AIRCRAFT ACQUISITION & MANAGEMENT

We're Encountering Some Turbulence, But Better Weather Is Ahead

by Andrew Richmond

It is May 2009—about a year after I wrote my last article for the *Air Charter Guide*. In that article, I covered the basics of aircraft acquisition and management, as well as alternatives to full ownership such as jet charter, fractional ownership, and jet card programs. At that time, there was talk of recession as the housing crisis developed, but the general outlook for our industry was good. For example, if you wanted to buy a brand new jet, you might have to wait years to take delivery. And if you wished to shorten the wait by purchasing a position from an existing contract holder, you could expect to pay a hefty premium.

What a difference just one year makes! Although OEMs still report backlogs of several years for certain models, contracts for new jets are being cancelled at a swift pace. This is despite the fact that buyers may be forfeiting substantial cancellation fees. Also, a growing number of aircraft owners find they now owe much more than their plane is worth. And the charter industry is seeing its worst downturn in recent history.

In this article, I'll identify what I see as the four key factors behind this unprecedented downturn, discuss the impact on specific areas such as aircraft ownership and charter, and then offer some thoughts on what may be up ahead—as well as a few bright spots.

How Did This Happen?

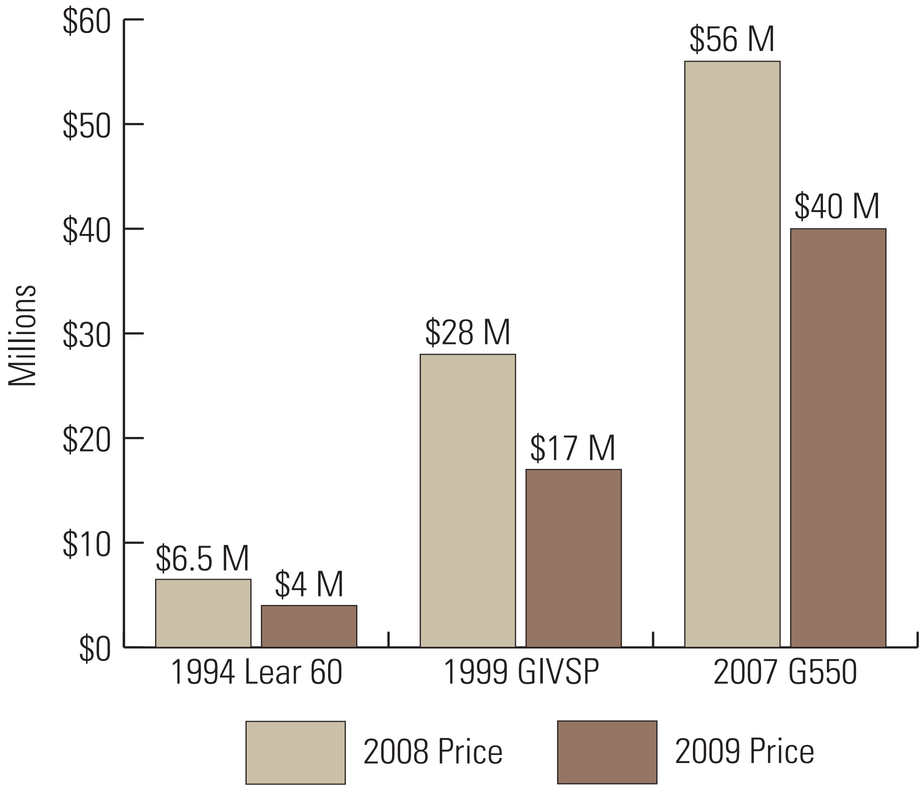
As I look back, here are the chief developments that brought us to where we are in the Spring of 2009.

1. Glut on the market. Fact is, too many planes were being built. Take the emerging VLJ category. Cessna quickly came out with the Mustang and had a reasonable level of success, but the market was not nearly as robust as some predicted. At one point, Eclipse planned on building 800 airplanes per year. If we did not need this many airplanes prior to their entry into the market, how could we need so many now? The glut wasn't limited to VLJs, of course; the story can be repeated in most aircraft categories.

2. Astronomical fuel prices. Our real trouble began in Summer 2008, when fuel prices soared as high a $7.00 per gallon, while direct aircraft operating costs are traditionally based on an average of $2.74 per gallon. Needless to say, this wreaked havoc on everyone's business models, made private jet travel prohibitively expensive for many people and companies, and caused the industry to retrench. To make matters even worse, the resulting shift to newer and more fuel efficient models caused the resale market—especially for older, less efficient aircraft—to collapse.

3. Stock plunge. As of this writing, the stock market is now at roughly half its October 2007 peak. Much of the wealth that might have gone to purchase a new or pre-owned jet has simply vanished. Even very wealthy people are safeguarding their assets, and businesses are holding on to cash. Aircraft ownership and jet charter are often among the first expenses to be cut.

