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The New Economics of Loyalty Programs

Customers want options. How to address that priority and still turn a profit?

By Andrew Watterson, Scot Hornick, and Raj Lalsare

Frequent flier and other loyalty programs are evolving rapidly, and airlines are now vying with credit card companies for strategic control. To exploit the new economics of loyalty programs, companies must balance the competing objectives of driving repeat purchases and generating cash from partners. The key is to think of a program's rewards as a currency and tailor that currency for the most profitable customers.

The dynamics of frequent flier and other loyalty programs are changing on several fronts. For airlines, the recent changes have caused their strategic control over the programs to be in danger of slipping into the hands of credit card companies that serve as intermediaries between airline and customer.

As this market evolves, companies seeking to capture more value will have to deepen their understanding of customer behavior and refine how they segment customers. For each meaningful segment, companies will then have to crisply define the currency of their loyalty program, so that customers give them repeat business that's profitable in the long run.

More Choice, Less Loyal

The original loyalty programs, pioneered by airlines in the 1980s, relied on air miles to reward customers. Reward miles became the de facto currency that customers earned by traveling and burned by redeeming for free air travel once they had accumulated certain threshold mileage amounts. Hotels and car rental firms soon followed the airlines.

Mileage rewards became the common currency of the realm and promoted travel that many customers might otherwise not have

been willing to buy. Airlines found value in several characteristics of the loyalty programs:

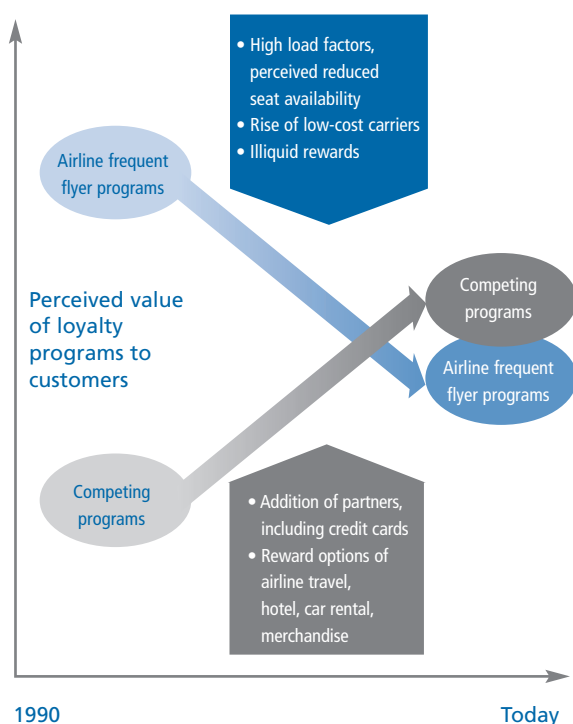
- They helped shape customers' travel decisions through the incentives of the air miles and rewards.
- As airlines distributed rewards, loyalty programs became an opaque channel for distribution of their marginal capacity.
- Airlines and credit card intermediaries benefited from the float of miles and breakage economics (the difference in customers' collective rate of earning and burning the points).

Credit card companies entered this market as intermediaries on the earn side of the equation, allowing frequent flyers to earn reward points by using credit cards for purchases. To do this, credit card companies bought miles from airlines and other enterprises for cash. Customers would then burn points to claim free travel rewards from the airline.

Today, revenues from credit card partners constitute the great majority of major airlines' total loyalty program revenues, according to analysis by Mercer Management

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Exhibit 1 The loyalty space has changed



Consulting. The top three North American airlines—American, Delta, and United—each derive close to \$1 billion in revenues from their loyalty programs, from more than 50 million members each.

The programs encourage customers to earn and burn mileage points in order to sustain a cycle of repeat purchases. They also promote use of credit cards and other partner business, so that the airlines can sell more miles to their partners (Exhibit 1).

In recent years, with more planes flying close to full, the availability and, possibly more importantly, the *perceived* availability of reward seats has declined. Among airlines and a few other cases, the float or overhang of outstanding reward points has reached exorbitant levels: Out of the roughly 2,000 billion miles awarded, only about 500 billion have been redeemed. As a result, customers have been turning to credit cards not only for earning miles but for burning them as well. In a recent WebFlyer survey, 81% of respondents agreed that “loyalty programs have gotten worse in rewarding loyal customers over the past 25 years.”

Not surprisingly, customers’ perceived value of the currency is declining; in the same WebFlyer survey, 93% of respondents agreed that “loyalty programs are not serving loyal customers, but are primarily a marketing tool.”

