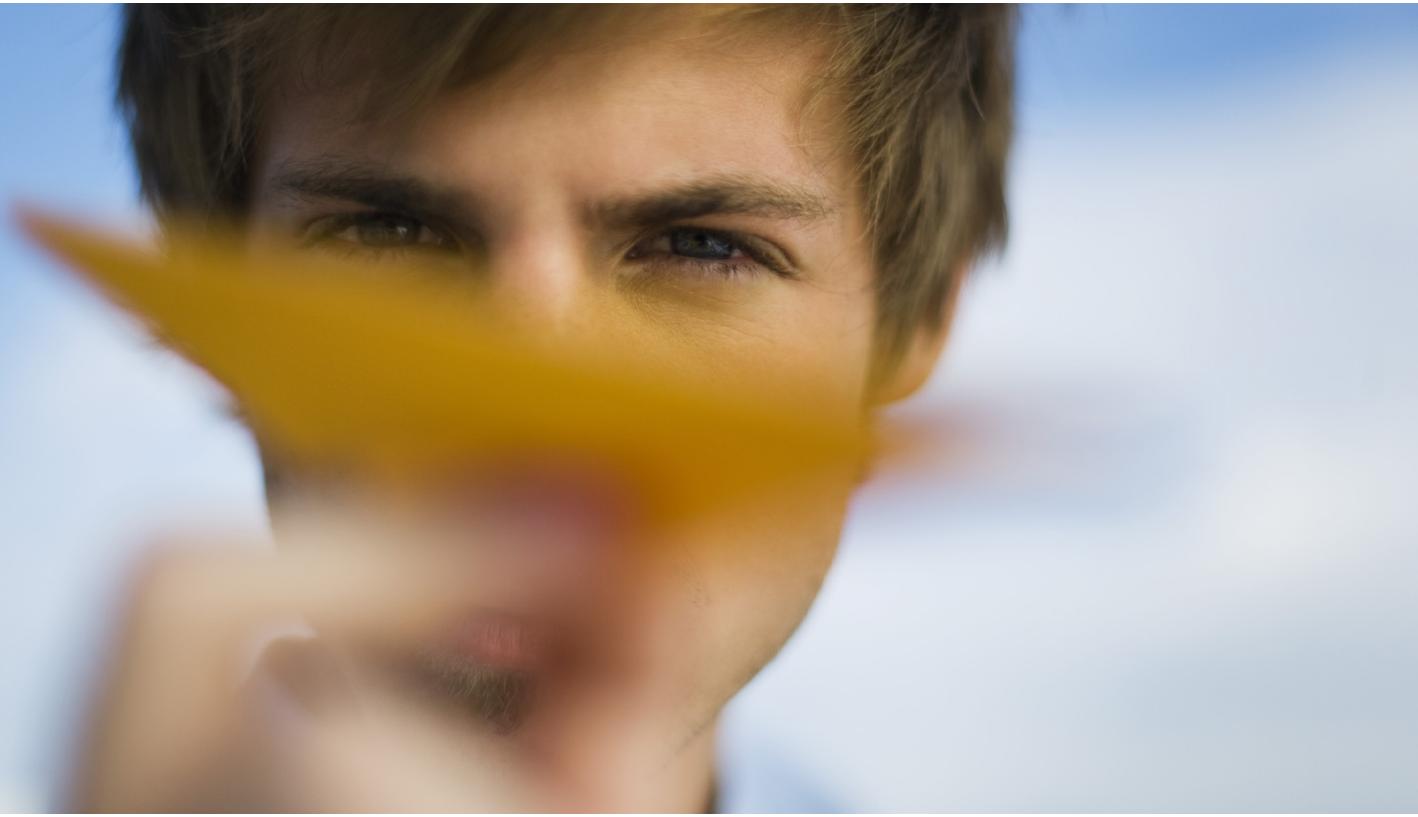


Frequent Flyer Program: Ready for take-off



Building a better
working world

Frequent Flyer Program at a glance



Almost all airlines have developed a Frequent Flyer Program (or "FFP") in order to help them improve customer loyalty, operating performance or load factors. Passenger's loyalty can be critical for legacy carrier airlines which are facing fierce competition from low-cost airlines on short and medium-haul, and Gulf airlines on international routes. An FFP should be viewed as a powerful marketing tool that allows airlines collect value added information (precise members profiles, consumer habits, etc.) on a population with high spending capabilities. Hence, the FFP is more and more becoming a business of its own rather than just "nice to have". These programs provide airlines with a source of recurring and low volatility income, which could expand rapidly provided that the airline gives sufficient focus to its program.

To extract the "hidden value" of these programs, several options have been observed; from creating a separate financial reporting entity (as established by Qantas) to conducting a full spin-off (in the case Aimia, a listed company which was formerly Air Canada's FFP).

Why is the FFP business model so financially attractive? What are the "pros and cons" of the various operating models offered to airlines? Does creating a separate entity create higher value of the FFP and therefore positively impact the overall value of the parent airline? What are the best ways to optimize the FFP's value?

These are the main questions that this paper seeks to provide answers to.

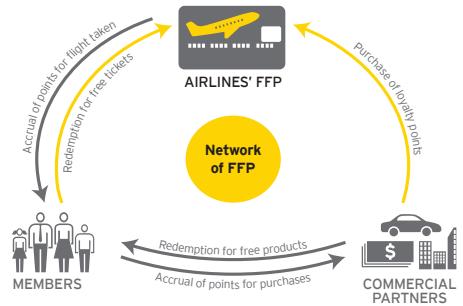
Airline loyalty programs

A Frequent Flyer Program is a loyalty program offered by many airlines to customers allowing them to accumulate (or "earn") points for flights taken or services bought from the airlines commercial partners. Members may redeem (or "burn") their accrued points for free air travel tickets or for other products and services available through a network of commercial partners.

