THE LEGACY EFFECT

RETHINKING LOYALTY FOR LOW-COST CARRIERS

AIRLINE BRIEF

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The past decade has been a bumpy ride at best for the airline industry. Security issues, high fuel prices, and the need to cut overhead have left legacy carriers struggling. In contrast, one sector has experienced growth — and it has been spectacular growth: low-cost carriers (LCCs). The achievements of the low-cost sector are enormous. One out of every five seats flown globally is on an LCC. In some markets (mainly on short-haul networks) these carriers have taken the majority share of traffic. In India, for example, they carry up to 70 percent of all traffic.

Traditionally, LCCs have based their value proposition on low prices and low fees. They largely avoided the frequent flyer loyalty programs that legacy carriers employed successfully during the ‘80s and ‘90s. But competition among them is tougher now. Low prices and low fees are not enough.

The increase in competition, coupled with the growing focus on business travelers, has led LCCs to test new models, including forming alliances, operating long-haul, and offering more products and services. It’s therefore only natural for them to invest in and continue to develop their frequent flyer programs (FFPs). These programs can make LCCs more competitive, profitable, and better positioned to retain valuable customers.

Today, eight of the 10 largest LCCs offer some form of loyalty program. Given these programs’ near ubiquity, carriers wishing to continue being competitive must now differentiate their programs and make them customer value oriented.

This paper reviews the various FFP models available for low-cost carriers and identifies their potential sources of value.
Before looking at the opportunity for LCCs, let’s examine loyalty programs that have worked well for legacy carriers. It’s arguably true that loyalty programs represent the crown jewels for traditional carriers — if executed well. Within the low-cost sector, however, loyalty programs seem to attract more ambivalence. Some senior LCC leaders have indicated there is no room for expensive frequent flyer programs in their tight-overhead business model, and believe this tactic should stay where it came from — large legacy carriers.

Low-cost carriers follow a simple business strategy: Achieve higher returns on assets and people by reducing the cost of operating to an absolute minimum. The service, operational, and overhead savings allow them to offer very attractive fares that entice incremental travelers, and to improve the yield per passenger by selling an unbundled mix of products, including ancillary services such as meals and on-board entertainment.

The low-overhead obsession has driven some of the low-cost airlines away from frequent flyer programs — or any other kind of frequency or revenue-based recognition program, for that matter. Instead, they choose to attract customers again and again with a low-price strategy.

But the LCCs that resist using these programs are missing two essential points. The first is that loyalty programs do not have to add to net costs, especially when the benefits of incremental travelers and incremental mileage are factored in. The second is that loyalty programs bring new business partners, affiliate revenue, and a potential for added profit to the LCC. In fact, loyalty programs can be the ultimate ancillary revenue source.

As the low-cost sector continues to grow and even dominate (as is the case on some short-haul point-to-point routes in Europe and India), operators should review the role of loyalty programs as drivers of revenue and additional profits.

The three fundamental questions for low-cost carrier loyalty:

> Why has loyalty been so successful for legacy carriers?
> What are the pros and cons of an LCC loyalty program?
> How can loyalty generate value for LCCs?
Low-cost carriers that resist using loyalty programs are missing two essential points. The first is that loyalty programs do not have to add to net costs, especially when the benefits of incremental travelers and incremental mileage are factored in. The second is that loyalty programs bring new business partners, affiliate revenue, and a potential for added profit to the LCC. In fact, loyalty programs can be the ultimate ancillary revenue source.
Although some low-cost carriers firmly stick to tried and tested low-cost principles, an increasing number of them are exploring new models. They’re motivated to do so by one of two drivers: the need to reduce costs even further or the need generate incremental revenue. A number of significant developments in the LCC market show how the sector is continually evolving:

> **Strategic alliances** — In 2010, AirAsia and Jetstar announced an alliance aimed at securing procurement economies of scale. The airlines anticipated realizing savings by working together on aircraft design and purchase initiatives.

> **Long-haul flights** — LCCs are expanding their networks. The use of wide-body aircraft has made it possible to offer longer flights, such as AirAsia X’s Kuala Lumpur-to-Sydney route, or short-haul player easyJet’s London-to-Marrakesh, Morocco journey.

