

How To Evaluate Potential New Markets

An organized, disciplined business planning process is essential to a company's success and growth.

Business planning is a valuable process that focuses the management team on accomplishing its goals and objectives. NATA, along with its Business Management Committee, called on industry veterans to develop a financial seminar directed at new senior management. The resulting seminar, "Fundamentals of Financial Management," is now a regular part of the NATA seminar series. Aviation Business Journal is running a series of articles covering three major components of the seminar:

- Using financial information proactively,
- Effective business planning, and
- Value of the aviation service enterprise from the buyer's perspective.

This second article explores a representative case study describing the annual business planning process followed by a prominent, mid-sized aviation services company.

Effective Business Planning

Business executive Robin Sieger once said, "Planning is as natural to the process of success as its absence is to the process of failure." Business planning is a tool that enables organizations to reach short-term objectives and longer-term goals. The process includes:

- Establishing a common vision of the company's mission and

primary objectives among all employees;

- Providing a venue for management to discuss the development of new services, expansion of existing services, and exit of unprofitable services;
- Creating awareness and stimulating ideas on how to compete against on-field and regional competitors;
- Providing a systematic method to evaluate competing projects and assisting in allocating scarce capital and people resources; and
- Giving employees a framework for decision-making (i.e., Does the decision I am making today get us closer or further away from our goals?).

On the practical side, business planning can help management establish capital budgets, secure debt or equity funding, and provide a benchmark for evaluating performance.

The case study that follows is an example of an annual business planning process followed by what we'll call ABC Aviation Services. The company sets aside a two-week period every October to review and revise "The Plan," then measure plan results (both quantitative and qualitative) on a quarterly basis. Although the first planning sessions were uncomfortable—with more discussion on "mission" and "who are we" than most managers felt they needed—they now look forward to coming together and discussing the ideas they collectively think could make the business more profitable.

The Business Planning Process

ABC Aviation Services has been in business for 18 years, and currently follows a full-service business model. However, like many of its competitors, ABC recently eliminated flight training and has evolved charter operations to use only managed aircraft. The company has two on-field competitors for fueling and specializes in Beechcraft aircraft repair in the shop. About 60 percent of profit is generated by the line department and 35 percent by technical services, with no profit contribution from the charter department.

The planning process begins with a series of six management meetings, about two to three hours each, with a very specific agenda. Everyone is expected to participate, and opinions are politely tolerated while facts and findings are respectfully debated.

Business Planning Agenda

The agenda for the business planning sessions is as follows:

Market Opportunities

Session 1: Competition. Each year one manager is given the task of providing an update on competitors. The manager is expected to know what competitors are doing in terms of market share, new products or services, new customers, relationships with the airport authority, etc.

Session 2: Market Trends. Market trends are assigned to a management member with the expectation that he or she will research general trends in the industry, gather

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data from aviation associations, and share information gathered at conventions or other industry meetings. Often the company engages an aviation consultant to provide input.

Session 3: Profiling Customer Segments.

Each department profiles the most valuable customers' characteristics, new customers, and lost customers. These profiles are documented, and later the company's most valued customers will be identified and profiled.

Company Capabilities

Session 4: Company Overview. This ses-

sion is generally led by an owner or CEO who reviews the current year-to-date results and the progress of recent initiatives when compared to The Plan. Strengths and weaknesses are reviewed, revised, and agreed upon.

Session 5: Potential Initiatives. Each manager is expected to present one or more new initiatives, continuation of a prior initiative, or ceasing of an existing initiative. Out of 15 or more ideas, usually five or six seem to gain consensus of the group and are investigated more thoroughly. Examples of the initiatives chosen by ABC Aviation Services:

- a. Leverage our good reputation in the service of Beechcraft tur-

bine aircraft into Learjet maintenance.

- b. Bid on a military contract based on a margin over cost of fuel. The current contract holder is believed to be at .44 cents per gallon over cost. The volume of fuel is about one million gallons per year.
- c. Develop an STC for the introduction of new engines for a King Air, model years 1972-1988, that potentially make the aircraft faster and more fuel-efficient.
- d. Purchase a life-like flight seat, controls, and video monitors for Microsoft Flight Simulator, and build a state-of-the-art flight simulator.
- e. Build six new corporate hangars, each with 3,600 square feet of aircraft storage and 1,200 square feet of office space. This initiative is an expansion of a project started two years ago.

Each of these initiatives will have a champion who determines the potential profitability over the next two years (considered ramp-up years) and during the next three steady-state years. ABC uses a standard Excel template, and with the assistance of the CFO or a consultant, managers determine the profit potential. The objective of this common template is to standardize each project so management can compare the alternatives. The guidelines of the analysis are as follows:

1. Cash inflows and outflows, before debt service, are estimated on a monthly basis during the start-up period to uncover lags in receipts relative to disbursements. Our examples show a summary of this monthly analysis.
2. Evaluate the project's cash flow on an incremental basis.

