



Regional success

Regional Express model survives tough times

by Gerard Frawley

'Annus Horribilis II' is the alarmist headline on the front cover of Regional Express's annual report for the financial year just gone.

And for almost every airline in the world it has most certainly been an 'annus horribilis'. Airlines worldwide are haemorrhaging red ink as global recession takes its toll. But against that background the latest profit result for Regional Express, or Rex, was outstanding. Australia's biggest independent regional airline must surely be one of the world's most profitable airlines at the moment on the basis of profit margin.

"We are very happy in our niche," Rex managing director Jim Davis told *Australian Aviation* in a recent interview. And why not, when Rex (including subsidiaries Pel-Air and Air Link) posted an enviable net profit of \$23 million on revenues of \$251 million. Profit and revenues were certainly down, but those falls (5.6 and 3.7 per cent, respectively) were nothing like the declines experienced by almost every other airline worldwide,

even when Rex's passenger numbers for the year fell by a more worrying 13 per cent.

Rex's consistent profitability of recent years is all the more remarkable for the fact it operates in the always tough regional aviation environment, where costs are high and margins are thin, and its surviving of the recent crippling pilots shortage that saw it lose no fewer than 90 pilots between July 2007 and February 2008. And then on two of its biggest routes Rex is facing stiff new competition from Virgin Blue E-Jets, there is continuing drought in many parts of rural Australia, it faced the fuel price hikes of 2008, and more recently swine flu heavily impacted Rex's Victorian traffic for a time.

"It's a very complicated business, there's so many challenges," said Davis, a former chief pilot of Rex predecessor Hazelton Airlines who succeeded Geoff Breust as MD in 2008, on running a regional airline. "There's challenges from government regulation, there's challenges from fuel prices, there's challenges from the new technology which you've got to try and bring into a regional operation, there's challenges with ageing aircraft, there's challenges with staff turnover."

But in spite of those challenges and complications, there's no doubt Rex has found a 'sweet spot' in the airline market. With more than 40 Saab 340s now in service on a network stretching across the southeast of the country, it has the size and scale that no other regional airline in Australia – QantasLink aside – comes near. Those Saabs, being second hand but still relatively young, are at a sweet spot themselves in terms of acquisition and operating costs. On all but five of its routes Rex is the only operator, mostly servicing routes too small for QantasLink and Virgin Blue. It has worked closely with the local councils that operate most of the regional airports it serves so that airport charges act as an incentive for Rex to attract more passengers to their towns, and aims to provide business friendly schedules and frequencies. And then Rex's focus on costs (with, for example, a single type aircraft fleet) and low ticket prices has seen it stimulate demand and grow markets.

"Maybe we've just been in the right place at the right time, but we've hit on a model that works," said Davis. "It's certainly a different model to the traditional one. I

remember back in the Hazelton days the management would look at ticket prices and say 'they're too low, this is terrible', but we never do that, we look at overall return, the ticket price is quiet incidental, and we get quiet concerned if we start to see them rise too much."

Explained Davis, "We tend to keep our costs down as much as possible, and within the constraints of a regional operation we try and keep our fares down, and our fares today are still lower than they were in 2003. That includes all the extra fuel costs and the CPI costs."

Davis said Rex has also been helped by the business acumen of its biggest shareholder and executive chairman, Singaporean Lim Kim Hai. Lim holds a 20 per cent stake in Rex and takes an active role in its day-to-day operations.

"He came into the business with no aviation background at all, no knowledge of how an airline works, and that was a huge advantage as he would just apply basic business principles, and quite often some of our inhouse experts would say 'you can't do that, we don't do it that way', and he would say, 'well, why not?', and more often than not it turned out we could do it a different way," Davis related.

Lim's application of basic business principles would certainly have helped as Rex battled that 13 per cent fall in passenger numbers last financial year. Rex's response, like almost every other airline's was to try and cut flights and frequencies to best meet demand.

"We made the decision early on to match our capacity to passenger demand," said Davis. "So as soon as we started to see a softening in the market, we started to reduce capacity, and at times we were reasonably aggressive in doing that."

