Airport Beacon Report

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FBO REAL ESTATE - OPPORTUNITY OR OBSTACLE?

By Michael A. Hodges, MAI, President/CEO

Some would argue that the most important relationship for an FBO is with their customer. I disagree! A single customer will not determine whether an FBO succeeds or fails. However, the relationship with the FBO's airport management can easily impact current or future opportunities for success. Airport/tenant relationships are almost always a roller-coaster ride, but at no time is the relationship under more strain than when it comes time to negotiate or renegotiate a lease. Although a lease is effectively a partnership between the airport and a tenant, it is generally viewed as a dictatorship from the standpoint of the tenant, and a subsidy program by airport management.

Fuel is typically recognized as the lifeblood of an FBO; however, the real estate component of the operation typically runs a close second relative to economic importance. On the positive side, the real estate component of an FBO business (terminal, offices, hangars, ramp) is an integral part of the FBO's ability to sell fuel and provide other profitable services to customers. As such, most FBOs look to fill their available offices and hangar space with not just any tenant, but with one that is not around a lot. If they are not there, chances are pretty good that they are out flying. And if they are out flying they will need fuel, maintenance, catering, and other services when they return.

On the negative side, the physical infrastructure of an FBO contributes to the company's overhead through costs associated with building maintenance, premises insurance, utilities, janitorial services, and rent and/or debt payments. While there are limited things that can be done about maintenance, insurance, utilities, or cleaning costs, rent is generally seen as a "controllable" component.

Hurricane Katrina: Gulfport / Biloxi Terminal

The Rent Expense

Rent is reflective of a landlord's (the airport in this instance) attempt to achieve a fair and reasonable return on their assets and investments. With FBOs, this can be in the form of ground rent, ramp/apron rent, building rent, or a combination of some or all of these. The best way to understand the concept of rent is to recognize that it is the cost associated with the occupancy of a specific part of an airport. (Percentage rents are typically associated with the privilege of operating a business on the airport and will be discussed later.) The value of the occupancy right is first and foremost the source of the debate between airport and tenant. More often than not, the debate surrounds the issue of what the tenant feels that is can afford to pay based upon the revenues that can be generated from that leasehold and its various components. The following is a brief discussion of each typical rent component and its role in lease negotiations. (I have also included some *FBO 101* to help understand some of the obstacles faced by today's FBOs)

Ground rent is generally a simple issue that is typically determined by a comparison with rates charged by similar and competing airports for similar uses of the property. In other words, FBO ground leases should be compared with other FBO ground leases, corporate hangars leases must be compared to other corporate hangar sites, SASO leases to SASO leases, etc. This conformity of use is important due to the various secondary factors that often impact rental rates paid, to include Minimum Standards,, leasehold size, development and/or operational standards, and other rates and fees paid.

A common question regarding ground rent is "What should it apply to?" Ground rent is usually applied to all areas of a leasehold that are not improved with a building footprint or paved ramp/apron. To best understand this concept, imagine you are looking down on your leasehold. All areas not covered by a building or ramp are considered unimproved land and are typically applied an unimproved ground rent. (Parking lots usually reflect an unimproved ground rental rate because the pavement is not capable of supporting aircraft.)

Facility rents are almost as straight forward as ground rent, as they are also best determined by a comparison with similar facilities at similar and competing airports. The previously described conformity of use also applies to buildings on the leasehold, but the FBO should also extend things a step further when assessing buildings on a leasehold by comparing office buildings on a leasehold by comparing office buildings to office buildings, terminals to terminals, hangars to hangars, etc.

In addition, it is importance to compare T-Hangars to T-Hangars, storage hangars to storage hangars, and maintenance hangars to maintenance hangars. Each building type typically offers different structural components (door and interior height and width, floor capacity, fire suppression systems, insulated vs. non-insulated, heated vs. non-heated, etc.) and therefore can reflect different opportunities to generate income. Other important factors to consider include age, condition, and overall utility.

Ramp/apron rents are often the most difficult and controversial. Ramps on their own do not provide a substantial "direct" revenue source to an FBO. While there are certainly some revenues directly attributable to the ramp (tie-downs, ramp fees, overnight fees), the vital role of the ramp is to help an FBO sell fuel and other services. Looking directly at a return on the construction cost of a ramp/apron will likely dictate a rental rate that is well above a fair and reasonable rate that most FBOs can afford to pay. Realistically, some of the fuel flowage fee is attributable to the ramp/apron, since it is the primary <u>leasehold</u> infrastructure component that contributes to fuel sales. Because the revenues associated with the ramp are mostly indirectly generated by fuel sales, it often behooves an FBO to offer to pay an incrementally higher fuel flowage fee to account of the occupancy and utilization of lease ramp/apron.

Fuel flowage fees are variable fees, or fees that vary depending upon the trends of the business, as opposed to other rent components that are fixed fees, or fees that are fixed regardless of what is happening with the business. (Variable costs are always preferable to fixed costs in the FBO industry due to its cyclical nature.) The fuel flowage fee arrangement benefits the airport by generating more revenue as activity levels at the airport grows, and it benefits the FBO by reducing the fixed overhead burden and passing the expense onto the customer.

