REPORT
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SPIN-OFF LOYALTY

It appears increasingly likely that some carriers will follow Air Canada's lead and spin off their frequent flyer programmes. But is this the right option?

Air Canada became the first airline to spin off its frequent flyer programme when it sold a 12.5% stake in 2005. By March 2007, the carrier's parent company ACE Holdings had sold the remainder of its shares in the Aeroplan programme. The spin-off was deemed a success, with ACE netting an impressive one-off benefit and Aeroplan's value more than doubling since 2005. But should airlines rush to make a quick buck by spinning off their FFPs? Or should they take a more cautious approach geared towards longer-term gains?

The spin-off strategy of ACE, which also sold other units during the same period, most notably its regional feeder operation Jazz, has shown that the sum of the value of independent units is larger than the former total value of the airline. This new school of thinking has caught the attention of airlines worldwide. For the US majors in particular, the value of the FFP unit alone might come close to the total value of the airline. However, only a handful of carriers, including American Airlines, Qantas and United Airlines, have publicly said that they are considering a possible spin-off of their FFPs. The majority of Asian, European and Middle Eastern carriers do not envisage such a move at this point, with their finances healthy enough not to warrant it.

The motivation for an airline to consider a spin-off is generally to improve its balance sheet. For instance, the market value of United's Mileage Plus programme, a business with an annual turnover of $800 million, is estimated at around $7.5 billion. This balance sheet approach is neither an airline industry innovation nor limited to FFPs as balance sheet improvements are always expected when companies sell selected units. Over the past decades, airlines have explored such opportunities by selling affiliated hotel companies and maintenance or catering units.

"Growth potential and free cash flow make frequent flyer programmes interesting investment targets"

RICHARD SCHIFTER
Managing partner, TPG Capital

Spin-offs are even more tempting now, as investment capital for such projects appears within reach of most major airlines. Richard Schifter, managing partner at TPG Capital, which has an impressive track record of active investments in the airline industry but has not itself invested in a FFP, confirms that FFPs are interesting investment targets "because of their growth potential and free cash flow characteristics". Schifter believes that as FFPs evolve they will become even more attractive to investors. In fact, a Morgan Stanley report cites FFPs as being more sustainable and less risky than direct airline investments.

Qantas chief executive Geoff Dixon identified a far more basic advantage of considering a spin-off: it allows a market value to be attached to the FFP operation. Dixon has quietly admitted to the current lack of transparency reigning in FFPs – a problem that is not only limited to Qantas. Many carriers, including the majors, still do not properly account for accumulated miles and redeemed awards on their own airline. This leads to a false picture of the value of the FFP operation. While the new IFRIC13 accounting standard, which determines how liabilities of loyalty programmes need to be handled, won't address the financial relationship between the parent airline and its FFP as such, it might help to steer some airlines in the right direction in the sense of more transparency,

The financial performance changes for the new owner, concentrating now on developing the value of the programme, which has cut ties with its former parent airline and is likely

to benefit from a better investment climate as a result. TPG Capital's Schifter makes no secret of the fact that the ability of the FFP to sell points to third parties and the financial basics between the FFP and the parent airline are the key drivers of value from an investor's perspective. This is almost the opposite focus of an airline-controlled FFP, which still primarily aims to create loyalty and build relationships with clients. Control over the programme is assumed by a party with a completely different strategy. An independent operator such as this might even touch on basics such as accrual and redemption rules on the former parent airline. For this reason, when spinning off FFPs it is important for airlines to "maintain some control over the programme", says Stuart Evans, European general manager of loyalty marketing agency ICLP.

It is telling that Air Canada accounted for a mere 25% of all miles accrued in the Aeroplan programme between March and September 2007, placing it well behind financial service companies in terms of miles accrued. Comparable parent airlines with in-house FFPs usually account for about twice this share in their programmes. This change of focus is also shown by Aeroplan's purchase of the UK's Loyalty Management Group last December. The company operates, among others, the Nectar programme, a UK consumer loyalty programme built around the Sainsbury's supermarket chain. Although FFPs are already highly profitable, even more money can be made by expanding into other sectors.

Aeroplan vice-president corporate strategy and business development Marc Trudeau says the biggest change in the relationship between Air Canada and Aeroplan since the spin-off is that there is "a lot more clarity between the two parties on the true costs and revenues" generated by the FFP. He adds that Air Canada has kept an element of control over the programme: "Air Canada's influence is very significant. They haven't lost control and the seats we buy from them are essentially controlled by Air Canada. Their access to members, data and communication channels has remained unchanged; the difference is they pay for the services.

"We didn't separate from Air Canada to gain an independence that would damage the brand or the partner itself. We decided it would be better to be separate from the airline, but that didn't mean our intentions were to do anything in the interests of Aeroplan that was against Air Canada." Trudeau says that "for the most part, nothing has changed".

But will Air Canada's Star Alliance partners be happy about having to deal with a third party loyalty company? Trudeau believes this is just something they will have to accept. "If other Star Alliance carriers are complaining, I would argue that it may be because we have a lot more resources than an average FFP," he explains. "We're more savvy than we were five years ago and it's not as straightforward on a bilateral basis as it used to be. We don't negotiate deals on a bilateral basis, it's trilateral. The price we charge is of great relevance to us so, like it or not, we will be involved in the negotiations. But it's not true to say that Aeroplan negotiates on behalf of Air Canada with other carriers."

