Nebraska Capital - Eighth Investment Report – May, 2018

Multiplus and Smiles (8% combined)

Multiplus and Smiles are the public traded loyalty plans of Brazil's two largest airlines, LATAM and GOL. With Air Canada's recent announcement that it will take back its loyalty plan from the public traded AIMIA, we know of no other arrangements around the world like what we have in Brazil, a circumstance that was obviously triggered by the Brazilian airlines' thirst for cash in prior years (they remain under very dry conditions we should add). For foreign readers, it is also important to note another peculiarity of the Brazilian loyalty market: here there are no exclusive arrangements between airlines and card issuers. All issuers enable their clients to send points to any airline-related loyalty program, and co-branded cards have just recently appeared. This makes competition amid the loyalty plans more intense on the one side, but their market share amid redemption options for points issued by card companies is much larger than in the U.S., for example, where options like cash-back are relevant. In addition, there is still a significant breakage of points within the banks, something our two investees are always working on.

Having their loyalty plans as separate public traded entities seems to have only disadvantages for the parent airlines, such as incremental taxes and minority shareholders to deal (and share profits) with. So, why would Nebraska want to be a minority shareholder in companies that not only depend on controlling firms that have relevant financial issues to deal with, but may also have points of conflict with these controllers?

To begin with, we cannot fool ourselves with the argument that Multiplus and Smiles have created large client bases after the IPO or that they have strong brands. Both companies are still (and will forever be) hugely dependent on their parent airlines, not only because of the long term contracts through which they buy cheap tickets, but also because clients are strongly motivated to send points from credit cards to the airlines' programs, in which they often already have a large balance of points received from the airline itself and where people perceive the most value for their points.

Coming back to the question, we had been following Smiles and Multiplus from a distance for years but, by the end of 2016, some factors had dawned on us:

1- As we were studying U.S. legacy airlines, we realized how important code-share partners in other countries had become for them. Through alliances and JVs, the financially strong U.S. carriers control most routes to and from the U.S. Recent deals in which these American companies have invested "a little" of their capital to keep their Brazilian partners alive, as well as increased operational ties, prove the strategic importance of keeping these local carriers fulfilling their "functions" and unavailable to competitors. It is remarkable that none of the Brazilian airlines went through a "Chapter 11" during our recent deep recession, despite huge losses and high leverage levels. Hence, while we are still not able to judge the equity value of Brazilian airlines, we currently believe that the risk of them disappearing is much lower than what we previously thought.

2- GOL owns 53% of Smiles, and LATAM has 73% of Multiplus. We would not consider investing in either loyalty plan in case the parent airline did not own a significant stake; one just needs to see what recently happened in Canada, where Air Canada had no ownership in AIMIA, to understand why. We believe that, for regulatory and reputational risks, it would be very difficult for GOL or LATAM to sabotage minority shareholders given their positions not only as suppliers to and clients of the loyalty programs, but also as our partners. In addition, the contracts above mentioned cannot be changed without the approval of board members who represent minority shareholders.

3- It is amazing to see how far beyond its original form Smiles has gone. Today more than 50% of points issued (excluding the airline) come from sources other than banks, and over one third of the miles are redeemed with partners other than GOL, mostly on foreign airlines. With that and the company's market share, revenue and profit growth shown on the table below, it is hard to argue that GOL is not satisfied. Moreover, Smiles has been doing a great job occupying those seats that GOL most wants it to use. We believe that such impressive feats are in large part due to the company's executive team and their set of incentives, both of which would likely not be replicable within GOL.

4- Multiplus, on the other side, has a contract with LATAM that allows it so little flexibility and so much thinner margins, that it would be almost irrational for LATAM to be much disturbed by the minority shareholders' 27% stake. And that is without noticing that the company has also done a good job expanding beyond banks for points earned and the airline for redemptions. Both Multiplus and Smiles have, for example, relevant revenues from subscription products (more on which below), as well as partnerships with hotel booking and car rental companies that are highly valued by customers and growing.

Given all of the above, we began to see Smiles and Multiplus as "investable", with the caveat that relevant risks exist, especially regarding corporate governance and contractual issues. Thus, we have limited our total exposure to these companies and decided to invest in both of them. It won't be a surprise for us if something goes off the rails.

The overall rationale for this investment is simple: besides fitting well into our circle of competence (finance, subscription-like, etc.), these businesses need no equity, generate a good float, pay out 100% of profits as dividends, are very resilient, and enjoy long term macro tailwinds as they lie between two growing industries, travel and credit card. But, when you go deep, Multiplus and Smiles are two quite different companies, and the industry itself is much more interesting than it seems from the top.

Multiplus's IPO came first, in 2010; when Smiles had its IPO, in 2013, it had to overcome two obstacles to find enough demand from investors: GOL was still perceived as a low-cost airline that would not attract high-spenders (a paradigm that has since changed a lot), and Multiplus was a dominant peer, delivering good profits and holding the industry's most desirable clients (Multiplus points have always commanded premium prices from the banks, whose top clients highly covet LATAM's international flights). To overcome these challenges, GOL not only attracted a private equity partner and a seasoned CEO from the credit card industry (along with a good team), but also designed a contract that gave Smiles much more flexibility than what Multiplus has with LATAM; basically, how many miles Smiles charges from its users is not tied to how much cash it pays GOL for that particular seat. With that, Smiles's management can exploit their pricing power as much as possible; they also have an easier time innovating and launching new products, such as a recent one that allows clients to book tickets without having the miles (and bring them later), and the all important Clube Smiles, a monthly subscription plan through which clients get some perks and points. The club is already the company's largest single source of miles issued, larger than any of the country's mega banks. Multiplus has done its homework here and launched its own club as well.

