Innovative Ways to Use Miles as an Alternative Form of Payment

Bob Brunner

CEO

RBH Financial Group, Inc.

Prerequisites

- Before you can use miles or points as an alternative form of payment you must be able to monetize your program

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Monetize the Program

- Already Accomplished
  - Liability Calculated
  - Partner awards purchased/sold
  - Points/Miles sold

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What Else Can be Done

- Once the exchange rate is established you can now:
  - Barter
  - IPO
  - “Sell” Liability

Barter

- Barter
  - Trading goods or service without the exchange of money.
  - Extend to Miles or Points as a non-cash transaction.
  - This will be discussed by another speaker later in the conference.

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IPO

- Sell your entire program to shareholders
  - Gain large amount of cash
  - Ability to fund extraordinary purchase
  - Ability to return shareholder value
  - Give away some control over your program
  - Lose access to significant ‘free’ cash

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Sell your Liability

- Remove the liability for your loyalty program from your balance sheet
- Improve Operating cash flow
- Improve Operating income
- Lose access to cash but not liquidity
- Lose interest earned on cash

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Definitions

- **Derecognition of Financial Liabilities:**

  "A financial liability is removed from the balance sheet when it is extinguished, that is, when the debt is discharged, cancelled or expired. The condition is met when the liability is settled by paying the creditor or <u>when the debtor is released from primary responsibility for the liability, either by process of law</u> or by the creditor"

Definitions Quoted from PWC.com IFRS: Classification, Measurement and Derecognition of Financial Liabilities

Objectives of Liability Derecognition*

1. Remove liability from the balance sheets of companies with point based loyalty programs, and . . .

2. Allow companies to improve cash flow and operating profits

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Who benefits?

-Airlines

-Credit Card Issuers

-Hotels

-Supermarkets

-Any company with point-based loyalty programs

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Stage 1

- Company moves cash and existing liability to a 3rd party company

- 3rd party company pays redemption costs or purchases redemption tickets until liability is extinguished

- Future liability and cash transferred using same formula

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Stage 1: Company Benefits

- Company immediately books to income the difference between liability amount and cash moved to RBH in present value model

- Or, company books the difference in A/R and cash moved as payment for redemptions is received in future value model

- Balance sheet is strengthened

- Payment to company for redemptions has positive impact on operating results

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More Advantages

- Risk of redemption volatility removed

- Risk of interest rate volatility removed

- Operating cash flow improved

- No need to defer future sales to cover liability -- all are booked to current year

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Disadvantages

- Significant cash outlay

- Loss of interest on cash (non-operating income)

- Possible tax implications

Cash and liability passed to finance company

Liability now funded and company books an account receivable for redemption funding

Cash from company → Finance Company

Liability from Company → Finance Company

Accounts Receivable To Company ← Finance Company

Finance Company . . .

A. Invests cash long term for better returns, or

B. Matches investments to redemption cycle to address interest rate fluctuations

Finance company receives cash and liability

Finance company invests long term

Finance company matches investment to redemption cycle

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How it works

Company holds cash / short term investments → Company earns interest on funds → Gains booked as non-operating income

Company holds account receivable → Company receives payment against redemptions → Account receivable reduced. Effect is on operating income

