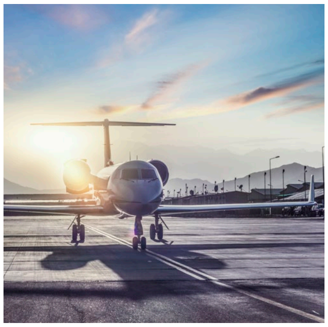
William Blair



Despite Headwinds, Consolidation of Fixed Base Operators Will Continue

Even in the midst of the COVID-19 pandemic, M&A activity among airport fixed based operators will continue, albeit at a different pace and through nontraditional deal structures. We examine the key drivers of valuations in this market.

Industry Commentary

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Consolidation among fixed based operators (FBOs) at airports over the past two decades has produced a handful of owners with more than 25 FBO assets. The five largest FBO consolidators made 24 acquisitions over the past five years, representing over 125 locations across the United States, Canada, and the Caribbean.

Despite this steady volume of M&A activity, the landscape remains highly fragmented. The current market provides ample opportunities for buyers and sellers, even with the challenges presented by COVID-19's impact on air travel. Private equity funds, infrastructure funds, and strategic acquirers are actively evaluating and acquiring FBO assets, pursuing opportunities to boost EBITDA by realizing economies of scale and reducing administrative costs across locations.

We expect the volume of deals, however, to slow in the near term as the pandemic causes many buyers to conserve cash and maintain a wait-and-see posture. In addition, market conditions are likely to require buyers and sellers to consider alternative deal structures. In addition to distressed situations, we expect many of the transactions that move forward over the next several quarters to be cashless mergers, an approach that can be used to satisfy buyers' and sellers' priorities in uncertain market conditions.

The Big Three FBO Owners

Despite being extremely acquisitive in the past 25 years, the three largest FBO companies own only 10% of the total number of operations at U.S. airports. Outside these three large players, the industry is extremely fragmented, creating ample opportunity for consolidation.

Signature Flight Support (BBA Aviation)	~35 Locations (1996)	→	~200 Locations (2020)
Atlantic	~10 Locations (2004)	→	~70 Locations (2020)
Jet Aviation (A General Dynamics Company)	~20 Locations (1996)	→	~30 Locations (2020)

Source: William Blair Research

Drawing on our experience as one of the most active advisors in the FBO space as well as recent conversations with business owners and investors, this report examines the trends that are driving FBO dealmaking. We outline the key drivers of FBO valuations, analyze the impact of the COVID-19 pandemic, and provide our outlook for M&A in the sector.

Valuation Drivers in FBO Transactions

There are five key aspects of an FBO's business that influence buyer interest and valuations. To establish realistic expectations and position an asset to maximize its value, sellers should be aware of how buyers view each of these factors.

Mix of Services

One of the primary considerations for buyers is the FBO's mix of services, which generally fall into one of three categories.

- **Traditional services** – Fueling and hangar rent represent the majority of traditional FBO services and are usually the most highly valued by acquirers. Value-added services, such as into-wing fueling and de-icing, can also be attractive to strategic buyers who see opportunities to expand an FBO's capabilities in these areas.
- **Maintenance, repair, and overhaul** – MRO is often the first way FBOs expand beyond traditional services. MRO revenues, however, are not as valuable to buyers as those from traditional services; MRO margins tend to be thinner because airplane owners have many choices for maintenance. MRO also requires a higher degree of labor than traditional FBO services, such as hangar rent, which requires almost none. Specialized MRO services, such as avionics or engine repair, are more highly valued than traditional airframe maintenance.
- **Charter and aircraft management** – This is the least valuable of the services offered by a full-service provider because airplane owners that engage an FBO to manage their charter aircraft can easily leave to engage with another charter manager. Aircraft management typically requires more overhead in the form of sales, marketing, and other back-office functions. Subscale charter and aircraft management businesses generate thin margins, and if a plane's capacity is underutilized, chartering can become unprofitable. If chartering and aircraft management are driving a large portion of the FBO fuel sales, this can also hurt the valuation placed on the FBO earnings, as that earnings stream could easily leave with the charter business.

When valuing an acquisition, buyers focus on how each service line contributes to EBITDA using a sum-of-the-parts approach, as each service is distinct from the others and has its own opportunities and risks. Buyers value traditional FBO services with a significantly higher multiple than MRO or charter and aircraft management. Some buyers will not consider businesses that have a significant amount of either MRO or charter services relative to traditional services. As a result, owners looking to position an FBO business for sale should prioritize improving and expanding traditional FBO services.

