
avios
velocity
frequent flyer
multiplus
CLUB PREMIER
KrisFlyer
FREQUENT FLYER
Miles & More
Lufthansa
LifeMiles
FLYINGBLUE

THE FFP SPIN OFF MODEL AFTER AIR CANADA

Air Canada's announcement to repatriate its frequent flyer programme into the airline sent shockwaves through the industry in May-2017

Shares in Aimia, the holding company of Aeroplan, plummeted after the news broke, while Air Canada shares enjoyed a significant uplift. Some observers were quick to call the end of the spin off model, arguing that the model was unviable from day one. Yet a closer look at the current loyalty landscape reveals a more nuanced picture. Aeroplan may have invented the wheel, but others are running with it, applying the lessons learned along the way.

IN MAY-2005, Air Canada Enterprises (ACE) first announced its intention of offering an IPO for part of Aeroplan, the frequent flyer programme (FFP) of Air Canada. It marked the first time an FFP would be divested by the airline through an IPO. Although spinning off a subsidiary hardly qualified as a new idea in the airline industry (think for example of Sabre, Amadeus or Le Méridien who were all spun-off from their respective airline), the notion of an independent loyalty company was ahead of its time in aviation. Earlier in Apr-2003, Air Canada filed for bankruptcy protection in a bid for survival, following the 9/11 attacks and the SARS crisis which hit its hub Toronto especially hard. Air Canada used the Canadian equivalent of the US Chapter 11 bankruptcy protection provision, namely the Companies' Creditors Arrangement Act (CCAA), to clean up its balance sheet. When Air Canada emerged from its CCAA status in 2004, the new shareholder base consisted of various parties, including creditors, management and Cerberus Capital Management, a New York-based private equity firm. In Sep-2005, ACE sold part of Air Canada's FFP through an equity carve-out – and Groupe Aeroplan started trading in the Toronto Stock Exchange. By the end of 2008, ACE had sold all of its ownership in Aeroplan. A 15 year agreement was put in place to govern the relationship between Air Canada and Aeroplan, specifying the price of the goods that both parties sell to each other (award tickets and Aeroplan miles) as well as provisions around the supply of award seats. But by 2017, and in anticipation of the expiry of this agreement, Air Canada announced its intent to launch its own loyalty programme in 2020, replacing Aeroplan. According to Air Canada, the new programme will offer additional earning and redemption opportunities, more personalised service and a better digital experience. In addition, Air Canada outlined that by managing their own programme (similar to peers in North America), it will be able to take better care of its customers by making decisions in real time that address specific needs. From a financial perspective, Air Canada projects that the net present value of the programme repatriation over a 15 year period will exceed CAD2 billion (USD1.6 million). Many observers believe that Air Canada set its eyes on gaining a bigger slice of the profits that are generated by the FFP, and ultimately decided it should go at it alone, instead of renegotiating better terms with Aimia.

The end of the spin off model?

Air Canada's announcement and the subsequent reaction on the Toronto Stock Exchange strengthened the belief of sceptics who at times had voiced fierce criticism of the model. At the core of their criticism, the spin off model only ever was a last resort solution for cash strapped airlines to raise capital: a short term solution that not only sacrificed one of the key assets (foregoing the future revenues of the programme), but also required the airline to give up control over its own best customers. In their eyes, Air Canada's decision was the final nail in the coffin for the spin off model, leaving only investment bankers and private equity firms as conflicted proponents of a model that was doomed to fail from day one.

But with the planned repatriation of the FFP back into Air Canada however, the spin off model did not come to an abrupt end. In fact, today a variety of programmes continue to operate as standalone companies following their carve out from the airline. And where Aeroplan may have suffered from a first mover disadvantage, the second batch of programmes have taken the model and applied a number of critical changes. The revised spin-off model manifests itself in three main areas:

