Lim Kim Hai: 'We grow in partnership with the community'

FLIGHT OF THE BUSH PHOENIX

THE ECONOMICS OF REGIONAL AIRLINES TURN EVEN NEAR-MONOPOLY SERVICES INTO HARD WORK – BUT REGIONAL EXPRESS UNDER EXECUTIVE CHAIRMAN LIM KIM HAI HAS FOUND A DIFFERENT STRATEGY.

STORY • KEVIN CHINNERY

SINGAPOREAN BIOTECHNOLOGY AND internet investor Lim Kim Hai likes "to have an unfair advantage in business". When he bought into the airline Regional Express as a passive investor in 2002, his unfair advantage looked grimly effective. Apart from Chris Corrigan's stake in Virgin Blue, few if any investors were beating a path to the casualty-ridden aviation sector.

Rex was a product of the 2001 wreck of Ansett, merging the busted airline's regional subsidiaries Hazelton and Kendall Airlines and their services in New South Wales, South Australia and Victoria. At the time, "there was an irrational fear of airlines", Lim, the executive chairman and biggest shareholder in Rex, says. "It was a perverse advantage: I was an outsider, so I could be more rational" about the prospects.

Rational maybe, but he was still a novice in an industry with economics that have cruelled even the best managers. After a dreadful start for Rex in 2002 and 2003, Lim took over the hands-on control and by 2005-06 the airline had achieved an after-tax profit of $15.7 million on revenues of $166.2 million. A listing on the Australian Stock Exchange in November 2005 also raised $32 million in cash.

The 2005-06 result represented a 141 per cent rise in profit on the previous year on a 20 per cent rise in revenue. Even after that climb, the carrier is forecasting a cruise to a further 20 per cent rise in after-tax earnings for the full 2007 financial year.

"It's one of the most profitable airlines in the Asia-Pacific region," says Derek Sadubin, chief operating officer of the Centre for Asia Pacific Aviation, an airline industry consultancy. "It's been a wonderful turnaround on its predecessor."

It was Lim the airline outsider who found another way of doing things. Aircraft are expensive, and their

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operating costs are high and fixed. Maximum aircraft time aloft, with maximum paying passengers on the seats – aircraft utilisation and passenger load factors – are critical. International operations do best on these benchmarks, followed by domestic capital-city services. Regional airlines are the worst, even when, like Rex, they are often the only operator in town.

"We can't fly overnight," Lim says. "We serve towns where demand is only in peaks at the start and the end of the day. In Australia, a regional city with 50,000 people is considered large, but an airline in the United States or Europe would not even look at it. Load factors for regional airlines globally sit about 55 per cent against the 70 per cent most international airlines work with."

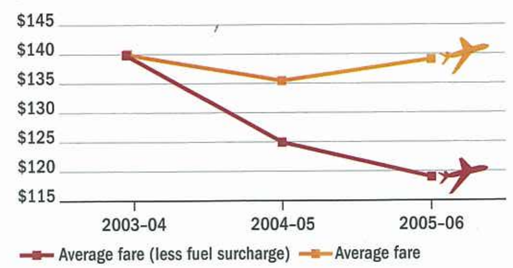
So the airline turned the usual formula on its head. "We stopped chasing the load factor," Lim says. "We have a load factor band that is optimal for us at around 65 to 70 per cent" – in fact, it hit 69 per cent in the 2007 first half to December – "but airlines with a monopoly and heading towards 70 per cent load factor are very happy, and they raise their prices. What we do instead is counter-intuitive: we add more capacity, bring down the fares and the load factors until new demand cuts in."

This comes from new passengers and flying at different times of the day to completely change historic passenger demand trends. "In Port Lincoln, with 15,000 people, we now have a service nine times a day," Lim says. "We start on four then work to five and so on. We grow in partnership with the community. We give them low fares and high service, and it works financially for us."

The model evolved out of trial and error, Lim adds. "We were able to spot the winning strategy on a few of our routes and then we applied it across the network." He does not know of any other airline doing anything similar. "It's completely contrary to the theory of monopoly pricing," he says.