Fueling

Because fuel volume is a highly visible, easily quantifiable metric and is critical to profitability, it is typically the first screening criterion for potential buyers. One million gallons has been the threshold for attracting interest, but buyers are now considering smaller airfields based on how quickly the FBO can reach and exceed this mark. But volume is only part of the picture, as not all fuel sales are viewed equally. Buyers are keenly interested in the proportion of sales to each type of customer, because their relative purchasing power varies and affects the margins on each gallon of fuel sold.

- **Commercial airlines** – Sales to this segment offer very thin margins, as commercial airlines have significant buying power. Airlines often do not buy fuel from the FBO; instead, the FBO stores and pumps fuel for a fee. Despite lower margins, buyers appreciate that fuel sales to commercial airlines typically provide stability and can put a floor under revenues.
- **Transient retail customers** – Planes that stop at an airport because they are on their way to another location or use the airport sporadically pay full retail price on fuel and generate attractive margins for FBOs. Thus, acquirers prefer to see a relatively large percentage of sales going to this customer segment.
- **Base tenants** – Customers that hangar their airplanes at the location and arrange for the FBO to fuel their planes at a specified margin above cost are less profitable than transient customers but more profitable than commercial airlines. Base tenants tend to be very stable relative to transient customers, which can be more event-driven. Because they are stable and generate good margins, acquirers like to see a significant percentage of sales going to this customer segment.
- **Fractional ownership groups** – Traffic from fractional ownership groups, such as NetJets and Flexjet, has a similar margin profile to traffic from base tenants; fractional ownership groups also contract for fuel at an agreed-upon margin above cost. This customer group can drive significant volumes.

Declining oil prices generally benefit FBOs' margins on fuel sales. FBOs tend to buy at the spot price and do not necessarily pass on all of the savings to customers as fuel prices decline.

Location and Location

As with most customer-facing businesses, location is important for FBOs. Acquirers care about both the airport's geographic location (i.e., the size and growth trends of the metropolitan area and region) and the FBO's location within the airport.

Where is the airport located? The demand for air travel in the local area is critical to buyer interest. In addition to general demographic trends, acquirers covet airports in areas that are home to Fortune 500 company headquarters or major sports venues, tourist attractions, or convention centers that host big events and regularly drive corporate and personal travel. Corporate business is somewhat more consistent and predictable than personal travel, but margins tend to be lower.

Where is the FBO located at the airport? Most larger airports have more than one FBO on site, so an FBO's position at the airport is critical. Being close to the airport's main entry point or the runway is a major traffic driver. Proximity to customs services is important for international travelers; an FBO located in the same building as a customs facility may be better positioned than other FBOs at the airport.

Competition
Competition comes in two forms: 1) other FBOs at the same airport and 2) other airports in the area. Being the only FBO at an airport is ideal and will justify a higher multiple. When an airport has multiple FBOs, the one with a better location, newer and more attractive facilities, and better relationships can dominate; it is common to see a lopsided division of fuel sales and large differences in EBITDA between two FBOs at the same airport. Conversely, even if an FBO is the only one at its airport, nearby airfields can provide competition. In this situation, cleanliness and upgrades at the facility can be important to customer retention.

Leases
The length and terms of the FBO's lease directly affect how long and under what conditions it can continue to operate before it must renegotiate with the airport operator. As a result, acquirers will evaluate an FBO's lease as a critical part of the due diligence process.

Length – Buyers want a lease with at least 10 years remaining; anything less creates a risk of losing the lease or having to spend a large sum on airport improvements in the near term to successfully renew the lease. This is particularly risky if there is any negative history between the FBO and the municipality, or if customers have complained about the FBO. Historically, FBO leases typically range from 20 to 40 years or more, but regulators, airport operators, and local officials are increasingly pushing for shorter leases.

Terms – The terms of the lease, including rent escalators and guaranteed extensions tied to capital improvements, are also important to buyers. Because FBOs are typically required to spend a specific amount of money on facilities over the life of the lease, extending the lease usually requires the FBO to commit to investments such as building a new hangar or completing renovations.

In addition to seeking shorter leases and capital expenditures, regulators, airport operators, and local officials frequently inject a certain amount of politics into lease negotiations. Potential acquirers need to understand the political dynamics of lease negotiations or extensions and assess the FBO's relationship with these officials.

COVID-19's Impact on FBOs
Not surprisingly, fuel volumes and the number of flights are down significantly from the pre-COVID-19 world. While air traffic has rebounded somewhat from the first peak of the pandemic in March and April, June volumes are still down considerably from last year's levels.

