



Riders on the storm:

Loyalty programmes can help airlines weather the challenges

THE CORONAVIRUS PANDEMIC is causing havoc in the airline industry. Loyalty programmes are helping airlines navigate the storm in various ways, with a strong focus on generating liquidity. Recent disclosures by some of the world's largest airlines project that their programmes are more valuable than the core airline. This projection and the ongoing crisis could be a catalyst for seismic change for loyalty programmes.

Summary

- Loyalty programmes adjust to the non-flying reality, extend status.
- Programmes utilised by airlines for three categories of revenue raising.
- The value of programmes compared to airline values is revealed.
- Can loyalty programmes survive without the airline?



As dark clouds gathered, loyalty programmes shifted focus

As the bottom fell out of travel in Mar- and Apr-2020, programme operators first turned their attention to adapting programme rules to cater for the new reality. Realising that travel was severely limited and would take considerable time to recover, programmes around the world shifted their attention to maintaining momentum with members, instead of the usual focus on travel. Many programmes waived elite tier requalification requirements, effectively extending the validity of the elite tiers. Some programmes also offered revised expiry policies. Most critically, programmes turned their attention to non-air accruals, promoting partners in an effort to drum up loyalty currency sales and member engagement. Some programmes even afforded elite qualification credits on non-air spend, something which was fairly uncommon before the crisis.

At later stages, some programmes are starting to provide travel-related offers again. Air France-KLM's Flying Blue programme for example is offering double elite credits for the remainder of 2020. Although some feared a run on the bank, this did not happen, and although many programmes witnessed an increase in non-air redemptions, very few actually implemented any restrictions. With the immediate changes out of the way, and cash becoming king in the fight for survival, the next step for some was to use the programme to generate liquidity.

The hunt for liquidity has tapped loyalty programmes

In what could be described as a testament to the severity and reach of the crisis, it was in fact the hotel industry, and not airlines, that first tapped their partners for cash. As early as Apr-2020, Hilton pre-sold

USD1 billion worth of Hilton Honors points to American Express, stating it would use the proceeds for working capital and general corporate purposes. Less than a month later, Marriott signed amendments to its existing co-brand credit card agreements with JPMorgan Chase and American Express, with USD570 million coming from JPMorgan Chase and USD350 million coming from American Express.

Three categories of revenue raising by airlines

Over on the airline side, three types of capital generators could be witnessed: the preselling of points or miles to partners, pre-buying of award seats by separate loyalty companies and using the programme as collateral for loans.

Pre-selling points: JetBlue was one of the first airlines to generate liquidity through the pre-selling of TrueBlue points to its co-branded credit card partner Barclays. According to JetBlue CFO Steve Priest, the agreement was a good opportunity to get a small amount of incremental liquidity at attractive terms (the transaction was sized at USD150 million).



The ongoing attractiveness of the travel co-brands was underscored by American Express CEO Stephen Squeri during a 2Q2020 earnings call, stating that co-brand cards in the consumer business were actually performing better than some of the proprietary cards, including the Delta

Air Lines, British Airways and Hilton co-brand cards.

In light of that comment, it was no surprise that in Jul-2020, IAG announced that American Express would make a payment to IAG Loyalty (the operator of the Avios loyalty currency) of approximately GBP750 million (USD981 million), a significant part of which would be a pre-purchase of Avios points.

Pre-purchasing reward seats: Separate loyalty entities, fully or partially owned by the airline, can pre-purchase reward seats from the airline for future usage. This reflects a trend whereby a separate entity is mandated with the development and management of the loyalty programme, reflecting a belief that this set-up is more conducive to realising the full potential of the loyalty programme.



Examples of airlines that have implemented this type of structure include Aeromexico, ANA, IAG, GOL and Lufthansa. Aeromexico announced in May that it would receive financial support from PLM (the operator of the Club Premier loyalty programme company) consisting of USD100 million using intercompany loans and award ticket advance purchases, funded by PLM's cash on hand. In a similar fashion, in Brazil, GOL announced the advance sales of reward tickets

to its loyalty programme Smiles, for a total amount of BRL1200 million (c. USD225 million) bolstering its liquidity position.

