Canada/Aimia transaction, its success may provide a template for other airlines looking for greater flexibility in accessing the financial power of their FFPs.

Alliances are Essential to Success

It cannot escape notice that the airlines with the largest and highest revenue producing FFPs are also those that belong to—or are the founding members of—large international network alliances. The advantages of tying FFPs to alliances are manifest. Alliance membership positively impacts the customer's satisfaction by increasing mileage accrual and redemption options, and airlines can benefit from increased marketing power and better economies of scale both operationally and in their FFPs. Belonging to an extensive network of airlines simply provides carriers with a much larger pool of potential customers from which to draw revenue.

While there are many airlines globally that belong to one of the three dominant alliances, there is further room for development. Currently, nearly 40% of the world's airlines are not aligned with any particular alliance.[x] There can be little doubt that these airlines will be looking for alliance opportunities to tap into potential traditional and ancillary revenue gains.

Conclusion

It is obvious that FFPs are robust profit enhancing tools; the data strongly indicates that there is a strong correlation between airline profitability and strong ancillary revenues that are primarily driven by the monetization of FFP platforms. While there are several models of FFP management available to airline managers, the most successful programs appear to be those that are run as separate business units within the overall airline holding company. As seen from the Air Canada example, outright spin-offs of FFPs appear to net only temporary benefits; while the carrier may realize a temporary uplift in working capital, they will not realize the long-term ancillary revenue that FFPs can provide. Looking carefully at the timing of Air Canada's divestiture of its Aeroplan FFP, it is evident that spinning off an FFP to an outside organization is something that is en vogue only when a carrier is in extremis and in need of an injection of cash to survive. Indeed, it appears that loyalty companies that operate FFPs tend to outperform their parent airlines in terms of EBITA margins due to their relatively low overhead and recession resistant product.

Whichever FFP management method that an airline chooses, it is clear that the decision-making process must be aided by the accurate valuation of their programs. Globally, mba expects that airlines will more actively consider the special value that FFPs offer. Since the revenues generated by FFPs represent a profit source that is free of the inherent risks found in their traditional lines of business, airlines will increasingly look to these highlight these programs to boost investor confidence, protect their bottom line performance, and access needed capital.

What is mba up to?

NEWS:

mba hosted the Annual 2017 Charity Golf Tournament on Monday, October 23rd at Congressional Country Club in Bethesda Maryland to benefit [Orbis International] and the Flying Eye Hospital. Sponsors and attendees raised over $200,000 for the non-profit organization. This contribution will assist Orbis in continuing its work combating preventable blindness and providing surgery and educational opportunities to communities around the globe.

Kathryn Peters, Director of Business Valuation and Economic Analysis, led a workshop on Maintenance Forecast Modeling on Wednesday, October 18th at the Airline Economics Growth Frontiers New York 2017 Conference.

David Tokoph, Chief Operating Officer, attended the Airline Economics Growth Frontiers Hong Kong 2017 Conference on Tuesday, October 31st as a Key Speaker on Residual Value Forecasting and Assessment. He also participated on the Aircraft Valuations panel exploring the case for a middle of the market (MOM) aircraft.

Upcoming Events:

ISTAT Latin America, *November 15th – 16th, 2017*:

mba is proud to be a Silver Sponsor of the ISTAT Latin America Forum, taking place at the Hilton Bogotá in Bogotá, Columbia. Anne Correa, Director of Business Development, will be moderating the Emergent Airlines Panel.

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[ii] United States. Securities and Exchange Commission. *American Airlines, Inc: Form 8-K.* July 12, 2016. Washington, D.C. *American Airlines SEC Filings.* Web. Accessed 11 Sept. 2017.

[iii] Pandit, Pankaj. *Revitalizing Airline Loyalty-Frequent Flyer Programs.* WNS Global Services. Web. 2015. Accessed 11 Sept. 2017.

[iv] Ernst & Young Advisory. *Frequent Flyer Program: Ready for take-off.* Ernst & Young Advisory. Web. 2014. Accessed 11 Sept. 2017.

[v] IATA. *IATA - IATA Forecasts Passenger Demand to Double Over 20 Years*, IATA, 18 Oct. 2016, www.iata.org/pressroom/pr/Pages/2016-10-18-02.aspx. Accessed 12 Sept. 2017.

[vi] Sorensen, Jay. *2016 Top 10 Airline Ancillary Revenue Rankings.* IdeaWorksCompany.com. Web. 2017. Accessed 11 Sept. 2017.

[vii] Ernst & Young Advisory. *Frequent Flyer Program: Ready for take-off.* Ernst & Young Advisory. Web. 2014. Accessed 11 Sept. 2017.

[viii] Diem, Sandra and Evert de Boer. *Taking Club Premier to new Heights: How Aimia Helped Aeromexico Optimize Its Loyalty Program.* Aimia, Inc. Web. 2012. Accessed 11 Sept. 2017.

[ix] "Company." Miles & More - Company, Miles and More Gmbh, www.miles-and-more.com/online/portal/mam/rowr/general_information?nodeid=72265641&l=en. Accessed 12 Sept. 2017.

[x] Pandit, Pankaj. Revitalizing Airline Loyalty-Frequent Flyer Programs. WNS Global Services. Web. 2015. Accessed 11 Sept. 2017.