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How do 'Income Approach' Aircraft Appraisals Differ?

What's an income approach to aircraft appraisal, and how does it differ from a sales comparison approach? Jeremy Cox highlights how the income approach could provide a logical rationale for upgrading your jet and persuading your bank or financier to back you...

Just by reading the words 'Income Approach Appraisal', you could be forgiven for believing you're in for a dusty, boring read. Nothing could be further from the truth! This is an area of aircraft appraisal filled with interesting twists and turns...

First, though, let's cover the very basics. What exactly is an income approach? Simply defined, an income approach is a method of determining both the present value and the future economic benefits of owning an aircraft (or fleet of aircraft).

In the past, I've noted that an aircraft may be worth more than the appraised fair market value (FMV) to a buyer and seller, based upon their own unique circumstances. Let's use the following hypothetical example of a special-use aircraft to illustrate this method of appraisal. (Note, our example could be just as easily used for an aircraft owned and operated in Part 135 charter).

What is the Income of the Aircraft Operation?

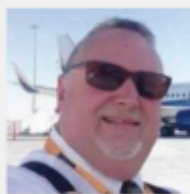
Imagine you own two 40-year old Learjet 35A jets that are outfitted and operated as air ambulances (Medi-Vac). Your 'S Corporation' has three five-year contracts with separate insurance companies for you to provide emergency evacuation air-lift services from the Caribbean and southern Florida, delivering sick or injured patients into the New York area.

A typical mission is Miami to Long Island with a patient and spouse aboard. The patient is tended to by a flight nurse and two pilots occupy the cockpit. Normally, you charge \$30,000 for this flight and you typically are called to make this flight once every four days. Other reoccurring missions are Punta Cana to Long Island and Ochoa Rios to Long Island and you charge more for these flights.

Now imagine that you are planning to reduce the fleet age by half. In doing so, you will reduce the



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total-time-in-service of the aircraft (currently 24,500 flight hours) to 7,000hrs, as well as lower your direct operating cost by more than 10%. Moreover, you will add a touch more range and reduce trip times marginally.

This can all be achieved by swapping your fleet of 40-year-old Learjet 35As with two 18-year-old Learjet 45s. To achieve your goal, however, you must get financing which will require an appraisal...

What are Your Borrowing Needs?

Having paid \$1.9m for each of your Learjet 35As in 1984, you paid off the loan for both aircraft within five years. Unfortunately, today each of your aircraft will struggle to appraise at 25% of what you paid for them, even though the Learjet 45s that you are seeking to buy have fared even worse than your Learjet 35As, based upon 'Residual Value'.

You need to borrow \$3.5m and you can't put your current aircraft on the market until you have their replacements on your certificate and flying missions. Ultimately, your bank wants proof of 30% collateral-to-loan before funding the purchase, and you need a better than FMV appraisal.

While it is highly unlikely you will get an appraisal that comes close to \$1m for both the aircraft, you make a key move when you call an appraiser who's familiar and competent in calculating FMV utilizing the 'Income Approach to Value'.

How is Income Approach to Aircraft Value Different?

After scrutinizing your journey logs for each aircraft, your income statements and your annual expense records, your savvy appraiser determines each Learjet 35A aircraft that you own flies 604.8 hours per annum (utilization), and generates a Net Revenue of \$755,000 (\$2.7m Annual Revenue versus \$1.945m expenses).

The Likely FMV of each of your Learjets individually is \$450,000, and therefore your appraiser can calculate the Capitalization Rate as follows: $\$450,000 / \$571,535$ (Net Revenue minus tax) = 78.7%

Next, your appraiser performs the calculation represented in Table A (below) to determine the Income Approach FMV result of each aircraft (this is the Direct Capitalization Approach to obtain the Income Value). Based on the calculation, FMV via the income approach is \$726,000 for each aircraft, versus \$450,000 if only the sales comparison approach to value were used. ➡

Table A:
Illustration of FMV via Income Approach

Gross Income	\$2.7m
Expenses	\$1.945m
Federal/State Tax	\$183,465
Net Income	\$571,535
Capitalization Rate	78.7%
Net Income/Capitalization Rate	\$726,000 (rounded)

What are the Benefits of Changing Aircraft?

Next, we need to compare the benefits of replacing your ageing Learjet 35As with newer Learjet 45s.

Among the advantages that you'll gain by moving into the Learjet 45 models (in our illustrative example) are:

- A lower direct operating cost (DOC) resulting in \$1,292 being saved on each Miami International Airport (KMIA) to LaGuardia Airport (KLGA) flight;
- The lower DOC could reduce your annual cost by \$144,940;
- The time per mission (KMIA to KLGA) would be 0.16hrs less per flight due to the higher cruising speed and better economy.

On the downside, you will be making a monthly loan payment for the next five years. Currently you make none, as your Learjet 35As were paid off decades ago. You do, however get to book the interest payments as an expense (in this case about \$75,000p/a). With all things considered, your annual balance sheet per aircraft is represented in Table B (right).

While the details may not look so attractive to you, remember that when you sell both of your Learjet 35As you'll be able to apply this realized amount to your loan (assuming no 'pre-payment' penalty), generating a \$157,944 annual saving on your loan expense.

Finally, with newer, faster and more efficient aircraft you can fly more missions and attract additional contract clients who may have been put off before because of the age of your fleet.

Our imaginary scenario has a happy ending. With a collateral value amount established as \$1.452m (when you were only required to justify \$1.05m) you easily satisfied your banker and he/she quickly got your loan approved so you could move ahead with the much-needed update of your Learjet fleet.

What I have shown you is a highly simplified

Table B:
Illustration of Annual Balance
Sheet After Upgrading

Gross Income	\$2.7m
Expenses (Without Loan)	\$1.8m
Loan Expense*	\$350,232
Net Income**	\$549,708

* Your loan is \$3.5m for both aircraft. The annual balance sheet above is for one aircraft (\$1.75m) plus the expensed interest of \$75,000 has been deducted from the annual 'per aircraft' loan amount; ** Before Tax Net

method of calculating the FMV of a special use aircraft by utilizing the income approach. Although we used a Medi-Vac example, a similar income approach could be applied to the appraisal of a charter-use aircraft.

Guarantee Your Happy Ending...

Those seeking a real-life happy ending to an income approach aircraft appraisal are strongly advised not to take the above simplified example and apply it to their own situation. If you do, you will likely be very wrong in your final FMV.

This is because every real-life scenario is unique and has multiple factors and points of value that must be considered to produce both a credible and defensible opinion of value. For an accurate assessment, you should contact an appraiser with a firm grasp of income approach appraisals. However, the point has been made that the income approach to value could provide a logical rationale for upgrading your fleet and persuading your bank or financier to back you! ■

More information from
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