Rex is a sole operator on most of its 38 routes and goes head-to-head with QantasLink, its biggest regional rival, on just four. (A handful of marginal routes in NSW are formally licensed to keep them to a single, protected operator). "The first and foremost priority is to continue expanding by servicing the same routes more intensively," Lim says. The airline adds new routes only if they use the economies of scale of an existing hub airport. It also slams the door on new entrants or the return of QantasLink.

REGIONAL EXPRESS AVERAGE PASSENGER FARE



Source: Rex annual report

The expansion at Port Lincoln, South Australia, came after QantasLink quit from a short presence on the route last year, and Rex added 50 per cent more capacity when QantasLink left Burnie, Tasmania. In February, new services were added between Sydney and the NSW towns of Grafton and Taree after the withdrawal of Big Sky Express.

A move further north into Queensland ended last year when Rex decided not to buy the Brisbane airline Sunshine Express. At the same time, it axed uneconomic services to Armidale, NSW, Devonport, Tasmania, and Portland, Victoria.

The entry barrier is formidable, Lim says. "No one can compete on price because it is already very low, and if you try to come in with three services against nine you would be trashed. Our markets are too small for big jet operators to come in with turboprops to service towns of 30,000 people. But we are too big for guys who want to start with two or three aircraft – those days are over."

Soaring fuel prices can actually help. "Our prices have been going down as surcharges have been going up, so it still looks cheap. Our main competition for business travellers is the car. Petrol-pump prices are high and three hours in the car and back is expensive compared to a $99 ticket from us."

Traffic on capital-city routes made the big switch from car to aircraft more than a decade ago, but Rex is still gaining so-called modal shift every time it ramps up frequency or enters a new town.

"On the new routes, they have never seen our pricing before," Lim says. "A benchmark of $99 for a ticket on the one-hour sector picks up a lot of entry-level business."

Rex is now locking up future capacity. It operates 31 out-of-production Saab 340 aircraft and leased an additional 25 of the later model, 34-seat Saab 340B Plus aircraft last year. Taking all the new aircraft at once means better lease terms than Rex has on most of the existing fleet, Lim says.

The expansion is still flexible: the minimum uptake is nine aircraft over three years, which can be absorbed if necessary by replacing older aircraft coming off lease. As it is, Rex will take eight in the first year and still not meet demand. "So everything is prepared for expansion", depending on what Qantas does eventually on regional routes.

Rex passenger numbers hit 1.2 million in the full year to last June. It also achieved a 20 per cent rise year-on-year in the first half of the current financial year and is continuing to outpace percentage growth in available seats.

Even with ticket price growth down by 3 per cent once the fuel levy is excluded, the airline's first-half, after-tax revenue margin of 10.9 per cent was better than both Qantas and Singapore Airlines and only just behind the rebounding Virgin Blue.

"The model is sustainable, there is every chance of keeping it going," Sadubin says, adding: "The main challenge is the overhang of Qantas and QantasLink on regional routes where they do not want to operate" as a result of the airline's undertakings to the federal government to protect marginal regional services in exchange for approval of its private equity sale plans.

Rex has been lobbying the federal Minister for Transport and Regional Services, Mark Vaile, to let it have the routes instead, arguing that it would do a better job than a reluctant Qantas.

Virgin Blue is deploying new Embraer 170 regional jet aircraft this year, but Sadubin believes they are unlikely to go head-to-head with Rex.

Unlike many regional airlines, Rex no longer depends on feeding passengers to larger airlines. Its market is in states that are drought-hit rather than mineral-rich so it has not had to rely on the mining boom either – although mining demand has been good for its charter business – and the return of rains should boost scheduled passengers again.

Lim also plays down the importance of government travel contract business, such as a recent $60 million NSW government tender. "They are not winner-take-all," he says. "They are shared, and travel managers still decide on route and price."