As a result, many FBOs have had to cut costs, including laying off employees. Rents for hangar space are stable, putting a floor under revenues. A small percentage of tenants have negotiated to reduce or delay their rent payments, but the vast majority are paying in full and on time. Together, cost-cutting and rent payments, as well as some liquidity provided through the CARES Act, have helped keep FBOs cash-flow positive.

William Blair believes that private air travel will rebound more quickly and decisively than commercial air travel, as passengers who are able to avoid commercial airports and flights will choose to do so. Still, it will take time, possibly years, for air travel to return to pre-pandemic levels. Events that attracted visitors to fly to a location (sporting events, conferences, etc.) have been canceled indefinitely, and widespread adoption of online meeting technologies may permanently reduce corporate travel.

Outlook for FBO M&A Activity
Consolidation will continue in this highly fragmented industry throughout the pandemic. But several factors will likely slow the pace of dealmaking.

There is a disconnect between sellers' valuation expectations and what buyers are willing to pay. Until this gap narrows, fewer deals will get done. In addition, many potential acquirers may wait to resume M&A activity as they focus on conserving cash and adapting to survive the downturn. Still, a great deal of dry powder is available, and we believe that transactions involving FBOs with desirable characteristics and buyers who understand the market will continue.

Given the extensive consolidation that has occurred in the industry over the past two decades, much of the "low-hanging fruit" in the FBO market has already been harvested by strategic acquirers and infrastructure funds. Nonetheless, while multiples are likely to come down from pre-COVID-19 levels, the ability to realize benefits from scale could lead buyers to offer attractive valuations for FBOs that are well-positioned in their markets. Attractive deal opportunities remain, but they will require more effort to identify, which is expected to slow the process.

Private equity funds looking to enter the space will likely need to buy four or five FBOs in one transaction to establish a scalable platform. By realizing synergies and reducing administrative costs, financial sponsors can improve EBITDA across a group of FBOs in ways that would not be possible with a single transaction involving a small FBO.

Focus on Structure
Given the disconnect between the valuation multiple sellers expect based on pre-COVID-19 transactions and what buyers are willing to pay in the face of current uncertainties, it is unlikely that many regular-way transactions will be completed over the next several months. We expect that most near-term transactions will either be distressed situations or involve a creative approach. Some less traditional approaches that are becoming more prominent in today's market include:

Emphasis on synergies – While synergies are important in most transactions involving a strategic acquirer, they can take on added significance in situations where there is a disconnect between the seller's and buyer's valuation expectation. Finding a match that generates large synergies allows the buyer to pay what is nominally a high valuation to the seller but amounts to a much lower valuation for the buyer, when accounting for the anticipated savings. In addition to eliminating duplicative expenses, optimizing the labor force, and using scale to get better rates on purchases such as fuel or insurance, FBO synergies can be found in the buyer's and seller's network of locations. For example, if the seller has locations that are en route or otherwise complementary to the buyer's locations, this can drive traffic and fuel sales.

Earn-outs – For sellers that are eager to generate liquidity in a market in the midst of a temporary downturn, including an earn-out component can help bridge the gap between what the buyer is willing to pay and the seller's expectation of what the asset will be worth over the next several years. Basing the earn-out on how quickly fuel sales after the acquisition return to pre-pandemic levels, for example, allows the seller to generate some liquidity now and retain the opportunity to generate additional proceeds down the road.

Cashless mergers – With this approach, both the target's and acquirer's stock are valued using pre-pandemic, 2019 multiples. This allows sellers to preserve their equity value and benefit from the growth opportunities that come from being part of a larger enterprise. Buyers gain scale and diversity but do not have to agree to a value amid extreme uncertainty and pay cash for the target. William Blair has substantial expertise with cashless mergers. We believe this approach is a viable and appealing way for sellers to position their equity for continued growth and for acquirers to pursue long-term strategic goals without straining critical cash resources.

To learn more about these and other trends that are shaping the dealmaking environment for FBOs, please do not hesitate to contact us.

Select Transactions

Not Disclosed
Leading Edge Jet Center
has been acquired by
InstarAGF

Not Disclosed
Rectrix
has been acquired by
Ross Aviation

Not Disclosed
MidlanticJet
has been acquired by
Landmark Aviation

Not Disclosed
Hawker Beechcraft FBOs
have been acquired by
Signature Flight Support

Not Disclosed
SevenBar Aviation
has been acquired by
Atlantic

Not Disclosed
Mercury Air Centers
has been acquired by
Atlantic

Represents transactions completed by banker while at prior firms