



Where is the fractional industry headed?

Providers' growing pains have resulted in many changes for share owners. More changes seem likely as the companies struggle to manage costs.

This column usually focuses on the nitty gritty of fractional investments—contract terms, negotiating concessions, fuel surcharges and the like. I thought it might be useful, though, to step back and take stock of how the industry has evolved since its blossoming in the mid 1990s, and to consider where it may be headed. It's certainly been a fascinating trip so far.

Fractionals have had their growing pains, largely because this has proven to be a difficult business in which to turn a profit. Perhaps the single biggest change over the years has been the nature of the business model itself.

Early on, fractional providers marketed their service as a new and improved version of the traditional aircraft manage-

ment arrangement—one in which, for the first time, the owner would enjoy relative cost certainty and guaranteed liquidity.

The provider bore most of the variable-cost risk. The owner paid a purchase price for his share at the outset, plus a monthly management fee and an hourly rate, both of which would increase over the life of the investment by no more than 3.75 percent per year or the increase in the consumer price index. In many cases, the provider guaranteed to buy the share back from the owner at a specified minimum price at the end of the contract term.

Sure, the owner would face a surcharge if fuel costs went up, but fuel prices were pretty stable back then and the base rates against which increased costs were measured were reflective of the actual cost of fuel. Thus, it was fairly easy to determine what flying fractionally would cost.

Over time, though, the industry has experienced increases in maintenance, pilot, insurance and other management and operating costs, as well as a down market in preowned aircraft values. And providers have responded by slowly but surely shifting the variable-cost risk to

the owners—adding pilot-salary and insurance surcharges, as well as increasing fuel surcharges that in some cases cover more than actual rising fuel costs.

Bearing the Risk

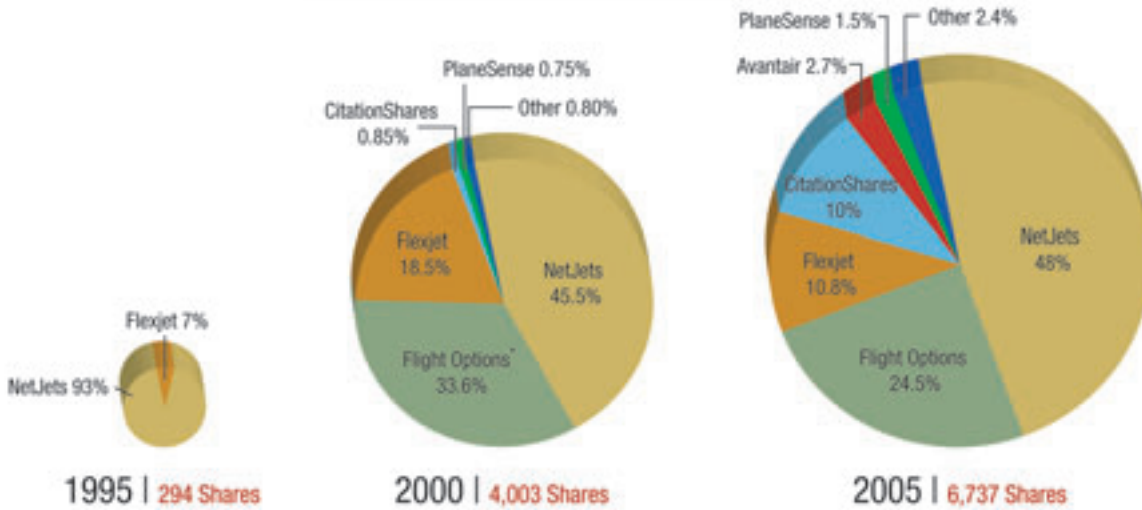
In addition, the providers long ago eliminated any guaranteed floor on aircraft valuations in the repurchase of fractional shares. The result is that today's fractional owner is much like the traditional owner—paying a fee for aircraft management but bearing the variable cost and market risk himself.