Loan collateral: The final category involves loans where the programme is pledged as collateral. In Jun-2020, American Airlines



announced plans to pledge its AAdvantage programme as collateral for a government loan under the CARES Act. But perhaps the most significant development occurred in Jul-2020 when United Airlines announced it had secured a USD5 billion term loan from Goldman

Sachs, Barclays and Morgan Stanley using its MileagePlus programme. As part of the process, it offered highly detailed reporting around the performance of its loyalty segment. Among other things, United revealed a 2019 EBITDA of USD1.8 billion

(~26% of United's adjusted EBITDAR) for MileagePlus, producing the equivalent of a 34% EBITDA margin against USD5.3 billion in cash flow from sales (~12% of United's revenue).

The paradox of programme valuations vs airlines

As part of the airlines' pursuit of liquidity, two remarkable things happened. For the first time in history, US majors were talking openly about the value of their loyalty segments. United estimated that the enterprise value of the programme was USD21.9 billion using a target EBITDA

Loyalty companies offer higher profit margins, a greater degree of control over the levers of profitability and are scalable and asset-light. The air transportation business on the other hand remains characterised by high levels of volatility and low levels of control.

AIRLINES USING THEIR LOYALTY PROGRAM FOR LIQUIDITY
SOURCE: ON POINT LOYALTY





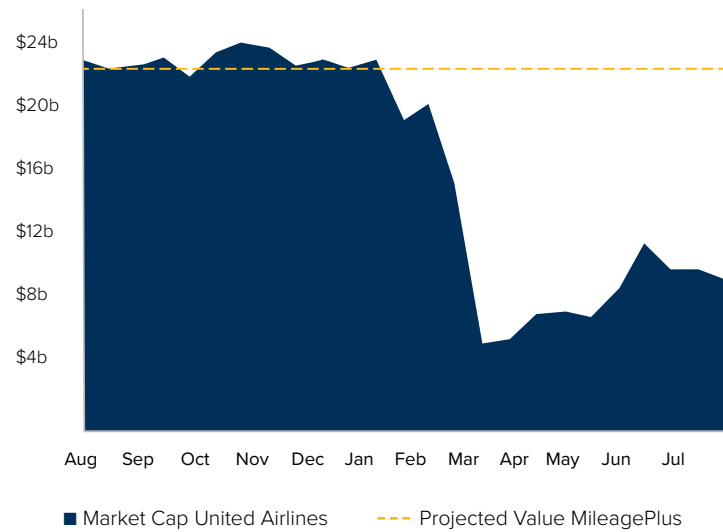
multiple of 12 (a discount to where publicly traded loyalty companies once traded). American disclosed that an external appraisal yielded a value of between USD18 and USD30 billion for AAdvantage. This leads to the second remarkable observation: in both cases the projected value exceeded the current market cap of the airline.

This disparity is as much a reflection of the underlying core business dynamics of the two businesses (airlines versus loyalty companies) as well as a reflection of investor appetite for the respective businesses, resulting in different valuation multiples. Loyalty companies offer higher profit margins, a greater degree of control over the levers of profitability and are scalable and asset-light. The air transportation business on the other hand remains characterised by high levels of volatility and low levels of control.