> **Codesharing and interlining** — Both legacy carriers and LCCs understand the potential gains from feeding passengers into each other’s networks. The interline agreement between Gol (a Brazilian LCC) and Delta Air Lines allows Delta Air Lines to issue point-to-point tickets in Brazil. Similarly, members of the SkyMiles program can collect miles on flights operated by Gol.

> **Offering frills** — In an effort to attract high-yielding traffic, some LCCs are starting to add amenities to their products. AirAsia X, for example, offers lie-flat seats within its long-haul network. Jazeera Airways, a Kuwait-based LCC, introduced a business class product complete with complimentary food and beverage service in 2009. In September 2012, following a successful trial, easyJet implemented allocated seating across its network.

Both LCCs and legacy carriers have benefited by applying innovations from each other’s playbook.
When consumers choose an airline, loyalty programs play an important role in their decision-making process—ranking third behind only price and schedule. But this benefit is only one of several that play into the contributions of traditional frequent flyer programs. A frequent flyer program (FFP) provides three sources of value for an airline. First, it’s a key influencer of behavior. Flyers consider membership in a loyalty program an important consideration when they choose between carriers—so much so that when price and schedule are on par, a membership in a specific FFP may be the deciding factor.

More importantly, some regular customers willingly pay a premium to travel on a carrier in which they hold a frequent flyer card. Research shows that in a significant number of cases, corporate travelers are willing to deviate from their company’s travel policy in order to travel on a preferred but more expensive carrier. As a result, frequent flyers tend to pay higher fares compared to nonmembers. Potentially losing the perks associated with an elite-tier membership has proved to be a formidable barrier to exit for these flyers.

Second, a frequent flyer program is a source of third-party revenue. Airlines have become increasingly innovative in using the FFP and its currency (such as miles, kilometers, or points) as an additional revenue source. Credit card programs, both co-branded and affiliated varieties, have become cash generators for the airlines. In some cases, the sale of miles to partners has generated richer margins than the traditional business of selling seats directly to customers. Airline currency’s profitability is dependent on a wide range of interconnected drivers that include generosity, breakage level, partner agreements, airline passenger load factors, and overall cost efficiency.

Finally, FFPs are a tool to understand, quantify, and predict customer behavior. These programs can serve as data repositories that allow airlines to analyze and better comprehend their customers’ current and future value. By combining transactional data with financial and demographic data, airlines gain insight into what customers value and are willing to pay for.

On a tactical level, these data-based insights enable differentiated messages based on customer profiles, driving costs down as well as increasing marketing campaign response rates. On a more strategic level, analysis provides usable, quantifiable, and empirical insights that can help shape the business across the enterprise.
Southwest Airlines started flying in 1971 but did not launch a basic loyalty program until 1987. Why the resistance? Several characteristics endemic to LCCs help explain why loyalty programs are not as pervasive as they are among legacy carriers. These characteristics range from the no-perquisites economic models that serve as the basis of the LCC concept to institutional resistance among management. By and large, resistance falls into seven categories:

> **Price sensitivity** — Low prices — the very reason for a low-cost carrier’s existence — may deter the successful implementation of loyalty programs. Ideally, these programs should make customers less price sensitive. But the LCC customer is more willing to forego services such as catering or conveniently located airports in return for a cheaper seat. Belonging to a loyalty program isn’t as likely to make this type of customer pay a premium for a ticket as it would a less price-sensitive flyer.

> **Focus on leisure travel** — Most low-cost airline customers are leisure travelers, a group that is traditionally more driven by price than points. This segment may not provide sufficient value to the airline to warrant special treatment.

> **Existing distribution channels** — Most LCCs use a direct-distribution channel strategy in which customers give demographic and contact data to the airlines, as opposed to a booking agent. Legacy carriers have more need to use a loyalty program to gain access to customers’ data.

> **Organizational mindset** — Traditional loyalty programs, being the domain of legacy airlines, are frowned upon by many in the low-cost world. Marketers within LCCs may need to generate internal enthusiasm for these programs by pointing out their benefits. (See “Why Low-Cost Carriers are Made for Loyalty” on page 8.)

