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Airlines Mull Spinning Off Mileage Plans

IdeaWorks contributed information to this article - - see italics.

The latest head scratcher for airline executives: Is it possible to peel off one of your more profitable components -- your frequent-flier program -- without irreparably damaging your core business?

"It's like saying what is the value of your heart?" says Jay Sorensen, president of airline marketing consultancy IdeaWorks Co., in Shorewood, Wis. "You can put a value on it, but it's not worth anything if you rip it out of your chest."

Despite this, Mr. Sorensen actually favors the spin-off idea, one which is building steam across an industry grappling with soaring oil prices and declining stock values. Investors, analysts and consultants alike are coming to believe that frequent-flier programs -- which sell miles to partners, like credit-card companies, who offer them as rewards -- can be better moneymakers than the airlines they support. Splitting off a subsidiary makes it unavailable to subsidize a struggling airline. That, the theory goes, can lead to better decision making at both units.

The spinoff model has gained currency since Air Canada's parent company, ACE Aviation Holdings Inc., spun off a portion of Air Canada's frequent-flier program, called Aeroplan, to the public in 2005. It was the first airline to do so.

Aeroplan LP, now 69%-held by the public, boosted its net income by 41% in the first half of this year and increased its revenue by 22%. Its stock price has soared to 22 Canadian dollars (US\$21.91) a share at the close of trading yesterday on the Toronto Stock Exchange. The program has about five million members and is the leading loyalty program in Canada.

Now American Airlines parent AMR Corp. is coming under pressure from a major shareholder to do the same with its far-larger AAdvantage program. AAdvantage is the world's first loyalty plan, launched in 1981, and has grown to 57 million members worldwide.

A spokesman for American declined to comment beyond an official company statement that said the company "regularly" considers the best use of its strategic assets and the long-term impact on shareholders. At a Merrill Lynch conference last year, Gerard Arpey, American's chief executive, said of the broader issue of potential uses for strategic assets, that "many of these deals that have been done, you end up paying for that over the next five or 10 years."

Another big carrier, UAL Corp.'s United Airlines, is studying the idea of spinning off its Mileage Plus loyalty program, already a subsidiary, into a stand-alone company as part of a five-year strategic plan to improve its core airline business and improve the other businesses in its portfolio.

Frequent-flier programs were formed in the early 1980s as simple marketing tools to gain passenger loyalty. But in time, they evolved into far more as airlines began selling miles to credit-card companies and retailers. American has hundreds of major partners that buy miles from the carrier. Industry experts say such purchases are lucrative to airlines, but most carriers don't disclose revenue or profits from the transactions.

That lack of disclosure frustrates investors like Hannes Smarason, who believes the frequent-flier programs can function as stand-alone companies and bring more value to shareholders. Mr. Smarason, whose \$6 billion investment fund FL Group, of Reykjavik, Iceland, owns a 9.14% stake in AMR, wants American to follow the Air Canada model. He sent a letter to AMR's board this week urging directors to consider spinning off the AAdvantage program and possibly other assets, such as their American Eagle commuter carrier.

Mr. Smarason began buying shares of AMR last fall. Since he disclosed his stake in the company in December, the stock price has dropped nearly 30%, most recently Monday when shares fell 14% after the airline provided third-quarter revenue guidance that fell short of analysts' expectations.

Investors deserve to know more about the value of the businesses, he said. "Nobody knows what the true worth of the AAdvantage program is because we have no information about it," he said.

The 39-year-old Mr. Smarason, the CEO of FL Group, began investing in airline stocks five years ago. He acquired a controlling stake in the flagship carrier of Iceland, Icelandair, in late 2003, then later sold it. Airline stocks now account for nearly 20% of the firm's holdings.

United in 2002 moved its 48 million-member Mileage Plus plan into a UAL subsidiary called United Loyalty Services LLC. Last year, the plan produced \$600 million in revenue, though it isn't a stand-alone company and doesn't disclose its profitability or costs.

Bear Stearns analyst Frank Boroch, in a July research note, said Mileage Plus is "perhaps the most underappreciated asset at UAL." The analyst estimated United's frequent-flier plan could be worth \$7.4 billion and that United could unlock shareholder value by spinning off Mileage Plus and other assets.

Air Canada's successful spin-off of Aeroplan was part of a larger restructuring of the entire company. Before Air Canada went into bankruptcy-court protection in 2003, it, like its big U.S. rivals, owned a commuter airline, a maintenance organization and the loyalty program. When it exited from restructuring the following year, the airline emerged as a collection of stand-alone units under the umbrella of a new parent, ACE Aviation.

Aeroplan, like other frequent-flier programs, makes money by selling frequent-flier miles to more than 70 partners, which hand out the miles to customers as rewards. Aeroplan buys reward-travel seats from Air Canada at a discount to supply to travelers redeeming their miles.

Industry experts caution that while frequent-flier programs can succeed alone, a spinoff can accelerate the decline of the core airline business. Aeroplan's stock has soared since it went public, but Air Canada's share price has swooned since the ACE sold some of the carrier's shares to the public last year.

Some analysts believe Air Canada trades at a discount to the big U.S. carriers because it no longer owns Aeroplan or its heavy maintenance arm. Now, frustration over U.S. airlines' weak stock prices has helped create the push for asset spinoffs that investors believe will produce stronger results in their portfolios.