Airport Beacon Report

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Percentage Rents and the Level Playing Field
By Michael Hodges, MAI, President/CEO

In an FBO lease, there are two basic types of contracts: the market-based land and facilities lease and the percentage lease. The market-based lease uses the estimated market rent as determined by comparison with other FBO facilities at similar and competing airports. This is the prevalent and preferred method in most areas.

However, in an attempt to "level the playing field," many airport sponsors have gone to percentage leases when negotiating new leases and renewals. Percentages vary depending on the area, age, and quality of the facilities, as well as numerous other factors, and can range from 2 to 5 percent of gross revenues generated by the FBO.

Typically, a percentage rent lease is offered to appease an FBO tenant that feels they are not paying a fair rent for facilities in comparison with other tenants on the airport. While on the surface this may seem like a reasonable alternative to market-based rents, this method does not always provide the most equitable alternative. For example, take the scenario of two identical FBO facilities on the same airport. For the sake of comparison, assume that Facilities A and B lie next to each other and each lease ten acres of unimproved land, five acres of ramp area, and a 30,000 square foot office/hangar facility. Through comparison with similar facilities, assume that market-based rent for the unimproved land is 10 cents per square foot, ramp area is 20 cents per square foot, and building rent is $3.00 per square foot. Annual rent would be approximately $177,000, or $14,750 per month. Since both facilities offer the same land and building area and similar quality and condition, each facility should generate the same annual rent.

Next, let's look at the same two facilities under a percentage rent scenario. Assume that the airport has determined that an appropriate percentage rent is 3 percent of gross revenues. Facility A is an average operator who has been in business for several years, but has made some poor management decisions or perhaps is just having a substandard year. Gross revenues for the year are $3,000,000. Facility B is a nationally recognized first-class FBO with a significant market share and annual gross revenues in excess of $5,000,000. Given this information, Facility A would pay an annual rent of $90,000, while Facility B is responsible for $150,000 per year in rent. Both operators utilize identical leaseholds, yet Facility B pays 67 percent more rent. This excess rent is not because of an advantage of superior facilities, but because it is a more successful operator who generates higher revenues than its competitors with the same facilities. In other words, Facility B is penalized for its success. (Not to mention the fact that neither FBO would pay the equivalent of a market-based rent in this scenario.)

While this example is simplistic in its presentation, the fundamental concept is clear. The percentage rent lease creates a distinct disadvantage to the successful

operator. Furthermore, it creates the potential for an FBO with inferior facilities, but a successful operation, to be charged more rent than a competitor with new Class A facilities. Also, there is the potential for a good operator in old facilities to be charged more rent plus higher maintenance expenses. The inequities potentially generated by a percentage rental agreement are alarming from the FBO's perspective. Consequently, as with other management-intensive real estate such as hotels or restaurants, it is imperative that the value of the real estate and business are analyzed independently.

While there are numerous negatives to a percentage rent lease, there can also be positive consequences to this type of lease agreement. Percentage rents typically vary based on the income stream for the preceding month with a predetermined base, or minimum rent. Therefore, if an FBO suffers through a poor month, rent would be adjusted accordingly, Whereas, in a market-based lease, a fixed rental amount would be due no matter how successful the business is from month-to-month. Obviously, this can be a distinct advantage for an FBO in an area that suffers extreme seasonal fluctuations in business.

In today's marketplace, it is very common for airports to use a combination of the market-based and percentage rents in negotiating FBO agreements. In fact, this is consistent with the Grant Assurances where is states that it is reasonable for an airport to charge market-based rents for the right of "occupancy" of property on the airport, plus percentage rents for the rights associated with the opportunity to operate a commercial aeronautical business on that property.

The selection of the most appropriate type of lease contract is dependent on numerous variables. However, a market-based lease with rent derived by a comparison with similar facilities is generally considered the most appropriate. This method keeps the airport in the real estate business, and the FBO in the business of serving the flying public. Furthermore, a market-based lease also allows for "peace of mind" knowing that the rent is fair and equitable compared to competing FBOs in the region.

