Regional Express Holdings Limited (REX)

We give REX another flythrough!

Recommendation: Accumulate | **12 October 2007**

Investment Rating

Regional Express Holdings (REX) is Australia´s largest independent regional airline, established in 2002 from the merger of Hazelton and Kendell. REX is the sole provider in the majority of its routes. Airlines are capital intensive and have traditionally offered poor returns for investors. Rex effectively holds monopoly position in ~60% of its routes, many too small to be profitably serviced by Qantas, Virgin Blue, or Jetstar. The dividend payout-ratio is planned at 30-40%. This is at the high end given airlines have considerable capex requirements. Freefloat is small and share turnover low. Despite this we believe REX offers considerable value given its strong business model and attractive long term prospects.

Event

- REX is prospering from its duopoly position in regional air travel despite conditions for regional aviation remaining difficult. High fuel prices and the ever increasing burden of regulatory and security compliance has bankrupted smaller regionals. Five regional operators folded in FY07 alone with more expected to follow. REX is now large enough to support the considerable cost base and can grow into routes left by the smaller failed airlines. REX has expanded into Queensland with its first route – Brisbane- Maryborough - operating 36 flights per week. REX is likely to bid for tenders on various State regulated and subsidised routes.

Impact

- Our remodeling of REX increases our confidence in our positive recommendation and $3.35 valuation. Changes in our lease/ownership assumptions see our FY08 NPAT retreat $2m to $28m but our FY09 forecast increases to $31m. Diluted EPS forecasts for FY08 and FY09 are 24cps and 26cps respectively. We retain our valuation and price bands but the recent increase in share price sees us downgrade our recommendation from Buy to Accumulate.

Recommendation Impact

Recommendation downgraded from Buy to Accumulate.

Recommendation Trigger Guide

BUY	ACCUM	HOLD	REDUCE	SELL
	▼			

$2.65 | $2.85 | $3.75 | $4.15

Note: Marker indicates price of $2.69 at publication date.

Snapshot

Last Price	$2.69
Market Cap.	$325 million
52 Week High	$2.88
52 Week Low	$1.11
Shares on Issue	121.0 million
Sector	GICS - Transportation

Valuation

Intrinsic Valuation	$3.35

Risk

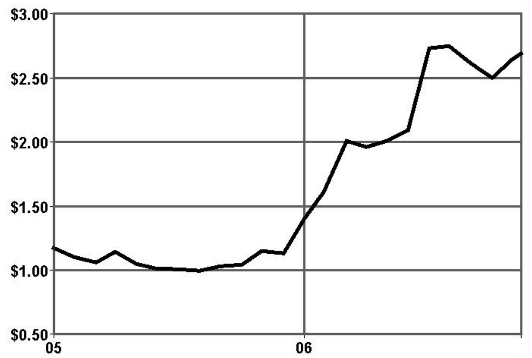
Business Risk	Medium
Pricing Risk	Medium
Company Beta	0.77
Sector Beta	0.96

Investment Fundamentals

Year-end Jun	FY06A	FY07A	FY08E	FY09E
NPAT ($m)	15.7	23.1	28.0	31.0
EPS (¢)	15.4	20.4	24.0	26.0
EPS Growth (%)		32.8	17.6	8.3
PE Ratio (x)	17.5	13.2	11.2	10.3
DPS (¢)	5.0	6.6	7.0	8.0
Dividend Yield (%)	1.9	2.5	2.6	3.0
Franking (%)	0	100	100	100

Source: Aspect Huntley analyst estimates.

Price Chart



Business Description

The Rex Group (REX) provides passenger airline, freight & charter air services. It is essentially the merger of the businesses of two air carriers in Australia, namely the passenger airline businesses of Hazelton and Kendell.

Event Analysis

REX is prospering from its duopoly position in regional air travel despite conditions for regional aviation remaining difficult. High fuel prices and the ever increasing burden of regulatory and security compliance has bankrupted smaller regionals. Five regional operators folded in FY07 alone with more expected to follow. REX is now large enough to support the considerable cost base and can grow into routes left by the smaller failed airlines. REX has expanded into Queensland with its first route – Brisbane- Maryborough - operating 36 flights per week. REX is likely to bid for tenders on various State regulated and subsidised routes.

Competition from Virgin (VBA) and Qantas (QAN) will likely intensify. Route frequency remains paramount for regional travel making it difficult for larger jets to compete. Virgin has recently bought six Embraer 170s and 11 Embraer 190 jetliners, which seat up to 80 and 114 people respectively and should be operational this month. Despite being smaller than the aircraft Virgin normally operates they still challenge only a few REX routes and carry greater cost on low passenger volumes than REX's 34 seater Saabs. The Embraer jets will likely be used to make low passenger routes, currently serviced by 144 seater B737-700s, more profitable. The first route serviced by the new aircraft will likely by Sydney-Canberra, a route not flown by REX. Current legislation allows turbo-prop planes to avoid certain costs jets face, such as baggage and passenger screening. Screening equipment typically costs $10m outright with considerable ongoing staffing costs. This stresses the already fragile economics of these routes. In addition runway upgrades would likely be required on many routes. Airlines will push for local councils to meet or at least share costs.

Keeping and attracting flight crew is increasingly difficult. Loss of pilots from regional to major airlines is nothing new but has increased recently with the rise in flights globally spurred in part by discount airlines. July was particularly bad for REX. A recent recruitment drive saw REX pick up more than the pilots they lost, with around 48 pilots joining over a 9 week period since financial year end. REX doesn't expect to stop losses of pilots to the majors but does expect to increase the number of new pilots coming through. Last week REX launched a cadet program for pilots to overcome the often prohibitive upfront costs of obtaining a license, with fees upward of $80,000. Between 20 and 40 candidates will be loaned 50 – 100% of these training costs and begin operating in one of REX's divisions. Training is expected to take 8 months with cadets bound to REX for a minimum six years.

