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Americas/Brazil
Equity Research
Airlines

Airlines and Loyalty

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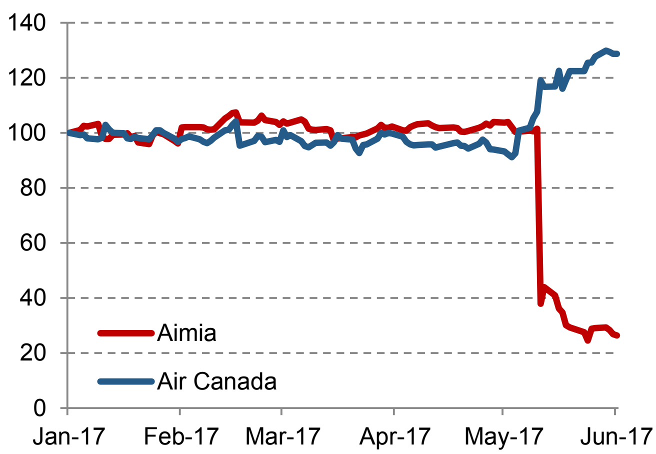
COMMENT

Days of Future Past

- **Air Canada to end exclusive contract with Aimia:** Last month (May 11), Air Canada (AC) announced its decision to launch its own loyalty program in 2020 upon the expiry of its commercial agreement with Aimia (AIM), the operator of Aeroplan. Effective June 30, 2020, Aeroplan will no longer be the loyalty program for Air Canada. We recall that Aeroplan has been independently owned and operated by Aimia for almost a decade.
- **AIM down 74%; AC up 30%:** Since early May, Aimia shares dropped 74% or ~CAD1bn while Air Canada shares are up 29% or ~CAD1.3bn which means more than full transfer of value from the loyalty company to its parent airline. According to AC's press release, Air Canada expects the net present value of the program repatriation to exceed CAD2bn over 15 years, with more financial details to be provided on September 19.
- **Negative read-through for MPLU3 and SMLE3:** While we acknowledge it's still early to discuss contract renewals for Multiplus and Smiles, we believe this event will anticipate concerns on the matter. Bear in mind that the listed loyalty plans in Brazil enjoy commercial agreements with their parent airlines somewhat similar to that between AIM and AC, in terms of expiration clause and transfer price for points and tickets transactions which, at the end of the day, is a relevant driver for costs and profitability. We can fairly say that Aeroplan's spin off and its subsequent IPO was a benchmark case for the IPO decisions of Multiplus and Smiles.
- **Message from the future:** Even though this event happened three weeks ago, it seems to us that the market hasn't paid much attention to this fact so far (including us). Also, the AIM-AC case could be a possible (not necessarily likely) future for Multiplus and Smiles as their contracts with parent airlines also have expiration clauses. However, there is still plenty of time to discuss the matter and figure out better outcomes for all parties involved. It's an opportunity to avoid a drastic future without impacting the present, as Wolverine accomplished in X-Men movie: Days of Future Past.
- **No reasons to panic, at this point…** The contract between Multiplus and TAM only expires in 2024YE (7.5 years from now) and in 2032YE for Smiles-GOL (15.5 years from now). In this context, (i) we don't expect any decision to be made by parent cos in the next 3-4 years, and (ii) the high dividend profile of both loyalty companies should offer downside protection.

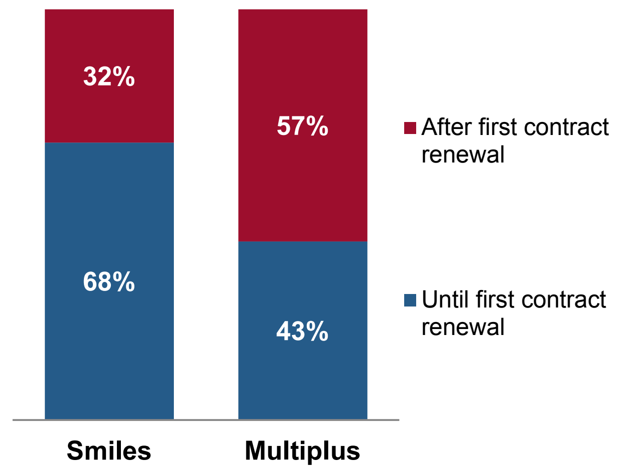
- **but, what-if the bear case happens?** As sensitivity analysis, if we were to assume that Latam and Gol follow Air Canada and decide not to renewal their contracts with Multiplus and Smiles, respectively, then there would be significant downside risk to the loyalty names (and possible upside risk to parent airlines). Bear in mind that (a) ~57% of our DDM-based TP for MPLU3 derives from the dividends to be paid from 2025 onwards, (b) ~32% of our DDM-based TP for SMLE3 derives from the dividends to be paid from 2033 onwards, and (c) our base cases assume contract renewal at current conditions and perpetuity for both companies. Conversely, it means an equity value of BRL 3.2bn for MPLU3 and BRL2.3bn for SMLE3.