EXHIBIT A—EXPANSION INTO LEARJET MAINTENANCE

ABC Aviation Services

Project Cash Flow Analysis + Inflows - (Outflows)

October 2004

Project Name: Expansion into LearJet Maintenance

Assumptions:

Labor Hours Billing Rate	\$75.00	Hour
Billable Hours Annually	1650	Per Employee
Annual Wage	\$32,500	Per Employee
Benefits	20%	of Wages
Profit Margin on Parts	15%	Avg
Cost of Capital	14%	Weighted Average

	Start-Up		Steady State		
	Current 2004	Year 2005	Year 2006	Year 2007	Year 2008
Incremental Capital Investment					
Purchased Equipment	(75,000)	(100,000)	0	(50,000)	0
Tools	(10,000)	5,000		(5,000)	
Additional Working Capital	(5,000)	(25,059)	(16,706)	(13,922)	6,961
Total Investment Required	(\$90,000)	(\$120,059)	(\$16,706)	(\$68,922)	\$6,961
Incremental Hours Billed	0	2,970	4,950	6,600	7,425
Incremental Revenue					
LearJet Labor	0	222,750	371,250	495,000	556,875
LearJet Parts	0	77,963	129,938	173,250	194,906
Incremental Costs					
Labor COGS	(19,500)	(117,000)	(96,525)	(128,700)	(144,788)
Parts COGS	0	(66,268)	(110,447)	(147,263)	(165,670)
Incremental G&A					
Training	(10,000)	(5,000)	(5,000)	(2,000)	(2,000)
Internal Administration	(2,000)	(1,500)	(1,500)	(1,500)	(1,500)
Net Cash Flow	(\$121,500)	(\$9,115)	\$271,009	\$319,866	\$444,784
Net Present Value	\$489,724				

3. Be consistent on treatment of inflation, overhead allocations, and taxes; burden all projects equally or not at all.
4. Use the same cost of capital to determine the net present value (NPV) of each investment.
5. Include all incidental effects (or spin-off business). A project that appears to be a negative may actually be a positive because it brings more profit dollars to other areas of the business.
6. Forget sunk costs. For example, if you have already built a 300,000-gallon fuel farm, don't burden your new project with this cost (for example, your military contract proposal) even though you may need it to accomplish the project.
7. Estimate working capital requirements by considering the increase in accounts receivable, accounts payable, and inventory.
8. Separate the investment decision from the financing decision. Don't think you can afford to do something with less profitability because you can get debt today at a lower rate. Senior management needs to determine, later and separately, whether the new investments are to be financed with debt, leases, supplier participation, or equity.

Financial Results

Exhibit A (on page 24) shows the Excel template used by ABC to determine profitability of a project. In this example, we have

summarized the expansion of technical services into Learjet maintenance services.

The Learjet maintenance analysis tells management that the aggressive movement into this product line requires a \$288,727 investment (mainly for equipment and training) and a positive NPV of \$489,724 to the company through 2008.

Exhibit B (on page 26) shows the same analysis for securing the military fueling contract.

The military contract analysis illustrates that if the company is successful in securing the contract at .40 markup over cost, the project requires a \$125,000 investment in working capital (if the company uses a contract management company to reduce working capital requirements)

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and produces a positive NPV of \$509,145 over the same period.

All five projects were evaluated in the same way, and Exhibit C (below) is a summary of the capital requirements and NPVs produced over the same period.

Project Comparison

Management is brought together in a final session where each project is discussed and contrasted. The participants are asked to combine the knowledge of the marketplace, competition, and current customer base with the financial results to determine the best course of action.

Session 6: Project Selection

Management reviews and evaluates the results of the analysis. Additional considerations include:

- How much capital investment can we afford this year?
Further, management should consider any capital requirements negotiated for lease extensions. Of the potential projects the new hangar project is the most expensive, but it is the only capital investment that could qualify.
- What is the relative risk of each project? New business risk has two major components. First, do we have the resources (people, expertise, money, desire) to accomplish our objectives, and second, what is the current size and ongoing demand from the market? Is the revenue stream from this investment sustainable or subject to termination or bold competition?

Armed with this mix of information, the management team produces a subjective ranking of each project according to these risks. For example, the discussion around LearJet maintenance openly acknowledges the company does not have the expertise in-house, yet they feel they understand the maintenance of aircraft extremely well. The market for LearJet maintenance is underserved in their location; there are many based LearJet aircraft regionally. It would take some time to become established, but when accomplished it would represent a significant and sustainable revenue stream.

