

Latin America Airlines

■ Industry Overview

Reasons To Smile? (A Brief Look Loyalty Programs, In a Global Context).

- **Good news, bad news** — while our analysis reveals that airline loyalty program spinoffs could have positive ST implications for the host airline, longer-term trading data reveals that the host airline shares tend to materially underperform their loyalty program counterparts. Among other factors, airlines spinning off loyalty programs must balance potential ST gains, against the risk of giving the market too much information (*how bad are margins without loyalty program results, etc.?*).
- **A (mostly) un-trodden path** — with the exceptions of Air Canada and TAM, the global aviation industry has refrained from Loyalty Program spin-offs. Overall, the short-term capital-raising benefit seems to be more than offset by concerns regarding (A) a re-allocation of the airline's overall profitability and valuation (with the loyalty program piece often boasting stronger margins), and (B) losing control of their customers. Citi's Andrew Light mentioned that Qantas seemed to have considered this route a few years ago (but backed away), while our colleagues in Asia have stated that this entire topic has been "off the radar screen."
- **Aeroplan vs. Multiplus** — we note that Air Canada's stock price has lost -94.1% of its value (in Canadian dollars) since its IPO, versus a decline of -11.1% for Aeroplan. Separately, TAM's local share rose +11.7% from the point of Multiplus' 2/4/10 IPO through the close of 8/13/10 (the LAN-TAM MOU was announced that afternoon). Multiplus' shares advanced +46.3% over the same period.
- **Why not upgrade?** — we estimate that a partial spin-off (similar to TAM's strategy on Multiplus) could add ca. US\$1.00/ADR to our GOL target price, assuming a ca. 35% EV/customer discount (owing to GOL's smaller, less diversified network vs. LATAM, rising long-term breakage ratios, *and our concern that many current Smiles customers might be long-term customers of a global flag carrier that no longer exists* (Varig)). We balance the implied target price add against a stock that has bounced ca. +25% in 2 weeks (w/o any meaningful f/x help), the risk that 2Q12's balance sheet might look worse than the market expects, and on our concerns on a cloudy competitive outlook. We remain Neutral on GOL.

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We continue to believe that a potential Smiles program IPO could create short-term (trading) opportunities in GOL. . .

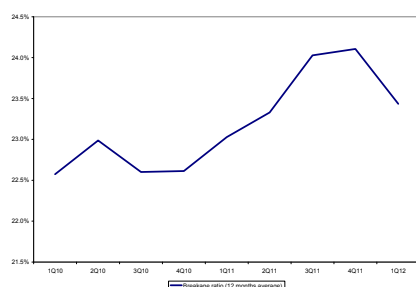
Summary

We advise clients against taking bullish positions on airlines, simply because those carriers are contemplating loyalty program spinoffs. On a global level, *our colleagues mention to us that almost no carriers have even ventured down this path*, as managements seem to have concluded that such spinoffs are not worth it. In our April 27th *Gol Linhas Aereas Inteligentes (GOL)* note, we had highlighted the possibility that GOL's potential spin-off of Smiles could serve as a trading catalyst for the shares (we cited that as one of the specific reasons that we upgraded the shares).

Assuming that GOL pursues a spin-off that is similar to what we saw with TAM's Multiplus program, we estimate that such a move could add US\$1.00/ADR to our target price (via a reduction in net financial leverage). We consider Multiplus' EV/customer (ca. R\$7.2B, divided by LAN/TAM combined loyalty program membership of 13.8M, or R\$522M/customer). Our other (*very basic*) assumptions include:

1. A spin-off of ca. 27% of Smiles (in-line with the above);
2. A discount of 35% (on an EV/customer basis, using Bloomberg and company data) versus Multiplus, owing to (A) GOL's smaller network versus LATAM (in terms of the number of destinations, as well as the relative lack of geographic breadth of its offerings), and (B) the notion that an important portion of Smiles' loyalty program customers stemmed from the carrier's April 2007 acquisition of Varig (GOL/Varig no longer offers flights to any long-distance destinations, such as New York, Tokyo or Paris). GOL's 2007 annual report stated that (Varig) Smiles program had over 5 million members (and we guess that many of the latter members were long-time loyalists of an airline that no longer exists); and
3. We note that Multiplus' breakage ratio (the number of points redeemed, divided by the number of points issued), has risen steadily since the time of that company's IPO (please also see figure 1).