Competition in this business is rather "indirect"; in other words, the best way to conquer clients is not to lower how many miles you charge per ticket, but rather to make it easy for people to use their miles, as well as (and a very significant factor in Brazil) to offer bonuses (bring ten miles from your card, get fifteen here). Thus, Smiles's product innovations and pricing flexibility have enabled it to grow much faster than Multiplus, although it usually charges more miles per comparable seat.

Historically, contracts between the loyalty plans and banks priced miles in U.S. dollars, especially for Multiplus where many redemptions are for international trips. With the recession (that devalued the Brazilian Real in 2014/15), Multiplus began to receive much more cash (in Reais) per mile, without seeing its costs rise accordingly; this trend has been reverting, in large part because Smiles and Tudo Azul (the non-public traded loyalty plan of Brazil's third largest airline) have driven strong bonus campaigns to attract customers in the last two years. These bonuses don't affect Smiles's margins in the short term as management prices redemption offers to keep their gross margins within their target range. Nevertheless, over time, devaluing the miles is unsustainable and Smiles's management must know that, as they have recently indicated that their gross revenues per mile will likely grow from here - after all, they must seriously take under consideration the long term risk of alienating clients who may, sooner or later, find out that their miles are worth more with the competitor.

The table below shows how financially healthy both companies are, as well as the competitive environment we have just described.

Multiplus	2013	2014	2015	2016	2017
Clients (MM)	10.9	11.7	13.3	15.2	17.9
Gross Billings ('000 R$)	2,008,975	2,126,818	2,564,990	2,353,284	2,453,737
Recurring Profit (NBK data)	259,904	337,633	479,742	516,105	468,744
Smiles	**2013**	**2014**	**2015**	**2016**	**2017**
Clients (MM)	9.4	10.0	10.7	11.6	12.7
Gross Billings ('000 R$)	1,007,983	1,151,037	1,654,579	1,714,675	1,908,062
Recurring Profit (NBK data)	207,844	287,731	375,854	550,803	604,681

Our first investment in the sector was in Multiplus, in January, 2017, a small 3% of the fund. Back then we saw the pressure on margins coming, but the valuation was good and the downside protected, leaving us with a nice upside from long term growth, as well as from a huge hidden value that we see in this company. We have since added a little to this stake. We understand that the company's margins are still going to decline a little more before stabilizing, because of the time it takes for points coming into the balance sheet at lower unit prices to be used by clients, when they pass through the income statement. In addition, we acknowledge that unlocking that hidden value is not simple, not only because LATAM seems uninterested in changing anything, but also because of the risk of disturbing the relationship with those core, frequent clients, who certainly keep track of how many miles they are charged. But messing up with that is not the only way to unlock value, the company could, for example, be more innovative, more flexible on pricing for sporadic clients, and use more of the huge reservoir of seats available at LATAM's international airline partners. To be clear, we are not here criticizing the company's management at all, to the contrary, we believe they are doing quite a good deal given their constraints. Multiplus has once been a darling amid stock market analysts in Brazil; today it is mostly overlooked – we are agnostic to such things, but if forced to take an opinion on it, we would likely say we like the odds in stocks that are "in the freezer".

The more we studied the sector and Smiles's particularities, the more we appreciated the company. Although its business model has already been quite explored, there may be a good deal more to come. Moreover, we found two opportunistic chances to build our stake in the company. The first was on May 18, 2017, the same day that we first invested in Coelce – from our previous report you may remember that our whole stock market dived on this day. The second came recently, when the stock took another big hit because the company disclosed that it plans to pay only 25% of 2018's profits as dividends; this was followed by an unfortunate comment from GOL's CFO, leading the market to worry about undue interference. In reality, we (and everyone who follows Smiles closely) already knew that management is looking for ways to expand the business and that this will likely involve spending capital to either acquire some sort of travel related business or put money upfront to operate the loyalty plan of some other airline in Latin America. In that light, the company's board decided to put out the formal message on the dividend cut (although it may not materialize in case management cannot complete any deal), giving us a nice chance to add to our holdings at a moment when our judgments on the attractiveness of the company, as well as its risks, had cemented without relevant variations since our initial investment. Although we have not yet seen Smiles's management make acquisitions, we believe any such a deal has a good chance of success, given the team's operational prowess and the value of the company's current client base.

As is normal at Nebraska, we have relatively low expectations for growth at Smiles, in part because of the competition, not only from Azul (the third, fast growing airline), but also from card issuers trying to offer more rewards themselves, a process that ebbs and flows without gaining much traction so far, as our leadings banks may fear not only disrupting the breakage they currently enjoy within their card-points, but also alienating clients who value Smiles and Multiplus (something that became clear when Itaú had to revert a decision that changed the exchange rate from its points to Multiplus's from 1:1 to 1.25:1). Regarding Multiplus, we understand that the company will keep struggling to compete given the status-quo; however, the competitive environment (the frequent bonus campaigns that put Multiplus in a deadlock of either matching to hold market share but lose margins, or vice-versa) seems close to its toughest point.

To close, Multiplus is now worth less than R$4.80 billion, and Smiles R$8.20 billion. GOL's total enterprise value stands at about R$18.00 billion. Those figures can give you a final idea of how much value Smiles's management has created, as well as how cheap Multiplus is looking at broader metrics - LATAM is a good deal bigger than GOL when its international routes (from Brazil) are included.

We appreciate your attention,

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