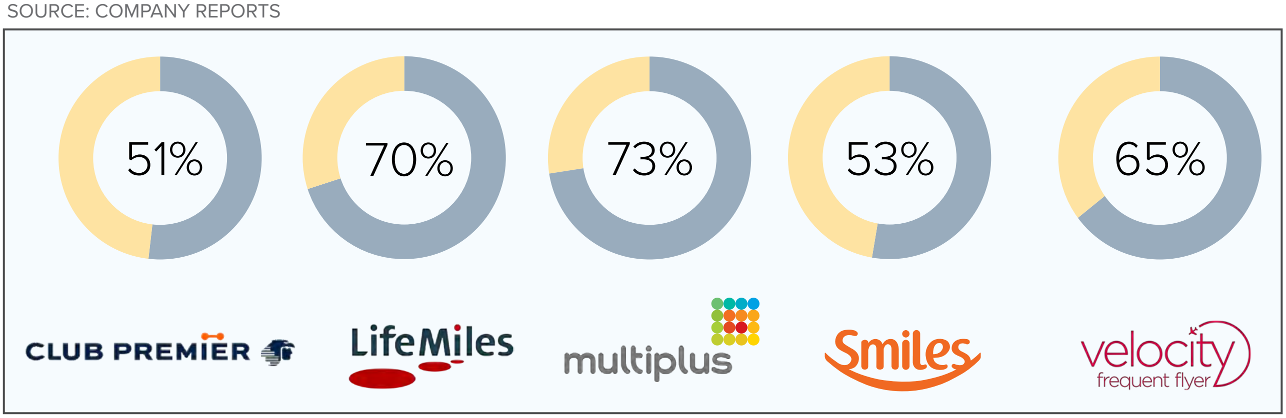
Airline Keeps Control – Unlike the Air Canada divestiture, in each of the subsequent pure FFP carve outs, the airline has kept a controlling stake in the new entity (pure carve outs exclude the airline-FFP combos conjured by Etihad Airways). Undoubtedly, maintaining a majority share and therefore a far greater deal of control would have been a key consideration for airline boards. This majority control applies both to the listed companies as well as those that entered into private investments. Multiplus and Smiles for example are listed on the Sao Paulo Stock Exchange, but for both companies the airline remains the majority shareholder. Virgin Australia and Avianca, which created new FFP entities in partnership with private equity companies, also kept majority shares, giving them a greater degree of control over the programmes.

Strategic as well as financial rationales

It is no secret that raising capital remains a core consideration for carve outs. At the same time, the notion that only distressed airlines have opted for a carve out does not hold. At the time of their respective carve outs, Avianca and Virgin Australia were not overly leveraged, and would in fact have had access to alternative sources of financing. Another example is AirAsia that set up its AirAsia BIG loyalty business as a separate entity from day one, realising the business would operate better as a standalone entity operating at arm's length from its various group airlines. And early on, AirAsia BIG partnered

PERCENTAGE OF FREQUENT FLYER POINTS OWNED BY THE AIRLINE POST SPIN-OFF

SOURCE: COMPANY REPORTS



with a strategic investor, in an effort to accelerate and enhance the development of its loyalty business.

Building partnerships instead of IPOs

Air Canada and a number of other carve outs used the IPO instrument to float their loyalty business. But in the more recent FFP carve outs, the airline opted instead to partner with a single investor to form a strategic partnership. Avianca, for example, partnered with Advent International, a private equity firm. According to Avianca, Advent's experience and focus would help to further enhance LifeMiles' ability to enter new markets, diversify and accelerate the gross billings base, strengthen its commercial partner network, and acquire non airline related expertise. Bringing outside expertise could help to realise quick wins as a result of the knowledge transfer, as well as enhanced governance that comes with an external investor.

Although the changes in some ways offer a radical departure from the early Aeroplan model, the attractiveness of the model for outside investors seems to remain intact. Industry observers indicate a continued strong interest from a variety of investors, with recent carve outs reported to attract more than 30 parties in the initial rounds. The strong interest is explained by some of the characteristics of the FFP model, including its high margin and strong cash flow business. In addition, the loyalty business tends to be more stable and requires little capex investments. Depending on the location of the airline, it may also offer a window to invest in emerging markets, playing on the macro trends like a growing population, growth in air travel consumption, as well as the credit card space. But even in established markets like Australia, FFP investments can attract significant value – Affinity Equity Partners for example paid close to a 14x EBITDA multiple for its 35% stake in Virgin Australia's Velocity programme. Equally important for the investors is the ability to form a partnership with the airline, which is considered an attractive partner, typically combining a very strong brand with a formidable presence in the market.

Will we see more carve outs in the future? Undoubtedly, the Aeroplan termination as well as TopBonus's bankruptcy (AirBerlin's programme) has made investors more discerning. Investors will want to make sure there is a sustainable, balanced commercial relationship and a healthy airline parent. At the same time, investors continue to look for sound investments to place their capital. Where they will happen is anybody's guess, but going by the existing carve outs, they could follow a cluster pattern, where a single spin off could help pave the way for subsequent carve outs (Latin America is a good example where no less than four airlines followed a carve out strategy). In the world's largest market, the United States, no airline has opted for a

carve out strategy. What we are seeing however, is an increasing number of (very large) airlines that are evaluating their FFP strategy and many are preparing the FFP business for monetisation should they decide to do so at some point in the future. Separating the FFP from the airline can be a stepping stone in this process.

