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Delayed before takeoff: Aimia still hoping for turnaround on Aeroplan

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Let's look back to late summer of 2013 and the investment case for Aimia Inc., the operator of the Aeroplan rewards program.

A huge cloud of uncertainty had lifted with the news that Toronto-Dominion Bank would issue an Aeroplan credit card, with existing partner CIBC marketing its card only to existing customers. Aimia said it planned to greatly enhance the benefits to Aeroplan members, making seats on Air Canada easier to obtain. The members would use more miles, hurting Aimia's margins in the short term, but revenue would gain in the long term.

Investors bought in. Aimia shares hit 52-week highs, crossing the $18 mark, and many analysts saw prices of $20 or more in the coming year. Alas, Aimia stock never crossed that threshold and has spent the past six months falling, instead.

The company's earnings announcement earlier this month prompted the latest selloff, in which Aimia shares hit a 52-week low of $13.96 on Nov. 18. Despite beating expectations for the third quarter, management's lukewarm commentary about 2015 made much of Bay Street realize that Aimia's long-term story may be longer off than once thought.

"This year has been a transition year for Aimia, as it successfully rebuilt its financial services foundation in Canada," CIBC's Perry Caicco wrote in a note to clients. "However, it seems that one transition year is leading to another."

Aimia was a part of Air Canada until 2002, when it was spun off as a separate company, in part to create or own loyalty-program offerings outside Canada. Today, it also owns and operates Nectar, the largest loyalty program in the United Kingdom and Italy, as well as programs in the Middle East and Mexico. There are no other sizable "loyalty marketing" companies trading in the public markets, analysts say.

Aeroplan is the single biggest part of Aimia's business, with more than half the company's revenue and, in 2014's third quarter, the vast majority of its earnings

Aeroplan makes its money by selling "miles" to TD and CIBC, who give them to credit-card customers as a reward for spending. Aeroplan must then purchase seats on Air Canada flights when Aeroplan members cash in their miles. The key to the business is getting a price from the credit-card issuers that more than covers the expenses of the redeemed miles.

The 2013 deal with TD helped, as the price paid per mile increased. At the same time, however, Aeroplan's desire to make more and better flights available put upward pressure on costs.

As well, there is a timing issue: In any given period, Aeroplan members can, as a whole, use many more miles than they earn. It's a short-term pressure on earnings when Aeroplan must spend an increasing amount to satisfy redemptions even as it may be selling fewer miles to the credit-card issuers. This is expressed as a "burn-to-earn" ratio.

This ratio is now working against Aimia. "After a quick rise in points accumulation by new cardholders at TD and Amex, there should be a fall-off in this activity while redemptions (thanks to a healthier program) continue to be strong," says Mr. Caicco, who has a "sector perform" rating and $17 target price. "As well, the cost of those redemptions is now higher, thanks to program improvements."

This trend, if not its scope, largely could have been foreseen more than a year ago when Aimia announced the migration to TD. A newer wild card is the announcement earlier this month that Visa Canada and MasterCard Canada are reducing their "interchange fee" to 1.5 per cent for the next five years.

Interchange fees help card issuers cover various costs, including the costs of loyalty programs. Aimia, and the analysts who cover it, expect card issuers to absorb the blow by cutting the amount they'll pay for Aeroplan miles. At this point, Aimia says "the full impact" is tied to the details of implementation.

Mr. Caicco says the interchange-fee cut "has thrown into question our estimates for free cash flow," as all that is known is that Aimia's agreements with card issuers allow it to "share the pain" of an interchange cut. Mr. Caicco estimates about $1-billion of its gross billings come from CIBC and TD, so a 10 per cent cut in interchange fees means $100-million is at risk. He considers a 50-50 share – or $50-million in lost free cash flow – a "worst case" scenario.

Kathleen Wong of ***Veritas Investment Research*** says that if CIBC and TD ask Aimia for a 6 per cent reduction in the price it pays per mile, it could reduce her estimate of Aimia's fair value, currently $15, by $2.50. (***Veritas*** and Accountability Research, another firm that focuses on companies' accounting, have been negative on Aimia for some time, going against the prevailing sentiment in 2013.)

Unfortunately for Aimia, it can't point to its international operations as a saving grace. When the positive effects of a falling Canadian dollar are stripped out, gross billings fell in the company's two international segments, with EBITDA, or earnings before interest, taxes, depreciation and amortization, below expectations, says analyst Tim Casey of BMO Nesbitt Burns Inc., who has a "market perform" rating and $17 target price, recently reduced from $19. "The European businesses face economic and competitive challenges and U.S.operations have been restructured," he says in a note.

All of these factors have combined to create a sharp pullback in expectations. An example: Drew McReynolds of RBC Capital Markets , who had an "outperform" rating and $20 target price in September, 2013, estimated at the time that Aimia would produce $374-million in EBITDA in 2015. He now forecasts $270-million in 2015 EBITDA, and his current rating is "sector perform," with a $17 price target. "Relatively limited visibility" on the 2015 free cash flow outlook is one of the reasons he cites for "limited near-term upside."

Mr. McReynolds, like the analysts who have "buy" ratings on the shares, says he is positive on the longer-term growth outlook for Aimia. Investors, however, should expect Aimia to sit on the runway for some time before any potential takeoff.