Figure 1: Relative performance of AIM and AC



Source: Bloomberg, Credit Suisse Research

Figure 2: Breakdown of CS DDM-based TP



Source: Company data, Credit Suisse estimates

- **Market cap and parent's ownership bring alignment:** Relatively to the AIM case, the Brazilian loyalty names enjoy the benefit of having parent airlines as relevant controlling shareholders. Latam owns 73% of Multiplus (or BRL 4.7bn at current market value) and Gol owns 54% of Smiles (or BRL 4.1bn), while Air Canada had no stake in Aimia. We believe this fact should help SMLE3 and MPLU3 to avoid drastic scenarios. However, the question is whether the downside on the loyalties' market cap can be fully captured in the market value of the parent airline, as seen in AC-AIM case.
- **What about post-IPO tax inefficiencies?** A relevant theme that should drive future renewal discussions is the tax inefficiencies as a consequence of the spin-off of loyalty plans. We see two major inefficiencies from: (i) tax on revenues (PIS/COFINS) as the rates for airlines are lower than for loyalty companies, and (ii) income taxes as loyalty programs have been profitable and thus paying taxes, while parent airlines have been delivering negative profitability (even fully consolidating the results of loyalty plans).

More details about:

- **Agreement between Latam and Multiplus:** The operational contract between Multiplus and Latam was signed on December, 2009 with a 15-year term (therefore expiring in 2024YE) and automatic renewals for 5-year periods if no declaration by either party is made to the contrary with prior notification of 120 days in advance.
- **Agreement between Gol and Smiles:** The operational contract between GOL and Smiles was signed in December, 2012 a 20-year term (therefore expiring in 2032YE) and automatic renewals for 5-year periods if no declaration by either party is made to the contrary with prior notification of 2 years in advance.
- **Aimia:** Formerly Groupe Aeroplan, Aimia is a data-driven marketing and loyalty analytics company based in Montreal. Aimia manages various loyalty programs including Aeroplan in Canada, Nectar (Italy and the UK) and provides loyalty strategy,

program development and management services to clients underpinned by product and technology platforms. The company also owns stakes in loyalty programs, such as Club Premier in Mexico, Air Miles Middle East and Think Big, a partnership with Air Asia and Tune Group. Groupe Aeroplan was spun out from Air Canada's former parent company, ACE Aviation Holdings Inc., in 2005 before re-branding itself as Aimia in 2011.

Companies Mentioned *(Price as of 01-Jun-2017)*

ACE (ACEL.NS, Rs65.9)
Aimia (AIM.TO, C$2.33)
Air Asia X (Unlisted)
Air Canada (AC.TO, C$17.77)
Gol Linhas Aéreas (GOLL4.SA, R$7.65)
LATAM Airlines (LTM.N, $11.19)
Multiplus (MPLU3.SA, R$40.04)
Smiles (SMLE3.SA, R$61.72)
Tune Ins Holdings Berhad (TUNE.KL, RM1.28)

Disclosure Appendix

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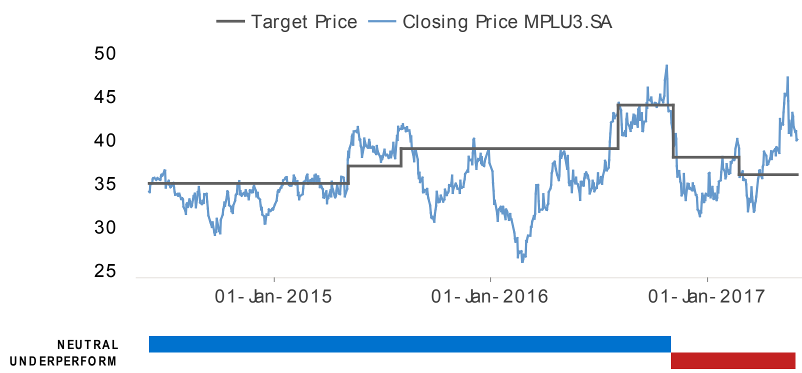
3-Year Price and Rating History for Multiplus (MPLU3.SA)

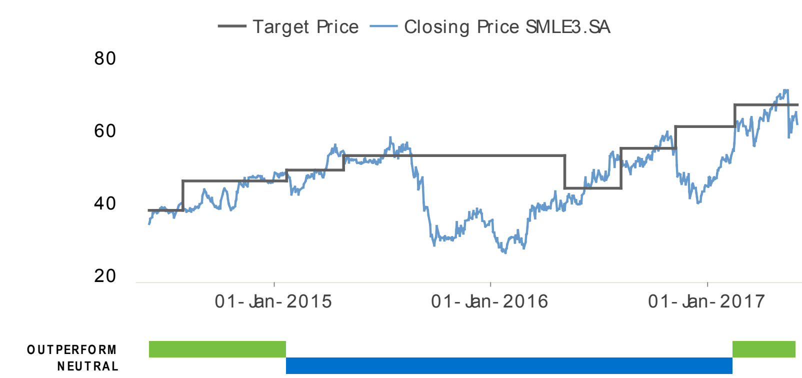
MPLU3.SA	Closing Price	Target Price	
Date	(R$)	(R$)	Rating
04-Jun-14	34.05	35.00	N
06-May-15	38.65	37.00	
31-Jul-15	41.25	37.00	*
03-Aug-15	41.26	39.00	
03-Aug-16	43.25	44.00	
04-Nov-16	39.08	38.00	U
23-Feb-17	39.01	36.00	

** Asterisk signifies initiation or assumption of coverage.*



3-Year Price and Rating History for Smiles (SMLE3.SA)

SMLE3.SA	Closing Price	Target Price	
Date	(R$)	(R$)	Rating
04-Jun-14	34.14	37.87	O
31-Jul-14	39.50	46.00	
22-Jan-15	48.00	49.00	N
28-Apr-15	54.00	53.00	
31-Jul-15	55.31		*
04-Aug-15	55.75	53.00	N
05-May-16	38.00	44.00	
08-Aug-16	51.00	55.00	
08-Nov-16	55.92	61.00	
16-Feb-17	59.25	67.00	O



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