Separation gaining momentum

Selling a part of the FFP to outside investors may be a bridge too far for some, but the recent increase in FFP separations demonstrates the growing realisation that these models actually can create value for all stakeholders. As early as 2002, United Airlines created a wholly owned subsidiary called UAL Loyalty Services, Inc (ULS), that was tasked to increase the overall value of United Airlines' loyalty businesses by focusing management attention on these activities and enhancing the range of products and services offered to MileagePlus members and business partners. United Airlines reported the ULS segment over the period 2002-2005 until it emerged from bankruptcy protection in 2006. Soon after in 2008, Qantas for the first time included separate reporting for the group's loyalty business. The new reporting structure coincided with record profits for Qantas for the half year ended 31-Dec-2007. Although Qantas declared to prepare for a partial sale of the loyalty business at the time, the onslaught of the global financial crisis, and shifting board priorities resulted in an infinite postponement. Qantas did however continue to operate and report its Qantas Frequent Flyer business as a separate business segment. In 2014, IAG created a separate entity for its Avios segment. According to IAG, the new, very clean business model provided extraordinary transparency around cash flows and SLAs, helping the programme both internally within the group, as well as externally with partners. In the same year, Lufthansa announced that the management and governance of the Miles & More programme would be outsourced from Deutsche Lufthansa AG to the direct subsidiary Miles & More GmbH. According to a joint report by the Executive Board of Lufthansa and the Managing Director of Miles & More, the separation would bring a number of benefits, including faster decision processes, as well as faster rates of implementation. More recently in Asia, ANA announced the incorporation of ANA X Inc on 21-Oct-2016. According to ANA, the new company is tasked with the management and development of customer related programmes, including its ANA Mileage Club, and has two shareholders: ANA Holdings which owns 85% and ANA Trading which owns the remaining 15%. With major established players moving their programmes into separate entities, clearly there must be a strong rationale for such a move.

> It is hard to overstate the financial significance of the direct cash flows by the programmes. Delta Air Lines for example is predicting a USD4 billion contribution from its American Express partnership alone by 2020

Understanding the impetus for change

Whilst new accrual structures (like the move to value-based instead of distance flown earning) and new qualification criteria for elite status tend to receive a lot of attention, a quieter evolution has been taking place in the background. This evolution will help to explain the recent moves to separation. From its gimmicky start on the fringes of airline marketing, the frequent flyer programme today has evolved into the airline's largest customer, that can produce the single largest cash flow, and offer the single largest customer repository with the richest data. Firstly, the FFP typically represents the single largest consumer of an airline's seat production. For US majors, the percentage of traffic