> **Customer perceptions** — In the eyes of a customer, rewards from an LCC loyalty program versus those from a legacy carrier could be harder to come by and less valuable once gained. Three principal reasons contribute to this perspective. First, most LCCs operate short-haul networks, meaning passengers don’t have the opportunity to earn as many miles per trip as they can with legacy carriers that operate long-haul flights. This is true even in cases where the underlying payback to the customer could be the same or better, in dollar terms. Second, the value of a reward may be underappreciated as a result of the LCC’s pricing strategy. The perceived value of a reward on an LCC will be affected both by the normal low fares as well as occasional sales that could lead to zero fares in some markets. Third, most LCCs operate as stand-alone networks. Because of this, they cannot offer the global reach that the Star Alliance, oneworld, and SkyTeam alliances offer legacy carriers. The lack of high-profile aspirational rewards such as business and first class tickets and upgrades, along with no international partner network that covers “dream” destinations, reduces their potential appeal.

> **Partner perceptions** — As with customers, partners may place a lower value on a mile from an LCC compared to one from a legacy carrier. This perception could make it more difficult for an LCC to negotiate rates with commercial partners that generate reasonable margins.

> **High risk of dilution** — LCCs have been very apt at using fees for services to drive incremental revenue. Offering these services as perks in a loyalty program could have significant diluting effects (e.g., loss of revenue from foregoing excess luggage fees). In addition, LCCs tend to operate under higher passenger load factors. A greater percentage of reward tickets could cause displacement of paying passengers.
IN FLIGHT: EXISTING LOW-COST LOYALTY PROGRAMS

Loyalty programs are not new to the low-cost sector. In fact, as the table shows, eight of the top 10 low-cost carriers already offer a frequent flyer program. The nature of the airlines mentioned below varies from pure low-cost carriers (e.g. Ryanair) to those that offer a more diversified product (e.g. Air Berlin).

These LCC loyalty programs are remarkably similar in design. Most offer an accrual structure based on the dollar amount spent on the ticket, as opposed to the actual miles flown. Unlike some of their legacy counterparts, these programs also offer an unlimited supply of reward tickets, albeit at flexible reward levels. According to a 2012 study by the IdeaWorksCompany, LCCs Air Berlin, Southwest, and Gol held the three top spots among carriers offering the best overall reward availability.

EXISTING FFPs FOR THE TOP 10 LOW-COST CARRIERS

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Source: Airline Business: The Final Countdown: Countdown of the 10 biggest low-cost carriers by revenue, April 2012
WHY LOW-COST CARRIERS ARE MADE FOR LOYALTY

When it comes to introducing and managing a loyalty program, being a low-cost carrier offers a number of distinct advantages. When these airlines design their programs, they can draw from more than 30 years of industry practices and integrate best practices to fit the LCC model, and reject what doesn’t work. Airlines can design tailor-made solutions that comprise specific software, hardware, and hosting solutions that fit their requirements. In some cases, airlines may opt for a fully outsourced solution whereby a service provider is responsible for running the program against predefined key performance indicators.

Cutting-edge loyalty platforms come with a range of business models that offer increased versatility and agility. The benefits and opportunities available to LCCs include:

> **Focus on ancillary revenue** — Low-cost carriers were the first to introduce fee-based additional services in an effort to generate incremental revenue. The ability to break down the product (an airline seat) into saleable parts will help them in the creation of a loyalty program which is geared toward bottom-line results. These programs also support LCCs’ ancillary revenue strategies by helping them sell points to partners.

> **Simpler fare and network structure** — LCCs’ product offerings tend to be less complex than those of legacy carriers. As a result, their frequent flyer programs can be relatively simple and easy to understand for the customer. A good example of this simplicity would be a fare structure allowing for a transparent accrual structure, including the possibility of basing the accrual on the dollar amount spent. LCCs are also better placed to track the actual revenue contribution from individual customers.

> **Best practice integration** — When low-cost carriers design and operate new programs, they can draw on best practices within the airline industry. Using preexisting industry knowledge ensures a steep path of innovation, as program managers can apply readily available insights to the more difficult tasks, such as accounting for liability or ensuring sufficient award-seat availability.