UPCOMING SEMINARS

Georgia's Airport Association
St. Simons Island, Georgia
October 22,2004

Southwest Chapter AAAE Non-Hub/ General Aviation Airport Issues Conference
Las Vegas, Nevada
November 11-12, 2004

An Emerging Market: Commercial MRO

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

Although Maintenance Repair and Overhaul (MRO) tenants are not flashy and do not reflect the same notoriety as a new air carrier coming to town, the benefits of marketing and leasing to a company conducting MRO activities should not go without notice. In general, MRO tenants provide steady revenue for the airport and jobs for the community. Their operations are aviation-related and contribute to fuel sales and the number of operations from the airport. In order to market and develop relations within the industry it is import to understand current trends and the outlook.

The outlook for the MRO market varies significantly from one source to the next, but all the sources and analysts seem to agree that the industry is slowly beginning to recover from the traffic slowdown of late 2001, and should resume steady growth over the next several years. There are several factors which bode well for the industry. First, the worldwide fleet of commercial aircraft (including both passenger and cargo aircraft) is expected to double by the year 2020. Second, the age of the aircraft fleet continues to increase requiring more maintenance and upgrades. Thirdly, newer model wide body aircraft and engines will contribute to increased maintenance costs. While unscheduled downtime will be lower, their sophisticated electronics and materials require more hours of scheduled testing and maintenance.

As times change both airlines and maintenance suppliers are trying to define their positions and structure the most efficient models for supplying and

demanding maintenance services. While the solutions vary by geography, type of provider, airline size and nature of work provided, several trends are starting to emerge:

- Outsourcing of maintenance work
- Growing importance of Original Equipment Manufacturers (OEM)
- Formation of maintenance alliances
- Growing Cost of Maintenance

A typical airline spends about 10 percent of its total costs on MRO. This is the third highest operating expense after wages and fuel. As one of the largest expenses, airlines are constantly looking for ways to lower this operating expense while still maintaining the integrity of their fleet. Until several years ago, aircraft maintenance cost received little attention from senior management at most airlines. That is no longer the case since the MRO industry for commercial aircraft has become a more open and competitive market. The competitive pressures have led to far reaching changes in the market for commercial aircraft MRO services. More and more, airlines are choosing to outsource their MRO activities to third-party airlines, independents, and original equipment manufactures (OEMs), including both system and airframe integrators.

Although the financial ramifications of 9/11 were devastating to the MROs across the nation, the situation has become a determining factor to revisit the cost-effectiveness of using third-party companies to perform heavy maintenance. In many cases, in-house maintenance departments of the airlines have become too big and inefficient. As such, the airline executives are realizing the benefit of offloading heavy maintenance. The airlines new focus on core competencies and cost control has led airlines to seek to become, in the words of Robert Crandall, former CEO of American Airlines, "virtual airlines." In other words it is a company that performs only its core task of carrying people and freight from point to point. A fully virtual airline would not own its planes and would outsource all activities, including MRO. The only service they would concentrate upon would be to fly people and cargo from point A to point B. Ideally, the airline would deal with only one supplier, which would hold all inventory and organize the entire supply chain for the airline.

As airlines continue to consolidate and focus on core capabilities, they are farming more and more of their maintenance work out to a diversified, eager-to-please supply chain of independent MRO providers. While 70 percent of total maintenance work is still performed in-house, that figure is down from 90 percent in the 1970s, as airlines outsource to third parties or to autonomous, market-based Strategic Business Units (SBU) within the company who operate more or less independently. Some large carriers have spun off their MRO divisions announcing their intention to set up independent SBUs while others have closed shop and established a third-party supply relationship such as America West.

Understanding the outlook and current trends is essential in developing business opportunities for airports. Third party maintenance providers are growing and expanding across the country and airports need to market and cater to these providers since more and more airlines are concentrating on their core competencies and outsourcing the MRO business.

Airport Business Solutions is recognized as the leader in providing valuation, analysis, and consulting services to airports and aviation businesses, and offers a diversity of backgrounds and experience which provides a new, creative, and "outside the box" perspective on a myriad of aviation issues and problems.

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