



24 November 2005

# PRICE | \$1.10

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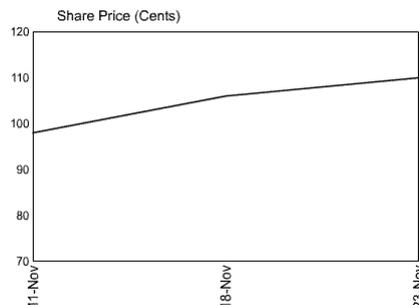
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Fully diluted shares  
on issue | 115M

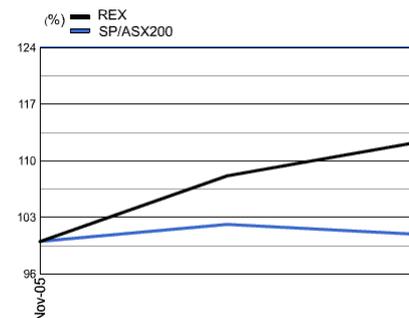
## Performance & Valuation

Last Price | \$1.10  
52 wk hi/low | \$1.11 / \$0.95  
12 mth price target<sup>3</sup> | \$1.53  
Valuation | \$1.33  
Valuation methodology | DCF

## Share price performance



## REX versus SP/ASX200



# Regional Express Holdings Ltd | REX

## Initiating coverage

### Key points

- REX listed on the ASX on 9 November 2005, with a market capitalisation of \$115M.
- The Prospectus valuation multiples suggested a PER of 7.6X this year (A-IFRS) and enterprise multiple of 3.1x.
- REX provides regional airline passenger services and the 50% stake in Pel-Air allows it to also provide airfreight services.
- Pel-Air offers a number of opportunities for REX including a more stable earnings profile, substantial cost synergies and access to facilities that it can use to launch additional passenger services.
- Its fundamentals outpace any comparable airline in Australia by a big stretch and match some of the best arithmetic on offer overseas.

### Comment

- REX has monopoly control over 60% of its routes (due in part to State Government edicts). The economics and history of regional airlines in Australia shows a clear case of market failure which can only be redressed by Government intervention.
- Of the 33 routes in the REX network, 21 are serviced by REX alone.
- The company has enjoyed substantial increases in traffic since its inception and it has a highly coveted 540+ weekly slots available to it at Sydney Airport (where restrictions make access times highly valued).
- It achieves load factors above 65% (and well above 70% on some routes) and has leverage to population shifts away from the cities.

### Investment View

- Our arithmetic on an actual tax-paid, puts REX on a PER of 6.4x this year. This compares with QAN on 11.8x.
- There are risks associated with airlines and there has been a confluence of negative factors undermining airline prosperity in recent years – drought, SARS, collapse of Ansett and 9/11.
- We believe risks still remain but would argue that REX has a balance sheet and business strategy that will allow it to meet these excesses head on and they are well and truly factored into the modest forecast multiples.

## Earnings Summary

Y/E Jun	2005A	2006F	2007F
Revenue - A\$M	137.1	146.6	155.9
EBITDA - A\$M	16.2	23.8	28.2
NPAT (reported) A\$M	13.5	19.7	18.5
NPAT (normalised) A\$M <sup>1</sup>	13.5	19.7	18.5
EPS (diluted) - cents <sup>2</sup>	16.9	17.1	16.1
EPS (diluted) - % chg	n/a	1.6	(6.4)
PER (diluted) - x <sup>2</sup>	6.5	6.4	6.9
DPS - cents	0.0	0.0	4.0
Dividend Yield - %	0.0	0.0	3.6
Franking - %	0	0	35

Notes:

1. Normalised earnings is pre goodwill, amortization and after adding back non-recurring items.

2. Based on normalized earnings.

3. Price target is calculated by moving current valuation one year forward.

# Final results analysis & outlook

Regional Express Holdings Ltd | 24 November 2005

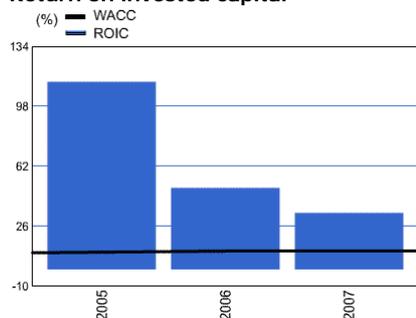


## Valuation

Methodology: DCF<sup>1</sup>

Key assumptions	
Beta	1.3
WACC %	11.2
Forecast period years	10.0
Risk premium %	5.5
PV cash flows \$M	143.4
less net debt/(add cash) \$M	(9.4)
add equity adjustments <sup>2</sup>	0.0
Total	152.8
Fully diluted shares on issue M <sup>2</sup>	115.0
Value per share \$	1.33

