

# Regional Express Holdings Limited ( REX )

Share price turbulence causes undue concern

**Recommendation: BUY**

13 December 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

- Share price has fallen with concerns over shortage of pilots and increases in costs, in particular fuel cost. We believe the pilot shortage will hurt FY08 profits by limiting expansion plans. We remain confident in REX as a longer term story but short-term deterioration in operating performance will influence share price. We see share price weakness as an opportunity to Buy, but remind subscribers that the period of underperformance may last upwards of a year. REX maintains guidance of 10% NPAT growth.

## Impact

- Unlike most airlines REX has no debt. Key to our valuation is free cash flow. Airlines typically trade on low earnings multiples because of their capital intensive nature. REX planes are cheap which helps free cash flow. We estimate REX will produce \$17m in free cash flow in FY08, which at \$2.00 is a 7% free cash flow yield. This is a reasonable return for a difficult year.

## Recommendation Impact

Recommendation remains a Buy

## Recommendation Trigger Guide

BUY	ACCUM	HOLD	REDUCE	SELL
\$2.40	\$2.65	\$3.50	\$3.90	

Note: Marker indicates price of \$2.07 at publication date.

## Snapshot

Last Price	\$2.07
Market Cap.	\$250 million
52 Week High	\$2.88
52 Week Low	\$1.44
Shares on Issue	121.0 million
Sector	GICS - Transportation

## Valuation

Intrinsic Valuation \$3.20

## Risk

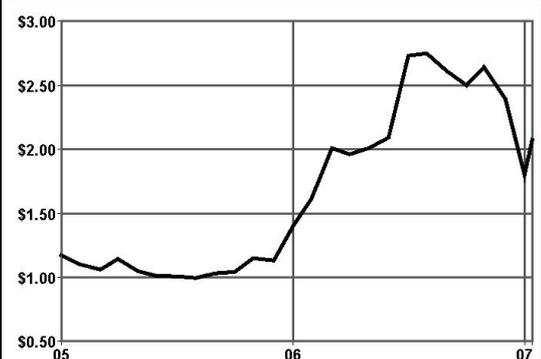
Business Risk	Medium-High
Pricing Risk	High
Company Beta	0.78
Sector Beta	0.96

## 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 (%)		32.8	5.9	19.0
PE Ratio (x)	13.5	10.1	9.6	8.1
DPS (¢)	5.0	6.6	7.0	8.0
Dividend Yield (%)	2.4	3.2	3.4	3.9
Franking (%)	0	100	100	100

Source: Aspect Huntley analyst estimates.

## Price Chart



## Business Description

Rex is the largest independent regional airline. Rex operates an airline servicing regional routes and was established in 2002 with the merger of Hazelton and Kendell. REX is the sole provider in the majority of its routes. REX also operates charter and freight flights through now wholly owned Pel Air and Airlink.

### Event Analysis

Share price has fallen with concerns over shortage of pilots and increases in costs, in particular fuel cost. We believe the pilot shortage will hurt FY08 profits by limiting expansion plans. We remain confident in REX as a longer term story but short-term deterioration in operating performance will influence share price. We see share price weakness as an opportunity to Buy, but remind subscribers that the period of underperformance may last upwards of a year. REX maintains guidance of 10% NPAT growth.

Results for first quarter FY08 indicated the load factor of 66 for the quarter was 2% below 1Q07 and below the average for FY07 at 68.3. If you break this down monthly we see a poor July at 65.3 compared with 66.1pcp, a softish August at 66.2 compared with 66.8 pcp, and a flat September at 69, the same as pcp. Load factors are key to profitability. Once load factors reach 70 on any particular route REX typically adds another flight. REX says the deterioration in load factors came from putting on extra flights early in the year. The load factor is now around 69 and could temporarily rise above 70 as capacity constraints hold back the introduction of new flights.

Previously targeted 20% pa capacity growth for the next three years remains an objective but will unlikely be met in FY08. Year to date REX still managed to increase Available Seat Kilometers (ASK) by 12%. September was its worst month and the last month in which there were flight cancellations. Cuts in flights saw ASK fall from 71.36m in August 07 to 66.09m in September 07. REX expects to be in a good position by March 08. We forecast a 5% increase in ASK in FY08 rebounding to a 21% increase in FY09.

The first quarter result saw a 32.2% jump in 'Other Costs and Expenses' against a smallish 6.9% increase in Passenger Revenue. This was initially alarming given the importance of cost control to profits. The reason is the first time inclusion of Pel Air which was Equity accounted in 1Q07 but fully consolidated in 1Q08. Revenue from Pel Air was not included in Passenger Revenue as it operates freight and charters. If you compare Cost per ASK, which excludes Pel Air, then costs remained steady on last year at 18.4 cents per ASK, excluding fuel. Most of the low lying fruit has been plucked in terms of cost savings for REX, but potential savings remain. REX will soon target the engineering division.