In all during the last financial year, Rex cut around 10 per cent of its passenger capacity. "We didn't quite match the drop in passenger numbers but we got fairly close."

That came mainly from trimming capacities, but Rex subsidiary Air Link withdrew completely from RPT services in December. This saw services (operated by piston Piper Navajo and Cessna twins) to Bourke, Cobar, Coonamble, Lightning Ridge, Mudgee and Walgett all cut, while Air Link's Sydney to Dubbo and Sydney to Bathurst flights (operated by Beech 1900Ds) were transferred to Rex itself. The only route Rex itself exited was Sydney-Mildura.

"We did exit some routes (the previous financial year), which was more on the back of the pilot shortage," said Davis. That pilot shortage had seen Rex can its Sydney-Cooma, Melbourne-Griffith and Brisbane-Maryborough flights (the latter its first, brief, foray into Queensland, while Melbourne-Griffith services resume on



PILOT IN COMMAND Rex MD Jim Davis started his career as an airworthiness engineer with the then Department of Transport, then spent 25 years flying as a commercial pilot, culminating in being chief pilot for Hazelton Airlines. After Kendell Airlines and Hazelton merged to form Rex in 2002, Davis continued for a time as chief pilot in charge of the Hazelton AOC before he became executive general manager operations in 2003. He was subsequently managing director operations, chief of staff of the chairman's office, and was appointed managing director in May 2008. (Paul Sadler)

October 9). "We were still recovering from that in the first half of the (2008/09) financial year, and that meant our capacity was reduced anyway, but going forward from that we mainly cut frequency."

While frequency has been cut, the Rex fleet numbers have grown slightly, as newer Saab 340B Plus aircraft are added, and older Saab 340A models are sold off or converted to freighters and transferred to Pel-Air. "We've had a net expansion in aircraft, and that does mean we've had spare aircraft, and that has enabled us to pick up charter opportunities, to also pick up the mining work that Pel-Air is doing out of Townsville, and now to expand into Queensland with RPT."

While Rex has had to balance capacity and fleet numbers, it has also had to attend

to the new competitive threat from Virgin Blue, which is now using Embraer E-170s to compete on Sydney-Albury and Melbourne-Mildura (both of which are also served by QantasLink).

"The impact of the Virgin Embraer jets hasn't been as large we thought it might be," Davis observed. "It certainly hasn't been to the point where we've lost money because of them - we still make money on those competitive routes, and while we're making money we'll be there."

Rex may not have lost too much skin from Virgin's jet incursion on these traditional turboprop routes, but official figures do show the stimulatory effect the 70-seat E-Jets have had. For the 12 months to June 30, thanks to VB's twice daily services traffic on Sydney-Albury grew 22.7 per

IN THE SHOP A Rex Saab undergoes maintenance in the airline's new Adelaide hangar. Rex has 20 apprentice aircraft maintenance engineers at the moment, just under 20 per cent of its maintenance workforce. (Paul Sadler)





BIGGEST BASE About half of Rex's flights operate through Sydney Airport. The airline's corporate headquarters are adjacent to the airport in Mascot, heavy maintenance is performed in Wagga Wagga and Adelaide, and pilot bases are in Lismore, Dubbo, Orange, Albury, Wagga and soon Townsville. (Paul Sadler)

cent, by far the biggest increase of any of the top 50 routes in Australia for that period, Bureau of Infrastructure, Transport and Regional Economics (BITRE) figures show. Melbourne-Mildura (which VB flies once a day) was up 13.5 per cent:

Rex is certainly the little guy in competing with the giants of Qantas's QantasLink and Virgin Blue on Sydney-Albury and Melbourne-Mildura, against Virgin Blue and Jetstar on Sydney-Ballina (which serves as a gateway to Byron Bay), and against QantasLink on Sydney-Dubbo and Sydney-Wagga, but, in general terms, says Davis, "we have no ambition to compete with the low cost carriers and the larger aircraft that QantasLink operates."

If a key part of the Rex strategy is not taking on the big carriers in any major way, on other parts of its network it is in turn Rex that is the 900lb gorilla, and smaller operators the minnow.