Aircraft Market Price



Source: Vref, TWC Aviation estimates

4. Negative (and unfair) press. Like many of you, I cringed when the Big Three automakers flew separate private jets to beg for billions of dollars from taxpayers. I knew that this would make our industry an easy and immediate target for the press and legislators, and that is exactly what happened. Literally overnight—and completely unfairly—private air travel went from being chic, exciting, and desirable to a symbol of outright profligacy. It was suddenly "uncool" to own or charter a jet.

So, those are the causes. Let's go into more detail about some of the effects on the main areas of our industry, as well the new reality for current and potential owners and charter customers.

> **"We have never witnessed such a precipitous and immediate decline in aircraft values."**
>
> Paul Wyatt, editor-in-chief of Aircraft Bluebook–Price Digest

Another Look at Commercial Travel

Last year, with tongue slightly in check, I mentioned commercial flying as an alternative to private travel, and then more or less dismissed it as an option. This year, though, as painful as commercial travel can be, some cost-conscious or image-conscious businesses and individuals are reluctantly choosing to endure the long delays, bad service, minimal privacy, limited airports, inedible food, long security lines, and multiple connecting flights. This will change as the economy improves, but for now it appears that some travelers are willing to continue to endure commercial travel until better times appear on the horizon

New Facts and Figures of Aircraft Ownership

Aircraft values have dropped substantially in the past year. As Paul Wyatt, Editor-in-Chief of the *Aircraft Bluebook–Price Digest* commented, "We all know that the business aircraft industry is cyclical in nature, and over the last 60 years the *Bluebook* has reported these peaks and valleys to our subscribers. However, we have never witnessed such a precipitous and immediate decline in aircraft values."

Depending on the aircraft model and age, I have seen drops of as much as 50 percent from the peak price. For example, last year a 1994 Learjet 60 might have sold for as much as $7 million—this year some are selling for half that much. Does that mean that they are now great values? Well, maybe. However, let's look at a few things before we draw any conclusions.

First of all, in 1994 a brand new Learjet 60 would have sold for about $9.5 million. During those 15 years, annual depreciation was probably about 5 percent per year, by which measure the Lear should be worth approximately 25 percent of its original purchase price, or just under $2.5 million. Instead, today's asking price is around $4.5 million, which shows that some aircraft are holding their value better than you might expect.

As aircraft prices have declined, so have operating costs. Aircraft management companies have become more competitive on management fees, charter commissions, and hangar prices. This means that even though aircraft owners will make less money than before from each charter flight, lower operating costs can help reduce the negative impact on their profit margin.

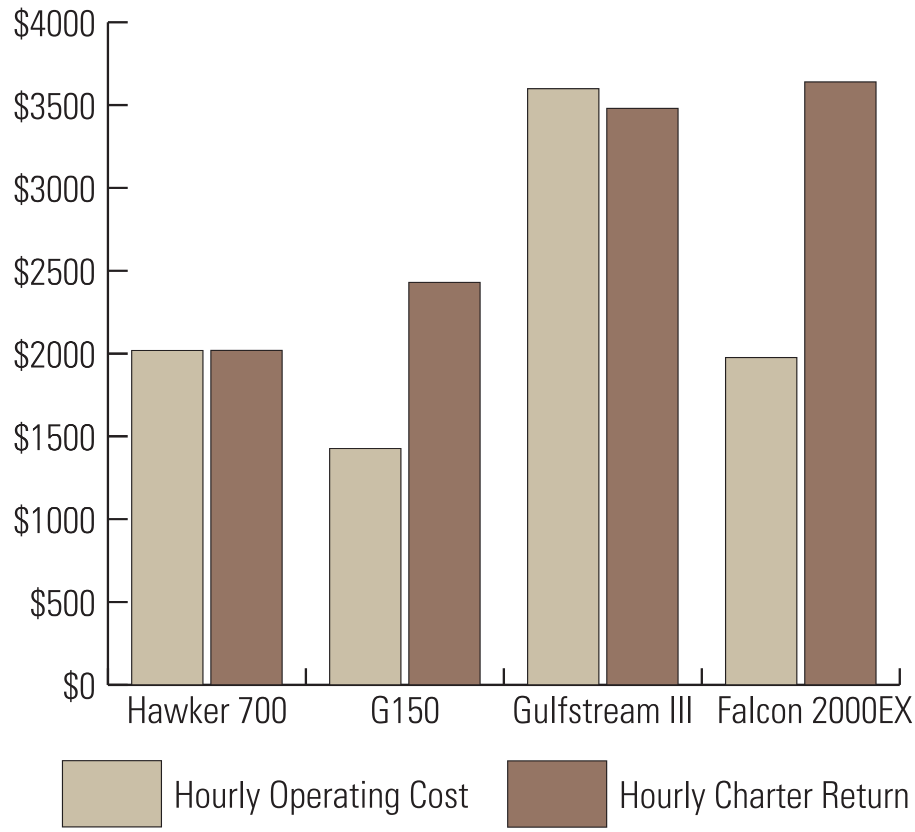
Fuzzy Math?