## Return on invested capital



## Ratio analysis

Year end Jun	05A	06F	07F
Revenue growth %	0.0	6.9	6.4
EBITDA growth %	n/a	47.0	18.3
EBITDA margin %	11.8	16.2	18.1
EBIT margin %	9.0	13.4	13.1
Tax rate %	0.0	8.0	30.0
ROA %	31.0	24.3	19.8
ROE %	96.8	36.0	22.5
Net debt/equity %	0.5	(30.1)	(44.8)
Net interest cover x	17.7	NaN	n/a
Capex to deprec'n %	397.4	122.2	70.9
NTA per share \$	0.23	0.64	0.78

## Multiple analysis

Year end Jun	05A	06F	07F
Market cap M	125		
Net debt (cash) \$M	(9.4)		
Options \$M	0.0		
Enterprise value \$M	116.0		
EV/EBITDA x	7.2	4.9	4.1
EPS c	16.9	17.1	16.1
P/E x	6.5	6.4	6.9
Cashflow / Share c	(7.4)	19.5	22.4
Price / NTA x	4.7	1.7	1.4

## Shares outstanding

Year end Jun	05A	06F	07F
Basic M	80.0	115.0	115.0
Other M	0.0	0.0	0.0
Fully diluted M	80.0	115.0	115.0

## Notes:

1. Discounted cash flow. 2. Equity adjustments and shares on issue include all notes and options on issue (if in the money or deemed appropriate).

Year end Jun	2005A	2006F	2007F
<b>Profit &amp; Loss Summary   A\$M</b>			
Operating revenue	137.1	146.6	155.9
Invest & other income	0.0	0.0	0.0
EBITDA	16.2	23.8	28.2
Depreciation/Amort	(3.8)	(4.2)	(7.7)
EBIT	12.4	19.6	20.5
Net Interest	(0.7)	0.7	1.7
Pre-tax profit	11.7	19.5	22.2
Tax expense	0.0	(1.6)	(6.7)
Minorities/Assoc./Prefs	1.8	1.8	2.9
NPAT	13.5	19.7	18.5
Non recurring items	0.0	0.0	0.0
Reported profit	13.5	19.7	18.5
add goodwill/non recurring	0.0	0.0	0.0
Adjusted profit	13.5	19.7	18.5
<b>Cashflow Summary   A\$M</b>			
EBITDA	16.2	23.8	28.2
Working capital changes	0.0	(0.5)	(0.1)
Interest and tax	(0.6)	(0.9)	(2.3)
Other operating items	(21.5)	0.0	0.0
Operating cashflow	(5.9)	22.4	25.8
Required capex	(15.1)	(5.1)	(5.5)
Maintainable cashflow	(21.0)	17.3	20.3
Dividends/Other	0.0	0.0	(2.3)
Acq/Disp	6.4	(30.1)	0.0
Other investing items	4.2	0.0	0.0
Free cashflow	(10.4)	(12.8)	18.0
Equity	0.0	35.0	0.0
Debt inc/(red'n)	4.6	(22.2)	(18.0)
<b>Balance Sheet   A\$M</b>			
Cash & deposits	4.5	22.6	40.6
Inventories	3.0	3.4	3.6
Trade debtors	7.3	7.4	7.3
Other curr assets	4.5	4.5	4.5
Total current assets	19.3	37.9	56.0
Prop., plant & equip.	24.5	55.5	53.3
Non-curr intangibles	0.0	0.0	0.0
Non-curr investments	1.9	3.7	6.6
Other non-curr assets	4.6	4.6	4.6
Total assets	50.3	101.7	120.5
Trade creditors	12.4	12.4	12.5
Curr borrowings	0.5	0.5	0.5
Other curr liabilities	13.5	14.3	16.9
Total current liab.	26.4	27.2	29.8
Borrowings	4.1	0.0	0.0
Other non-curr liabilities	1.2	1.2	1.2
Total liabilities	31.7	28.4	31.0
Minorities/Convertibles	0.0	0.0	0.0
Shareholders equity	18.6	73.3	89.5