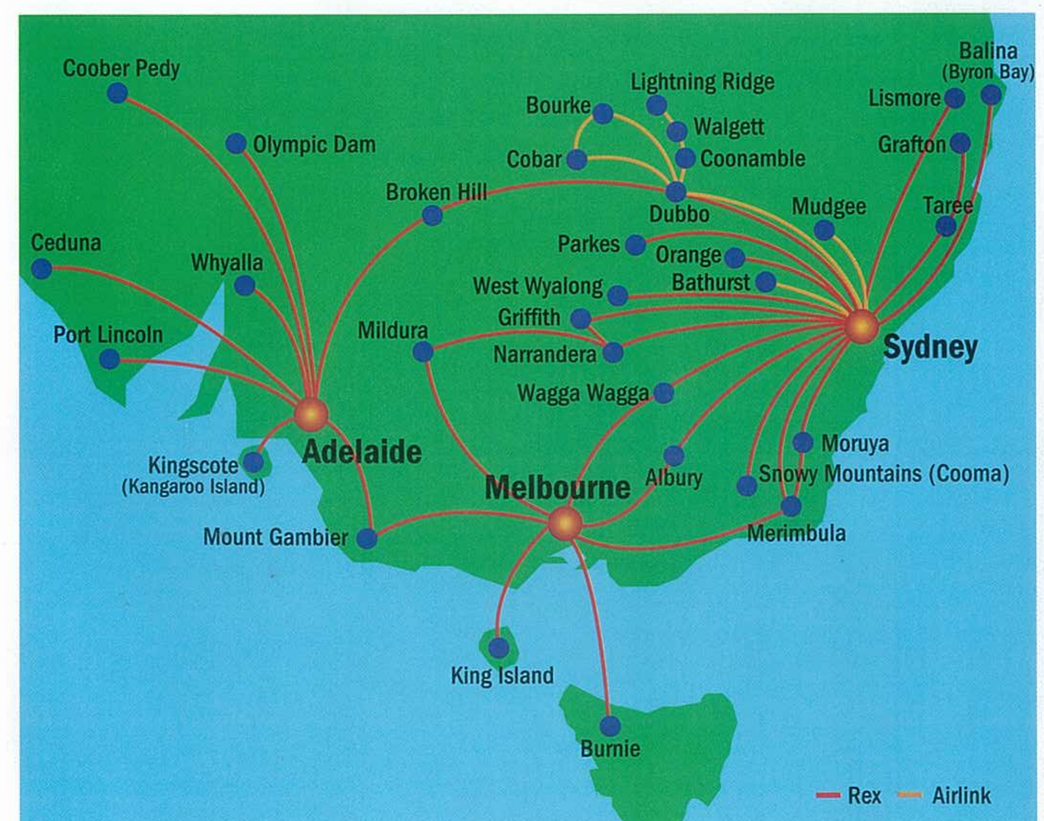
Lim's first year at Rex appeared to simply confirm that airlines are a risky investment. He had initially bought in as a passive investor but withdrew from the board after six months as Rex headed towards a $30 million first-year loss. Lim returned only on condition of executive control. "If we lose money, at least we would lose it in our own way," he says.

However, he had seen something solid in the business. "It had things going for it. It was managing 1000 flights a week, and that meant that it was operationally sound."

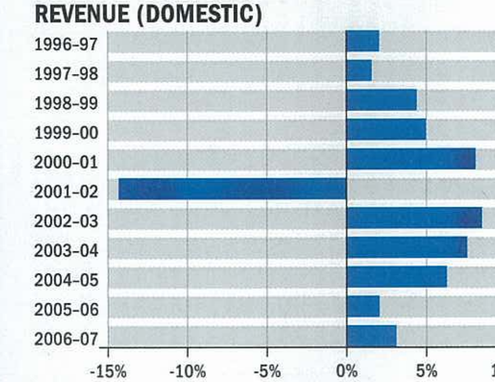
Lack of airline experience meant room to apply common sense. "Airlines are complex. There is no single brainwave to fix them. It is the ability to handle hundreds and thousands of small things and get them right. When we started, we said, 'Let's just get a little bit better each day'."

A small but typical example were credit card charges, Lim says. "We wanted to levy according to different types of cards, because American Express charges much more than others. But there was no system that could handle that so airlines either charge an average of all cards or a flat fee which does not charge back to Amex.

"We worked for a year and now we can charge according to the card. We handled things as a business not as an airline, where there is a tendency to say things have always been done this way." ●



AUSTRALIAN AIRLINE INDUSTRY REVENUE (DOMESTIC)



Source: IBISWorld

Flight paths: Competing services to regional towns and cities in the south-east