> **Fewer papers and fewer people** — New technologies, which have been embraced both by carriers and customers, allow airlines to run a program without cards, paper statements, or extensive contact centers, thereby significantly reducing associated costs.

> **Smart redemptions** — One of the greatest recent advances in airline loyalty is a better understanding of how to manage redemptions. Airline, hotel, and retail program managers know that, with clever targeting, the cost of an award can be very low — or even free. Program operators use the concept of smart redemptions when they leverage the fact that members like to treat themselves when it comes to turning in currency. By upselling the member to a more expensive, higher-margin product (similar to the way a supermarket shopping program might offer a more expensive, higher-margin bottle of wine as an aspirational reward), the cost of the redemption comes down — or can even be completely covered.
Airlines that acquire and retain customers, and get them to increase their spending, will be the most profitable. With that customer focus in mind, LCCs need the proper infrastructure to tie loyalty programs to their customer value calculations. Databases are important: the ability to analyze and act on the data is even more important. Given that focus, there are six key elements for the LCC customer strategy:

1. **Understanding customer segments** — LCCs tend to have large email databases but little understanding of the actual customer segments in the repository. Analytic structure enhances program managers’ ability to recognize high-value customers and potentially reward them accordingly. In addition, customer profiling can boost an airline’s ability to sell ancillary services. A loyalty program is a great tool for understanding which customers are price sensitive and which are willing to pay for additional services. For those willing to pay for services, bonus miles are a useful incentive to buy additional services.

2. **Finding new customers** — The ubiquitousness of LLCs means that seats on these carriers will become a prominent travel reward category for loyalty programs. By selling a loyalty currency to partners, low-cost carriers not only achieve significantly higher margins than normal fares would offer, but can also access new customers. Agreements with partners that allow for cross communications will also enhance brand awareness of the LCC in the marketplace.

3. **Attracting business travelers** — Many low-cost carriers are looking to the corporate segment as a new, higher-margin customer base. Offering some form of loyalty program that features travel-related benefits will be a key prerequisite to entering this market.

4. **Monetizing loyalty benefits** — Once an airline has successfully started delivering these benefits, the benefits associated with the FFP can be packaged and sold to other customers, creating a new revenue stream.

5. **Creating competitive advantage** — LCCs previously competed with legacy carriers based on price. Today, as the LCC market continues to grow and new competitors enter the market, the landscape is changing. Once cost efficiencies have been maximized, LCCs must start looking at other ways to differentiate their product from their competition. A well-designed loyalty program reduces the likelihood a flyer will view travel with an LLC as a commodity, and increases the likelihood of brand loyalty.

6. **Cementing partnerships** — LCCs are increasingly creating partnerships with traditional carriers. The ability to earn points from airline partners is expected by consumers and enhances the success of any airline partnership.

Several of the top LCCs offer new frequent flyer enrollees the opportunity to receive newsletters and offers. But a few programs — notably Airberlin’s topbonus and Southwest’s Rapid Rewards — give loyalty program currency to customers who choose to subscribe. Coincidentally — or perhaps not — Airberlin and Southwest are among the top low-cost carriers, as ranked by revenue.
Whether or not the low-cost and full-service business models converge, loyalty will play an important role in the industry. With eight of the 10 largest LCCs already operating some form of loyalty program, it’s only a matter of time before more carriers follow suit. The impact of loyalty programs, however, depends on the underlying business model of the airlines. We have identified three categories of LCCs that benefit differently from loyalty:

> **Classic LCCs** — Another name for this group could be “true price fighters.” LCCs in this category enjoy a sustainable cost advantage in a market and offer a very basic product supplemented with ancillary services. A loyalty program would be another distribution channel to sell seats — effectively using partners to buy seats — potentially at yields higher than what the airline would realize by selling directly to customers. These airlines carry significant leisure traffic and operate in Tier 2 airports. Examples of classic LCCs include Ryanair and Tiger Airways.

> **Intermediate LCCs** — Airlines in this category often compete with established legacy carriers. They fly in and out of Tier 1 airports carrying a mix of business and leisure passengers. Given the huge yield differences between these two passenger categories, these airlines would benefit from greater insights into customer behavior in order to identify and target their high-yield passengers. These insights would also offer the ability to sell loyalty currency to partners and influence business travelers more effectively. An example of an intermediate LCC is easyJet.