Percentage Rents

While percentage rents are not commonly the sole revenue source for airports from their FBO tenants, many airports are following a trend of including percentage rents as a supplemental component of their rental agreements with FBOs. This percentage rent is in addition to the base occupancy rent received for the land, ramp, and/or facilities. The justifications for this is actually set forth in the FAA Grant Assurances by addressing rent for land and improvements in the sense of paying for *occupancy right* to a leasehold at the airport, while the percentage rent relates to the business aspect of the *operational right* of operating a for-profit business enterprise on the airfield. While paying both may not seem fair, it is a growing trend in the airport management industry as airports struggle with the potential of a reduction in Federal and/or state funding. It also better reflects the two different aspects of operating an FBO on an airport: occupying space and operating a business. This trend also follows the standards of the shopping center/mall real estate industry (which probably best mirrors the FBO industry), where most developments charge a base rent against, or plus, a percentage of revenues.

The Revenue Opportunity

While a significant expense to an FBO, real estate can also be an enormous revenue opportunity. Tenant-occupied office space and hangars not only provide a stable source of income to offset fixed overhead costs, but they also provide a level of stability to fuel sales and other aspects of the FBO's business. However, it is important to analyze the real estate component separately from the other business aspects of the operation.

Historically, many FBOs have been willing to discount the rents for their office and hangar space in anticipation of recovering these "losses" through the sale of fuel and other services. Unfortunately more often than not, things do not balance out. It is crucial for FBOs to ensure that they are receiving a fair return for the occupancy of office and hangar space by carefully assessing all prospective costs associated with the space. The sale of fuel and services should be a separate "business-related" issue, if for no other reason than there is a significant labor aspect that does not accompany tenancy of office and hangar space.

What if the customer insists that office/hangar occupancy and fuel deals be tied together? In these cases, the FBO must recognize that if a discount is offered, it should only be after the tenant achieves a certain benchmark of fuel sales, not just because they think they will generate certain volume levels. (Promises are often far from reality.)

Nevertheless, for the FBO, the discount is still better reflected in the price of fuel as opposed to the rent for the office/hangar space. The space is still being occupied whether or not the tenant is flying and burning fuel. The goal should be to entice them to buy more fuel at home, and the fuel discount is more tangible to the operator and has a lesser financial impact on the FBO (assuming the customer buys more).

The Market's Impact

Real estate can be an FBO's greatest attribute or biggest nightmare, depending on market conditions. Whether with the airport or a subtenant, the rental rate associated with a lease must reflect current market conditions. Sometimes this good (when the market is up), and sometimes it is bad (in a down cycle). However, always keep in mind that rates set at the commencement of a lease are reflective of a specific point in time. As such, it is essential to provide for future changes by allowing for periodic adjustments as market conditions shift. This especially applies to subleases within the development. Make sure that sufficient flexibility is provided to maximize occupancy and rates as demand increases. While long-term leases provide stability, they also limit flexibility. At a minimum, provide for early termination or relocation of subtenants if certain benchmarks or conditions are not met. This will allow you to maximize revenue opportunities when times are good because you can almost guarantee that the airport is looking for ways to maximize their opportunities at the same time.

Joke of the Month

A doctor was addressing a large audience in Tampa, Florida. "The material we put into our stomachs is enough to have killed most of us sitting here, years ago.

"Red meat is awful. Soft drinks corrode your stomach lining. Chinese food is loaded with MSG." He continued, "High fat diets can be disastrous, and none of us realizes the long-term harm caused by the germs in our drinking water. But there is one thing that is the most dangerous of all, and we all have, or eventually will have, eaten it. Can anyone here tell me what food it is that causes the most grief and suffering for years after eating it?"

After several seconds of quiet, a 75-year-old man in the front row raised his hand, and softly said, "Wedding Cake."

HURRICANE KATRINA: SEADOG RESPONSE

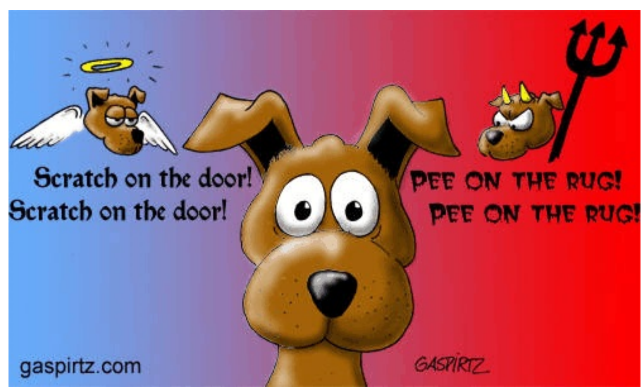
By Mark R. Davidson, A.A.E., Vice President

Last year, after several airports in Florida suffered severe hurricane damage, a number of airports in the southeast formed a group called SEADOG. The name is short for the "Southeast Airports Disaster Operations Group" which now provides a rapid-response to airports that have suffered a disaster in the region. Hurricane Katrina provided the first opportunity for the group to lend a hand and the following will provide insight into the devastation and the work performed by one of the respondents.