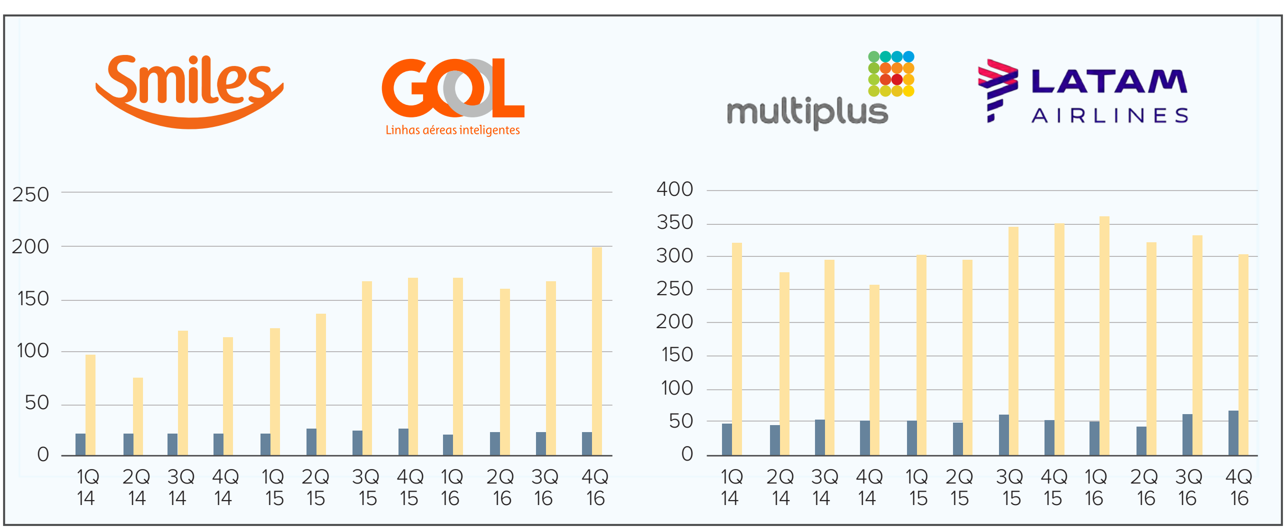
(RPMs) used for award travel hovers between 6% and 8% of total RPMs, with Southwest being an outlier at 12.7%. Although this number is lower for carriers in other regions, more likely than not the FFP represent the single largest consumer of seats. One of the advantages of this is that the awards can offer an opaque distribution channel where the airline is in control over individual pricing, with minimal or no distribution costs. And in some cases, the FFP has applied customer driven revenue management principles that go far beyond the typical accept reject decisions commonly supported in a bid pricing revenue management environment. Secondly, on the back of the growth of the programmes, loyalty penetration (share of passenger revenues contributed by its members) has reached levels in excess of 50%. As a result, the FFP offers the airline the single largest repository of customers, that it can serve with targeted offers and promotions enabled by rich customer insights. This ability stems partially from the FFP's external relationships, providing additional data around consumer behaviour and preference. In Australia for example, it is estimated that one out of every three dollars spent on a credit card earns Qantas Frequent Flyer points, giving Qantas potentially a significant data advantage. Thirdly, it still is hard to overstate the financial significance of the direct cash flows by the programmes. Delta Air Lines for example is predicting a USD4 billion contribution from its American Express partnership alone by 2020. This holds both for programmes within the airlines, as well as those operated as carve outs. In the latter category, the airline is net recipient of cash reflecting the larger size of the redemption volume generated versus the costs incurred in purchasing the miles currency. With this newly gained status of the frequent flyer programme, airline boards would be well advised to reexamine some of the existing management and governance structures of their programmes.

Deciding the best structure

In the early days, management of the programmes was relatively simple. The miles were earned by flying on the airline, and redemptions (mainly award tickets) utilised mostly distressed inventory. As a result, airlines were able to book the liability at marginal cost rates, resulting in an attractive spread between the yield of the miles sold to partners and the cost incurred on the books. The main focus of the programmes was on running rich elite structures, offering goodies and perks to the airlines' best customers. In many legacy carriers, the management of the programme was done by line managers, who would rotate in and out of the position, similar to how other functions were staffed in the airline. But today's programmes, as mentioned, play a starkly different role. In many cases, the majority of the miles are earned outside the airline, and whilst the

BALANCE OF TRADE BETWEEN THE FFP AND THE AIRLINE (MILLION BRL)

SOURCE: COMPANY REPORTS



elite benefits and qualification structures continue to play a vital role, the evolution into miles as a currency has transformed the programme management – and the associated challenges faced.

New accounting rules have put a greater onus on the programmes to account for liabilities correctly, and will continue to become even more specific in the near future. But broadly speaking, there are two areas that airlines will need to solve from a commercial and organisational structure point of view. The first challenge is how to optimise the commercial structure between the FFP and the airline. Key components here are the allocation of cost for miles earned on the airline, and the mechanism to allocate, secure and compensate for, award seat inventory. Deciding cost is relatively straightforward; the latter however requires a deep understanding of the trade offs between freeing up inventory for awards (potentially causing revenue dilution or displacement) and the downstream effects this has on the member's share of wallet. The concept of foregoing revenue today to reap greater benefits in the future has not necessarily sunk in yet with many revenue management departments. The second challenge is how to best structure the FFP from an organisational point of view. Given its unique position and ability to create value, should the programme continue to be embedded in the airline, or, follow what ANA, Lufthansa, IAG and others have done, namely convert it into a separate entity producing its own profit and loss statement? Or should it follow what the likes of Virgin Australia, Avianca and AirAsia have done, and partner with an outside investor? The answer will depend on a number of criteria, including the individual programme characteristics, market dynamics and shareholder orientation. Moving from an embedded department to a separate unit under the group banner represents a relatively straightforward move, whereas opening the door to an outside investor poses a decidedly more complex equation. But in essence it boils down to the question whether the programme with outside support and investment can realise a net value creation that outweighs the in-house solution. As Qantas shows, airlines certainly are able to do it alone, but for others the inherent competing

