

Regional Express Holdings Limited (REX)

Pilot shortage sees services cut!

Recommendation: BUY

09 November 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

- Serious pilot shortages have caused REX to suspend some services as REX scales back two routes with low patronage. REX is suspending its single return service between Sydney and the Snowy Mountains for six months beginning November 19. The service operates six flights a week and is more popular during the winter snow-season. REX is also suspending its thrice-daily Brisbane – Maryborough service until March. REX does not expect to suspend any more routes. These two route suspensions will free up 2 – 3 sets of crew each able to fly 3 – 4 sectors daily.

Impact

- These disruptions will likely impact first quarter trading results due next week as well as the full year results. We reduce our number of flights assumption for FY08 and to a smaller degree FY09 which reduces NPAT from \$28m to \$25m for FY08 and from \$31m to \$30m for FY09. We reduce our valuation 5% to \$3.20 and maintain our positive recommendation. We believe these difficulties are short term and remain confident REX will continue to provide a superior service.

Recommendation Impact

Recommendation is a BUY.

Recommendation Trigger Guide

BUY	ACCUM	HOLD	REDUCE	SELL
\$2.50	\$2.75	\$3.60	\$4.00	

Note: Marker indicates price of \$2.12 at publication date.

Snapshot

Last Price	\$2.08
Market Cap.	\$252 million
52 Week High	\$2.88
52 Week Low	\$1.11
Shares on Issue	121.0 million
Sector	GICS - Transportation

Valuation

Intrinsic Valuation \$3.20

Risk

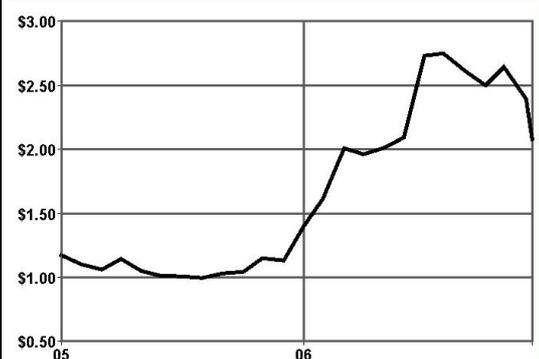
Business Risk	Medium-High
Pricing Risk	High
Company Beta	0.78
Sector Beta	0.96

Investment Fundamentals

Year-end Jun	FY06A	FY07A	FY08E	FY09E
NPAT (\$m)	15.7	23.1	25.0	30.0
EPS (¢)	15.4	20.4	21.6	25.7
EPS Growth (%)		32.5	5.9	19.0
PE Ratio (x)	6.9	8.1	9.6	8.1
DPS (¢)	5.0	6.6	7.0	8.0
Dividend Yield (%)	4.7	4.0	3.4	3.8
Franking (%)		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

Some bumps ahead bet REX maintains flight path

Serious pilot shortages have caused REX to suspend some services as REX scales back two routes with low patronage. REX is suspending its single return service between Sydney and the Snowy Mountains for six months beginning November 19. The service operates six flights a week and is more popular during the winter snow-season. REX is also suspending its thrice-daily Brisbane – Maryborough service until March. REX does not expect to suspend any more routes. These two route suspensions will free up 2 – 3 sets of crew each able to fly 3 – 4 sectors daily.

So far REX has suspended two routes operating a total of 27 flights per week from a total of over 1,300 per week. The routes cancelled are not materially profitable themselves but do hurt REX's hard won reputation as a reliable airline with traditionally the lowest cancellation rates in the Australia as well as hampering expansion plans by crimping capacity growth.

Currently REX has no spare pilots forcing them to cancel flights ad hoc if pilots call in sick causing considerable disruption and customer ill-will. Last Sunday REX had to cancel Lismore and Moruya flights due to pilot illness. By suspending less vital routes REX intends to create a pilot supply buffer short term and hopefully avoid future reputation destroying disruptions to existing services.

Major airlines, including new entrant Tiger, are poaching pilots particularly from regional carriers to service increased capacity. REX typically pays its pilots almost half the rate international jet pilots command and by doing so attracts earlier stage pilots looking to accumulate the hours required to fly jets internationally. There is a natural attrition of pilots to the majors but recent swings have caught REX off-guard. Since July pilot turnover on an annualized basis has reached 61%, well above the 18% in FY06 and 7% in FY05. REX currently has 200 active pilots and 240 employed pilots. REX estimates current routes require 240 active pilots which includes a supply buffer. The majority of the 40 non-active employed pilots are in their final stages of their two month ground school and simulation training. These new pilots are expected to progressively begin service between now and Christmas

REX is addressing the issue of pilot shortage longer-term by establishing its cadet program which includes a new professional pilot academy in joint venture with Mangalore Airport Pty Ltd as well as loan arrangements for the estimated \$80,000 cost of the 32 week training program. REX has received 700 applications to date with the first batch of 20 candidates expected to begin training December 10.

REX has increased its fuel surcharge from \$24 to \$27 as jet fuel prices approach US\$100. We estimate a \$24 fuel surcharge and a \$27 fuel surcharge would have generated between \$34m and \$38m of additional revenue respectively in FY07, more than covering the entire \$35m fuel cost. While the price of fuel has increased from around US\$79/barrel average in FY07 to current US\$91/barrel, strength in the A\$ has mitigated fuel cost inflation. We estimate that the average A\$ price of fuel will increase only A\$8 from the FY07 A\$101 estimated average as the A\$ appreciates from an average A\$0.786 in FY07 to a forecast A\$0.87 for FY08. Further we assume an average fuel cost of US\$95 for FY08, above current levels.

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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	--	--	--

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

Kim Hai Lim	19.0%
Joe Tiau Tjoa	11.5%
Kim Lark Lim	10.0%
Kerk Chuan Seah	9.0%
Canberra Air Pty Limited	7.7%

Previous Research

12/10/2007	We give REX another flythrough!
05/09/2007	Clear skies expected!
25/06/2007	REX flying high!
25/05/2007	Initiate coverage of REX.

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

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

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)

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