

The Value Equation and You

To do the math, you must first understand the language

By Peter v. Agur, Jr.

CUTTING A DOLLAR OF COSTS IS SEEN BY THE SHORT-SIGHTED AS A CHEAP AND EASY PATH TO DIRECTLY IMPROVE PROFITS BY A DOLLAR.

SUMMARY: The relatively high cost structure of maintaining a business aviation flight department makes the department a seemingly easy target for corporate cost-cutters, especially since the flight department is not an income-producer. Countering such a simplistically based cost-cutting initiative begins with an understanding of the benefits the flight department provides to the company.

“Pete, I’ve been told our flight department’s budget is way out of whack. I would like for you to conduct an operational and financial audit,” said Joe. Thus began one of the most surprising flight department reviews we have ever done. A large bi-coastal company with a single-aircraft flight department had recently relocated from California to support its growing Northeast headquarters. With the relocation came a new point of report for the flight department: Joe. He was asking us to conduct a due diligence review that would respond to concerns about perceived excessive flight department expenses as well as identification of any use or cost issues that could run awry of the Sarbanes-Oxley Act.

I asked Joe what had triggered his call to our firm. He replied that he’d had several conversations with internal and external sources who had indicated that other companies operated aircraft like theirs for substantially less money. He went on to describe fairly “normal” trip requirements. Their long-range jet provides top management trip support (mostly for the CEO). Their use is in sync with the industry norms for that type of aircraft (passenger loads, destinations, trips, days and hours flown, etc.). However, he also pointed out that their key passenger has very high standards and expectations for trip services.

Joe also told me that their flight department staff of five is comprised of a manager-chief pilot, a captain, a first officer, a flight attendant, and a technician. No incidents or events triggered the request for an audit, EXCEPT he had been told that the flight department’s costs were out of line. He had even done a quick comparison against Conklin & de Decker’s numbers. The disparity reinforced his concern. That is when he called us.



THE VALUE EQUATION

I have been a strong proponent of the Value Equation for a long time. In fact, many aviation managers stake the future of their flight departments on it. But, if that is as far as you go, you could be making a big mistake! There is no doubt that the Value Equation is a great tool because, like most great tools, it is easily understood and used. But if you use it literally, it can work against you, to devastating results. The Value Equation states that value equals benefits minus costs. Therefore, the assessed value of anything is positive if its benefits exceed its costs. Using a little high school algebra, you calculate that you can raise value simply by lowering costs.

Of course, we aviation professionals are not troubled by a little algebra. After all, we are numbers people. Most of us can recite from memory dozens of numbers that describe our airplanes: maximum gross weight, maximum fuel capacity, fuel flow per hour, takeoff and climb speeds, cruise speeds (in mach, knots, and miles per hour), approach speeds, “N” number, aircraft serial number, and on and on. Most importantly, almost every one on those numbers means a great deal to each of us about our aircraft’s performance and capabilities. That familiarity comes from years of experience combined with the in-depth knowledge we have gained about the conditions surrounding the application of that information.

Your chief financial officer is a numbers person, too. I’ll bet your CFO can recite, from memory, your company’s most recent EBIT, ROI, ROA, hurdle rate of return, stock price, market value, and on and on. And most importantly, every one of those numbers means a great deal to the CFO about your company’s performance and capabilities. That, too, comes from years of experience combined with the in-depth knowledge the CFO has gained about the conditions surrounding the application of each of those numbers.

So the question remains, if airplane people and financial people are both numbers people, why is there so much confusion amongst us? For instance, if you and your CFO differ on the value of your aviation services, it’s possible that each of you is using different numbers dialects—value, cost or efficiency.

THE VALUE DIALECT—THE SUM IS GREATER THAN ITS PARTS

Value is the purest and most encompassing dialect of the language of economics. It is *the* objective, *the* goal, *the* touchstone of success. Yet value is harder to understand when the dialects of costs and benefits are being used independently to describe it. For instance, “We are not investing in business aviation to save money. You cannot cost-justify a company airplane.” The CFO was speaking to a gathering of the top management team of a multi-billion dollar company as he and the CEO were introducing their new flight services. He went on to describe the greatest benefit for their investment was the improvement in the company leadership team’s productivity and quality of life.

