Airport Beacon Report

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THE EVER-CHANGING FBO LEASE

By Michael A. Hodges, MAI, President/CEO

Many FBO leases began 20 years ago or more, a time when long-term leases were the norm, not the exception. Many of the FBOs who enjoyed (or suffered through) the long lease terms will have to face dramatic changes in the way airports are now managed and operated when they go to renegotiate.

For the most part, gone are the days when airports were managed by local officials or ex-military who had limited knowledge of commercial aviation and its impact on the local and regional economy. Today, airports are generally operated and/or managed by highly-trained airport managers and directors, and in some cases private companies that are purely profit motivated.

Airports now often have dedicated individuals or departments whose primary function is to maintain relationships with the airfield's tenants, negotiate leases, and enforce all rules set forth by the lease or Minimum Standards.

Given the FAA's push to make airports more self-sustaining, airport officials are now more aware of the need to maximize their income opportunities from their tenants. And, due to such regulations as Sponsor Assurances, which sets forth guidelines for airports that receive Federal funds, they are more cognizant of maintaining "fair and reasonable" rents for all tenants on the airfield. In other words, the "sweetheart" deal is now a thing of the past.

As a result, airports must be aware of some of the basic misconceptions experienced when renegotiating a lease in these changing times.

The Airport Authority said, "Let's negotiate." Foolishly, I said "Over my dead body."

Reality #1 - Leasehold Improvements

One of the more common misunderstandings tenants have in lease negotiations is that the leasehold improvements - or those improvements constructed at their own expense during the term of the previous lease - should continue to be credited to them in the calculation of renewal rent. The harsh reality: *At the end of the lease, unless specifically stated to the contrary, all land and improvements should become property of the airport sponsor. Also known as the reversion clause.* The lessee's investment credit for any improvements were recognized and amortized during the previous lease term. Put another way, unless there are specific renewal clauses, the airport sponsor should have the right to renegotiate the lease with the current tenant or any other interested party. The airport should be the owner of the land and all improvements at the end of a lease.

Reality #two: Term and Consumer Price Index

Another significant issue in lease negotiations is the length of the lease term. In the past, terms of 20 to 50 years (or more) were relatively common, with fixed rent throughout the entire term. However, current leases generally reflect much shorter terms of 10 to 30 years. Even more significant, they usually include a periodic rent adjustment every one, three, or five years based on the Consumer Price Index (CPI) or some other pre-set adjustment factor.

Market rent, as assigned by a Market Rent Analysis or appraisal, is generally applicable only at the time of the analysis because values are estimated through analysis of historical information or, at best, current data. Periodic application of a CPI adjustment to a lease can potentially cause rental rates to grow at a significantly faster pace than what local real estate values (or aviation market trends) are experiencing. Consequently, while long-term leases are still recommended in order to allow a tenant to adequately amortize capital improvements, one must be wary of indexed adjustments. Here's why: It is very possible that contract rent may exceed market rent in the future. A more prudent alternative is to obtain a long-term lease with periodic reappraisal or renegotiations. This provides the security of a longer lease, but potentially prevents dramatic increases which do not accurately reflect current market conditions. As the airport sponsor, while increasing revenues is a primary objective, a lease is a partnership with your tenant, and everyone benefits from an economically viable landlord/tenant relationship.

Reality #3: Percentage Rents

Another method of income generation currently used by airport authorities is the imposition of percentage rents (also known as business privilege fees), as well as fuel flowage fees.

In the past, the most common application of these percentage rents was to have them go into effect after a minimum level of gross revenues were achieved. However, it is now more common for percentage rents to be charged in addition to all base rent starting from the first dollar earned. This trend is also consistent with the FAA's Sponsor Assurances which indicate that it is appropriate for an airport to charge a base rent for the "occupancy" of land and/or facilities, while also incurring percentage rents for the privilege of operating a commercial aeronautical business benefitting from the airport infrastructure and amenities. While the application of a percentage rent is up to the discretion of the airport, you must be aware of the relationship between and overall financial impact of, base rent, percentage rent, and fuel flowage fees.

With regard to fuel flowage fees, it is important for the airport to remember that these fees are most often directly passed-through to the customer when they buy fuel, similar to a tax. As such, as long as fuel flowage fees are reasonable and consistent with the marketplace, they have limited impact on fuel prices or the FBO's profitability.

Reality #4: Required Improvements

Another trend in lease negotiations is for the airport authority to minimum amount of capital improvements to be completed. In most cases, lease negotiations are predicated upon certain capital improvements being completed, but many airports fail to be the driving force on the minimum financial commitment to be tied to the allowable lease term. It is important to recognize that for an airport to commit to a longer lease term, there must be a significant commitment on the part of the tenant, as well.

While the primary key to a successful negotiation is communication, knowledge is also an important factor. Each party's goal in lease negotiation should determine the fair value of the property being leased (whether improved or vacant), and the prospective benefits to each party from entering into a long-term lease/partnership. While these goals may not always be achievable, you must assume that a viable middle ground can be realized. For this to occur, it is important that both parties be aware of the historic market trends, while being cognizant of current market conditions and future opportunities.

AIRLINE CUSTOMER SERVICE: AIRPORTS MUST PICK UP SLACK

By Mark R. Davidson, A.A.E. Vice President

When I was a child, my parents made an effort to make me look presentable anytime we traveled by air. Equipped with my clip-on tie and short sleeve dress shirt (some say there is no such thing as a short sleeve dress shirt), I looked as if we were heading to church. Those were the days when airline travel had luster and prestige. Nowadays, airlines strapped for cash have eliminated the frills and appear to overbook and understaff each city (on purpose) in order to stay solvent. Customer service does not appear to be as important to the airlines as it once was.