Two main forms of loyalty programs exist, the "stand-alone" program which enables the accumulation and the redemption of points from a single provider and the "coalition" program (see the diagram opposite) allowing members to accrue and redeem points with many commercial partners affiliated to the network.

The coalition program is typically seen as the most meaningful loyalty program, as it has many benefits over the stand-alone program:

- ▶ Members have more opportunities to accumulate and redeem points leading to a better perception of the value of the program;
- ▶ Commercial partners can collect data on customers at reduced marketing costs, allowing them to optimize the impact of their marketing campaigns;
- ▶ The coalition program offers commercial partners the ability to acquire and retain at lower members cost;
- ▶ Companies can also increase the exposure of their individual brand through this network association.



As part of the coalition program, the quality and extent of the commercial partnerships are strategic for the success of the loyalty program.

The main commercial partners of FFP's are generally banks, credit cards providers, car rental companies, hotels and retailers.

Many FFP players but few listed

FFP	Airlines	Members (million)
Asia Miles	Cathay Pacific/Dragonair	4.0
Aeroplan - Aimia	Air Canada	4.7
Avios	British Airways/Iberia	5.9
Smiles	GOL	9.3
Qantas FFP	Qantas Airways	9.4
Multiplus	TAM	11.6
Air China	Air China	19.9
Flying Blue	Air France - KLM	21.0
Miles & More	Lufthansa	23.0
JAL Mileage	Japan Airlines	25.0
AA Advantage	American Airlines	72.0
SkyMiles	Delta Air Lines	74.0

Although almost all airlines are using loyalty programs however, few are highly developed. Only three FFPs are listed (highlighted in the opposite table): Aeroplan - Aimia, which emerged from Air Canada's restructuring, Multiplus (owned by TAM airlines) and Smiles which is the GOL airlines program. The table shows some of the most well-known FFPs, along with the number of members.