If you do not fully understand the value dialect you might assume they were making their commitment based on intangible benefits. Actually, they were talking about both specific elements of the value equation: Value equals benefits minus costs.



What was implicit in their case was that the benefits of business aviation services (time savings, flexibility, reliability, productivity improvements, fatigue management, hassle reduction, etc.) exceed the marginal costs of those benefits. Marginal costs is the difference between the costs of one choice (business aviation) versus the costs of its reasonable alternative (the airlines) to achieve a given outcome (door-to-door transportation).

An example of a shift in perspective from one of a cost basis to a value basis is Warren Buffet's view of business aviation. When Mr. Buffet named his first airplane "The Indefensible" he may have been poking fun at the marginal cost focus he and other financial wizards have historically placed on business aviation. Over time and with experience he came to more fully understand and appreciate the broad spectrum of benefits gained from the use of business aviation. As a result, he has renamed his aircraft, "The Indispensable."

In fact, his belief in the business aviation value equation is so great that his company, Berkshire Hathaway, may be the largest investor in business aviation today. That is a huge statement made by one of the world's most respected investors.

THE COST DIALECT – THE TYRANNY OF THE DOLLAR

So, if the value of business aviation does exceed its costs, why is there so much emphasis on those costs? Maybe another investor can give us the answer

A few years ago the chairman of a major investment banking company told me, "I want five things from my aviation operations. The first three are safety, safety and safety. Next, I want world-class service. And finally, I will treasure every nickel the flight department saves making those things happen." He was concisely describing how to achieve his sense of value. He wants the benefits of business aviation to be delivered to the highest standards and *then* he wants the costs to be contained. His vision of value was clear.

But when economic times get tough even farsighted leaders may find it necessary to shift their value equation. A stronger focus on costs may be needed because revenues are depressed. Yet, why is there such a strong focus on costs when it is easy to see that revenues are the true lifeblood of any enterprise? After all, everyone knows you need to spend money to make money.

The answer is deceiving. Consider that most healthy companies work very hard to sustain a real rate of return (defined as profits—revenues minus costs—divided by revenues, minus the rate of inflation) of from 3 percent for utilities, financial institutions, etc., to 15 percent or more for niche or high-margin operations such as many service businesses and heavy equipment manufacturers. These rates of return are the foundation for an interesting phenomenon that my friend, Weird Roy, refers to as the "Tyranny of the Dollar."

The Tyranny of the Dollar gains its power from simple mathematics. If you want to add one dollar of profit or offset one dollar of loss at the bottom line, you have two choices: Either add from \$6 to \$33 of revenue to the coffers, or eliminate \$1 of cost. The result



is the Tyranny of the Dollar—cutting a dollar of costs is seen by the short-sighted as a cheap and easy path to directly improve profits by a dollar.

You can count on tyranny's path leading directly to your door! Your flight department's budget is likely to be among the largest pools of "cost" dollars your company has. Making that path even more attractive is the fact that your flight department's budget does not directly create revenues for the company. Plus, there is an easier and less expensive alternative to "costly" business aviation services—the airlines.

Of course, you and your passengers know there is no comparison between the airlines and your aviation services. Unfortunately, it is not unusual for numbers people to take the myopic view and compare the two methods of travel.

Consider their logic. If you assume that safety and time are true commodities, the two choices (company airplanes and the airlines) are interchangeable. It is arguable that safety is a commodity. After all, the accident rates for the major airlines and corporate aviation are statistically identical. It is also often said by 1950s-style managers and hardcore green-eyeshade types that people can travel on their own time commercially because they will still get the job done. That logic has behind it the power of the Tyranny of the Dollar.

Take the following as an example. Assume you operate a Citation Ultra with an annual cash budget of \$1 million. Also assume you fly a little over 500 hours per year and cover 200,000 passenger-occupied miles with an average load of three passengers. Your average cost-per-passenger-per-mile is \$1.67. Finally, assume your company's travel department is buying airline tickets for an average of \$0.50 per passenger mile. By trading expensive business aviation dollars for cheaper airline dollars, your company can save \$1.17 per passenger mile. Taken to the extreme (no company aircraft use), the savings would be \$700,000 per year plus the liberation of the capital invested in the airplane for other corporate uses that may create revenue.