When Aeroplan was spun off, the Air Canada name was removed from its branding, which Trudeau says was important to allow the loyalty company to enter sectors outside the airline industry. "The reason we branded differently from Air Canada was to make sure Aeroplan would be recognised," he explains. "We had to create some distance with the airline because we're entering sectors where Air Canada is not relevant. We're a marketing company and we offer services aimed at increasing the loyalty of customers. The right way to do this is to reposition the brand."

Robert Milton, chairman of ACE Aviation and the architect of the break-up of Air Canada, describes Aeroplan as a "great, stable, cash-flow business", and says that "the market likes these". He adds: "Airlines are great incubators for businesses, but if you don't get them out of the airline they won't do anything other than be sucked alive."

However, airlines would be well advised not to limit their views to a potential one-time financial gain. While spin-offs in other sectors are usually justified by the "non-core business" argument, this hardly applies to FFPs, which are crucial to every airline and their marketing strategy. These soft factors are, however, beyond a pure investor's

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perspective. It would therefore not come as a big surprise if Qantas decided to set up a separate business division for its FFP within the airline, rather than spinning it off.

Evert de Boer, loyalty director Asia at Carlson Marketing, believes airlines will be more likely to follow this strategy than to sell off their FFP's through an initial public offering, due to slowing economic conditions. "We will see more spin-offs where airlines make their FFPs transparent and treat them as separate profit centres that are run as a separate unit of the airline," he says. This is a strategy that was followed by Mexicana in January when it restructured its Mexicana Frecuenta FFP into a separate unit within the airline group. Mexicana's senior vice-president of public relations and customer service, Adolfo Crespo, says there are "no plans to sell it, as it is an integral part of our business".

However, De Boer points out that selling off FFPs through an IPO is a "very interesting option for North American carriers". He says it make particular sense for US airlines because they have "a large domestic market, a focus on economy class and a mix of short- and long-haul flying". American Airlines, which has the largest loyalty plan in the world in its AAdvantage FFP, last year came under pressure from shareholder FL Group to spin off the programme. American has said this is one option its board is considering, but FL Group, frustrated at the lack of progress in moving this forward, sold most of its 9.1% stake in the carrier late last year. ACE's Milton believes AAdvantage is "the most valuable FFP on the planet" and is worth $15 billion, but has been "compressed into American Airlines".

Aeroplan's Trudeau advocates FFP spin-offs, but adds a note of caution on market conditions. "It's a good idea for airlines to spin off their FFPs into separate businesses. It allows the operator to track all the ins and outs, which allows for much better decision-making," he says. "It's not all black and white though. It's only a good thing in certain conditions; the financial markets have got to be healthy." Trudeau describes Aeroplan as "the guinea pig" and says he has been taken aback by the level of airline interest in its separation from Air Canada: "We've been contacted by over 30 airlines to see what we did and how we did it. This has surprised us."

But ICLP's Evans does not see a string of similar transactions taking place in the airline industry, due to the complexity of carrying out such deals. "I don't believe there will be a wave of spin-offs because senior managers with sufficient understanding of this market are limited," he says. "It's not an easy thing to do. It's like changing the wheels on a moving car. I don't think a rash of airlines will do it, probably no more than five or six in the next couple of years." Evans points out that "any dominant home market carrier, provided they can remain dominant, can spin off their FFP". However, he cautions that while "spinning off is great", airline loyalty programmes are "very constrained if they don't deal with liability".

It remains to be seen whether an independent programme will really be able to deliver the same qualitative value to an airline as an in-house FFP in the medium-term. Before selling FFPs, airlines should consider the wider picture and evaluate alternative directions their programmes could take. Given the strategic implications at stake, refraining from spinning off FFPs might bear greater rewards for airlines further down the road. ■

For more on ACE's spin-off strategy read our chief executive interview with Robert Milton at: **flightglobal.com/Milton**

POTENTIAL OUTCOME OF LOYALTY SPIN-OFF

A possible outcome of spinning off a frequent flyer programme can be shown using a simplified calculation model for a fictitious airline (*see table*).

Model B is characterised by full transparency due to the proper inclusion of the parent airline in the FFP finances. The airline realises a profit of $150 million with a $450 million turnover.

In Model A the airline excludes itself from the accounting even though the FFP remains the same in models A and B. This results in a very different picture. The fictitious airline now makes a $50 million profit with a total turnover of $200 million.

If the FFP is sold, the new programme operator will replace the airline behind Model B. It can clearly be seen that while the airline will realise a one-time benefit from the transaction, it faces recurring costs leading to the $105 million loss shown in Model C after the sale has gone through.

The airline now purchases miles while it sells an award inventory like any other programme partner.

Moreover, a management fee will be levied by the programme operator to cater for special needs of the airline, such as the operation of an elite programme.

Such a fee is also paid by Air Canada to Aeroplan.

HYPOTHETICAL FREQUENT FLYER MODELS

	A	B	C
Miles accrued on parent airline		250	-250
Miles accrued on partners	200	200	
Awards used on parent airline		-150	150
Awards used on partners	-50	-50	
Administration costs	-100	-100	-5
Total FFP operation	**50**	**150**	**-105**

Fictitious annual figures in million US$.

ABOUT THE AUTHOR

Ravindra Bhagwanani is managing director of Global Flight, a consultancy specialising in frequent flyer programmes. It is teaming with Airline Business to launch Loyalty 2009, a new event for the FFP community. For more information visit: **loyalty2009.com**