Sources: Brokers' reports, companies' reports, EY analysis

Operational benefits of FFP business

Three sources of cash inflows

The sources of cash flows for FFP mainly consist of (i) **gross margin on points** redeemed, (ii) **working capital benefits**, and (iii) the revenue from the **breakage**:

- ▶ The **gross margin on points** redeemed is the spread between the cost of points and the price for which they are sold to commercial partners;
- ▶ The **working capital benefits** come from interest on positive float stemming from the received cash from the sale of points (an average of 10 months to 2.2 years¹ before redemption of points);

- ▶ The **breakage** is the expiration of unused points (which usually takes place 6 to 36 months¹ after issue) which results in no reward on these points and no associated costs.

The main cash outflow results from the purchase of rewards (free airline tickets or products/services from commercial partners).



¹ Redemption and breakage expiration time observed on the sample of FFP presented above

Cash generative business model

As described above, the main operational benefits of FFPs result in the cash generated by the spread on points, interest on negative working capital and the breakage revenue. In addition, this activity does not require substantial investments so there are low cash outflows related to capex. The FFP business model is different from that of the airlines as a whole and its benefits could result in a lower volatility of earnings for the parent airline:

Spread on points (cost of points)	The frequent flyer program sells points to its commercial partners and can price them differently with each partner.	<p>Cash generative business</p>
Breakage revenue	Some of the points sold remain unused by the members until expiration. Thus, there is no cash outflows associated with the purchase of rewards.	
Negative Working Capital Requirements	Members generally wait for accumulating enough points to make redemption. During this period, the FFP receive cash billings (from commercial partners) with no cash outflows (before redemption) and earn interest income on the cash generated.	
Asset-light based	The cash (re)investment requirements for FFP businesses are low compared to the capital-intensive needs of airlines.	
Other benefits for the parent airline	<ul style="list-style-type: none"> ▶ FFP is crucial in order to drive customer behaviors on an airlines' market globally impacted by the price competition from the Gulf and low-cost airlines. ▶ Airlines could derive additional revenue from the monetization of the data mining needed for running the FFP business. ▶ Thanks to the cash generative nature of the business, the FFP helps reduce the airline's earnings volatility (driven by oil and currency fluctuations, strong exposure to economic downturns, etc.). 	

As outlined above, a FFP could be a very attractive and cash generative business. Airlines therefore have interest in considering their FFP as a business unit, and are more and more thinking how to create value with this activity by giving it more focus and autonomy.

Another key consideration when dealing with FFP is deferred revenue or "debt of miles". Indeed, under IFRIC 13 (issued in 2008), airlines reporting under IFRS need to record on their balance sheets the miles earned by each customer when he (she) purchases his (her) flight ticket as a liability.

Strictly speaking this debt of miles is "deferred revenue"; in other words, the airline which sells a ticket for €100 will "defer" the portion of revenue corresponding to the advantage granted (i.e. the miles, say €1) until the miles are actually redeemed or expired.

Also, if an airline sells some miles to a third party (say a credit card company), it will need to account for the future cost of providing the service when the customer will actually burn his mile.

While the situations can sometimes be a little more complex than that as the passenger/consumer could also decide to "burn" his miles on another airline (which is part of the same airlines' alliance) or by purchasing a service from another service provider. The "debt of miles" however shouldn't be seen as an issue for the parent airline.

In the first example (sale of an airline ticket), this debt will only be representative of the "cautiousness" which exists in recording the revenue from a given sale, while in the second example we know that the sale of a mile to a third party will generate a positive spread (as the mile is sold for more than cost) which

is a working capital benefit as the mile will be redeemed several months after its issuance or a pure profit in the case of "breakage".

While many just see the "debt of miles" as a threat or risk that weighs on the airline, a more educated vision of it would be to say that this debt of miles is representative of the normal functioning of a highly cash generative business and is therefore the normal counterpart of a very valuable intangible asset. But to change this perception, it often takes more than an explanation.

As a matter of fact, the process of subsidizing the FFP is often a good way to help change the perception around the FFP.