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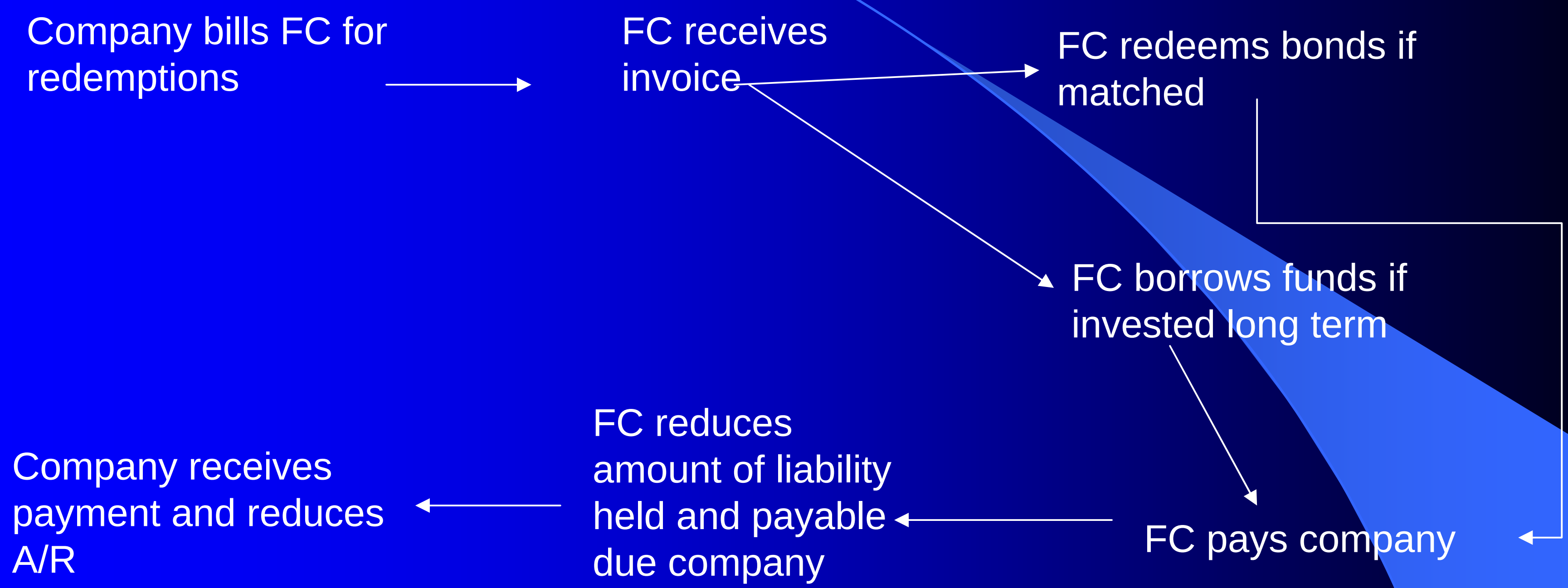
Redemption

Redemptions are paid annually by borrowing funds if invested long term, or redeeming bonds if invested to match the redemption cycle



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Result:

New liability transferred to finance company, along with new cash

Company transfer new liability

Company transfers new cash

Company books new account receivable

Finance company receives new funds and liability

Finance company retires loan

Finance company invests remaining funds

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Impact on Cash Flow

Operating cash flow is improved for company as costs are currently handled as a current expense on the income statement without a cash offset.

Both of the following exhibits are income statement neutral, but the lower example is cash flow neutral where the top example is cash flow negative.

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Impact on Cash Flow

Redeemed tickets → Liability debited → Revenue credited → Marginal cost handled as current expense

Redeemed tickets → Cost incurred for marginal costs → Revenue received to cover marginal costs → A/R reduced

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Process: Stage 2

- Investing company borrows funds equal to cash provided by company
- Investing company loans money to company at LIBOR, plus desired margin
- Rate to company must be lower than higher priced secured debt
- Loan to company secured by cash/securities held by investing company to pay liability
- Company uses loan to pay off another higher priced secured loan
- Savings on debt service Improves cash flow and earnings

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Stage 2

Finance company holds bonds purchased with cash received from company

Finance company borrows equivalent sum at LIBOR

Finance company loans funds to company at LIBOR, plus – using bonds as collateral

Company retires higher priced collateralized debt

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Process: Stage 3

- Investing company provides secure line of credit using newly unencumbered asset as collateral
- Rate for line of credit same as previous loan secured by same asset
- Company now has same (or improved) liquidity as before transaction with improved balance sheet

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Stage 3

Company has newly unencumbered asset → Finance company provides line of credit against this asset at same rate as previous loan → Company can draw down line as needed

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Ongoing Program

- Same as Year 1, but for Year 2 and beyond, company calculates the difference between redeemed and issued points

- More redeemed than issued, RBH pays company

- More issued than redeemed, company transfers new liability and cash to RBH

- Company books all sales/revenue to current year's income statement, whereas previously some was deferred

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Financial Company Risk

- Assumes risk associated with interest rate fluctuations
- Assumes risk associated with number of points redeemed
- Assumes risk associated with timing of redemptions
- Potential to assume risk associated with price of redemption

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Thank you

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Questions

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