# Final results analysis & outlook

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Regional Express Holdings Ltd | 24 November 2005



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Year end Jun	2005A	2006F	2007F
<b>Divisional Summary A\$M</b>			
<b>Revenue</b>			
Division 1	137.1	146.6	155.9
.....			
<b>EBITDA</b>			
Division 1	16.2	23.8	28.2
.....			
<b>Margin %</b>			
Division 1	11.8	16.2	18.1

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# 1 | SWOT

## Strengths

- Regional monopolies protected by Government legislation.
- Excellent track record at a time when fundamentals were negative.
- Exposed to regional centres which are gaining from population drift.
- No debt and capacity to buy aircraft on much more attractive terms than lease.
- De-risked through acquisition of more stable earnings stream (Pel-Air).
- Substantial holder of “slots” at Sydney Airport.
- Partnership with the bush.
- Strong brand recognition.
- Experienced workforce.

## Opportunities

- Opportunities through charter and expansion using Pel-Air airport facilities.
- Defence contracts (Pel-Air).
- Opening up of NSW Government ticketing for government employees.
- New routes (potentially Queensland).
- Cost savings through merging Pel-Air.
- Industry consolidation (balance sheet muscle), as well as other offshore opportunities.

## Weaknesses

- Maintaining skilled labour
- In an industry that has serial issues, most of which have significant and negative implications for REX.
- Exposed to CASA edicts for safety upgrades.
- Limited pricing power.
- Exposed to pricing policies of airport owners.

## Threats

- Higher oil prices.
- Usual suspects – drought, bird flu pandemic, terrorism.
- Predatory competitors.
- New competitors; airport pricing models.
- Continuing (and arguably) non-commercial edicts imposed by CASA and DOTARS.
- NSW Government policy change on mandated one carrier, routes.

## 2 | Overview

### Preamble

**Yes, it is an airline...**

Yes, it is an airline. This is usually the point where most investors roll their eyes and remind you of 9/11, SARS, drought, terrorism and possible bird flu pandemic. And that makes for a very interesting debate, some of which may be relevant but most of which is academic and no more than a distraction.

**But you only pay 6.4x current year earnings**

Yes it is an airline, but that is why you pay 6.4x current year earnings and not 16x (market average). Yes it is an airline, but it is not exposed to the highly competitive trunk route corridors in Australia (namely, the east coast and where Impulse airlines got caught in a territorial price war back in 2000) and the aircraft do not venture outside of Australian airspace.

**Many reasons to avoid the airline industry**

There are many reasons to avoid investing in the airline industry and many anecdotes that you could proffer as reasons for avoiding REX. The history of the industry in Australia has been a graveyard for well meaning (but poorly vested) capital and more than 70 carriers have disappeared over the last 20 years. A number have been swallowed up by larger carriers, but a number have also fronted liquidation, receivership and bankruptcy. The most notable name on the scrapheap was Ansett Airlines, which went down in 2001.

**The view of the Australian industry is equally coloured by the revolving Chapter 11 door in the US**

Against that background, the debate in Australia now centres on the two listed domestic carriers - Virgin (ASX:VBA) and Qantas (ASX:QAN) – and peripherally on the only other listed regional carrier, Skywest (ASX:SKW). And it is easy to be dismissive, as both the majors confront higher oil prices (around 25% of total costs on average) and fight over the same turf in the domestic trunk routes. The view of the Australian industry is equally coloured by the revolving Chapter 11 door in the US which is a quick entry and slow (or never to) exit for many domicile US carriers.

**But what about REX?**

It all adds up in the minds of Australian investors and feeds the view of a high risk industry that offers little growth prospects. True, but what about REX?

**REX was established in 2002**

REX was established in 2002 from some of the rump of the fallen Ansett and is an amalgam of Hazelton Airlines and Kendell Airlines. Both these businesses were successful regional airlines prior to the Ansett collapse and subsequent administration period.