Unlocking the FFP valuation potential?

Business cases: Partial sell-down or separate financial reporting can benefit the whole airline group perception

Only few airlines companies have tried to capture the market value of their FFP business: Air Canada with Aeroplan - Aimia, TAM with Multiplus, GOL with Smiles and Qantas Airways with its program. These limited business cases suggest that partial float or carved out financial reporting can benefit the core airline while

the complete spin-off, as Air Canada did with Aeroplan, could lead to extract even more value but with a risk of a reducing value in the residual airline business. The table below summarizes the main specifications of the four analyzed business cases:

	Spin-Off	Partial Float	Separate Accounts																																																																																	
History	ACE (Air Canada's holding sold Aeroplan	Brazilian airlines TAM and GOL sold portion of their FFP (respectively 27% of Multiplus and 28% of Smiles)	Qantas decided to carve out its FFP as a separate division in 2008																																																																																	
Business metrics	<p>Aeroplan - Aimia (Canada) Created in 1984, Aeroplan was a FFP integrated to passenger business operations of Air Canada until 2002. In 2005, ACE Aviation Holdings (Air Canada's parent company) sold 12.5% of Aeroplan through an IPO unit trust structure. From 2005 to 2008, ACE progressively sold its remaining stake. The Aeroplan Group made several acquisitions of loyalty management and marketing companies and is now a pure loyalty management company. The company's name's changed to Aimia Inc. in May 2012.</p> <ul style="list-style-type: none"> ► Airline tie up: Air Canada ► Revenue (FY12): 2,249m CAD ► EBITDA margin (FY12): 15.5% ► Members (active, FY12): 4.7m ► Partners (FY12): 75 ► Points expiration: n/a ► Breakage: n/a 	<p>Multiplus (Brazil) Multiplus was created in 2009 to manage TAM's Frequent Flyer Program (TAM Fidelidade). TAM Fidelidade, launched in 1993 and was the first Brazilian FFP. In April 2010, TAM decided to float 27% of Multiplus, keeping a 73.2% interest. Multiplus is listed on the Brazilian index. TAM airlines has merged in April 2012 with LAN airline (Chile) to form the LATAM group.</p> <ul style="list-style-type: none"> ► Airline tie up: TAM (LATAM group) ► Revenue (FY12): 1,476m BRL ► EBITDA margin (FY12): 16.4% ► Members (Q213): 11.6m ► Partners (Q213): 445 ► Points expiration (FY12): 2 years ► Breakage (FY12): 21.3% 	<p>Smiles (Brazil) Smiles was created in 1994 by Varig airline as its Frequent Flyer Program until 2007 when Varig and Smiles were acquired by the airline GOL. As a successful loyalty program, Smiles became an independent business unit of GOL in January 2013. In April 2013, 28% of Smiles went public, while GOL retained a 57% stake. Smiles is listed on the Brazilian index.</p> <ul style="list-style-type: none"> ► Airline tie up: GOL ► Revenue (FY12): 317m BRL ► EBITDA margin (FY12): 37.1% ► Members (Q213): 9.1m ► Partners (Q213): 203 ► Points expiration (Q213): 3-5 years ► Breakage (Q213): 16.3% 																																																																																	