Exhibit D (on page 27) shows the results of the risk ranking, and when combined with the financial data helps to clarify the most profitable projects. In general, the projects that appear in the right uppermost quadrant of

EXHIBIT B—SECURE THE MILITARY CONTRACT

October 2004

Project Name: Secure the Military Contract

Assumptions:

- No additional fuel storage needed
- Lease 2 fuel trucks \$2,150 per month/per truck
- 2 Additional Line Employees \$18 per Hour
- Benefits 20% of Wages
- Cost of Fuel \$1.50 per Gallon
- Profit Margin per Gal \$0.40 \$ over Cost
- Contract Mgt Fees \$0.04 per Gallon
- Cost of Capital 14% Weighted Average
- Contract Awarded April 1, 2005 for three years.
- Other Services provided upon request.
- Billing & Collection is handled by contractor/credit card, payment to ABC is 30 days

	Start-Up		Steady State		
	Current 2004	Year 2005	Year 2006	Year 2007	Year 2008
Incremental Capital Investment					
Purchased Equipment	0	0	0	0	0
Tools	0	0		0	0
Additional Working Capital	0	(93,750)	(31,250)	0	0
Total Investment Required	\$0	(\$93,750)	(\$31,250)	\$0	\$0
Gallons per Contract	0	750,000	1,000,000	1,000,000	333,333
Incremental Revenue					
Military Fuel	0	1,425,000	1,900,000	1,900,000	633,333
Other Services	0	71,250	95,000	95,000	31,667
Incremental Costs					
Labor COGS	0	(72,014)	(86,400)	(86,400)	(28,800)
Fuel COGS	0	(1,125,000)	(1,500,000)	(1,500,000)	(500,000)
Lease on Fuel Trucks		(43,000)	(51,600)	(51,600)	(51,600)
Contract Management	(3,500)	(30,000)	(40,000)	(40,000)	(13,333)
Incremental G&A					
Training	(500)	(500)	(500)	(500)	(500)
Internal Administration	(2,000)	(1,500)	(1,500)	(1,500)	(1,500)
Net Cash Flow	(\$6,000)	\$130,486	\$283,750	\$315,000	\$69,267
Net Present Value	509,145				

EXHIBIT C—SUMMARY OF ALL PROJECTS

Project Name	Capital Requirement	NPV @ 14%
LearJet Maintenance	\$ (288,727)	\$ 489,724
Military Contract	\$ (125,000)	\$ 509,145
STC for King Air	\$ (120,000)	\$ 398,000
Flight Simulator	\$ (10,000)	\$ 175,000
New Hangars	\$ (1,728,000)	\$ (376,117)

the graph are those considered to have the most potential. In this case study, the building of the corporate hangars is considered the least risky in terms of implementation, with high market potential. However, it has a negative NPV within the analysis period, and the project does not have a positive NPV until 2010; not unusual for a capital-heavy hangar project. In contrast, building a flight simulator is something management feels they can do very well, but the market potential is very low.

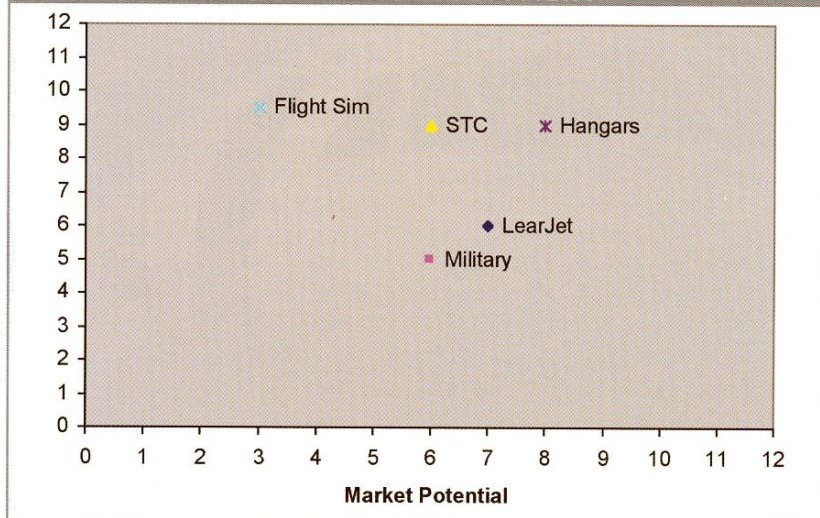
Which project(s) did management finally choose? We'll let you decide. The business planning process can be a very effective tool by coordinating and focusing a company's management team. The real advantage comes from combining management's subjective and objective

knowledge into an action plan that all understand and support. Choosing only the most attractive projects for investment builds business value.



Mark Chambers has more than 30 years in the aviation service industry and is managing partner of Aviation Resource Group International.

EXHIBIT D—PROJECT RISK ASSESSMENT



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