REX does not hedge fuel costs, which represent almost 16% of revenue in FY07. It does impose fuel surcharges, which mitigate rises in fuel prices. Fuel surcharges are pegged to those of Qantas for competitive reasons. Charters under Pel-Air are also made on a fuel cost adjustment basis. REX does not expect a material impact in FY08 from currency. REX loosely hedges US$ currency exposure given considerable leasing and engineering costs denominated in US$. Aircraft purchases, however, are not hedged and present potential upside should the US$ continue to weaken.

We forecast REX to expand capacity by 16% in FY08 with 37 planes at year end taking capacity to over 1,250 seats, excluding AirLink and PelAir. We expect REX to add seven Saab340B to its fleet, with four already added in the first week of FY08, at an assumed cost of AS$2.3m per plane. We expect REX to retire two Saab 340s, converting them to freight aircraft to be operated by the now wholly owned Pel Air. We assume a similar acquisition/retirement schedule continues to 2012.

We forecast the decline in air fares in real terms excluding fuel levies to continue, with a forecast average fare per passenger excluding fuel charges of $110 in FY12, down from $119 in FY07. This suggests a 4% p.a. real decline in the average fare over the period. We assume REX's load factor- a distance weighted measure of a plane's utility – to be 67% over the medium term, below FY07's 68.3% but above historical average.

Our remodeling of REX increases our confidence in our positive recommendation and $3.35 valuation. Changes in our lease/ownership assumptions see our FY08 NPAT retreat $2m to $28m but our FY09 forecast increases to $31m. Diluted EPS forecasts for FY08 and FY09 are 24cps and 26cps respectively. We retain our valuation and price bands but the recent increase in share price sees us downgrade our recommendation from Buy to Accumulate.

Profit & Loss ($M)

Year to 30 Jun	2005A	2006A	2007A
Sales Revenue	**--**	**170**	**224**
Total Revenue ex. Int.	--	173	224
EBITDA	**--**	**25**	**38**
Depreciation & Amort.	--	-4	-6
Goodwill Amortisation	--	--	--
EBIT	--	21	32
Net Interest	--	1	1
Profit Before Tax	--	22	33
Income Tax	--	-6	-9
Outside Equity Int.	--	--	0
Profit after Tax	**--**	**16**	**23**
Significant Items after Tax	--	--	--
Reported Profit after Tax	**--**	**16**	**23**
Preferred Dividends	--	--	--

Cash Flow ($M)

Year to 30 Jun	2005A	2006A	2007A
Receipts from Customers	139	191	249
Funds from Operations	4	27	41
Net Operating Cashflow	**5**	**27**	**39**
Capex	-15	-18	-34
Acquisitions & Investments	--	-14	-5
Sale of Invest. & Subsid.	--	--	--
Net Investing Cashflow	**-7**	**-33**	**-36**
Proceeds from Issues	4	35	--
Dividends Paid	--	--	-7
Net Financing Cashflow	**9**	**25**	**-6**
Net Increase Cash	6	19	-4
Cash at Beginning	1	5	24
Exchange Rate Adjust.	--	--	-1
Cash at End	**8**	**24**	**19**

Ratios and Substantial Shareholders

Year to 30 Jun		2005A	2006A	2007A
Profitability Ratios				
EBITDA Margin	%		14.88	16.96
EBIT Margin	%		12.41	14.43
Net Profit Margin	%		9.27	10.31
Return on Equity	%	0.00	22.86	22.52
Return on Assets	%	0.00	15.78	14.75
Debt/Safety Ratios				
Net Debt/Equity	%	-18.47	-34.28	-12.20
Interest Cover	x		141.32	90.72

Top 5 Substantial Shareholders

Joe Tiau Tjoa	11.5%
Kim Lark Lim	10.0%
Kerk Chuan Seah	9.0%
Canberra Air Pty Limited	7.7%
Kim Hai Lim	6.8%

Balance Sheet ($M)

Year to 30 Jun	2005A	2006A	2007A
Cash & Equivalent	9	24	19
Receivables	7	7	11
Inventories	3	4	7
Other Current Assets	4	1	1
Current Assets	**24**	**36**	**38**
Prop. Plant & Equipment	32	46	111
Intangibles	--	1	7
Other Non-Current Assets	4	1	1
Non-Current Assets	**54**	**64**	**120**
Total Assets	78	100	158
Interest Bearing Debt	--	--	6
Other Liabilities	27	32	56
Total Liabilities	**27**	**32**	**56**
Net Assets	51	69	102
Share Capital	69	70	82
Reserves	--	-2	1
Retained Earnings	-18	2	19
Outside Equity Int.	--	--	--
Total Shareholders Equity	**51**	**69**	**102**

Previous Research

05/09/2007	Clear skies expected!
25/06/2007	REX flying high!
25/05/2007	Initiate coverage of REX.

Principals & Directors

Principals

Chairman	Mr Kim Hai Lim
CEO/MD	Mr Geoffrey Breust
Company Secretary	Mr Irwin Tan

Directors

Mr Russell Hodge(Non-Executive Director, Pel-Air Operations)
Mr John Wallace Sharp(Deputy Chairman, Independent Director)
Mr David Miller(Executive Director)
Mr Kim Hai Lim(Executive Chairman)
Mr Geoffrey Breust(Managing Director)
Mr James (Jim) Davis(Executive Director Operations)
Mr Thian Soo Lee(Non-Executive Director)
Mr Robert Winnel(Independent Director)
Mr Stephen Jermyn(Non-Executive Director)