**The business has undergone a complete rebuild**

The business of REX has undergone a complete rebuild and is expected to report a bottom line of around \$20M this year (c/f a loss of \$24M in FY03). What has changed in that time would provide an excellent case study for business school candidates and a salutary lesson in applied business techniques.

**Key to success was not in the revenue line**

The management of REX understands that the airline's key to success was not in the revenue line (that is, don't maximise what you can't control) but in the cost line (manage what you have some control over, costs). Costs per ASK (average seat kilometres – measure of capacity), is forecast to record a 10% decline on predicted arithmetic for this year over FY04 (16% if oil prices had remained the same). By the same token, average airfares have fallen 21% since the company began operations in FY03. *But its return on assets last year was 18% (operating margin also of 18%), and it is predicted to be 19% this year (22%).* This compares with:

- QAN of 4.8% (forecast for FY06) and operating margin this year of 17%, or
- VBA of 10% and 22% (forecast) respectively.

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**High fixed costs and low variable costs**

Operating an airline is a very simple proposition: high fixed costs and low variable costs means you have to at least cover your variable costs and anything above that contributes to fixed costs. That is the starting point (airline economics 101). This position can be used to establish a cross subsidised model, whereby the more profitable routes subsidise the less profitable routes (which in many cases are the newer routes). This will move the company to at least break even so that it can sustain itself without the need for external capital. For REX, that occurred during the 2004 financial year.

**Be equally mercenary and adjust or cancel scheduling**

The second stage is to set a plan in action which ensures that the return from each of your routes meets at least your cost of capital and can be (potentially) leveraged up above this cost. That is, they have the capacity to be sustainable above a fully costed route benchmark. In the event that the route dynamics are not attractive and this is unlikely to change, then the company has to be equally mercenary and adjust or cancel its scheduling. REX has withdrawn a range of services since it began operations in 2002, including, Sydney- Coffs Harbour; Sydney-Latrobe Valley and Melbourne-Devonport.

**REX monitors all its route traffic weekly**

The third stage is to expand where the potential route arithmetic looks tempting. REX monitors all its route traffic weekly and monitors other routes where it has no presence but where the dynamics appear attractive. For instance, REX started flying between Sydney and Cooma (Snowy Mountains) in June 2005 and Sydney and West Wyalong in March 2005. It moved from commercial trial to full commercial services in September this year for the West Wyalong service. This was in concert with the Bland Shire Council which "partnered" with REX for this trial and has been (typically) very supportive. The load factor for the West Wyalong-Sydney route touched 70% in September (c/f an average load factor for the company of 65%).

**The numbers so far are impressive**

The model is evolving, but the numbers so far are impressive and the financial performance is far ahead of its peers. But that is not all, as the company has several opportunities to advance its performance and has a number of unique and defensible advantages over its competitors:

**REX has a unique and defensible facility at Sydney Airport**

- REX has over 540 weekly slots secured at Sydney Airport, which is more slots than has been secured by QantasLink. It is the third largest holder of slots at Sydney airport and is the largest holder of NSW regional slots. Due to the restrictions and curfew in place at Sydney Airport, this is an enviable and unique component of REX's operations. Additionally, unlike airlines with jet equipment, REX's turbo-prop fleet is able to operate at Sydney during curfew hours.

**REX has mandated monopolies, protected by Government legislation**

- REX offers services to 33 destinations, 21 of which are not serviced by any other airline. Of these, 11 routes are operated by REX only under a NSW Government mandate. While these regional monopolies will be reviewed by the Government and are not guaranteed to prevail in perpetuity, the history of regional airlines in Australia and the economics of operating these services, suggests they are unlikely to change. That is, unless the demographics similarly and dramatically change (and for the better).

**NSW Government travel policy has swung in favour of smaller regional players like REX**

- The company has made very public its issues with the allocation of Government travel plans, which have tended to favour QAN (both Federally and at the State level in NSW). One of the reasons REX stated that it withdrew its Canberra-Sydney route was the discriminatory way Commonwealth airline travel allocations for its public servants favoured QAN. Up until June 2005, the NSW Government travel procurement licence (Contract 1008) was held by Qantas. It was put to public tender and the current contract (effective from 1 December 2005) is held by Carlson Wagonlit Travel (an independent and international travel agent). REX has publicly applauded the tender success of Carlson Wagonlit as it now potentially is a beneficiary of the Government's "best fare of the day" policy.