EBITDA margins comparison	<p>Aimia vs. Air Canada</p> <table border="1"> <caption>EBITDA margins comparison: Aimia vs. Air Canada</caption> <thead> <tr> <th>Year</th> <th>Aimia</th> <th>Air Canada</th> <th>Airlines industry</th> </tr> </thead> <tbody> <tr> <td>2012a</td> <td>15%</td> <td>8%</td> <td>-5%</td> </tr> <tr> <td>2013a</td> <td>13%</td> <td>11%</td> <td>7%</td> </tr> <tr> <td>2014e</td> <td>14%</td> <td>11%</td> <td>9%</td> </tr> <tr> <td>2015e</td> <td>14%</td> <td>13%</td> <td>10%</td> </tr> </tbody> </table> <p>Legend: Aimia (yellow), Air Canada (purple), Airlines industry (grey)</p>	Year	Aimia	Air Canada	Airlines industry	2012a	15%	8%	-5%	2013a	13%	11%	7%	2014e	14%	11%	9%	2015e	14%	13%	10%	<p>Multiplus vs. LATAM</p> <table border="1"> <caption>EBITDA margins comparison: Multiplus vs. LATAM</caption> <thead> <tr> <th>Year</th> <th>Multiplus</th> <th>LATAM</th> <th>Airlines industry</th> </tr> </thead> <tbody> <tr> <td>2012a</td> <td>37%</td> <td>9%</td> <td>-5%</td> </tr> <tr> <td>2013a</td> <td>16%</td> <td>12%</td> <td>7%</td> </tr> <tr> <td>2014e</td> <td>20%</td> <td>15%</td> <td>9%</td> </tr> <tr> <td>2015e</td> <td>22%</td> <td>16%</td> <td>10%</td> </tr> </tbody> </table> <p>Legend: Multiplus (yellow), LATAM (purple), Airlines industry (grey)</p>	Year	Multiplus	LATAM	Airlines industry	2012a	37%	9%	-5%	2013a	16%	12%	7%	2014e	20%	15%	9%	2015e	22%	16%	10%	<p>Smiles vs. GOL</p> <table border="1"> <caption>EBITDA margins comparison: Smiles vs. GOL</caption> <thead> <tr> <th>Year</th> <th>Smiles</th> <th>GOL</th> <th>Airlines industry</th> </tr> </thead> <tbody> <tr> <td>2012a</td> <td>37%</td> <td>-5%</td> <td>-5%</td> </tr> <tr> <td>2013a</td> <td>28%</td> <td>8%</td> <td>7%</td> </tr> <tr> <td>2014e</td> <td>24%</td> <td>11%</td> <td>9%</td> </tr> <tr> <td>2015e</td> <td>24%</td> <td>13%</td> <td>10%</td> </tr> </tbody> </table> <p>Legend: Smiles (yellow), GOL (purple), Airlines industry (grey)</p>	Year	Smiles	GOL	Airlines industry	2012a	37%	-5%	-5%	2013a	28%	8%	7%	2014e	24%	11%	9%	2015e	24%	13%	10%	<p>Qantas vs. its loyalty program</p> <table border="1"> <caption>EBITDA margins comparison: Qantas vs. its loyalty program</caption> <thead> <tr> <th>Year</th> <th>Qantas FFP</th> <th>Qantas</th> <th>Airlines industry</th> </tr> </thead> <tbody> <tr> <td>2012a</td> <td>20%</td> <td>10%</td> <td>-5%</td> </tr> <tr> <td>2013a</td> <td>22%</td> <td>11%</td> <td>7%</td> </tr> <tr> <td>2014e</td> <td>18%</td> <td>9%</td> <td>9%</td> </tr> <tr> <td>2015e</td> <td>10%</td> <td>10%</td> <td>10%</td> </tr> </tbody> </table> <p>Legend: Qantas FFP (yellow), Qantas (purple), Airlines industry (grey)</p>	Year	Qantas FFP	Qantas	Airlines industry	2012a	20%	10%	-5%	2013a	22%	11%	7%	2014e	18%	9%	9%	2015e	10%	10%	10%
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Based on the business cases analyzed, we observe different options to extract the "hidden value" of FFP from airlines.

The choice of each option is a complex question and depends on many factors (operational, strategic, etc.).