OVERVIEW OF CURRENT FREQUENT FLYER OPERATING MODELS

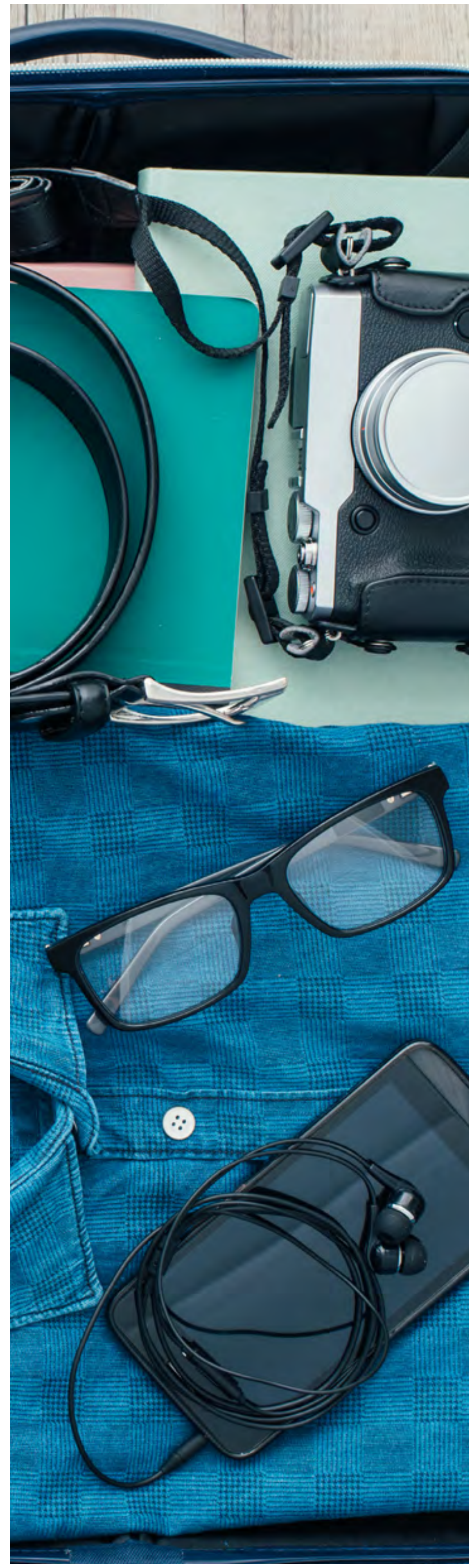
SOURCE: COMPANY REPORTS

EMBEDDED IN AIRLINE	SEPARATE SEGMENT	CARVE-OUT
American Airlines AAdvantage	ANA MILEAGE CLUB ANA	CLUB PREMIER
Emirates Skywards	avios	LifeMiles
FLYINGBLUE	FREQUENT FLYER	multiplus
SINGAPORE AIRLINES KRISFLYER	Miles & More Lufthansa	velocity frequent flyer

interests and priorities may prove to be too time consuming, resulting in a suboptimal outcome.

Perhaps in the future, as and when the dust settles on the Air Canada repatriation, more information will emerge that will give us a more complete picture of what really happened – including how different stakeholders weighed their strategic options. Future MBA students will undoubtedly sink their teeth into the Air Canada – Aeroplan case study, and apply their newly learned game theory principles. But today, airline boards should be careful to dismiss different strategic options a priori based on the Air Canada–Aeroplan saga. In deciding the best structure for the FFP, it is worthwhile to note that although the FFP and the airline share the same customer, they have very different business drivers and company cultures. The different characteristics manifest themselves in different ways including shareholder profiles where short term investment horizon hedge funds typically trade in airline equities, and long term investors (for example, pension funds) prefer loyalty companies. Given the different company profiles, it is natural to consider a different management structure for the FFP. Can a separation realise the full potential of the business? The answer will depend on the airline's individual ability to realise change, and the particular characteristics of the airline's core market. As mentioned before, Qantas is the textbook example of an airline realising tremendous value from its loyalty business without any outside investment. The challenge however is that Qantas represents a small group of airlines that has achieved this level of maturity. Despite the growing consistent cash flows that Qantas Frequent Flyer has generated, investors have still been slow to reward Qantas in terms of valuation, as the Qantas Frequent Flyer business continues to attract airline valuation multiples, instead of the higher loyalty business multiples.

So far, the debate has been focused on unlocking value, and ownership. But reducing the issue to just a matter of ownership will prove to be a myopic – and potentially costly – view. In reality, the speed at which the programmes and the competitive landscape is evolving, should warrant a very different discussion.



Evert de Boer is a Partner at Singapore-based FFP Investment & Advisory. De Boer has authored numerous publications on frequent flyer programmes, including the recent book Strategy in Airline Loyalty, published by Palgrave Macmillan. AL