Jet fuel price typically follows oil price on a one month lag. We assume oil remains at US\$100 to the end of FY08, implying a US\$87.2 average price, accounting for the lag. Oil is assumed to remain US\$100 in FY09 rising to US\$110 in FY10. Assumptions of a constant refinery margin and surcharges coupled with US\$/A\$ forecasts of 87.6, 90.0, and 95.0 cent average exchange rates for FY08, FY09, and FY10 sees the price of fuel per litre increase 13% in FY08, 12% in FY09, and 3% in FY10. We expect REX's fuel bill to increase more than this, namely 15%, 35.5%, and 14.6% in FY08, FY09, and FY10 from increased flights. We expect the fuel surcharge to remain at \$27.

Unlike most airlines REX has no debt. Key to our valuation is free cash flow. Airlines typically trade on low earnings multiples because of their capital intensive nature. REX planes are cheap which helps free cash flow. We estimate REX will produce \$17m in free cash flow in FY08, which at \$2.00 is a 7% free cash flow yield. This is a reasonable return for a difficult year.

**Profit & Loss (\$M)**

Year to 30 Jun	2005A	2006A	2007A
<b>Sales Revenue</b>	--	<b>170</b>	<b>224</b>
Total Revenue ex. Int.	--	173	224
<b>EBITDA</b>	--	<b>25</b>	<b>38</b>
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
<b>Profit after Tax</b>	--	<b>16</b>	<b>23</b>
Significant Items after Tax	--	--	--
<b>Reported Profit after Tax</b>	--	<b>16</b>	<b>23</b>
Preferred Dividends	--	--	--

**Ratios and Substantial Shareholders**

Year to 30 Jun	2005A	2006A	2007A
<b>Profitability Ratios</b>			
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	14.81

**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	19.3%
Joe Tiau Tjoa	11.5%
Kim Lark Lim	10.0%
Kerk Chuan Seah	9.0%
Canberra Air Pty Limited	7.7%

**Previous Research**

09/11/2007	Pilot shortage sees services cut!
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
<b>Net Operating Cashflow</b>	<b>5</b>	<b>27</b>	<b>39</b>
Capex	-15	-18	-34
Acquisitions & Investments	--	-14	-5
Sale of Invest. & Subsid.	--	--	--
<b>Net Investing Cashflow</b>	<b>-7</b>	<b>-33</b>	<b>-36</b>
Proceeds from Issues	4	35	--
Dividends Paid	--	--	-7
<b>Net Financing Cashflow</b>	<b>9</b>	<b>25</b>	<b>-6</b>
Net Increase Cash	6	19	-4
Cash at Beginning	1	5	24
Exchange Rate Adjust.	--	--	-1
<b>Cash at End</b>	<b>8</b>	<b>24</b>	<b>19</b>

**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
<b>Current Assets</b>	<b>24</b>	<b>36</b>	<b>38</b>
Prop. Plant & Equipment	32	46	111
Intangibles	--	1	7
Other Non-Current Assets	4	1	1
<b>Non-Current Assets</b>	<b>54</b>	<b>64</b>	<b>120</b>
Total Assets	78	100	157
Interest Bearing Debt	--	--	6
Other Liabilities	27	32	55
<b>Total Liabilities</b>	<b>27</b>	<b>32</b>	<b>55</b>
Net Assets	51	69	102
Share Capital	69	70	82
Reserves	--	-2	1
Retained Earnings	-18	2	19
Outside Equity Int.	--	--	--
<b>Total Shareholders Equity</b>	<b>51</b>	<b>69</b>	<b>102</b>

**Principals & Directors**

**Principals**

Chairman	Mr Kim Hai Lim
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 James (Jim) Davis(Executive Director Operations)
Mr Thian Soo Lee(Non-Executive Director)
Mr Robert Winnel(Independent Director)
Mr Stephen Jermyn(Non-Executive Director)

© Copyright Huntleys' Investment Information Pty. Limited (HII) (a wholly owned subsidiary of Aspect Huntley Pty Limited),2007. All rights reserved. Australian Financial Services Licence no. 240892. No material may be reproduced, except as allowed by the Copyright Act, without the prior written approval of HII. Some of the material provided by HII is copyright and is published under licence from ASX Operations Pty Limited ACN 004 523 782 ("ASXO"). Consensus forecast data is copyright Thomson Financial.

DISCLAIMER: While the above-mentioned advice and information are based on information, which HII consider reliable, its accuracy and completeness cannot be guaranteed. This report is made without consideration of any specific clients investment objectives, financial situation or particular needs. Those acting upon such information do so entirely at their own risk. For a copy of HII's Financial Services Guide, please go to <http://www.aspecthuntley.com.au/FSG> or phone HII on (02) 9256 8000 to request a copy.

DISCLOSURE: The directors and associated persons or entities of HII may have an interest in the securities discussed in this report.