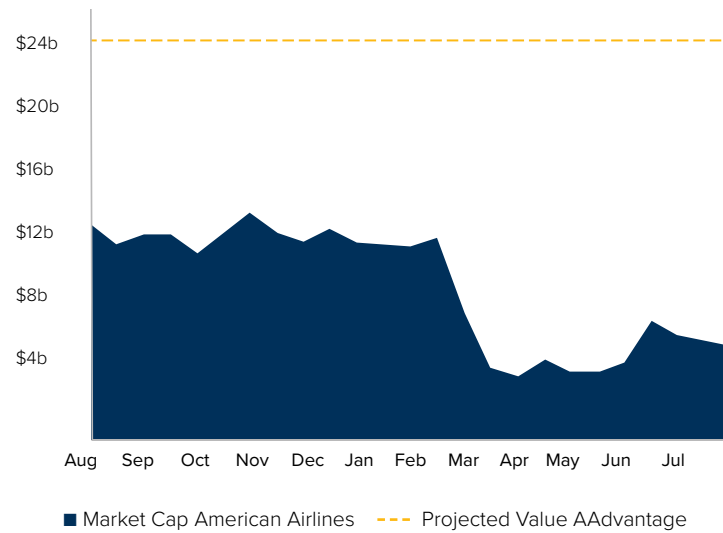
The notion that the loyalty segment could receive a higher valuation than the airline business is hardly a new concept in the industry. While this may sound counterintuitive, the industry has witnessed multiple transactions in the market where the value of the programme exceeded that of the airline (most recently Virgin Australia’s programme received a valuation significantly higher than the airline itself).

It has been somewhat accepted as an inconvenient truth, with some observers describing it as “funny money”. Paradoxical as it may seem, an increasing number of arm’s length transactions are corroborating the hypothesis. Clearly, the fact that some of

UNITED AIRLINES MARKET CAPITALIZATION
SOURCE: UNITED AIRLINES



AMERICAN AIRLINES MARKET CAPITALIZATION
SOURCE: AMERICAN AIRLINES



Against the backdrop of the current environment, clearly the elephant in the room is the question of what will happen to the programme in case the airline ceases to operate.

the world’s largest and oldest programmes are actively embracing this notion may very well be a watershed moment for the industry.

The full implications are yet to sink in; United sets the tone

Although the valuations grabbed some headlines, these revelations were lost amid all the ongoing stream of COVID-related developments, ranging from social-distancing on planes, speculation about U- or V-shaped recoveries, to discussions around mandatory mask wearing.

But as the realisation slowly sinks in, there will be effects across financial, operational and strategic areas.

Firstly, as the ascribed value receives progressive confirmation in the form of term loans and investments, investors and analysts will surely look to other airlines in an effort to understand their programmes’ relative value. Also, the increased level of disclosures by United is likely to raise the bar across the world in terms of clarity.

Secondly, as the hypothetical value continues to be corroborated by market transactions, airlines themselves will need to do some soul-searching around key questions such as: is the programme structured optimally? Are the correct capital allocation decisions made considering the opportunity? Is the airline reaping the right value from the programme? Finally, on a strategic level, airline management and shareholders must ask the question what the right long term strategy is for the programme.

In order to effectively tap the capital markets, the programmes need to have a greater degree of autonomy. A good example is LifeMiles (the loyalty company partially owned by Avianca), that was able to secure a term loan in 2017 using its considerably better credit rating compared to that of Avianca.

Some observers have dismissed the notion of a loyalty programme more valuable than the airline as unconceivable, given the intrinsic links between them. Without an airline, there is no programme.

While this is generally true, there are some examples that point in a different direction. Against the backdrop of the current environment,

clearly the elephant in the room is the question of what will happen to the programme in case the airline ceases to operate.

Like a dog without a bone. Can loyalty programmes survive alone?

