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looking back...and ahead

THE FRACTIONAL BUSINESS HAS CHANGED SINCE **BJT**'S FOUNDING. MANY MORE CHANGES SEEM IMMINENT_by James D. Butler

LEGENDARY GOLFER BEN HOGAN once said that the secret to the game is "in the dirt." By that he meant the nitty gritty of digging into the details. This column usually focuses on the "dirt"–the details of fractional investments. But on the occasion of this magazine's fifth anniversary, it's worthwhile to consider the big picture–where the fractional business has been and where it's going.

In some ways, the industry looks much like it did when BJT published its first issue in October 2003. The biggest fractional companies remain NetJets, the market leader; Flexjet; Flight Options, which merged with TravelAir; and CitationShares, which was a relatively new entrant back in 2003.

Yet, as the fractionals have struggled to achieve profitability, the business model has continued to evolve–mostly to the detriment of shareowners. Early on, the fractional providers touted cost certainty as a great benefit of share ownership. They would do all the work, managing and operating the aircraft, and take the risk of operating-cost increases above an annual cap of 3.75 percent, as well as the risk of fluctuations in the market value of the aircraft.

Slowly but surely, though, the fractional providers have shifted the variable-cost risk to the owners. Base rates for fuel have been kept artificially low while burn rates have been set artificially high, such that fuel surcharges have become a profit center for some as well as a way to recoup positioning costs (despite sales pitches promising that owners don't incur such costs). Additional surcharges for insurance and pilot salaries have sprouted. Guaranteed minimum share repurchase prices have been abolished. Over time, cost certainty for owners has been substantially eliminated from the fractional model.

Flyers have been willing to pay higher rates to fractional jet card programs to avoid the steep capital investment and variable-cost risk that fractional ownership entails. Meanwhile, lower hourly rates and zero capital costs have been attractive to those willing to fly in block charter programs on networks of mostly older aircraft. And we are starting to see the emergence of regional air taxi services that fly short hops on discrete routes using the new very light jets.

Fractional providers have responded to customer needs in some ways–extending primary service areas, eliminating ferry fees, introducing distance-based pricing, offering discounts in exchange for owner acceptance of more restrictive travel dates, eliminating remarketing fees and permitting owners a limited ability both to sell unusued hours and to purchase concessions such as short-leg waivers. However, no provider has packaged all these benefits into a single program.

At the same time, the providers have made it more difficult for owners to sell their shares to third parties–effectively suffocating any secondary share market.

Where do we go from here? The economics of the fractional business remain a significant challenge. The key question is whether private flyers will continue to be willing to fund the capital cost of purchasing aircraft and assume the market risk associated with owning this asset, or will instead prefer to pay higher flying rates in order to leave that cost and risk with the providers.

For Flexjet and CitationShares, which are owned in whole or in part by aircraft manufacturers, profitability may not be critically important inasmuch as aircraft sales into these programs support their parent companies' bottom lines. And NetJets, with the backing of Berkshire Hathaway, could have enough staying power to increase its market dominance and thereby gain pricing power. The prospects for Flight Options–which recently was acquired by a private equity firm and has instituted management changes as well as layoffs and other cost-cutting measures–may be more uncertain.

And new challenges are on the horizon. Staggering increases in fuel prices, which in some cases have doubled the cost of flying, may keep many introductory-level customers out of the market, or at least lead to a cutback in private flying. Smaller shares, combined with more jet card holders, will force the providers to accommodate more customers per aircraft–lessening their flexibility and perhaps increasing operating costs.

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The focus on reducing carbon emissions likely will shine a light on the fractional business and private air travel generally–easy targets for politicians looking for a convenient whipping boy. A carbon tax or "cap and trade" regime may be in the offing and likely will increase the cost of private flying. Fractional providers and the industry at large would be wise to get out in front on this issue.

The fractional operators face significant challenges over the next five years. One factor in the industry's favor that is sure to remain unchanged is the horror show that passes for commercial airline travel. Certainly, if Ben Hogan were alive today, he'd be flying on a private jet. ■

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