Figure 1. Multiplus Breakage Ratio



Source: Company Reports

Figure 2. Brief Statistics On Selected Airline/Loyalty Programs.

	Members (~MM)	Corporate Partners	Destinations	Publicly trade?	Point redemption rate
GOL (Smiles)	8.0	115	75	No	N/A
TAM (Multiplus)*	9.8	170	62	Yes	65.3%
LAN (LANPASS)*	4.0	46	66	No	N/A
Air Canada (Aimia) #	4.5	150	178	Yes	N/A

* While LAN and TAM collectively service over 150 destinations, we present the latest stand-alone (TAM) data above, as this piece focuses on TAM/Multiplus trading data, prior to TAM's MOU with LAN.

Aimia is formerly known as Aeroplan.

Source: Citi Research

Another reason to buy? (We would not go that far).

However, even as we recognize the potential short-term opportunity, we continue to be wary about (what seem to be) "stretch reasons" from the bulls to buy GOL, including: (A) 2012 EBIT margin guidance of 4% to 7%; (B) the possibility that Delta taking a bigger stake in the shares (in spite of the loss that it seems to have already suffered on the first purchase), or (C) speculation that the shares should have strongly benefited from TAM's delisting (higher scarcity value).

On a longer-term basis, none of the above reasons seem to have borne any fruit. Against this backdrop, we now approach the airline loyalty program spinoff potential with some degree of caution.

Global Airlines Have Shunned Such Spin-offs

Air Canada and TAM are the lone exceptions.

As we searched for examples of airlines, spinning off their loyalty programs, our conversations with our global colleagues revealed very few instances in which airlines have even considered taking this course of action. Citi Europe's Andrew light mentioned to us that a few carriers (such as Qantas) have considered spin-offs of their airline loyalty programs in the past. However, almost all of them seem to have refrained from such a course of action for the following reasons:

1. Loss of control of their customers
2. Concerns that such spin-offs would simply re-allocate the airline's value, splitting it between two entities – with the combined value remaining the same (essentially leaving total valuation and profitability unchanged - just divided).

On the positive side, loyalty program sales (of course) can raise significant capital, which can provide the airlines with a short-term profitability boost. Looking at carriers that have either partially (or entirely) spun off their loyalty programs, and we have (A) Air Canada's 2005 spin-off of Aeroplan, and (B) TAM's spin-off of 27.7% of Multiplus in early 2010. In the case of Air Canada, the carrier IPO'ed after it had originally spun off 12.5% of AeroPlan (which now runs under the name Aimia). We understand that Air Canada no longer has a controlling stake in Aimia.

TAM's local shares received a short-term bounce, following Multiplus' spinoff. . .

In the case of TAM, we note that the carrier's local shares had received an early (short-term) boost, following Multiplus' IPO. However, trading data over a longer period (through 8/13/10's close – the LAN-TAM MOU was announced that afternoon), reveals that TAM's shares materially underperformed Multiplus' and had also been underperforming the Bovespa (until news on the afternoon of the 13th had begun driving the shares higher).

Figure 3. TAMM4 vs. MPLU3 (R\$, Multiplus IPO until MOU with LAN) – Feb 2010 IPO Through 8/13/10's Close



Source: Citi Research

Figure 4. TAMM4 vs. MPLU3 (February 2010 Through 7/18/12)



Source: Citi Research

...but TAM's shares subsequently underperformed thereafter. . .

As Air Canada did not IPO until after it had sold a stake in Aeroplan, the relative (long-term) trading differential yields the same answer.

However, even after TAM's announced MOU with LAN (until the point that TAM's shares were delisted), and we note that Multiplus' shares had still soundly outperformed TAM's.

In the case of Air Canada, although the statistics were different (an eventual full spin-off, and that Air Canada's IPO occurred after it had partially spun off its loyalty program), we note that the basic outcome was the same.