**REX has been awarded access as a preferred supplier**

REX also tendered for the NSW Government air travel business as an airline supplier and has been awarded access as a preferred supplier. This should provide REX with more Government travel share on competitive routes.

**Balance sheet strength and time on its side**

- There is a real opportunity for consolidation in the industry. The raw catalysts for consolidation include:
  - the ever increasing security and safety upgrades imposed by DOTARS (Department of Transport and Regional Services) and CASA on the industry
  - lack of pricing power of the smaller operators and higher fuel costs, and
  - private ownership of the major hub airports and the cost-plus business approach of regional airports and other suppliers of air transport infrastructure, including Airservices Australia and CASA, which are adopting user pays pricing models.

**Small players getting marginalised**

In the industry, there are four small to medium sized carriers and 25 other smaller carriers. REX now has the balance sheet to get a *big* seat at the table and can use time to its advantage.

**Baby boomers and population shift play into REX hands**

- The shifting population away from the heavily urbanised capital cities is a well established trend in this country and plays right into the hands of regional service providers, such as REX. It is difficult to measure this impact but suffice to say it is a net positive for the company. Anecdotally, Adelaide to Port Lincoln is one of the best performing routes in the Rex network and it attracts a large number of passengers that have moved to Port Lincoln for lifestyle reasons and regularly commute back to Adelaide.

**REX has acquired a 50% stake in an airfreight business, Pel-Air**

- One of the key issues that investors confront with airlines is volatility, notably due to business shocks (force majeure, such as SARS and 9/11). Conscious of this, but also looking for opportunities to expand (and soften) the business base, REX has acquired a 50% stake in an airfreight business, Pel-Air Aviation Pty Ltd. On our arithmetic, Pel-Air was acquired on an enterprise multiple in FY07 of a mere 2.8x (largely due to substantial cost savings on the back of real synergies). The mutual expansion of services using facilities offered by both carriers is compelling and it could provide REX (amongst other things) with a vital beachhead into the lucrative Queensland regional passenger airline market.

**OTP better than the rest**

- REX has the best 'on time' departure record of all major Australian carriers operating out of the highly congested Sydney Airport. This is measured by the OTP (on-time performance) statistics produced by the Commonwealth Department of Transport in the 12 months to June 2005.

**On the basis of end of year cash, our enterprise multiple is below 3X**

- The pricing for REX addressed all the risk factors and the market capitalisation of \$115M puts REX on a Prospectus PER multiple for FY06 of 5.8x and enterprise value multiple of 3.1x. However, on the basis of forecast year end cash, our enterprise multiple is below 3x (on \$1.00 per share offer price).

**It is in a sweet spot**

Yes it is an airline, but it is in a sweet spot and has some of the most attractive fundamentals in the industry. And we believe those fundamentals will improve markedly over the next few years.

**Listed on the ASX on 9 November 2005**

## Float details

REX listed on the ASX on 9 November 2005, with a market capitalisation of \$115M (115M shares @ \$1.00 each). It raised \$35M by the issue of new shares, leaving the vendors post raising with 80M shares (just under 70% of the company). Escrow conditions apply to approximately 62.4% of the shares on issue (71.8M), leaving just over 8M shares held by the vendors which are not subject to escrow. The escrow period ends one year following the listing of REX on the ASX.

## Application of monies raised

The company identified the following initiatives to support the monies raised in the IPO:

The use of proceeds of the IPO

Use of Proceeds	\$M
Investment in Pel-Air	\$12.00
Purchase of an additional Saab 340B	\$2.15
Repayment of debt for purchase of three Saab 340B aircraft	\$4.60
Balance payment on purchase of two Saab 340A aircraft	\$0.65
Purchase of additional engines and spares	\$3.50
Proposed additional aircraft purchases	\$4.50
General working capital	\$4.90
Expenses of this Offer	\$2.70
<b>TOTAL</b>	<b>\$35.00</b>

Source: REX.

**REX will acquire 50% of Pel-Air for \$12M**

### Pel-Air Aviation Pty Ltd (Pel-Air)

REX will acquire 50% of Pel-Air for \$12M, following the IPO. Pel-Air is a freight and charter company which was incorporated in 1984. A full description of the company and background is discussed later in this report.

