INVESTMENT MEMO

Short Thesis

Company	International Airlines Group (IAG.L)
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1. Thesis

IAG sits on two underappreciated structural risks that the market is not pricing. The first is earnings quality: the company recognises a material and growing portion of revenue through loyalty breakage assumptions that no external party can verify. The Avios liability has grown 27% in four years to €3.3bn, and IAG's own annual report states that a five percentage point shift in the breakage assumption moves reported profits by €103m. That is 2% of operating profit moving on the back of one internal estimate. The second risk is free cash flow: British Airways must replace its ageing 777-200 fleet, and the bill is already disclosed. Capex rises from €3.4bn in 2026 to a peak of €5.6bn between 2029 and 2031. At that level, free cash flow is effectively eliminated. The market is pricing IAG on record current profits with no apparent discount for either of these realities.

2. The Mechanism

When a company issues loyalty points, it cannot book that money as profit straight away. It holds a portion as a liability, representing something owed to the customer. That liability disappears in one of two ways: the customer redeems the points, or the company decides they will never be used. The second scenario is called breakage. For IAG, breakage is triggered when an Avios account has been inactive for 36 consecutive months.

The breakage estimate is an internal assumption based on historical redemption data and management's view of future customer behaviour. No analyst, auditor or regulator can independently verify whether the number is conservative or aggressive. It sits entirely at management's discretion.

This creates a real and underappreciated risk. In a weak year, management can raise the breakage assumption and release more of the deferred liability into revenue with no new economic activity behind it. The bigger the loyalty liability, the more meaningful that lever becomes. At IAG, the liability is both large and growing.

3. The IAG Specific Case

The Avios liability has grown from €2,630m in 2022 to €3,348m in 2025, a 27% rise in four years. It is one of the largest loyalty liabilities in European aviation and a growing line item on the balance sheet.

Points issuance has more than doubled, from €662m in 2022 to €1,406m in 2025. IAG has pushed Avios aggressively through credit card deals, co-branded programmes and airline partnerships. More points in the system means a larger pool of potential future breakage.

In 2025, the liability movement produces a €285m residual after accounting for all disclosed items. That gap has grown fourfold from €51m in 2022. Subsequent investigation of Avios Group Limited's standalone Companies House accounts suggests this is largely a currency and consolidation artefact rather than undisclosed breakage, which partially weakens this specific point. The core concern, however, remains.

IAG's own report states that a five percentage point change in the breakage assumption moves the liability by €103m. The sensitivity alone confirms that this assumption is material to reported profits. What management cannot be pinned down on is whether it has moved.

IAG Avios Liability , Four Year Movement (€m)

	2022	2023	2024	2025
Avios Liability (closing)	€2,630m	€2,712m	€2,888m	€3,348m
Total Deferred Revenue	€7,644m	€8,023m	€8,536m	€8,739m
Opening Avios Liability	€2,820m	€2,630m	€2,712m	€2,888m
Points Issued	€662m	€1,085m	€1,453m	€1,406m
Revenue Recognised	(€801m)	(€1,052m)	(€1,397m)	(€1,389m)
Exchange Movements	(€72m)	€34m	€107m	(€158m)
Unexplained Residual	€51m	(€49m)	(€120m)	(€285m)

Source: IAG Annual Reports 2022–2025, Note 24 (Deferred Revenue). All figures in € millions.

4. Why the Market Is Missing This

Sell-side analysts covering IAG treat Avios as a straightforward positive. The focus is on partner revenue growth and margin expansion at IAG Loyalty, which delivered £469m in operating profit in 2025. Loyalty is talked up on every earnings call as a capital-light growth engine.

No analyst commentary or model has been identified that questions the breakage assumptions underpinning that €3.3bn liability, despite the sensitivity figure sitting plainly in the annual report. The assumption is not stress-tested. It is simply accepted.

This is an earnings quality blind spot. The market is pricing IAG on profits that include a component nobody can independently verify. Investors who look past the loyalty growth narrative and into the mechanics of revenue recognition will find a more complicated picture than the consensus suggests.

5. ESG Implications

The breakage issue creates ESG exposure across two pillars that institutional investors screen for. These concerns sit separately from the earnings quality thesis and carry their own weight.

Social

A loyalty programme is built on a promise: spend with us and you will be rewarded. When a company issues points it statistically expects will never be redeemed and prices that expectation into its revenue model from day one, it is profiting from the gap between what customers think they are earning and what they will actually receive. Regulators are paying attention. The FCA's Consumer Duty requires firms to deliver good outcomes for retail customers, and while loyalty programmes fall outside its direct scope, the direction of travel is clear. Practices that profit from customer inertia are coming under scrutiny.