Figure 5. Air Canada vs. AIMIA (CAD)



Source: Bloomberg

Figure 6. Selected Global Airline Comps

Company	Country	Ticker	Rating	Price 08/08/12	Target Price	P/E		EV/EBITDAR	
						'12E	'13E	'12E	'13E
Low-Cost									
RyanAir	Ireland	RYA.I	1	\$5.03	\$5.27	12.0x	12.4x	9.5x	6.9x
West Jet	Canada	WJA.TO	NR	\$16.33	NR	14.8x	12.0x	N/A	N/A
AirAsia Bhd	Malaysia	AIRA.KL	3	\$1.19	\$0.92	11.8x	9.5x	13.2x	9.2x
Tiger Airways	Singapore	TAHL.SI	3H	\$0.56	\$0.37	NM	NM	15.6x	30.4x
Cebu Air	Philippines	CEB.PS	1	\$1.63	\$1.91	9.9x	10.2x	10.9x	7.6x
Air Arabia	United Arab Emirates	AIRA.DU	1	\$0.18	\$0.22	9.0x	8.3x	2.1x	4.2x
easyJet	United Kingdom	EZJ.L	1	\$8.81	\$10.93	8.7x	7.8x	11.4x	5.1x
Spirit	United States	SAVE.O	1	\$20.64	\$27.00	11.1x	8.8x	11.5x	5.7x
GOL	Brazil	GOL.N	2H	\$4.93	\$4.75	NM	NM	10.2x	9.5x
Median						10.9x	9.9x	11.1x	7.2x
Low-Cost Hybrids									
Jet Airways	India	JET.BO	1H	\$6.87	\$9.90	NM	NM	21.3x	11.0x
Copa Airlines	Panama	CPA.N	1	\$78.67	\$104.00	9.6x	7.7x	7.5x	5.9x
Median						9.6x	7.7x	14.4x	8.5x
Premium Passenger/Cargo									
LATAM	Chile	LFL.N	1	\$23.83	\$33.00	112.5x	9.3x	9.4x	8.3x
Cathay Pacific	Hong Kong	0293.HK	1	\$1.59	\$1.84	79.6x	14.8x	6.0x	6.6x
Korean Air	South Korea	003490.KS	NR	\$42.70	NR	6.2x	5.8x	NA	NA
Singapore Airlines	Singapore	SIAL.SI	3	\$8.71	\$7.57	42.4x	32.7x	6.1x	5.4x
China Airlines	Taiwan	2610.TW	3	\$0.42	\$0.41	21.8x	9.5x	16.5x	9.4x
EVA Airways	Taiwan	2618.TW	3	\$0.58	\$0.56	21.0x	8.7x	14.0x	7.4x
Median						32.1x	9.4x	9.4x	7.4x
Legacy									
Intern. Consolid. Airlines	United Kingdom	ICAG.MC	1	\$2.42	\$3.22	NM	23.6x	13.4x	6.5x
Lufthansa	Germany	LHAG.DE	1	\$12.35	\$18.60	35.9x	11.0x	6.0x	4.8x
Scandinavian Air	Sweden	SAS.ST	1H	\$0.87	\$1.19	NM	4.6x	15.6x	1.7x
Air France	France	AIRF.PA	2H	\$5.38	\$5.58	NM	NM	8.6x	5.9x
Garuda Indonesia	Indonesia	GIAA.JK	1H	\$0.08	\$0.08	11.9x	8.9x	8.0x	6.8x
Turkish Airlines	Turkey	THYAO.IS	1	\$1.82	\$2.24	13.9x	8.8x	4.8x	7.2x
Air China	China	0753.HK	1H	\$0.66	\$0.88	7.8x	7.1x	8.1x	6.3x
China Eastern	China	0670.HK	2H	\$0.33	\$0.35	10.6x	7.6x	10.7x	7.7x
Aegean Airlines	Greece	AGNr.AT	2	\$1.60	NR	NM	NM	3.8x	11.4x
China Southern	China	1055.HK	3H	\$0.47	\$0.52	12.9x	11.7x	11.7x	7.9x
Median						12.4x	8.8x	8.1x	6.8x

Notes: (1) EPS Estimates for "NR" companies are taken from I/B/E/S or Bloomberg Consensus Estimates. All estimates and values are calendarized and are in US\$.
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Prices are intra-day levels.

(GOL.N; US\$5.02; 2H); Source: Citi Research

Appendix A-1

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