



# FRACTIONAL OWNERSHIP'S Impact on the Aircraft Market

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Originally published as part of the sixteenth annual *Teal Group Business Jet Overview* and prepared by Richard Aboulafia, Vice President of Analysis at the Teal Group, this article provides valuable context and insight regarding the impact of fractional ownership on the overall business jet market.

## FIRST, A LITTLE HISTORY...

The original fractional business jet ownership company was Executive Jet, formally re-branded as NetJets in 2002. Created in 1986, NetJets is owned by Warren Buffet's Berkshire Hathaway. In the mid 1990s, two fractional providers linked to manufacturers joined NetJets—Bombardier's FlexJet and Raytheon's Travel Air. Numerous other independent providers have also arrived, most notably Flight Options. By late 2001, these four U.S.-based companies held the bulk of the fractional market. According to JETNET, NetJets was the market leader in early 2006 with a 48% share. FlexJet had 11%, and Flight Options (incorporating Travel Air) had 24%. NetJets is the company best positioned to survive in its present form.

Of course, fractional customers didn't materialize out of thin air. Most switched to private aviation as an alternative to scheduled air service, which is frequently perceived to be inconvenient and unpleasant. Fractional companies are proud that 70-80% of their client bases have had no experience with private plane ownership. And most of these newcomers came from first- and business-class sections, which provide a disproportionate amount of airline profits. By some estimates, 8-12% of these sections have moved to private aviation. More importantly, these are the passengers who pay full price; these are not the people using upgrade coupons or other means to move into the better part of the plane.

## A FAMILIAR MODEL

This development in aviation effectively mirrors a broader economic trend—moving toward an “hourglass” model. As with retail stores, customers are splitting into a large cost-sensitive element (scheduled air service, which is becoming more Spartan than ever), and a small, price-inelastic element (private aviation). There is less and less of a middle market. This phenomenon means that the top end of the business jet market will grow faster than the other segments. It also means the air taxi concept is likely to find itself in that no-man's land between the top and bottom of the hourglass.

So, the departure of these passengers had a strong negative impact on airline finances. The airlines took the defensive move of co-opting the trend toward private aviation. This led to Avolar, the most ambitious example of the numerous-airline fractional concepts. United admitted defeat with its Avolar program in March 2002. Actually, Avolar's demise was presaged by a variety of other events in the fractional and airline business jet industry. In November, both major UK carriers—British Airways and Virgin Atlantic—shelved their plans for corporate jet services. In December 2001, Raytheon Aircraft spun off its Travel Air unit, which was an unprofitable distraction for trouble-ridden Raytheon. Travel Air was merged with Flight Options, which retained 50.1% of the new company, but the company failed to find any investors, and by early 2003, Raytheon was again saddled with the combined entity.

## PROFITABILITY AMONG FRACTIONAL PROVIDERS

Perhaps the most interesting development in the fractional industry has concerned profitability. While Avolar was dying in March of 2002, Warren Buffet admitted that NetJets lost money in 2001. While the company did make a small profit in 2000, the costs of European expansion in 2001 outweighed the small profit earned in the U.S. during that year. He also doubted that the other fractional players made any money at all. This statement was quickly refuted. In April, Flight Options stated that it had made its first quarterly profit in the last quarter of 2001, although events since then cast serious doubt on this claim. Around the same time, Bombardier admitted that FlexJet did not make money in 2001 and could only hope to break even on operations in 2002, which they didn't.

