Separation Anxiety: Considerations in Frequent Flyer Program Monetization

At the time, the pioneering spin-off (and subsequent IPO) of Air Canada’s frequent flyer program (FFP) appeared to usher in a new era of loyalty program monetization. In many ways, the creative but radical divestiture of Aeroplan in 2005 provided an alternative pathway in an industry that was grappling with escalating factor costs, persistent over-capacity and over-leveraged balance sheets. Despite the initial buzz, however, managerial apprehension in the years that followed prevented widespread adoption of the strategy.

More recent successes – including Virgin Australia’s $293 million, 35% divestiture of its Velocity FFP to Hong Kong-based Affinity Equity Partners in 2014 – have prompted airlines to revisit the merits of FFP monetization, so long as valued customer relationships aren’t jeopardized in the process. While it may not be the best choice for all carrier models, the strategy deserves careful consideration.

In this Executive Insights, we examine the strategic rationale, value maximization strategy and separation dynamics associated with carving out all or part of an airline loyalty program across a continuum of strategic alternatives (see Figure 1).

Figure 1
Loyalty Program Development

Separation Anxiety: Considerations in Frequent Flyer Program Monetization was written by John Thomas and Dan McKone, managing directors, and Brett Catlin, an engagement manager, in L.E.K. Consulting’s Aviation and Travel practice. John, Dan and Brett are based in Boston. For more information, contact aviation@lek.com.
FFP Separation: A Strategic Rationale

Key benefits arising from a separated FFP typically include:

- Raising significant funds quickly
- Driving improved managerial focus
- Creating greater investor transparency

The liquidity factor. The ability to raise significant funding is often cited as the primary motive behind loyalty franchise monetization. Early on, these divestitures might have been associated with airlines that were on the verge of insolvency. However, recent moves by Qantas and Lufthansa to separate their FFPs without immediately seeking outside capital suggest the “distressed imperative” is not the only factor.

Dedicated management. A carved-out loyalty business (“LoyaltyCo”) can attract and harness the energy of a talented leadership team (often with a different managerial skill set). This team is exclusively focused on optimizing LoyaltyCo’s stand-alone marketing services, capabilities and value, often freeing the business to grow with fewer constraints. When autonomously managed, a loyalty program arguably has more license to aggressively pursue inorganic expansion. We observe that separated FFPs are also forced by the market to be increasingly competitive in areas such as CRM, merchandising and promotion. They also tend to be more assertive in enlisting a diverse set of partners capable of enhancing everyday program relevance.

Create greater investor transparency. Another benefit is the ability to grant investors greater insight into enterprise financials that were not previously shared, understood or appropriately valued. Indeed, the presence of a “conglomerate discount” has led various global carriers to divest seemingly symbiotic assets such as technology platforms, maintenance divisions and regional operations. Observable market multiples for airlines versus consumer marketing companies notionally support the assertion that the two distinct business profiles can be worth more separated than together. The rationale behind this is that a combined entity, run by traditional airline executives, can bias capital decisions to what these executives know best.

In other words, “inefficient” economic outcomes can result if cash flows generated by the loyalty program are reinvested to serve the core airline first instead of migrating to the opportunity with the highest marginal return on invested capital. This second argument is controversial, since it implies that not all decisions are made rationally. There remains, however, the risk that cross subsidization can occur between operating units when they are jointly managed. The mere potential to obscure underperformance in the core airline’s operation could lead skeptical investors to discount a combined entity.

Ensuring a Successful Separation

For airlines, it is important to build a separation architecture that does not cede undue control. Unless clear provisions are made in advance, dividing the program financially and operationally from the parent company can affect the airline’s ability to promote repeated high-value behaviors among the customer base.

As a first step, the organization must examine its prevailing policies around the spread (i.e., gross margin on points), float (i.e., working capital) and breakage (i.e., expired currency) associated with the loyalty program. It is also critical to ensure that the internal carrying cost of the currency accurately represents the slate of future liabilities associated with benefit fulfillment. Even for publicly traded companies subject to IFRIC 13, the internal mechanism for valuing the nominal “point” is often inadequate when it comes to a separation. In L.E.K.’s experience, determining and validating this metric is a key initial activity in a successful separation.

Operationally, transitioning from an in-house program to a separated entity must be tightly choreographed to ensure continuity in service delivery. For many organizations the question of “who owns the customer relationship” becomes a stumbling block when core CRM technology systems are divided. This conflict can extend to third-party coalition partners who are integral to the program’s economics (i.e., co-branded credit card providers). The point of delineation is often between recognition and accrual/redemption, with the airline owning the former and the loyalty program owning the latter. Regardless of the ultimate split, it is imperative that a level of real-time data access (i.e., customer knowledge) and robust communication channels be retained for all parties to the agreement.
Once the financial model has been assessed and the operating platform defined, the organization can begin to address a broader set of equally important issues to increase the likelihood of commercial success post-separation.

Drawing the Lines for Longevity

While the separation of LoyaltyCo from the airline implies greater autonomy, the extent of this independence raises a number of strategic questions, including:

- What merger and acquisition alternatives will be permitted?
- What coalition development freedoms will be allowed?
- What is the appropriate accrual/redemption framework?