In 2007 and early 2008, aircraft were selling at premiums never seen before. For example, a new Gulfstream G550 could be purchased for approximately $47 million from the factory with a three-year wait for delivery. In contrast, some used G550 jets were selling for as much as $60 million. The difference was the premium some buyers were willing to pay to get a jet now rather than later. This decision was usually driven by emotion or speculation, rather than any sound fundamentals.

Was there a more practical alternative for these emotional buyers? Yes, and it may surprise you. The G550 buyer could have waited the three years and chartered another G550 in the interim. Here's how the numbers work.

- At $7,500 per hour, flying 300 hours per year, the buyer would have spent approximately $2.25 million per year to charter a G550—which is $6.75 million for 900 hours of charter during the three year waiting period.
- By purchasing the jet immediately at a premium, the buyer would have only incurred approximately $900,000 in operating costs ($3000 per hour x 300 hours).
- Fixed overhead would likely be at least $1 million for pilots, capital costs, insurance, maintenance, and overhead. So, the cost to own would be very close to the cost to charter, yet owning immediately would require paying as much as a $13 million premium.
- Tax write-offs may skew these numbers somewhat, but not enough to offset a $13 million premium.

Profit Per Charter Hour



Note 1: Average fuel price of $3.50/gallon
Note 2: Hourly operating numbers provided by Conklin & de Decker
Note 3: Hourly charter return computed with fair market rates

A Tale of Two Gulfstreams

The tremendous drop in the value of jet aircraft is yielding some odd results. For instance, a year ago a GIV-SP might easily have sold for $28 million. This year, a similar jet could be purchased for $15 million. Bad news for sellers, better news for buyers, and an interesting situation for charters. An owner who bought a GIV-SP for $15 million might be willing to earn less per charter hour, since his cost of capital is lower than it is for the owner who paid $28 million. This means that charter rates for two identically configured GIV-SPs could be $1,000 apart. And while this means less profit per hour for the $15 million owner, it also makes it a far more attractive choice for charter customers.

Singing the Charter Blues

The falloff in the charter market has been massive—anywhere from 30 percent to 70 percent depending on the geographic market and class of aircraft. This has ramifications for charter operators, aircraft owners, and charter customers. In some cases, charter companies have been selling their lift at below their true cost just to keep the planes in the air. This strategy further hurts the market, by dramatically reducing profits for charter operators and forcing them to find new ways to compete or simply shut the doors for good.

As charter rates decline, older, less fuel-efficient airplanes with higher operating costs will exit the charter market. For instance, a Gulfstream GII no longer meets the new price/value criteria for cost-efficient operations, whereas the GIII does make the cut—at least for now. Currently, a Gulfstream GIII currently charters for approximately $4200 per hour. The operating cost can be as high as $3600 per hour. As the charter rate is forced downward, it will reach a point where

Advertorial

Independent Safety Audits: Moving Toward a Universal Standard

Today there are more than 2,500 air charter operators in the US, flying thousands of planes. And when it comes to evaluating the safety of their operations, aircraft, and crews, the burden ultimately falls upon charter customers. Until recently, this burden was made easier through independent audit and certification programs from commercial safety firms. The industry is changing rapidly, however, as the world of safety standards undergoes a major transformation.

QUESTION: What is the background of today's business aviation safety standards?

RICHMOND: In the 1990s we saw the emergence of commercial safety firms with competing standards. First there was Wyvern Consulting, now owned by CharterX, and then ARG/US. They're still the leading companies in the field.

QUESTION: What services do they offer?

RICHMOND: They provide independent safety audits, some of which are onsite, and then approve and certify charter operators that meet specific criteria. They also offer extra-cost services that provide additional information about charter operators, as well as preflight data on a specific plane and crew.

QUESTION: Have these certifications and services helped charter customers make more informed choices, and allowed charter companies to differentiate themselves?

RICHMOND: I think there is an awareness among many charter customers. Even if customers don't understand all the criteria behind a specific rating, an ARG/US or Wyvern logo offers a certain level of assurance.

QUESTION: Sounds like a great system for everyone. Why would anyone want to change it?

RICHMOND: Two internationally respected nonprofit organizations now offer what I think is a much better model. In 2002, the International Business Aviation Council introduced the International Standard for Business Aircraft Operations (IS-BAO), which is a code of best practices for corporate flight departments and charter companies. And then in February 2009, the Air Charter Safety Foundation launched their Industry Audit Standard (IAS), which was developed as a universal safety standard for charter operators.