Stiff competition from Rex on its Adelaide-Mount Gambier, Adelaide-Whyalla and Adelaide-Port Augusta services was in part behind the collapse of Mount Gambier based O'Connor airlines in December 2007, while more recently another South Australian operator Air South (profiled in the June issue of *AA*) has announced it is quitting services to Kangaroo Island from

October 17, in the face of what the airline called "the Rex juggernaut".

"The ex O'Connor routes have been going quite well, we've increased frequencies on Adelaide to Mount Gambier and Adelaide to Whyalla," Davis said. "Mount Gambier is now one of our best routes."

The next stop for "the Rex juggernaut" is Queensland, but here it will be a tougher battle. From October 1 Rex is due to start services from Townsville to Mackay, a route already served by QantasLink. Since February this year, following the collapse of MacAir, Rex's Pel-Air subsidiary has based two Saab 340s in Townsville to operate fly-in/fly-out charter services to Barrick Gold's Osborne Mine, so Rex's new Mackay flights can leverage off the aircraft and resources already in place for the mine contract.

"It's an opportunity that arose mainly due to the fact that Pel-Air had established an operation in Townsville," Davis said of the Mackay flights. "This gave us some economies of scale and synergies, for instance we'd normally have to place two Saabs in Townsville to operate the new route, but we've only had to place one because there was existing capacity with the Pel-Air Saabs. Also the ground handling operation was already in place, and there's also the potential to share pilot resources between the two operations."

"JUGGERNAUT?" Rex's 40 plus Saab 340 fleet operates 1300 flights a week to around 30 destinations in New South Wales, Victoria, Tasmania, South Australia and Queensland. (Andrew McLaughlin)



It seems Rex's further expansion in Queensland is likely, possibly linking up to the airline's NSW network, which currently extends as far north as Ballina and Lismore.

Rex will no doubt be hoping its new incursion into Queensland is more successful than its first attempt at expansion into the sunshine state. After a deal to purchase regional airline Sunshine Express collapsed in August 2006, in July 2007 Rex launched a Brisbane base and began services to Maryborough, a former Sunshine Express route (Sunshine Express had stopped RPT operations on October 1 2006).

Launching Brisbane-Maryborough "was just excruciatingly bad timing," said Davis, as flights began "just when the pilot shortage hit us at its peak. And it involved a large investment, setting up a new base in Brisbane, and every capital city operation is expensive." Rex ceased services on the route in November 2007.

"This operation out of Townsville obviously is a lot cheaper because it's not a capital city and we have the existing synergies. So we'll see how it goes, and if it is successful we'll see what other opportunities exist in Queensland."

The pilot shortage which curtailed Rex's first Queensland expansion was without doubt the most traumatic episode in Rex's seven year history.

"At the peak of the pilot shortage we lost 75 pilots in six months," Davis recalled. "That's an annualised lose rate of 64 per cent, and in the financial year up to the end of June 2008 we lost 50 per cent of our pilots. I often liked to say that would have been like Qantas losing 1000 pilots a year. What sort of airline can survive that sort of attrition? But we did."

It was an extraordinary time for the airline, as pilot resignations caused Rex to cancel flights across the network and pull out of three routes altogether. Disgruntled pilots took to websites like Pprune to argue for better pay and conditions, while Rex's public statements were startlingly frank

– “Rex Warns of Looming Catastrophic Shortage of Pilots in Australia” read an October 2007 press release. At the time it was cancelling 0.9 per cent of all its services due to pilot shortages – four times its normal cancellation rate.

“We did take the stand, and it’s not always a popular stand, that no matter what we paid our pilots we were not going to stop the bleeding,” explained Davis. “I’ve been a pilot myself, and the chance to go and fly a brand new A320 or 737NG and get \$160-180,000 a year – we cannot compete with that. So we took the stand early on that we couldn’t buy ourselves out of this fix.