Doug Faour is an Operations Specialist with the Jacksonville Airport Authority (JAA) and is one of thirteen employees from JAA's first team who volunteered to help out at Gulfport-Biloxi International. According to Doug, the volunteer team was comprised of individuals with different skill sets but a common purpose. Police officers, mechanics, administrators and maintenance technicians all traveled together to Mississippi in various airport vehicles just days after the Hurricane hit the Gulf region. The team brought their own supplies and equipment to ensure they would not be an additional burden on the airport. When Doug arrived, he was astounded at the devastation and the amount of foreign object debris (FOD) at the airport, from broken glass from the estimated 300 vehicles left in the parking lot, to trash that had blown on the airport operations area (AOA). Doug and other respondents spent days picking up FOD to achieve the ultimate goal of reopening the airport for commercial traffic.

Each morning at 8 AM, the team from Jacksonville along with other SEADOG airports such as Pensacola, Savannah, Brunswick, and Charleston. met with the Gulfport-Biloxi airport staff to discuss the day's agenda. Tasks included tearing out 7,000 square feet of mildewed carpet in the terminal to sweeping the runway. One of the major achievements Doug witnessed was their ability to relieve and cover for the Gulfport-Biloxi airport staff. By providing relief, employees could tend to their families and personal losses. Doug shared a story regarding an employee that lost everything he owned and made a decision to focus all of his efforts on restoring the airport to provide some sanity in his life.

Obstacles that arose during the relief effort included a lack of communication devices and the shortage of heavy equipment. Several of the SEADOG airport teams were dispatched in waves and the follow up teams were directed to bring certain tools and common parts to repair problems such as airfield lighting. Gulfport/Biloxi International was able to reopen on September 8th for commercial air traffic thanks to the Gulfport/Biloxi Airport staff, SEADOG, and multiple other agencies.



NOTE: All of us at *Airport Business Solutions* offer our thoughts and prayers to all of you who were effected by Hurricanes Katrina and Rita. (As well as previous hurricanes from the last two incredible seasons.)

On a personal and lighthearted note, Michael especially hopes for a quick recovery in New Orleans, so he can get his mother-in-law out of his house and back to her place in New Orleans!

ASK ABS

In each issue, we have included a section called "Ask ABS", where we request aviation-related questions from our readership. Each month we publish one question that we receive from our readers with a joint reply from our professional consulting team. Even if your question is not selected, all questions submitted will be responded to via e-mail. Please submit your question to mdavidson@airportbusiness.net.

This month's question actually comes from a tenant, Kerry Holton with H&L Aircraft Service, Inc. "*I run a small aircraft maintenance operation on a Federally funded field. I have asked my airport manager to interpret and enforce the Exclusive Rights and Minimum Standards policy on "Self Service". We are at an impasse as to the interpretation of a portion of this right. He quotes that "An aircraft owner, who is entitled to use the landing area of an airport, may tiedown, adjust, repair, refuel, clean, and otherwise service his/her own aircraft, provided the service is performed by the aircraft owner or his/her employees with resources supplied by the aircraft owner". "Employees" is the controversy - I interpret it to mean Employees of a corporate owned aircraft, where as the airport manager interprets this to be anyone hired by an aircraft owner (i.e. individual aircraft owner hires friendly mechanic from Delta Airlines to come to the airport and perform maintenance.) This interpretation has brought in several mechanics working on aircraft that do not have to meet the same Minimum Standards that we have to meet. Isn't this an exclusive right?*"

Well Kerry, I am not sure the issue is exclusive rights, but I think you have a valid concern. We have dealt with this issue several times, and to make sure we were advising our clients properly, we checked with FAA Headquarters. According to them, self-service includes activities performed by the aircraft owner or his/her employees with resources supplied by the aircraft owner. Moreover, the FAA defines an "employee" as an individual that is a W-2 employee, or a person that the aircraft owner pays payroll taxes on. A contractor hired to do a specific task is just that -- a contractor. They are not an employee any more that the plumber you hire to work on your sink is an employee.

I recommend you nicely suggest to your airport manager to read page A-2 of Advisory Circular 150/5190-5, Appendix I. In addition, more detail can be found in 14 CFR Part 43. If he has further questions after this review, have him give us a call.

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.

In addition, our international affiliate, Airport Business Solutions International, AEC, has helped numerous airports worldwide with a variety of airport management and operational issues and problems. Problems at international airports are no different from those experienced at airports in the U.S., and the diversity of experience and breadth of knowledge of Airport Business Solutions International has been extremely valuable in achieving comprehensive solutions to those issues.

For More Information

Michael A. Hodges, MAI
President/CEO
Airport Business Solutions
10014 N. Dale Mabry Highway, Suite 101
Tampa, Florida 33618-4426
Phone (813) 269-2525
Fax (813) 269-8022
mhodges@airportbusiness.net
www.airportbusiness.net