A caveat to Aeroplan Income Fund

Good returns likely, but ACE has too much control

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Veritas Investment Research has a reputation for not liking very many companies. Dissecting accounting at Nortel Networks Corp., Bombardier Inc. and Biovail Corp. -- all before they crashed -- are shining moments on the firm's highlight reel.

Corporate governance concerns helped to shape **Veritas**' negative opinion of Royal Group Technologies Ltd. before "people could even spell corporate governance," boasts Anthony Scilipoti, partner at **Veritas**.

These reports were thorny and yelled "sell." But while the independent research firm has built a reputation as a bear with a sharp eye for accounting, the list of companies it likes is growing as the firm expands. **Veritas**' 12 analysts cover 83 companies -- 25 are buys, 25 are sells and 33 are rated at neutral.

A newcomer to **Veritas**' "buy" column is Aeroplan Income Fund. Analyst **Peter Holden** says he likes it. Well, most of it, at least.

"We like Aeroplan, we really do," **Mr. Holden** said in a research report earlier this month. "It has the capacity to produce regular, reliable large cash flows. It has strong brand identity, an experienced management team and an admirably sized base of nine million high-earning, highspending members."

It's the corporate governance that doesn't pass the test.

Aeroplan came to market as a spinoff from ACE Aviation Holdings Inc., which still owns about 85.6% of the rewards company. As the parent of Aeroplan, ACE had the luxury of moulding Aeroplan's corporate governance rules.

"ACE has set up the governance of Aeroplan LP so that ACE utterly controls the board, with its power to appoint and remove management, so long as it has at least a 20% ownership stake," **Mr. Holden** said.

Aeroplan appoints two board members while ACE names the rest, he explained. There are currently nine members on Aeroplan's board. Should ACE's stake in Aeroplan drop below 50%, Aeroplan gets four seats.

But there's a catch. A big one. ACE -- "at its sole discretion" -- can increase the size of the board and fill those seats with ACE appointees, diluting Aeroplan's power over the board.

Should ACE's ownership fall below 20%, it still gets two spots on the board, as long as it is part of the so-called Commercial Participation Services Agreement, an agreement between ACE and Aeroplan kept secret for competitive reasons.

Aeroplan and ACE will forever be tied to each other in more than just corporate governance. ACE and Aeroplan do about $670-million in business between each other each year -- $210-million in sales of miles to Air Canada, $390-million in ticket purchases and $70-million in service purchases from Air Canada, **Mr. Holden** said.

This makes ACE, through its Air Canada airline, Aeroplan's second-biggest customer for miles and its biggest supplier of rewards.

Because of the financial ties between ACE and Aeroplan, **Mr. Holden** frets about what would happen if -- hypothetically, in the future -- "bad" people came to power at ACE and used their power over Aeroplan to ACE's benefit.

As it stands now, it wouldn't be to ACE's advantage to misbehave because, as Aeroplan's majority owner, it benefits when Aeroplan benefits.

"Down the road, were ACE to own only 20% of Aeroplan at the same time as Air Canada found itself once again in difficult financial straits, we would be far more concerned," **Mr. Holden** said.

"The solution is straightforward," he said. "There is no reason that ACE needs to control the Aeroplan board beyond its ownership position. In fact, given the potential for perceived or real conflict of interest, we see no reason for ACE to control the Aeroplan board at all."

That said, **Mr. Holden** still likes Aeroplan, he really does. "Aeroplan is significantly under-priced," he wrote -- in bold -- in his report.

"Buy Aeroplan in anticipation of ACE coming to its senses," he said.

"But press ACE to do the right thing!"