Governance

AGL runs statistical models on breakage and discloses a £90m sensitivity figure, which confirms the number is material. Yet breakage and redemptions are bundled into a single line with no split. AGL has the data to separate them. The decision not to is a choice, not a technical limitation. The FRC has been pushing for more granular revenue disaggregation under IFRS 15. IAG's disclosure sits in tension with that. For ESG-screened funds, a company that knowingly bundles a material, unverifiable assumption into revenue without flagging it is a governance concern worth pricing.

6. Open Questions

The following questions require further investigation before the thesis can be stated with full conviction:

- The €285m group-level residual is most likely a currency and consolidation artefact. The AGL standalone accounts filed at Companies House reconcile exactly: opening balance of £2,504m, adjusted for all disclosed movements, produces the closing balance of £3,079m with no gap. The residual at group level reflects euro-sterling translation differences between AGL and the consolidated IAG accounts. This partially weakens that specific point in the thesis, though the broader earnings quality concern stands.
- Whether IAG's breakage assumption has moved year-on-year. No specific percentage is disclosed, making this impossible to verify from public information. Access to investor relations or someone with inside knowledge of AGL's modelling would be needed to investigate properly.
- What proportion of AGL's £853m annual revenue release is genuine redemptions versus breakage. AGL released £853m of deferred revenue in 2025 and £862m in 2024, bundling both categories together with no split disclosed. The £90m sensitivity per five percentage point assumption change is confirmed at AGL level. The question of how much of the £853m is assumption-driven versus customer-driven cannot be answered from public information alone.

7. Fleet Replacement and Free Cash Flow Risk

Separate from the breakage thesis entirely, British Airways is running one of the oldest widebody fleets of any major European carrier. It operates 43 Boeing 777-200ERs with an average age of 25.2 years. Virgin Atlantic's fleet averages around seven years. These aircraft cannot fly indefinitely, and the replacement cycle has already started. The orders are placed. The capex profile is disclosed. This is not a risk that might materialise. It is a cost that is coming.

Management has guided capex at €3.4bn in 2026, rising to an average of €4.9bn across 2027 to 2028, then peaking at €5.6bn annually between 2029 and 2031 before dropping back to a €4.5bn run rate after 2032. Orders placed for British Airways include 18 Boeing 777-9X, 32 Boeing 787-10s, and 6 Airbus A350-1000s, with deliveries running from 2027 to 2033. Roughly two-thirds of that order book is replacement, not growth. The company is not buying new capacity. It is paying to stand still.

The arithmetic is simple. IAG generates roughly €5bn in operating cash flow annually. Against current capex of €3.4bn that leaves €1 to 2bn of free cash flow, which funds the dividend and buyback programme. When capex hits €5.6bn at peak, free cash flow is gone even if trading holds flat. Any weakness in revenue or margins pushes it negative. At that point IAG faces a straightforward choice: cut shareholder returns, take on more debt, or delay the aircraft it has already ordered.

Three things make the timing worse than a normal capex cycle. Boeing has repeatedly delayed delivery of the 777X, the aircraft BA ordered to replace its 777-200 fleet. Every year of delay means BA keeps flying 25-year-old aircraft that burn more fuel and cost more to maintain, while still carrying the commitment to buy the replacements when they eventually arrive. Fuel compounds this further: jet fuel is projected at $152 per barrel in 2026, roughly 70% above 2025 levels, and older aircraft are materially less efficient than new ones. And the hedging protection that has insulated IAG from fuel costs drops from 70% in 2026 to just 31% by Q4 2027, precisely as capex starts to step up. The market is pricing IAG on record profits today. It does not appear to be pricing what the next four years of cash flows actually look like.

8. Conclusion

IAG is a two-pillar short. The first pillar is earnings quality. The company carries a €3.3bn Avios liability built on a breakage assumption nobody can independently verify, releases £853m of deferred revenue annually with breakage and redemptions bundled together and unlabelled, and is covered by a sell-side consensus that has never stress-tested the assumption. The second pillar is cash flow. British Airways has an ageing widebody fleet that must be replaced. The capex to do it rises from €3.4bn now to €5.6bn at peak between 2029 and 2031, Boeing delays are keeping old aircraft in service longer than planned, fuel hedging falls away exactly when costs are rising, and free cash flow is eliminated at peak capex even in a flat trading environment. The market is pricing record profits today with no apparent discount for what the next four years of cash flows look like. The thesis strengthens if IAG reports any trading weakness alongside a rising breakage revenue release, or if free cash flow guidance is cut as the capex cycle accelerates. It weakens if IAG's operating profit grows fast enough to absorb the capex step-up and maintain free cash flow, or if AGL separately discloses breakage and shows the assumption has been unchanged throughout.