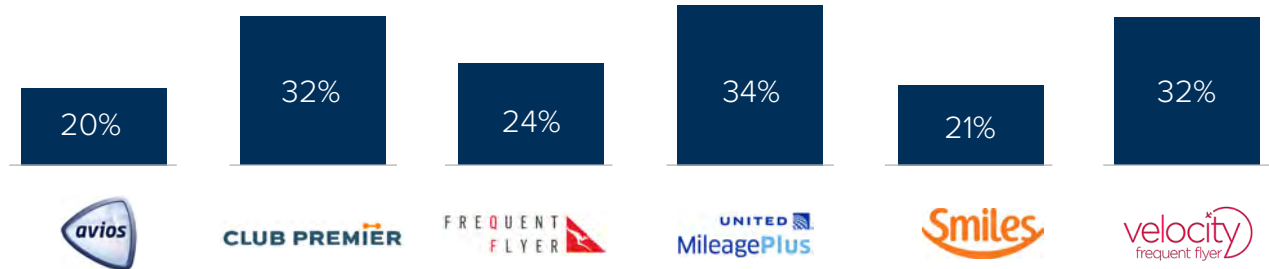
At this point, it seems unavoidable that more airlines will falter in the future as a result of the ongoing COVID-19 crisis. With IATA’s latest outlook indicating a longer recovery period, it remains unclear whether we are still in the eye of the storm or if the worst has passed. When an airline ceases to operate, generally one of three scenarios will occur.

Under the first scenario, the programme will cease together with the airline. This happened in the past when either no buyer could be found for the programme, or the programme simply did not offer any residual value. When Ansett Australia collapsed in 2001, Ansett Global Rewards points became instantly worthless. The prevailing accounting rules at the time may have contributed to this outcome, as programmes were allowed to provision for the liability at marginal rates instead of the fair value of the miles.

In the second scenario the assets of the defunct airline are acquired by a third party, in most cases another airline.