Put another, even more sobering way, the amount of revenue it takes to offset the \$700,000 cost difference between using corporate and commercial air travel ranges from \$4.7 million to \$23.3 million annually (\$700,000 divided by 15 percent and 3 percent profit margins, respectively). That's a lot of extra work needed to create the money to pay for the marginal costs of business aviation. Or, it is a lot of money that could go to the bottom line.

It is apparent that if costs were the only dialect in the language of value, the Tyranny of the Dollar would rule the land. But costs can tell only part of the story. *Efficiency* fills in the gap.

THE EFFICIENCY DIALECT—THE REST OF THE STORY

One of the major problems with cost management is that it can actually damage your department's ability to achieve its core objectives. For instance, if you cut costs by reducing your training you face the potential of raising your risks or reducing safety. If you cut your costs by buying fuel at only the cheapest FBOs, you may find passenger ground services to be unacceptably poor. If you cut your costs by reducing your parts



inventory, Murphy's Law says you'll miss the trip of the year because the right stuff wasn't on the shelf.

In the end, the chairman of the international investment company had it right. He was describing his department's goals perfectly: Achieve the set objectives for safety and service, and manage the fool out of the costs. In other words, he wanted his aviation services to be efficient. It is that complex and it is that simple.

And that leads us to the rest of the story. We conducted the review of Mike's department and came up with four significant findings:

First, Mike's flight services team performed to excellent operational and service standards. In fact, they were among the best we had ever seen.

Second, the company and the key passenger expected, and had approved, a number of services and costs that are consistent with their industry and their personal needs and expectations. The flight department's budget included those services and costs. So, Mike's team was simply doing what was expected of them. The company is currently conducting a survey to determine how their choices may vary from the norm. They will then establish policies and procedures assuring them that they remain well within the confines of the letter and intent of their internal guidelines as well as those of the Sarbanes-Oxley Act.

Third, the company's annual budgeting process hasn't worked well for flight services in the past. Where most of the rest of the company has substantial control over their operating costs, the flight department has control over less than half of its costs. Therefore, when a company department is asked to cut their cost by 10 percent, they can do so without being crippled.

But the flight department would lose more than 20 percent of its operating budget if it were expected to meet the same standard. And the principal won't let that happen. Therefore, until now, for all practical purposes, the airport had remained outside the normal corporate budget process. This budgetary accommodation was the foundation for the confusion that started the whole review process. They are seeking effective ways to place the flight department's budget into the company system.

Fourth, even though the flight department was "off budget," Mike had gone to the trouble of creating and maintaining his own set of financial books. Beyond that, he and his team had, without being asked to, routinely sought ways to achieve their safety and service objectives while saving money. They had achieved a number of successes in the arenas of fuel, maintenance, and other high-dollar line items. However, they had been keeping the information for their own use. No one downtown knew what they had accomplished.

In the end, Mike and his team were indeed creating relatively high costs. But those costs were absolutely in line with those needed to conduct business (safety and service) as the company and its principal had defined it. Even so, the flight department



had been quietly and proactively been whittling away at those costs to ensure they were creating the efficiencies they believed they should be achieving.

Mike and his team have been doing a great job in almost all arenas. The one they hadn't conquered was the one that almost got them into trouble—communicating with the company in a common dialect, the dialect of efficiency. In other words, even tens of millions of pennies saved may never be seen... unless you not only account for them but also show them to the right audience.

HOW AT RISK ARE YOU?

A number of aviation managers truly believe their departments, and their budgets, are impervious to the assault of the bean counters. They console themselves with an historic perspective that silence today from the company and its passengers about costs means that all will be well tomorrow.

Mike made no such assumptions. He was ready and able to make his case when the time came to answer financial questions. And it did come. If it hasn't already, it will come for you, too. When that time does come, don't take those questions as threats. If someone declares that "Your costs are too high," they may really mean, "We don't understand your value equation." If you have your house in order, as Mike did, you will be able to tell a great story, too.

Notice that Mike was not satisfied with simply benchmarking costs. He and his team actively sought ways to cut costs to retain only those that were absolutely necessary, and even those were reduced to the levels that still allowed the flight department to deliver the expected degree of safety and service.

In other words, Mike and his team managed their efficiency, the highest dialect of the Value Equation.

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