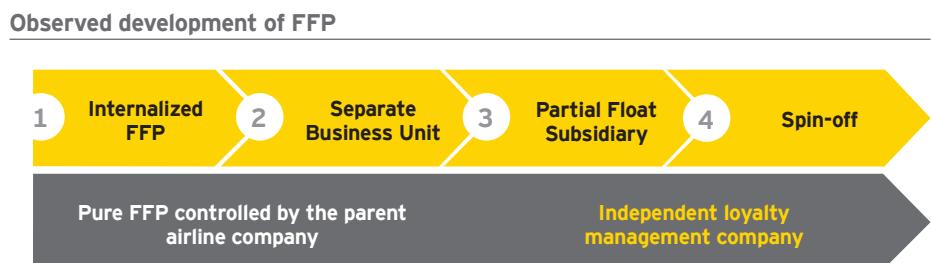
For each option, we seek to identify the main "pros and cons" that airlines have to consider before engaging in a separation process.

Source: Annual reports



Separation process: from internalized FFP to complete spin-off

Based on the business cases observed, the evolution of airlines' FFP seems to follow a step-by-step separation process in order to develop and enhance further value of this business. As presented in the graphic opposite, a FFP could develop from an (1) internalized loyalty program to a (2) separate business unit (eg. Qantas, Smiles before IPO), then to a (3) partially floated subsidiary (eg. Smiles and Multiplus) and finally to (4) an independent loyalty management company (eg. Aeroplan - Aimia).



1 Internalized FFP requires relatively low operating costs and investments. It is fully focused on passenger loyalty as it is completely controlled and managed by the "passenger business management team". It is more difficult to attract third party revenue stream (from commercial partners) and to clearly communicate the impact of the FFP on overall financial performance to the market.

2 Acting as a **separate Business Unit** gives more autonomy on decision making (separate budget under the supervision of the parent airline) and helps develop partnerships and revenue from third parties. Also, for listed airlines such as Qantas which discloses financial accounts for its FFP, it could positively contribute to the overall financial performance and could improve the value of the entire airline group. Nevertheless, the full valuation potential of the loyalty program may not be achieved as the volatility of the airline business earnings may mitigate its development.

3 Partial float/subsidiary allows a highly transparent view on the profitability of the FFP. The transfer pricing relationships between the FFP and the airline, which could be a critical issue, remains under the control of the airline. When listed, as with Smiles and Multiplus, investors can access a "pure FFP investment" without being exposed to the airline business volatility.

4 After a complete **spin-off**, a FFP company could offer better valuation upside for investors and more flexibility for the management to develop as Aimia did, making strategic acquisitions after separation from Air Canada. But, the stand-alone airline business would have no access to operational benefits of the FFP and remain fully exposed to the airline earnings volatility. Also, the loyalty company may no longer focus on passengers loyalty and the transfer pricing policy would not be under control.

Sources: Booz & Company research, Aeroplan, EY analyses

FFP valuation insight

Higher trading multiples for loyalty management companies than airlines

When looking at the trading multiples of our loyalty management peers sample (FFP and pure loyalty management companies¹), we observed a higher valuation perception of FFPs compared to listed legacy carriers.

Indeed, the analysis of the average EV/EBITDA multiples of loyalty management companies results in a 79% premium over the average EV/EBITDAR (Earning Before Interests Taxes Depreciation & Amortization & Rents) for our airlines peer sample as presented in the chart² below.