As the providers have shifted their business model, however, consumers have reacted. In no small measure, the rising popularity of jet cards reflects the willingness of owners to pay a premium to shift the variable-cost risk back to providers who, for that premium, have been willing to bear it on a relatively short-term basis.

This tango of shifting costs between owners and providers seems likely to continue as, by most accounts, providers have yet to find a business model that yields a decent profit.

James Butler is an attorney and the chief executive officer of Shaircraft Solutions LLC (www.shaircraft.com), based in Bethesda, Md. Shaircraft represents individuals and businesses with respect to a wide range of private air travel investments. Butler welcomes comments about his articles and suggestions for future topics and may be contacted at jbutler@bjtonline.com.

Fractional Market Share Comparison



* Figure includes Travel Air fleet which subsequently merged with Flight Options in 2002.

In addition to shifting variable-cost risk to owners, providers are offering more limited aircraft choices to minimize the complexity of maintaining, managing and operating their fleets.

The providers have made some strides toward better accommodating customers' needs by offering more options to customize the investment. We've seen somewhat expanded prime service areas and more flexible offerings in terms of combinations of aircraft and flight hours, programs that enable owners to exchange unused hours with other owners and the ability to purchase certain concessions. At the same time, however, we've also seen fewer service guarantees and other restrictions implemented by providers in order to more capably manage their capacity while accommodating their growth and new jet card passengers.

What does the future hold? Probably

more of the same as providers continue to manage costs in a complex business that has sophisticated and demanding customers and, at the same time, is labor- and

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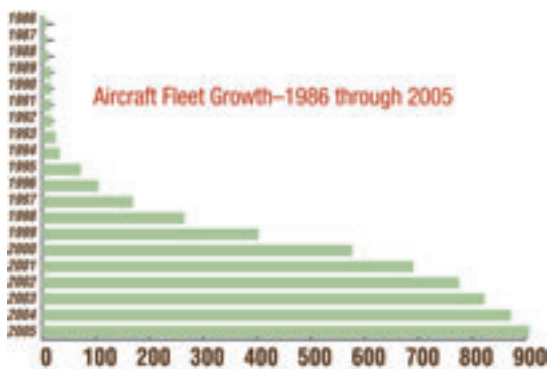


equipment-intensive and subject to many uncontrollable factors such as travel patterns, fuel costs, the fate of the airlines, the overall economy and the weather.

One development that certainly will

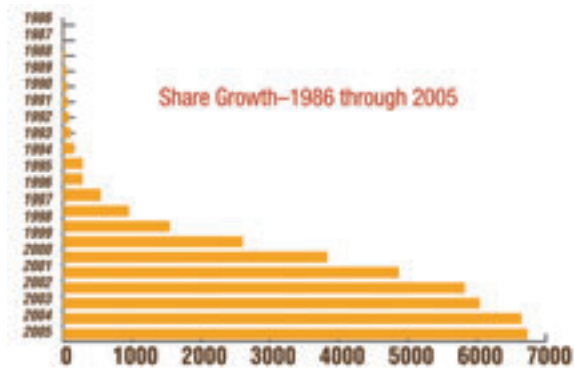
play a role in the future of the fractional industry is the advent of the very light jets. If a large percentage of fractional flights are less than one hour, it seems logical that many share holders will look at lower cost very light jets as an alternative to fractional flying. They'll have several options to consider: whole ownership; ad hoc and block charter with a charter company; and the yet-to-be-proven "air limo" concept. And although thousands of well-heeled owner-pilots apparently want VLJs—based on deposit-backed orders reported by the manufacturers—we've yet to see how much the end-user market will accept these small jets and, if it does, whether sufficient, experienced pilots will be available to fly them.

One thing seems certain: Fractional providers will have to stay on their toes and manage their businesses creatively in order to survive and thrive in what surely will be a challenging future. Stay tuned. ■



Once the fractional concept started to take off, providers' fleets grew rapidly. But the expansion rate has slowed in the past few years.

Source (all charts): Jetnet/Avdata



Like the fleets of fractional providers, the number of fractional shares has increased quickly since the late 1990s. But the rate of growth has recently declined.