“What we did was create the cadet scheme and create the flying school. We spent a lot of time looking for pilots overseas, and we did bring some in from South Africa at one stage. Apart from that all we could really do was recruit through our traditional channels as much as we could. We increased our training efforts, we ran back to back ground schools, we ramped up our capacity so that we could train up to 120 pilots a year. At that point we were reaching maximum capacity.”

They were tumultuous times, in part solved by the economic slowdown which has seen the big airlines stop pilot recruiting. But Rex’s longer term solution is the establishment of its own pilot training school and cadet pilot scheme. Rex launched the cadet scheme – loaning half the costs of flying training repayed over seven years flying with Rex – in October 2007, then that December launched its joint venture training academy with Mangalore Airport. In 2008 Rex bought out Mangalore Airport’s share in the academy, and subsequently relocated the renamed Australian Airline Pilot Academy to Wagga Wagga.

Currently operating from temporary facilities, construction on a new \$12 million campus for the academy at Wagga Wagga Airport began in July. When completed the facility will employ 70 people and have the capacity to train up to 200 pilots a year. The school’s 32 week live-in course sees pilots graduate with a commercial pilot’s licence, a multi engine rating and command instrument rating.

“If we get a cadet with 200 hours, a big airline isn’t going to poach him in six months,” said Davis. “If we recruit somebody from general aviation with 5000 hours, a big airline could very likely poach him before he’s even finished training. With the cadet pilots it will be several years before the larger airlines start to pick them up, and by then we will have had some return from them.”

That will be increasingly important when economic growth rebounds and the major airlines start hiring pilots again. “The



IN TRAINING Rex’s Australian Airline Pilot Academy operates a fleet of new Piper Warriors and Senecas for its intensive 32 week CPL course. (Rex)

industry will pick up and we believe firmly that the pilot shortage will return. It may not be quite as severe as last time, but the larger airlines apart from Qantas do not have schemes in place for training their own pilots, so they will come back and take our pilots again. We are a little future proofed because we do have our cadet scheme, and the cadets will be with us for five or six or even seven years before they move on. That gives us some continuity of our pilot workforce.”

But not only will the academy provide a steady source of pilots for Rex, it is also intended to become a profit centre in its own right, providing training for third party customers.

“We hope that within 12 to 18 months that the academy will be making money,” said Davis. Rex identifies Chinese airlines as one source of students for the academy, with the approval process with Chinese

civil aviation authorities currently underway. But it might not be just airlines that provide that pilot training income – Rex’s 2008-09 annual report identifies the RAAF’s interim flight screening and basic flying training requirements as business the academy will tender for.

Other opportunities Rex is pursuing are through Pel-Air. Rex acquired the remaining 25 per cent of Pel-Air, which operates charter, express freight and defence support services, in June 2007. The company is undergoing something of a restructure as its overnight express freight business winds back, and it seeks new work in resource charter and aeromedical fields.

“Pel-Air is changing direction at the moment,” said Davis. “Historically, most of its work was in the freight business, and we saw that collapse last year.” This saw Pel-Air replace its 10 Metro III and single Embraer Brasilia freighters with

FEWER FREIGHTERS Pel-Air’s freighter operations have contracted from 10 Metros, a Brasilia and three Westwinds to just three Saab 340 Freighters. (Robert Wiseman)





AIR AMBULANCE A Pel-Air Westwind taxis out at Sydney on an aeromedical retrieval mission. (Paul Sadler)

just three ex Rex Saab 340 converted freighters, leading to the retrenchments of 20 pilots (showing just how quickly the pilot shortage has turned around) and four ground staff. "Obviously that's a big downturn in business and that's because the overnight freight business has seen a huge softening in business. We haven't seen any signs of recovery yet, but we feel that that will probably recover before the passenger market does, so we're watching it very closely. If we see opportunities there we would probably convert more Saabs into freighters."

"We had to take the decision to redirect the business. For the last 10 years Pel-Air has been heavily engaged in medical retrieval operations, so that was one obvious area to expand in. Another direction is in defence, where we are tendering for some major contracts."

Pel-Air's chasing of Victorian and NSW air ambulance contracts has certainly caused some controversy, as the incumbent for both is the Royal Flying Doctor Service.