In 2004, NetJets provided an unprecedented level of transparency for the fractional industry. The company admitted that it had lost \$41 million in 2003, and even its U.S. operations (the most important and lucrative part) were only modestly profitable. The company flirted with net profitability in 2004 (\$10 million) but lost money again in 2005. It is entirely possible that the fractional business will never be seriously profitable. Making money with fractional

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operations is difficult. Unless a provider has a tremendous market presence (in terms of bases and planes), it needs to fly a large number of non-revenue-producing flights. After all, planes will often need to fly empty somewhere to pick up a customer; they might also need to fly empty after dropping off a customer. Airlines are occasionally hobbled by Airplanes On Ground (AOGs, planes that produce no revenue but still have a capital cost attached). Fractional companies are hobbled by something much worse—planes that produce no revenue but still have capital and operating costs attached. Fractional companies are also extremely sensitive to demand surges—fleets must be sized to meet the highest demand surge requirements. If they are not, customers will need to be paid for any violation of timing and availability guarantees. To avoid this, the fractionals will need to supplement their fleets by chartering other people's aircraft, which is an expensive proposition. Both solutions clearly detract from profitability.

Despite the difficulties inherent in making money with this business model, the fractional players all have big plans. They currently operate about 1,000 business jets with hundreds more on order. If they continue to lose money, their financial backers may decide to cut their losses the way that Raytheon tried to do with Travel Air. It is possible that this industry will follow the traditional pattern of new technology market development—a new idea leads to many players who suddenly discover that they need to make money. The industry then experiences a painful shakeout followed by a mature market that is often a duopoly. And as noted above, this industry may have a lot in common with dot-com and telecommunications businesses.

If fractional companies need to raise their prices to bolster their profitability, their relative competitiveness may diminish. They would be less able to attract scheduled airline service customers. Some recent converts might switch back to airlines. After all, a low barrier to market participation means an equally low barrier to market exit. The arrival of jet cards is an effort by fractional players to retain departing shareowners. Fractional companies account for 12-15% of

new business jet deliveries. Their orders, however, account for about 50% of the stated industry backlog (alarming, the rest of the backlog is completely opaque and non-verifiable). Fractional aircraft constitute 7% of the worldwide business jet fleet. Clearly, the future of the business jet industry is closely linked to the success or failure of fractional ownership. There is also certain to be a cost to manufacturers from fractional ownership itself. Any kind of concentration of market power in buyers increases their ability to negotiate lower prices, which affects manufacturer profit margins. Also, if competition among fractional ownership firms grows, possibly with the emergence of discount fractional players, price competition would result. This would further increase pressure on manufacturer margins as the fractional players try to pass down their cost-cutting efforts.

Another related problem for manufacturers might be the flexibility that fractional companies have when ordering aircraft. If a company buys one or two jets, the manufacturer will enforce the sales conditions and schedule, making deferrals difficult. But fractional companies with their greater



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market power will be able to demand deferrals (and possibly even cancellations) based on prevailing market conditions. Therefore, sales to fractional firms may be somewhat less “firm” than sales to traditional business jet end-users. This is particularly true if fractionals fail to raise their prices and need to cut their costs instead. Until it merged with Travel Air, Flight Options claimed to be profitable, and the company only purchased used business jets at much lower prices. The company they absorbed, Raytheon’s unprofitable Travel Air, only purchased new jets. The Flight Options model looks like the right one. This would be good for the industry (because of higher residual values), but not as good for manufacturers (because of fewer direct new sales).

### IMPACT ON THE MARKET

Fractional ownership will also have an impact on market cyclicality. We don’t know enough about how the mature industry will behave during inevitable market cycles. Looking to the commercial jetliner industry for a parallel, there are two alternatives. If fractional companies behave like jetliner

lessor GPA did in the 1988-1990 market upturn, placing large block orders in anticipation of continued market growth, fractionals may exacerbate market cyclicality. However, if they behave more rationally, like jetliner lessor ILFC, they will place large block orders when the market is down, and the buyer will then have the advantage over the manufacturer. While this ILFC model would further increase pressures on manufacturer margins, it implies a strong and welcome counter-cyclical impact on the market.

### CONCLUSION

Because fractional ownership companies emphasize greater utilization of aircraft, residual values may suffer. If a fractional firm uses a given plane twice as many hours per year as the current norm, values for the entire fleet of those planes may decline. And because fractional companies place large block orders for new business jets, they are more likely to dump large fleets of earlier models on the market, which would also hurt prices.

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