

T2RL'S First View is our rapid analysis of breaking news. It helps provide perspective, putting the facts in the context of our wider and deeper knowledge of the market.

Sabre and Datalex are Winners in The Frontier Saga

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The Facts

Republic Airways Holdings is officially the winning bidder in the auction of Frontier Airlines. So reported The Wall Street Journal on 14 August 2009.

<http://online.wsj.com/article/SB125019375046930049.html>

While the majority of the reporting concerned negotiations over pilot union contracts the implications for the IT services providers involved are also significant.

The Analysis

Frontier Airlines has been "interesting" in the Chinese sense for some time. Its bankruptcy was prompted by changes to the retention policies of its credit card providers which threatened to dramatically reduce its available cash flow. In its weakened state it has been forced to seek shelter with a larger and better-funded organisation. However recent quarterly results have been good, fuelled by the adoption of fare families, which allow customers the opportunity to trade up.

Initially it seemed that the proposal from Republic was the only available option until Southwest Airlines showed an interest. With startling rapidity the Southwest option developed and then faded as insurmountable problems with pilot contracts prevented a deal being done.

From a technology perspective the two bids were quite different in their potential impact and key suppliers Sabre and Datalex both have reason to celebrate the victory of Republic in this particular race.

Republic Airways Holdings is an airline holding company that already owns Chautauqua Airlines, Midwest Airlines, Mokulele Airlines, Republic Airlines and Shuttle America. Most of Republic's operating companies provide capacity to US major airlines under franchise relationships. As such they have no direct requirement for commercial IT systems like reservations and Internet booking engines. Only Midwest and the very small Mokulele provide branded service under their own names. These airlines have their own contracts for passenger services, with Sabre and Radixx respectively. In the absence of any other indication it seems most likely that Republic will leave Frontier to its own devices in the provision of commercial IT services.

By contrast Southwest is a hugely powerful branded airline with a record of assimilating acquired airlines very quickly into its own systems and processes. If Southwest had emerged victorious it is likely that the Frontier name and systems would disappear within a year.

Frontier's two key suppliers in the passenger services arena are Sabre and Datalex.

Sabre supplies the back-end systems that manage inventory, GDS distribution and airport services. Its contract with Frontier is based on passengers boarded and with 13.6 million passengers boarded by Frontier and its regional partners in 2008 is likely worth around \$6m per year. Sabre also supplies equivalent services to Southwest but in a rather different manner. Southwest is hosted in a dedicated mainframe complex within the Sabre data centre. Neither company makes public the terms of the contract for this service but it is reasonable to speculate that it is structured such that the addition of new capacity at the margin is very inexpensive compared to the standard PB charges for Sabre's other customers. We would expect that Southwest could absorb the PSS costs of the Frontier operation for no more than \$2m per year. For Sabre the delta between a Republic acquisition and a Southwest acquisition is around \$4 million per year.

The situation for Datalex is even more profound. Southwest manages its Internet sales operation internally and would quickly absorb the Frontier business into Southwest.com. An independent Frontier has adopted the "Air Canada" model of fare families with great success. Internal sources at Frontier attribute the airline's return to profitability to its adoption of the fare family approach. It engaged Datalex to build an e-commerce platform that would allow it to sell its services according to that model while remaining in the Sabre reservations system. Dublin-based Datalex is believed to have invested substantially in developing the capabilities needed by Frontier and would recover a proportion of that investment over a multi-year contract based on a payment per booking. With up to 80% of Frontier's bookings being made online, we estimate Datalex's revenue stream from the airline is probably of the order of \$3-4 m per year. Whilst this only represents around 10% of Datalex's total revenues its loss would have had a considerable impact.

So Datalex can breathe a sigh of relief, while Sabre has avoided a measurable impact on its Airline Solution Group bottom line. Despite this positive news Datalex's share price remains low.

The Speculation

Having avoided the loss Datalex could now be poised for substantial growth. It has cut over the new e-commerce suite for Copa this week after a long development period. Copa's new site is a huge improvement on its predecessor and will further drive Datalex's push into the application service business. Other airlines are looking hard at the benefits of the fares family approach and especially at the growth of ancillary revenue streams. Datalex is at the forefront of innovation in both these areas and should now be in a position to benefit from its investments in product development. If it is unable to capitalise as an independent company it must surely become a more attractive acquisition target for bigger players in the industry, although there is no indication that its current major shareholders are anxious to sell.