This attitude has a direct impact on how credit card companies and their customers value a point. If customers put a lower value on a certain reward currency, they have little incentive to use the associated credit card to earn that currency. Customers have been demanding more options, and credit card companies are pressuring airlines to boost the perceived value of their points by providing more options to burn mileage (Exhibit 2).

American Express has reacted to the perceived decline in reward currency values. In a recent overhaul of its Membership Rewards program, Amex is making two significant changes: first, making it harder to earn points, especially “double points” for everyday purchases at grocery stores and gas stations, in order to reduce customers’ earn velocity; second, shifting customers’ earn options to new ones that are more attractive to desirable customer segments, such as those who earn points at the Gap and Target versus those who earn at grocery stores and gas stations.

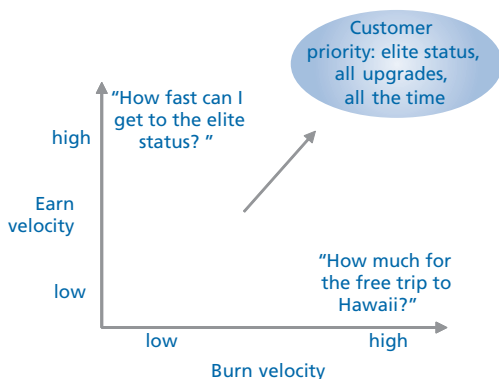
Some programs have capitalized on the demand for options. For instance, Hilton’s HHonors program offers redemption options including merchandise and tickets for airlines, rail travel, theme parks, and cruises.

Along the way, then, the two core objectives of airline loyalty programs started to diverge. Providing more options clashes with the airlines’ core goal of retaining customer loyalty. Consequently, despite the flow of payments from credit card companies to airlines, value has in fact been migrating to the credit cards.

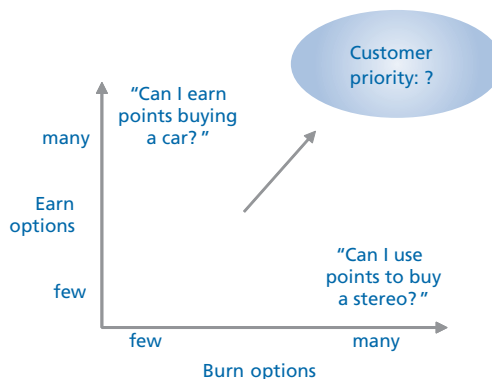
While credit cards already offer ways to earn points, they are responding to customer demand for more burn options, particularly for those customers whose marginal utility of reward points, beyond a threshold, is low. These include customers who cannot find travel rewards they would consider mean-

Exhibit 2 Customer preferences have evolved

From the traditional supply and demand side of loyalty economics...



...Customers are now seeking more options



ingful; those who would rather pay for their travel rather than deal with the hassles of award redemption; and those who have earned more points than they can ever use.

Hence the tag line for the American Express Membership Rewards program: “Because not everyone lives to earn airline miles.” The program lured customers who did not want travel rewards, offering to redeem earned miles for other rewards. By expanding their intermediation, the credit card firms are diluting the travel loyalty programs’ influence over travel purchase decisions.

Capital One has made perhaps the most aggressive push into the airline loyalty space with its “No Hassle Miles” cards. Customers trade 15,000 miles for flights worth up to \$150, 35,000 miles for \$151-\$350 flights, and so on. Why would this be attractive to some customers? Airlines may or may not be able to fulfill an award trip to Hawaii, depending on seat availability. But with the credit cards, by contrast, there is no guessing, because credit cards buy the ticket outright. In return for removing this uncertainty, customers pay a transaction fee.

Coin of the Realm

It’s helpful for executives to think of the loyalty market as a form of currency market. Airlines, hotels, credit cards, and other pro-

gram owners all have their currencies floating in consumers’ wallets.

