

Regional Express Holdings Limited (REX)

Clear skies expected!

Recommendation: Buy

05 September 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

- NPAT of \$23.6m was marginally above our \$22.8m forecast. Revenue grew 29% to \$225m and profit before tax margin improved 210bp to 14.7%.
- The number of passengers grew 18% in FY07 to 1.42m. Increased routes, flights per route, and transition to the new SAAB340 planes saw key metric, Available Seat Kilometers (ASK), increase 14% to 782m.
- The full year dividend of 6.6cps fully franked compares to 5cps in FY06.
- Management forecast earnings growth of 10%.

Impact

- While FY07 was a strong year for all airlines, we believe REX holds particular promise. REX remains sole operator on 31 of its 39 routes.
- We believe guidance is conservative, particularly given expected improvements in load factor of around 15% in FY08.
- Our FY08 NPAT forecast increases \$1m to \$29m implying EPS of 24cps, suggesting earnings growth of 18%.

Recommendation Impact

Recommendation remains a Buy.

Recommendation Trigger Guide

BUY	ACCUM	HOLD	REDUCE	SELL
\$2.65	\$2.85	\$3.75	\$4.15	

Note: Marker indicates price of \$2.48 at publication date.

Snapshot

Last Price	\$2.49
Market Cap.	\$301 million
52 Week High	\$2.88
52 Week Low	\$1.04
Shares on Issue	121.0 million
Sector	GICS - Transportation

Valuation

Intrinsic Valuation \$NaN

Risk

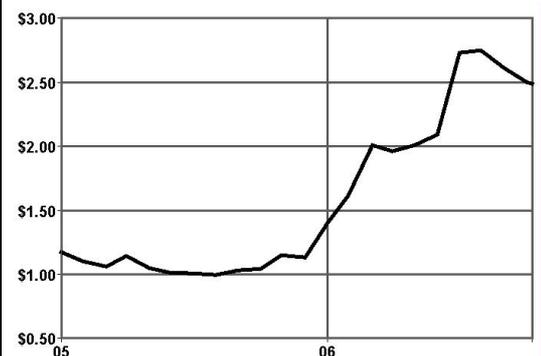
Business Risk	Medium
Pricing Risk	Medium
Company Beta	0.77
Sector Beta	0.96

Investment Fundamentals

Year-end Jun	FY06A	FY07A	FY08E	FY09E
NPAT (\$m)	15.7	23.1	30.0	30.0
EPS (¢)	15.4	20.4	24.0	24.0
EPS Growth (%)		32.5	17.6	0.0
PE Ratio (x)	6.9	8.1	10.4	10.4
DPS (¢)	5.0	6.6	9.0	9.0
Dividend Yield (%)	4.7	4.0	3.6	3.6
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

NPAT of \$23.6m was marginally above our \$22.8m forecast. Revenue grew 29% to \$225m and profit before tax margin improved 210bp to 14.7%. Diluted EPS was up 32% to 20.4cps. The full year dividend of 6.6cps fully franked compares to 5cps in FY06.

The number of passengers grew 18% in FY07 to 1.42m. Increased routes, flights per route, and transition to the new SAAB340 planes saw key metric, Available Seat Kilometers (ASK), increase 14% to 782m. The increase in ASK coupled with a 1.4% improvement in Load Factor to 68.3%, essentially a utilisation measure, drove total passenger revenue growth of over 20%.

Cost per ASK grew a small 0.7% to 22.7cps and excluding fuel, was steady at 18.6cps. Fuel costs as a percentage of total costs rose 50bp to 18.3%. This compares with a 5.8% increase in Revenue per ASK to 25.6cps.

REX continues to operate one style of aircraft which greatly reduces maintenance costs. As it slowly upgrades its SAAB 340 planes to SAAB 340 B aircraft, older planes are being moved into Pel Air for freight and charter use, as did the metro's when REX completed the upgrade to the current fleet in October 2006. For the six-month inclusion of Pel-Air, the charter and freight company managed an 11% increase in revenue to \$36.45m with EBIT of \$5.2m. AirLink almost doubled revenues to \$9m, producing EBIT of \$2.8m.

REX competes with QantasLink on only four routes, with QantasLink withdrawing from Port-Lincoln-Adelaide, Kingscote-Adelaide, and Burnie-Melbourne in FY07. New domestic entrant Singapore's Tiger Airways will likely achieve some success but unlikely at significant expense to REX. Tiger's current fleet of A320-200s are unable to land at all but three REX routes. Tiger appears to be focusing on the larger domestic routes in competition with Virgin and Jetstar. We do not believe the economics of REX's routes support a complete fleet readjustment for the larger airlines.

REX is entering Queensland with the introduction of a Brisbane – Maryborough service beginning October 2007. The company says it can service the Brisbane route at very low cost, allowing them to considerably reduce prices and compete aggressively.

While FY07 was a strong year for all airlines, we believe REX holds particular promise. REX remains sole operator on 31 of its 39 routes. The company ensures that no one route is particularly profitable to attract competitors. The top six routes make up less than 25% of profit. This, coupled with the small size of the markets serviced, the considerable capex required by competitors on new planes and/or runways to service these small routes, REX's proven reliability and low-volume low-cost base, favourable legacy timeslots, and joint-ventures with councils in areas serviced, gives us confidence that REX will retain monopoly services to these areas.

Management forecast earnings growth of 10%. We believe this conservative, particularly given expected improvements in load factor of around 15% in FY08. REX will likely exceed guidance considerably, with a possible upgrade in the half year result. Our FY08 NPAT forecast increases \$1m to \$29m implying EPS of 24cps. This suggests earnings growth of 18%. Our FY09 NPAT is \$30m and EPS 24cps. We believe our forecasts remain conservative, particularly flat earnings growth for FY09. Our valuation of \$3.35 remains and is considerably above the current \$2.50 share price.

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 Lark Lim	10.0%
Kerk Chuan Seah	9.0%
Canberra Air Pty Limited	7.7%
Kim Hai Lim	6.8%
Ming Yew See Toh	6.5%

Previous Research

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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