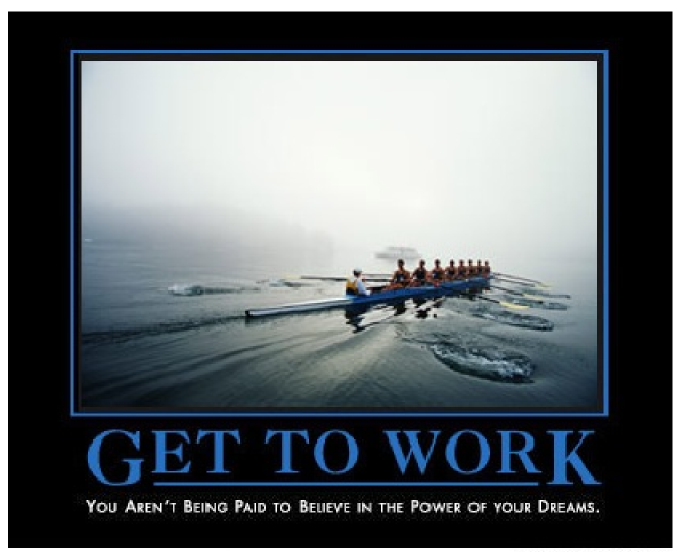
For instance, this past Christmas, US Airways and Comair, a subsidiary of Delta Air Lines did everything they could to tick-off as many customers as possible. US Airways advised that a combination of bad storms and an unusually high number of employees calling in sick led to the cancellation of more than 300 flights over the Christmas weekend, as well as more than 10,000 pieces of misplaced baggage. Comair said bad weather contributed to a computer malfunction that forced cancellation of all its flights on Christmas, with only 15 percent back in the air the following day. Approximately 40,000 Comair customers nationwide were affected.

Comair's technical woes, along with major service disruptions at US Airways, prompted U.S. Transportation Secretary Norman Mineta to launch an investigation by his Agency's Inspector General, Kenneth M. Mead. Mr. Mead immediately announced a broad, expedited investigation that would include a major audit of the entire airline industry's performance. Mead said he will be looking at how well the companies are living up to customer-service commitments to deliver bags on time, provide adequate and timely information to customers about flight delays and cancellations, and respond to customer complaints within 60 days.

Under current market conditions, it does not appear that the entire airline industry will be able to redirect this trend in poor customer service. Although there are a number of airlines that pride themselves on superior customer service, airport operators need to develop plans and programs to counteract the negative experiences that many air travelers are incurring. Of course, this is not new and a number of airports already have programs or personnel in place.

For instance, Jacksonville International Airport created a department dedicated to customer service which monitors complaints and implements programs to enhance the travel experience. Another example of an airport going above and beyond was Eagle County Regional Airport. While I served as their Airport Director, we implemented a customer service program called "Colorado Powder ASAP". In general, the award winning program entailed a customer service pledge, as well as cash incentives to any employee that demonstrated superior customer service. The program was unique since it included and provided incentives to all employees working at the Airport (i.e. Rental Cars, FBOs, Airlines), as well as prizes to customers that took the time to summit comment cards.

No matter how an airport operator decides to implement a customer service program, the most important aspect is that the operator recognizes the current situation. Once it has identified the problem, a solution can be developed and implemented to enhance the air traveler's experience. Who knows, maybe one day in the future I will feel complied to make my son wear the same clip-on tie the next time we travel.



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Ask ABS!?!

What is the optimal term that an airport should seek in a lease for an FBO or a corporate hangar? I know that every airport is unique and local conditions (laws, demand, etc.) may dictate the terms of a lease. *Tim Bradshaw - Airport Manager, Owensboro-Daviess County Regional Airport*.

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Tim - I hope that my article in this issue helps to answer your question to an extent, but let me attempt to take it a step further. Lease terms are a tricky issue, and you are right-on about every airport being unique and impacted by local conditions (although you forgot to mention politics). In the first article I ever had published ***(FBO Magazine*** in 1990), I wrote, "Airports are like snowflakes. There are no two that are exactly alike." Well, the same can be said for lease agreements . . . almost. Every airport has their own policies, procedures and politics which govern the maximum allowable lease term, with some having a fixed maximum lease term, regardless of the investment, with others having variable terms depending upon capital investment levels.

Although my standard answer as to how long a lease should be is: "It depends!". Some airports have little land left for development, and should be more stingy with their lease terms, while others have plenty of land to go around, and would be more inclined to be more flexible. In general, I think airports should allow the longest lease term allowable by their rules and procedures, but with numerous conditions attached. The following outlines a few of these conditions:

1) Make sure the investment is sufficient for the type of development proposed, to make sure you have something to revert to you at lease termination.

2) Structure the lease with a limited base term with multiple, multi-year renewal options, ***at your discretion***. This prevents you from getting "in bed" with a non-performing tenant with a lease that ties your hands for many years to come.

3) Provide for assignment approval clauses with significant conditions attached to your approval of the assignment of the lease. You do not want to provide a tenant with a long lease that creates value for them, then allows them to turn around and sell their leasehold for a premium with no benefits to the airport. (Not to mention the ability to know who they are selling to. Remember, you are not just signing a lease with that individual, but all future lessees that may buy their lease rights.)

While all of these conditions may seem like common sense, it is easy to lose sight of the objectives in the heat of negotiation. In addition, if you are prepared with all of the options available to you, it might help in overcoming some of the political pressures that may arise if the prospective tenant does not get their way.

Good Luck!

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