> **Evolved LCCs** — Airlines in this category have broken with the traditional ways of the LCC and started to converge toward the legacy carriers. Airlines in this category may have different cabins, airport lounges, long-haul flights, and mixed-model fleets. This category stands to gain the most from their loyalty programs as they enjoy all three value drivers: revenue from sale of miles to partners; greater customer insights leading to increased revenue and yield; and the ability to influence purchase decisions. By offering additional services they have leveled the playing field with legacy carriers. With schedules, price, and product being equal, the role of the FFP in the decision making process becomes pivotal. Examples of evolved LCCs include JetBlue and Virgin Australia.
CONCLUSION

As the airline industry comes out of the instability of the past decade, carriers need to focus not on the outside elements they can't control, but on their customers. LCCs have the best opportunity to do so, as they extend services and fees that have already proved attractive.

That said, as competition continues to heat up, these carriers need to find another connection with those customers. Loyalty program marketing does not have to be the expensive and potentially hard-to-administer proposition that legacy carriers have employed. It can be a way to increase customer value and boost ancillary value at the same time.

The important elements for LCCs that want to step up to this customer challenge are customer strategy, industry expertise, loyalty infrastructure experience, and customer data. The resulting program will yield a better, more-profitable air carrier.
ABOUT THE AUTHORS

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Evert de Boer supports Aimia’s global business development efforts in travel. Having worked on both the client and agency side, and across industry verticals, Evert enjoys a unique view of the challenges airlines face today. Evert has more than 12 years of extensive experience in airline loyalty programs. After crossing from the airline client side to agency side in 2002, he continued to work on airline CRM solutions for a wide range of clients. He started his career at KLM Royal Dutch Airlines in the Netherlands.

Evert has been a guest speaker at numerous events and institutions, including Cranfield’s School of Aeronautics (United Kingdom) and Toulouse ESC’s Aviation MBA (France). He has published a number of articles on frequent flyer programs and travel loyalty. His most recent article, on 30 years of frequent flyer programs, appeared in the June 2012 edition of the Journal of Air Transport Management. Evert earned a Master of Science degree in International Business Administration at the University of Maastricht, the Netherlands and Universidad Carlos III de Madrid, Spain. He is a graduate of the Berkeley-Nanyang Advanced Management Program from the Haas School of Business at University of California at Berkeley, and Nanyang Business School at Nanyang Technological University, Singapore.

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Ralph has an enormous wealth of experience in relationship marketing, including loyalty program concept development, delivery, and management, which he has built up during 20 years in the field. Ralph’s client experience includes the core areas of telecommunications, travel, finance, retail, hospitality, as well as more unusual sectors such as toys, utilities, and fast-moving consumer goods. Before moving to the Middle East to set up Aimia’s regional office and managed the launch of Etihad Airways Guest program in 2006, Ralph was based in the United Kingdom, where he worked with international airlines, hospitality groups, and UK-based companies. After working in the UK for several years, Ralph then moved to Aimia’s Brussels office where he covered Continental Europe and worked with Belgacom, Shell Europe, and the Lego Corporation.

Ralph’s expertise ranges from loyalty concept development and strategic consultancy to program setup and management of large relationship marketing programs, as well as classic loyalty programs and customer insight driven communication programs. Specific client loyalty experience includes working with such diverse brands as: Scandinavian Airlines; Shell Retail; Le Meridien Hotels; AXA Healthcare; British Gas; Eurostar; Debenhams; Diageo; Ford Europe; Lego; KLM; Harrods; Egg Card; Radisson; British Gas; MBNA; Sprint Telecom; Belgacom Mobile; Etihad Airways; Wataniya Telecom; National Bank Kuwait; Jumeirah Hotels; MasterCard; Qtel; Al Hokair Group; STC; Emaar Group; Wafi Retail; Riyadh Bank; Kuwait Airways; and Bank Muscat. Ralph is a frequent speaker at loyalty conferences in Europe and the Middle East and has had numerous articles published on loyalty program best practices.

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