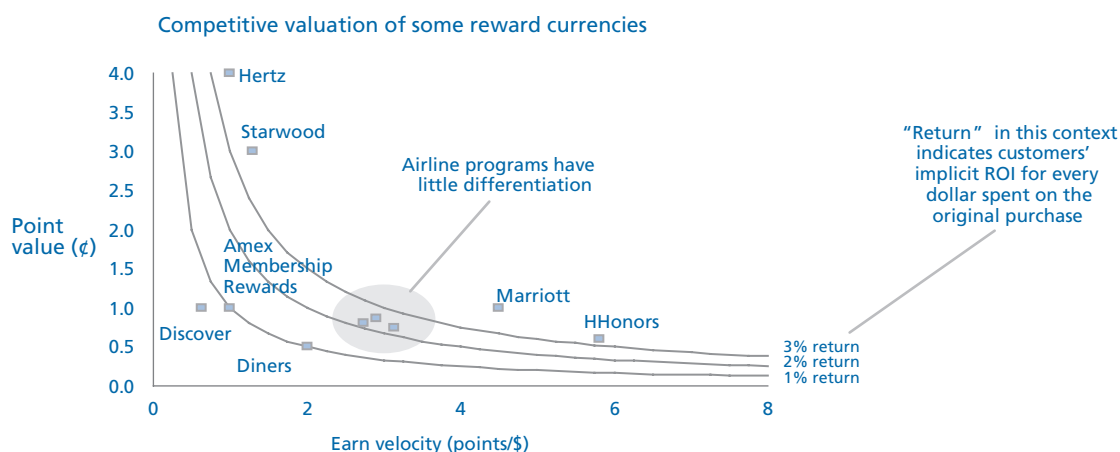
Some currencies are turning out to be stronger than others. Starwood, the hotel and resort chain, has engineered a higher-value currency than have airlines or other hotels. Customers realize that their implied returns vary across loyalty programs, and they are increasingly choosing one currency over another (Exhibit 3).

In real monetary markets, there have been periods when one reserve currency loses favor and the world shifts to another reserve currency. During the era of the gold standard, the British pound was the dominant currency. After 1914, as Great Britain turned from being a net creditor to a net debtor, the U.S. dollar gained primacy. With perpetual current account and fiscal deficits, the pound never regained its strength, and the dollar has remained unchallenged as the world’s main reserve currency. According to *The Economist*, nearly 70% of official foreign exchange reserves are in dollars today, with the Euro being the second most commonly traded reserve currency.

For loyalty programs, competitors must ask themselves which currency will gain primacy—credit card currency, airline currency, hotel currency, or something else?

Airline loyalty program currencies clearly

Exhibit 3 Customers realize their implicit returns vary across loyalty programs



Note: Earn velocity assumes \$5,000 annual direct spend and \$10,000 annual credit card spend; point value shown for burning directly into company product or for highest-returning reward
 Source: Company websites; Mercer analysis

have suffered the most over the past few years, as customers perceive that less aircraft capacity is earmarked for rewards, lowering the implicit value of airline miles. In a WebFlyer survey, customers reported a 50% success rate with airline award availability, compared to a reported success rate of 75% with hotel awards. As the overhang of reward points increases, the marginal value of points to customers will decline further, leading to decreased influence on future purchase and redemption decisions. With credit card companies increasing more earn and burn options, customers are learning to bypass the traditional airline loyalty program, putting the viability of this traditional model in question.

The risk of erosion of customer loyalty, therefore, is real for airlines, and loyalty programs must be restructured to acknowledge this new reality. Those programs that do not change face the risk of being secondary currencies, with a downward spiral of their currency and customer loyalty. Those that do restructure raise their odds of owning a dominant currency that customers want to keep and trade—leading to a mutually reinforcing spiral of increasing currency value and strong customer loyalty.

Several scenarios are possible:

- Realizing that credit cards are offering a

more tradable reward currency, customers stampede out of airline programs. Given the slow pace of change in loyalty programs (there haven't been any major overhauls of loyalty programs in nearly a decade), this scenario seems unlikely, since customers keep demanding air miles.

- A more likely scenario is the continued gradual erosion of airline loyalty programs, with credit cards seizing strategic control and airlines experiencing diluted monetary value and eroded loyalty. Loyalty programs must realize the next wave of change will be driven by financially flush credit card providers, such as Capital One, trying to disrupt the direct bond between loyalty programs and customers. It all depends on how quickly and aggressively the credit card providers are able to capture value.
- Some airlines arise to confront the challenge. United's recent launch of the "Choices" currency, which allows customers to redeem miles for non-travel awards, looks like such an attempt. Customer who carry United's co-branded credit card from Chase can earn a parallel currency to United's travel miles, thus increasing the perceived value of the cur-

rency for those customers who value non-travel rewards. This approach could keep the credit card partners happy as well.

For airlines, it would be a false hope to depend on customers' existing balance of reward points as equity in loyalty programs. Customers can change behavior quickly, especially when they perceive their marginal utility of reward points to be declining. Airlines must act before the credit card partners either decline to renew or substantially restructure the contracts that generate so much revenue for the loyalty programs.

In addressing this multi-dimensional challenge, where should managers of loyalty programs start their analysis: Customer satisfaction with the program? Customers' intent to re-purchase? Customer value? Credit card partners' satisfaction? Parent airlines' willingness to provide capacity?

