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By Susanna Ray and Hugo Miller
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Airlines, down in the dumps, consider unusual spinoff

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CHICAGO: in investors' sights

What if airlines like United and American owned assets that were worth at least as much as the carriers themselves, but few people even realized they had a separate value?

That is the case of frequent-flier programs, which are not reflected in airlines' share prices, leading some shareholders to clamor for the programs to be sold.

American's AAdvantage program, with more than 57 million members, could be worth as much as \$5.7 billion, according to a Morgan Stanley estimate. That is about the same as the market value of the parent company, AMR.

Mileage Plus of United Airlines has a midrange value of \$7.5 billion, says Bear Stearns, 1.5 times the value of the parent, UAL. Airlines could boost share prices by 20 to 27 percent by unloading the units, William Greene, an analyst at Morgan Stanley in New York, said recently.

Some investors say selling the mileage plans would help reverse the 17 percent drop this year in airline stocks amid a 52 percent rise in jet-fuel prices.

While airline executives have resisted giving up exclusive access to their best customers, they are now considering the view of activist shareholders who say it is time to copy the 2005 spinoff of Air Canada's Aeroplan, which has grown to about the same market value as Northwest Airlines.

"Spinning out the mileage programs would be very beneficial to shareholders," said Craig Hall, a Dallas investor who owns the fifth-biggest stake in AMR and wants American to divest AAdvantage. Hall calls the frequent-flier plans a "hidden asset" not reflected in airline valuations.

Carriers would gain cash from any sale and could still reap profits by keeping stakes while the loyalty plans expand. Released from airlines' control, mileage programs could move outside the air-travel industry, adding retail partners and luring more members, the strategy's backers argue.

The five biggest U.S. airlines said in the past month that they were reviewing the possible sale of their loyalty units. United, No. 2 by traffic behind American, is developing a profit-and-loss statement for Mileage Plus, though it has not yet decided if it will share the information. Delta Air Lines plans increased financial disclosure of SkyMiles next quarter.

Qantas Airways, Australia's biggest carrier, has met with Aeroplan to discuss how to release value from its rewards plans. If shares in one of these airlines' units are sold, they may find a buyer in Aeroplan. The company's chief executive, Rupert Duchesne, said in an interview in August that Aeroplan was in talks to buy stakes in other loyalty programs.

So far, none of the three biggest European airlines have said they plan to sell their programs. A British Airways spokesman, Richard Goodfellow, said the company was not considering selling either its Executive Club frequent-flyer plan or the Air Miles third-party loyalty program, which rewards regular customers at a range of shops with travel on the London-based airline.

Lufthansa is not planning to sell its Miles & More frequent-flyer plan, said a spokesman, Boris Ogursky.

Air France-KLM Group did not immediately return calls seeking comment.

Carriers are responding to pressure as airline shares have underperformed the Standard & Poor's 500 Index by 23 percent this year. FL Group of Iceland, which owns 9.1 percent of AMR, urged American to sell its frequent-flier program in an open letter to the AMR board in September.

"This has the potential to become a sustainable source of value creation if it's done in the right way," FL Group's chief executive, Hannes Smarason, said in an interview.

United's plan is probably worth more than \$7 billion, and Northwest's program has a midrange value of \$6.4 billion, according to Frank Boroch, an analyst at Bear Stearns in New York. United's market capitalization is about \$5.1 billion, and Northwest's is \$4.6 billion.

Boroch and Greene both computed frequent-flier valuations using Aeroplan as a model, because it is the only free-standing airline mileage business.

Air Canada's parent, ACE Aviation Holdings, raised 287.5 million Canadian dollars, or \$299 million at current exchange rates, when it sold a 14.4 percent stake in Aeroplan in 2005. That valued the Aeroplan Income Fund at about 2 billion Canadian dollars. ACE has since pared its holding to 20.1 percent, and Aeroplan now has a market value of 4.48 billion Canadian dollars compared with 2.87 billion for ACE.

Airline rewards programs now make money by selling miles to banks or hotels to give to customers. An independent program like Aeroplan would sell points to carriers as well as to banks, retailers and other customers, and then buy airline seats and other rewards at a discount, pocketing the difference.

About 14 percent to 17 percent of the miles go unclaimed, according to United and Aeroplan, also adding to profit. Aeroplan's 15 percent profit margin last quarter was more than twice as high as the most profitable of the top five U.S. carriers.

"The extra cost of carrying a frequent-flier passenger is virtually nil, assuming that person isn't displacing a full-fare-paying passenger," said Jay Sorensen, who helped run Midwest Airlines' mileage program and is now an industry consultant based in Shorewood, Wisconsin.

Creating a separate structure made Aeroplan a better business with more freedom to add partners and grow, said Karl Moore, a professor at McGill University in Montreal who has worked with the mileage plan's executives on business school projects. And it had another measurable benefit.

"It unleashed an enormous amount of capital that they wouldn't have otherwise had," Moore said.

Still, Aeroplan's success may be difficult to copy in the United States because Air Canada dominates air travel in its home market, Aeroplan can sell points at a premium to Canadian businesses, analysts say.

No carrier has similar clout in the United States.

"Aeroplan is entirely different," said Jeff Misner, chief financial officer of Continental Airlines.

"You can't take those multiples and apply them to a frequent-flier program here in the U.S."

Hall, the AMR investor, disagrees. "If it were spun out, it's like one and one equals three," he said.

While airline managers may be hesitant "from a control perspective," carriers have benefited from previous divestitures, such as when AMR in 2000 spun off the reservations service now known as Sabre Holdings, Hall said.

Airline executives may yet come around to Hall's viewpoint.

"I admit some people are scared," United's chief financial officer, Jake Brace, said this month in New York. Shedding the plans "is not traditional thinking in the airline industry, and if you just had an airline hat on, you might not do it. But we have to think what would be best for the shareholder."

Hugo Miller reported from Toronto.