The first issue concerns the ability of the separated loyalty entity to make acquisitions and divestitures with or without the consent of the airline. For a number of reasons, the possibility of capturing value through consolidation will hold some of the greatest appeal to potential investors. Accordingly, the airline needs to consider how it trades off the potential value of conferring this flexibility with potential conflicts of interest (or conflicts of focus).

The second involves the degrees of freedom that the airline grants to LoyaltyCo to strike outside partnerships or to pursue a broader coalition. Clearly, an important activity for customer loyalty programs is continued development of this slate of partnerships to drive day-to-day program engagement. If LoyaltyCo is restricted (even partially) from forming value-enhancing partnerships, it may be at a significant disadvantage versus competitors. Questions abound as to where the right balance is – depending on the number and type of partners enlisted – between enhancing, and actually diluting, the loyalty of the airline’s own customers. In the most extreme case, considerations need to be made about what actually defines a competitor of the airline and how protections can be crafted to prevent LoyaltyCo’s business development engine from directly or indirectly benefiting players that fall into this set.

Lastly, given the airline’s presence as the anchor tenant to the loyalty coalition, the balance of power around accrual and redemption must be thoughtfully designed. This is necessitated by the imbalance between a proliferation of accrual sources and a relatively fixed supply of “compelling” redemption opportunities. With redemption demand growing faster than supply, LoyaltyCo might need to pay higher rates in order to maintain the health of the program. There is also a risk that miles converge to some completely transparent standard (say, some factor of a penny per mile), thereby commoditizing the currency. Preventing this spiral through carefully crafted redemption frameworks is critical to maintaining the allure, and long-term health, of the program.

Unlocking Liquidity Through Separation

Over the past decade, airlines have derived nearly $3 billion in liquidity from partial or full loyalty program separation. The eight transactions that have been completed to date cover a wide range of geographies, transaction sizes and airline operating models (see Figure 2). For the airlines pursuing monetization in a non-distressed situation, the process generally occurred over the course of one to two years, with an initial architectural separation forming the base for a subsequent liquidity event.

For airlines considering partial or full separation of their FFP, there are a series of questions that should be addressed to ensure the concept is both financially sound and tactically achievable. For starters, how much value can be realistically captured from a separation? While comparable transactions provide a representative view, each program will have its own distinctive profile. Assuming the “size of the prize” meets internal requirements, management should then perform a more granular interrogation of the opportunity, including:

Commercial structure:

- What structures should be put in place to assure any required alignment of interests between the airline and the LoyaltyCo?
- What considerations should be made to accommodate changes in accrual structures (e.g., a move to revenue-based from distance-based)?
- Should minimum levels of activity be contracted?
Will minimum levels of redemption availability be guaranteed?

How will dynamic redemption mechanisms be calculated?

How will any fees be regulated and which party will benefit (e.g., fuel surcharges, close-in booking fees, etc.)?

Will any cash, assets and/or liabilities be transferred back to the parent entity prior to the spin-off?

How will brand(s) and other intangible assets be treated (e.g., will a licensing fee apply)?

What is the process for handling loyalty program partners for which the airline owns the relationship (e.g., other airlines, alliance partners, etc.)?

Governance considerations:

How long should the agreement run?

What mechanism should be put in place to protect minority party interests (e.g., related party transaction approval, etc.)?

What is the resolution process in the case of a merger or other event which fundamentally changes the airline/LoyaltyCo relationship?

Will a “golden share” or other similar instruments apply to the spin-off agreement?

How long will the airline serve as the anchor tenant to LoyaltyCo?

How will exclusivity be addressed in the future (e.g., if the airline wants to launch a new loyalty mechanism for specific customers)?

While none of these decisions are straightforward, all can be resolved through defined approaches; indeed, L.E.K. Consulting has helped numerous airlines and investors with these wide-ranging issues using rigorous bespoke analysis and extensive visibility into industry leading practices.

Bottom Line

Each airline must balance its broader loyalty strategy to the maximum benefit of stakeholders with both a short- and long-term view to value creation. While there is no one-size-fits-all approach, there are ample opportunities for airlines to extract further value from their FFPs.
L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 30 years ago, L.E.K. employs more than 1,000 professionals in 21 offices across the Americas, Asia-Pacific and Europe. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

For further information contact:

**Boston**
75 State Street
19th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

**Chicago**
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

**Los Angeles**
1100 Glendon Avenue
19th Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

**New York**
1133 Sixth Avenue
29th Floor
New York, NY 10036
Telephone: 646.652.1900
Facsimile: 212.582.8505

**San Francisco**
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

International Offices:
Beijing
Chennai
London
Melbourne
Milan
Mumbai
Munich
New Delhi
Paris
São Paulo
Seoul
Shanghai
Singapore
Sydney
Tokyo
Wroclaw

L.E.K. Consulting is a registered trademark of L.E.K. Consulting LLC. All other products and brands mentioned in this document are properties of their respective owners.

© 2015 L.E.K. Consulting LLC