"Coincidentally with the freight operations winding down, a lot of the state governments put out tenders for aerial ambulance operations, so we took the opportunity to throw our hat in the ring," said Davis. "These operations in Victoria and NSW are not medical style operations as the RFDS does, they are simply the provision of aircraft and crews, and it should be noted that both these contracts, prior to the RFDS taking them up, were operated by commercial operators. So it is not as though we're taking core business away from the RFDS, we're simply tendering for a contract to provide aircraft and pilots, and is a service we've done through Careflight for many years."

Pel-Air Westwinds have been used by Careflight and other operators for international medical retrieval flights for some time, and Pel-Air hopes to expand this business further with the conversion of the three Westwinds freighters it used until earlier this year on its now defunct Darwin-Melbourne express freight run

into utility aircraft that can be used for aeromedical or passenger charters.

Then there is Pel-Air's mining contract expansion, which includes not just the Barrick Gold Townsville contract, but in August it won a contract for Iluka Resources to use ex Rex Metro 23s to fly to the Jacinth-Ambrosia project.

"We see tremendous potential in the expansion of Pel-Air, and that's quite exciting," Davis remarked.

For another Rex subsidiary life is quieter at the moment. Dubbo based Air Link, since ceasing RPT services in December, now focuses on charter flying with its Beech 1900Ds, Piper Chieftains and Cessna twins.

"Air Link's fairly quiet, it's doing quite a lot of charter with its piston aircraft, but it's certainly not as busy as it was in the RPT days," observed Davis. Air Link's key assets are its two Beech 1900Ds, which, now exclusively flying charters, says Davis, "could be busier. We're still waiting to see how that market develops, obviously it is a very bad time for charter now, business has slowed." But, "we think they're the best 19-seater charter aircraft in the market, and we'd like to be able to develop that market with them."



photo - Paul Sadler

A bigger, but much longer term, fleet issue for Rex will be the eventual replacement of its Saab 340s, given there are no 30-seat class airliners now in production.

"The Saab is good for at least another 15 years, but there is no replacement aircraft around for the Saab right now. So we're very happy with the 30-seat size of aircraft, it is ideal for a lot of the smaller routes we fly. If a replacement aircraft is not brought into the market in the next 15 or 20 years then we'll have to upsize, and that will mean a change in our route network."

That would likely mean replacing the Saabs with second-hand 50-seat class Dash 8-Q300s or ATR 42s (but even then the Q300 is no longer in production, and most ATR production is of the larger 70-seat class ATR 72, with few 42s now being built).

"We could put a 50-seat aircraft on a lot of our routes, and going back in history a lot of them did have 50-seat aircraft with the Fokker Friendship," Davis noted. "But what we have found with our model is that the market responds very well to frequency, so putting on a 50-seat aircraft would mean a drop in frequency, and that will affect the demand from the market. We'd much rather run six or seven flights with a 30-seat aircraft than four or five flights a day with a 50-seat aircraft."

Not only would Rex have to cut frequencies, some routes would have to be cut altogether as they would be uneconomic for a 50-seater. This could force quite a significant recasting of the Rex business model.

"Moving to a larger aircraft means some of our smaller routes would have to be abandoned, unless the government decided it wanted to support air services to the smaller country towns."

Even though the youngest Saab was built in 1999, Davis said there was no great urgency in sourcing a replacement. "Given the lead time to introduce a new type we'd have to start looking around in about 10 years to see what is on the market. So we don't have to look right now, but it's certainly a problem not just for Rex but for all of regional aviation, and it's not just the Saab replacement, there's no 19-seater Metro replacement, there's no real Chieftain replacement, so this is a problem for the whole of the industry."

In the meantime, Rex is planning to take delivery of the final eight of 25 ex American Eagle Saab 340B Pluses being leased from Saab Aircraft Leasing under a deal announced in September 2006. Four older Saab 340s are being sold off.

Certainly, with new aircraft coming in and no shortage of pilots to fly them, plus its strong financial position (including no debt) and portfolio of aviation businesses, Rex looks well positioned to take advantage of any return to economic growth. ■