Our experience suggests that to capture value in this market with its new economics, airline executives should redesign their loyalty business by addressing four fundamental questions (Exhibit 4).

Which customers is the loyalty program targeting? Different customer segments have

Exhibit 4 Levers to redesign the loyalty business model

A fundamental questioning of the model required to sustain customer loyalty and revenues

Which customers?	<ul style="list-style-type: none"> • Current and future segments • Segment needs and value potential
Which partners?	<ul style="list-style-type: none"> • Number of partners • Breadth/depth of offerings
Which earn-and-burn structures?	<ul style="list-style-type: none"> • Earn and burn velocity and options • Transferability to other reward currencies • Exchange rates
What relationship with the parent company?	<ul style="list-style-type: none"> • Brand identity • Financial relationship with parent enterprise • Valuation and financial structure of the loyalty program

different marginal utility of a currency and different reward preferences. Do you have the right currency for the right customers?

One useful approach in this regard is to establish two currencies for different segments: a primary currency to meet the needs of loyal customers and a secondary currency for those who seek other rewards. It is possible to identify several meaningful customer segments and respond to their needs with several reward currencies. However, implementing more than one currency will require investment in the program infrastructure and capabilities, as most loyalty programs today, especially the airline versions, are operating with aging systems. Moreover, the approach to customer selection must be tailored to the unique characteristics of the loyalty program and underlying service brand (Exhibit 5).

Which partners should the program keep?

Because customers are showing a healthy appetite for more reward options, loyalty programs need trading partners to help strengthen the brand and currency. Of course, customers' preferences for a given partnership and perceptions of a given brand have to be considered in establishing partnerships.

In a recent Mercer survey, a large customer segment, which had high spending on groceries, displayed three times as strong a preference for earning airline miles via grocery shopping and gas stations as via wireless service. Other segments with different demographics would have other preferences. Yet loyalty programs are not currently differentiating among segments or developing partnerships accordingly. Many airline loyalty programs, for example, continue to bombard frequent flyers with wireless service promotions, when many of those travelers may have little desire for them.

In the same survey, customers indicated their preference will increase if events and experiential rewards were added to airline rewards—and their preference would increase four times as much if merchandise were added to the reward list.

Here, loyalty programs face a risk. A partner-

Exhibit 5 Customer preferences vary by activity frequency



ship with a casino, wherein spending money at the casino can earn reward points, may not be acceptable to all customers. Some might prefer a partnership with a steak house, others with an electronics retailer. The key is to offer the right selection of partners or “trading merchants” to the corresponding customers so they can use their currency as they prefer.

Which earn and burn structures should be offered? This involves determining, first, how a reward point will be valued by customers, since this will determine how much partners are willing to pay for points. Next, determine at what exchange rates customers will be able to trade the currency with other reward currencies.

For example, in United’s Choices programs, 15,000 Choices can be redeemed for a \$120 hotel stay—an implied exchange rate of 125 Choices per dollar. Hilton HHonors program lets customers redeem 55,000 points for a 3-day pass at Disneyland worth about \$100, an implied exchange rate of 550 points per dollar.

What relationship with the parent company is optimal? Traditionally, loyalty programs have been owned by the parent enterprise, but this is changing. For the next generation of programs, executives must determine if they want to retain full ownership of their currency, or to float it freely. Both options have merits and drawbacks. Owning a currency implies backing it up with reserves, that is,

the capacity (and contingent liability) to provide rewards. However, ownership also provides greater control over the selection of trading partners and exchange rates.

On the other hand, by spinning off the loyalty program, enterprises can unlock substantial monetary value. Last year, Air Canada raised \$200 million by selling 12.5% of its loyalty scheme, Aeroplan. This implied a total valuation of \$1.6 billion for Aeroplan. The prospect of unlocking value from the loyalty program has to be balanced with the risk of the program being too independent to drive repeat purchase behavior to the airline enterprise.

* * *

Customer loyalty programs have become a market with many currencies, each with different perceived values and implied exchange rates. The currency of credit cards is rising, as credit card firms appear to be seizing strategic control by capitalizing on customer demand for more options and the declining perceived value of loyalty points.

In this new environment, loyalty programs must balance the competing objectives of driving repeat purchase behavior and generating cash value from partners. Some program restructuring is in order, starting with crisply defining the program’s currency. What customers care about is no longer just miles or points. They want options, and successful programs will address that priority straight on, while ensuring that any new offerings also create superior business economics.❖