QUESTION: Why did the industry need these new standards? How do they improve on the status quo?

RICHMOND: First of all, they're extremely rigorous—for example, IS-BAO is comparable to ISO-9000—and each standard is the result of real collaboration with other industry organizations around the world. Profit was not one of their goals. Equally important, both standards are built around a Safety Management System (SMS), which provides a formal mechanism to evaluate and mitigate risk and continuously improve and promote safety practices and procedures within the company.

QUESTION: What can charter operators hope to gain by going through the time and expense of an IS-BAO or IAS audit?

RICHMOND: More customers. As awareness of IS-BAO and ACSF IAS standards grows—and it will—many customers will begin to choose companies that have earned one or both certifications over charter operators that have not.

QUESTION: Are leading charter companies and flight departments adopting these new standards?

RICHMOND: They are beginning to.

QUESTION: What about TWC Aviation?

RICHMOND: TWC Aviation is already certified as an IS-BAO Registered Operator. As of May 2009 only 16 Part 135 charter operators in the world have earned IS-BAO certification, so we're very proud of that. And this year we will go through an ACSF audit so we can earn IAS certification as well. We also have a formal Safety Management System in place, which at this time is not required by the FAA but will likely be in the near future.

QUESTION: What else can customers do to get a better comfort level with a prospective charter company, aircraft, and crew?

RICHMOND: Be proactive. Visit their offices, walk through their hangar and maintenance facilities, and speak with their employees. They can also check National Transportation Safety Board's Website—www.ntsb.org—to see if there have been any accidents or incidents.

QUESTION: It sounds very time consuming.

RICHMOND: Actually, it's an excellent investment of your time. First of all, what's more important than your safety? And second, you ideally want to build a long-term relationship with your charter company. This is a great way for you to get to know them, and for their charter team to learn about you and your specific needs.

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what the customer is willing to pay is less than the operating cost.

These factors are not only grounding airplanes for charter flights, many owners are taking their planes out of service altogether to reduce maintenance, hangar space, and insurance costs. Paradoxically, this might help improve things by changing the current supply and demand ratio. There are also potential tax advantages for owners who charter their planes, and that may cause some of them to keep their jets on charter certificates even at a loss.

Fractional Ownership and Jet Card Programs

The fractional ownership category has seen a sharp drop in new business. The jet card business was seen as an alternative to fractional ownership because it required no capital investment and had a much less significant perceived risk. However, even jet card sales are being challenged in this economy. Here's why. One of the main advantages of a jet card was guaranteed availability. In return for this guarantee, customers would often pay more than twice the typical charter rate, although this rate would only be charged on the legs flown, not the deadhead and reposition legs.

In an increasingly soft market, the likelihood of being unable to find a specific jet is much smaller than when the market was hot. This effectively negates one of the biggest jet card advantages. In addition, some charter companies are selling one-ways on a regular basis, and even waiving the repositioning fees to win the trip. This can make jet card flying more than twice the price of purchasing the same trip from a traditional charter company. No wonder jet card sales are down significantly.

Sunnier Skies Ahead

It's impossible to predict how the next year will unfold, and so I won't. However, rather than end this article on a negative note, I thought I'd go out on a limb just a bit and offer a few positive thoughts about what's ahead for our industry. First, I think it's likely that aircraft prices will stabilize at realistic levels, making ownership attractive for more buyers. Prices on newer aircraft will stabilize more quickly, since their fuel efficiency and lower maintenance costs make them more attractive alternatives.

As for the rest of the industry, the traditional charter business will start to return first. After all, it's the most economical way to access a private jet. The jet card category will be the next to improve, followed by fractional ownership.

I also think that the unfortunate and undeserved stigma attached to jet ownership and charter is only temporary, and that people and businesses will soon return to private air travel. And although it may be years before we see charter flights return to their 2007 volume levels, I still remain cautiously optimistic about the future. It will be interesting to look back a year from now and see if my optimism was justified. My bet is that it will be.

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Andrew Richmond is President of TWC Aviation, Inc., an aircraft management, charter, sales and maintenance company headquartered in Los Angeles, California, with bases of operation throughout the U.S. and abroad.

TWC Aviation has a diverse and growing managed fleet that includes light, midsize, super midsize, and large-cabin jets from Bombardier, Cessna, Dassault, Gulfstream, and Hawker Beechcraft. Since 1998, TWC Aviation has worked with hundreds of clients to evaluate their flying requirements and offer the best solution to meet their needs. Mr. Richmond has worked with clients from a variety of industries, including Fortune 500 companies, the entertainment field, and private individuals, to assist with the purchase or sale of all types of jet aircraft. Comments or questions can be emailed to Mr. Richmond at arichmond@twcaviation.com.