This happened for example in the case

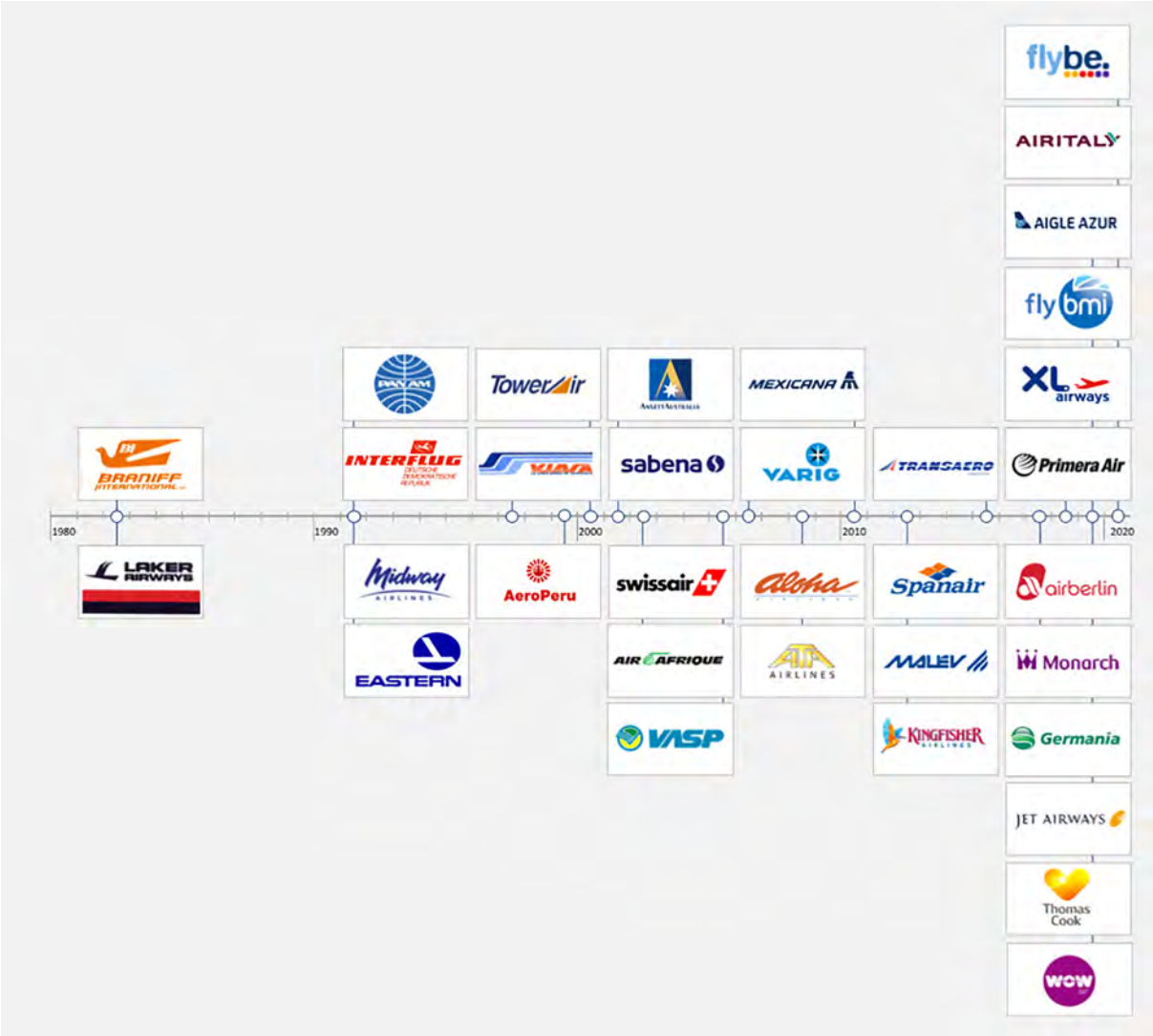
PROFIT MARGINS FOR AIRLINE LOYALTY PROGRAMS (2019)
SOURCE: COMPANY REPORTS





OVERVIEW OF SELECT DEFUNCT AIRLINES

SOURCE: ON POINT LOYALTY



Although non-air redemptions can help fill part of the gap, loyalty members’ general preference is geared towards travel.

of Varig, Pan Am and Swissair. In each of these cases, a new airline acquired the loyalty programme alongside other assets. In Pan Am’s case, its WorldPass members’ miles were folded into Delta’s SkyMiles programme when Delta bought the remaining profitable assets of Pan Am in 1991. In the case of Swissair, the Qualiflyer loyalty programme was split up, and the appropriate parts moved to Crossair, ultimately to end up with SWISS, when Crossair was transformed into SWISS International Air Lines in 2002. In 2006, Smiles, the programme of Varig, was acquired by a buyer together with the brands Varig and Rio-Sul, Varig’s route rights, and all but one aircraft. Smiles ultimately evolved as the programme of GOL and is partially listed on the Sao Paulo stock exchange. The third, and most exceptional scenario, is where a loyalty programme is able to survive as a standalone entity – without an outside investor coming to the rescue.

Jet Airways was a prime example of divorcing the airline from its loyalty programme

Very few have managed to achieve this, and JetPrivilege, the loyalty programme of Jet Airways, is probably the best example of such a scenario. Following the cessation of operations by Jet Airways in 2019, its loyalty company JetPrivilege was able to reinvent itself and carve out a new path for its future (it launched a new brand called InterMiles). It is a remarkable feat, given that when Jet Airways ceased to operate, JetPrivilege immediately lost access to its prime source of rewards, namely favourably priced Jet Airways seats. A number of factors help explain why JetPrivilege was able to do what it did.

First, it was in control of its own liability and budget. In other words, it actually controlled the cash in the bank for the outstanding liability. This proved to be critical, as the moment Jet Airways ceased to operate, JetPrivilege needed to go to the market to buy seats (in what is likely to be a constrained market given the reduction in capacity following the airline’s cessation).

Although non-air redemptions can help fill part of the gap, loyalty members’ general preference is geared towards travel. However, non-air can be material, as Lufthansa’s Miles & More programme demonstrates: it reported that almost one out of every three miles redeemed was for non-air rewards, whereas in the case of United MileagePlus only 4% of miles redeemed were for non-air rewards.

Secondly, the programme must have strong and ongoing partnerships that generate income from the sale of miles. In this context, the cessation of the airline is a less relevant factor, as airlines typically account only for a relatively small share of the miles earned (for example in the case of Multiplus, only 8% of earnings came from

the airline).
Lastly, the loyalty entity must have the technical and managerial skills to repivot the programme to another direction, reflecting the new business realities.