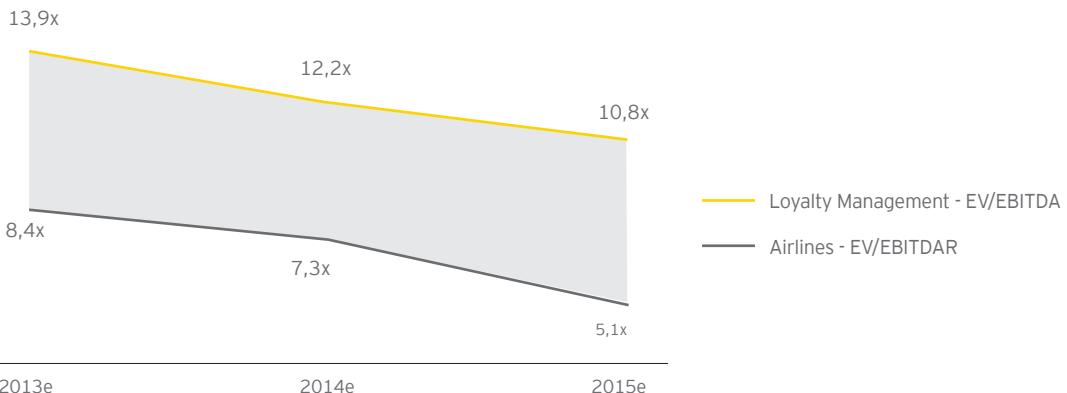
Based on operational benefits and on the higher value of FFP businesses compared to airlines, it could be surprising that only four airlines have engaged in a separation process. This can be partly explained by the fact that such a process implies certain organizational and strategic questions to be answered and could require costs and time for setting-up a separate subsidiary with no guarantee of success. As an illustration of the higher focus given to FFP, we can however note that at least three private transactions recently took place relating to FFPs (see next sector).

Loyalty management peers

Multiplus	Alliance Data
Aimia	Points International
Smiles	

Airline peers

Delta	Qantas
United Continental	Air France - KLM
Lufthansa	GOL
LATAM	Air Canada
British Airways & Iberia	TAM
Cathay Pacific	



Recent transactions in FPPs show high valuation potential

The table below presents three transactions that took place in 2012 and 2013:

Date of deal	Target (FFP)	Buyer	Seller	Deal value	% acquired	Eq. Value (100%)	Eq. Value mEUR	Total members	Eq. Value/Member (€)
20/11/2013	Jet Privilege	Etihad	Jet Airways	150 USD	50,1%	299 USD	228	2,5	91
18/12/2012	Topbonus	Etihad	Air Berlin	200 EUR	70%	286 EUR	286	3,1	92,2
29/10/2012	Aeromexico PLM	Aeroplan - Aimia	Aeromexico	88 USD	20%	440 USD	341	2,9	117,7

The “transaction member multiple” related to these operations results in a value per member comprised between €91 and €117.7. Applying an average of €100 to the number of members of any FFP could therefore indicate its potential market value. For obvious reasons, a price per member shouldn’t be used to derive a precise fair market value of a given FFP but it can be considered as a “back of the envelope” computation of how much such a business could be valued, assuming it is run successfully.

Sources: EY analysis, brokers' reports

1 Alliance Data and Points International

2 As the FFP have virtually no rent charges, their EV/EBITDA is equivalent to their EV/EBITDAR and provide a more “apple to apple” comparison to the legacy airlines’ EV/EBITDAR



Conclusion: Why only few separated FFP?

Establishing a performing separate FFP requires a large active member base and a strong partnership network, but the process to become a pure loyalty player is more demanding and complex. As our analysis demonstrate, FFP and loyalty management companies seem to generate more value than the traditional passenger business (based on trading multiples). However, when looking at the higher multiples, one should keep in mind that:

- ▶ The higher current multiples are not only arising from the business model of the FFP, but also translate the high expected growth of the programs (eg. exposure to emerging markets for Multiplus and Smiles).
- ▶ The companies that we analyzed, have a successful track record at as airline loyalty programs and have a strong coalition network.
- ▶ The listed companies analyzed have demonstrated their ability to constantly increase the perceived value of their program (clients segmentation, rewards, etc.); so as to obtain an active and large member base.

Keeping the FFP “internalized” would certainly not enable it to unlock its full value potential. On the contrary, a complete spin-off raises significant risk issues, such as:

- ▶ Some major operational issues (carve out, IT, social law, data privacy, etc.).
- ▶ The impact of spinning-off the FFP on the airlines’ financials (potential increased volatility of earnings).

Nevertheless, the trend towards greater autonomy and focus given to the FFP should expand in the future as airlines will realize that they hold a valuable asset.

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