These are the lessons to be learned from the JetPrivilege example. A ringfenced loyalty segment is better placed to support the airline compared to programmes deeply embedded in the airline. With a clear delineation of the programme’s budget and liability, the long term survival has a better chance. A programme that is hidden within the airline, and reliant on informal access to seats, will be less likely to survive.

Four key take-aways for the new environment

Significant uncertainty remains in the market. How will consumers react to the new reality? When will passenger volumes reach their former levels? Will travel as a reward have the same allure in the long term? Despite all the uncertainty, it is possible to draw a number of conclusions at this point.

1. A ringfenced loyalty segment

Any airline will benefit from having a clearly ringfenced loyalty segment. While a separate segment is not needed to pre-sell points to partners, it is a key requirement for other financing solutions. Having a separate entity also offers the advantage of tapping into an internal source of liquidity versus enticing partners with deeply discounted points. Essentially, selling discounted points transfers the benefit to the partner, whereas pre-purchasing reward seats transfers the benefit to a wholly- or partially owned subsidiary, leading to lower value erosion.

As history shows, a ringfenced programme not only has a better chance of survival in the worst scenario where the airline ceases to operate, it also carries a higher



value making the combination of airline and programme to potential investors more attractive.

One interesting category has been the airlines which have repatriated their loyalty programme. LATAM for example delisted its Multiplus subsidiary following an offer process for 27.3% of the outstanding capital stock of Multiplus owned by public shareholders through the Sao Paulo Stock Exchange. At the time of the delisting, the

The loyalty programme remains uniquely positioned as the ultimate tool to support the digitisation of airline businesses.

Multiplus programme had a market cap of BRL4.3 billion (USD806 million), which seems like a formidable sum given the current context.

The history of Topbonus, the programme of AirBerlin, on the other hand shows that a separate loyalty programme does not always guarantee a positive outcome, especially when the core airline halts payments for miles earned in order to preserve cash.

2. Reporting must be more comprehensive

On the back of United's detailed reporting, it is clear that the bar for reporting will be raised. There is clearly a trend in the industry to increase the level of external reporting. This would also require a more fundamental understanding of the true profitability of the loyalty segment. Today, different airlines use slightly different definitions of profitability for their loyalty segments. It is likely that the future will see greater convergence around definitions, and loyalty profitability will become an industry standard like RASM, PLF and CASM.

As the proportion of business travellers declines, the role of loyalty programmes will change

3. The programme must be able to respond to massive industry change

The industry is set to change for the foreseeable future. These changes include revisiting the existing logic for pricing and revenue management, reflecting new booking behaviours and passenger mixes.

Lower load factors across the board may further enhance the profitability of loyalty programmes, as displacement will be reduced significantly. This could further widen the gap between the loyalty programme and airline performance.

Most observers expect visiting friends and relatives (VFR) and leisure

travel to bounce back first, as corporates more diligently weigh the options of staff travel. With this outcome, the traditional 80:20 rule of a small subset of frequent flyers contributing the lion's share of the profits will change drastically.

Leisure travel will become more important, and with that, the role of the loyalty programme will change as well. As leisure travel will typically represent lower frequency intensity, the importance of non-air accruals will increase.

4. Loyalty programmes will be at the heart of airline digitisation

Finally, the loyalty programme remains uniquely positioned as the ultimate tool to support the digitisation of airline businesses. Even those airlines that will emerge differently from the crises (a likely outcome for most) can continue to tap and grow the value of the programme. Virgin Australia is a particular case in point – although slated to become smaller and more domestically oriented, it can continue to build the Velocity business by capitalising on its access to large partner networks.

As the airline industry faces formidable challenges, at the same time, opportunities will present themselves. Loyalty programmes could play a critical role in helping rebuild the industry. ^{AL}

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