**Changed its policy from leasing to outright purchase**

### Expanding the aircraft fleet and refinancing

The \$11.9M allocated for this purpose will be used for the purchase of additional Saab 340B aircraft, balance owed on two Saab 340A aircraft and repayment of debt for purchase of three Saab 340B aircraft.

The Company originally leased all its aircraft by way of operating leases, but has since changed its policy from leasing to outright purchase. REX has been acquiring planes because:

- Improved cash flow has provided increased balance sheet leverage
- The state of the Saab turboprop aircraft market favours purchase over operating leases. Notably, the cost of a Saab is currently equal to 2 to 4 years of lease payments, depending on the age of the plane, with the corresponding economic life of the assets between 11-16 years. The purchase of the three Saabs 340B aircraft that were leased, reduced aircraft expenses by about 40% of the lease cost even after factoring in depreciation and interest.
- Strong passenger growth rates have resulted in the need to increase frequencies and the subsequent economics has allowed REX to transfer to the larger Saab aircraft from the Metroliners.

**Strong passenger growth rates**

Prior to April 2005, the Company purchased five aircraft for cash, with an average useful life of 11 years. In anticipation of its IPO, REX:

- purchased a further five Saab aircraft using short term financing facilities in April and May, 2005; and
- committed to purchase another plane that will be delivered in November 2005.

The total cost of these purchases is around A\$7.4M, comprising:

- A\$2.15M for an additional Saab 340B;
- A\$0.65M, balance payment on 2 x Saab 340As; and
- A\$4.6M repayment for a facility to purchase the three Saabs 340Bs.

Two of the new aircraft are additions to the fleet and are earmarked for expansion of the network and additional charter work.

### Purchase of additional engines and spares

The administrators of Kendell and Hazelton still hold a large stock of spares and two aircraft engines that did not form part of the sale of assets to REX. These spares have been made available to REX for purchase on a pay-as-use basis over the last three years.

The Company has reached agreement with both sets of administrators to purchase their remaining stock of spares at about 20% of their list value.

## Capital structure

The capital structure following the IPO looks like this:

### Capital structure

	Before offer		After offer	
	Number	%	Number	%
Existing shareholders(M)	80	100	80	69.6
New shareholders under offer(M)	0	0.0	35	30.4

Source: REX.

## IPO Arithmetic

We have set out below the financial arithmetic that underpinned the list price of \$1.00 per share and a market capitalisation of \$115M for REX. On the Prospectus numbers, REX was listed on a forecast FY06:

- reported profit (based on actual tax paid, not notional) of 5.8X (PER), and
- EBITDAR multiple (on estimated cash balance at year end FY06) of 2.7X.

### Proforma Income Statement (\$M)

Y/E June <i>Accounting standards adopted</i>	Based on Prospectus information				
	FY03 <i>AGAAP</i>	FY04 <i>AGAAP</i>	FY05 <i>AGAAP</i>	FY06F <i>AGAAP</i>	FY06F <i>A-IFRS</i>
<b>Revenue</b>					
Operating	83.8	110.5	127.2	144.7	144.7
Non-Operating	10.5	0.7	9.9	1.9	2.1
Share of net income from Associate	2.7	1.6	1.8	1.8	1.8
	<b>97.0</b>	<b>112.8</b>	<b>138.9</b>	<b>148.4</b>	<b>148.6</b>
<b>Costs and Expenses</b>					
Aircraft fuel	(12.1)	(12.7)	(19.7)	(24.0)	(24.0)
Engineering, maintenance and port	(37.4)	(30.8)	(35.0)	(34.6)	(34.6)
Manpower	(36.9)	(35.6)	(38.2)	(41.1)	(41.1)
Marketing and selling	(14.7)	(12.8)	(12.2)	(10.5)	(10.5)
Administration costs	(3.8)	(3.4)	(2.4)	(2.4)	(2.4)
Other	(5.2)	(3.2)	(6.2)	(2.0)	(2.0)
	<b>(110.1)</b>	<b>(98.5)</b>	<b>(113.7)</b>	<b>(114.6)</b>	<b>(114.6)</b>
<b>EBITDAR</b>	<b>(13.1)</b>	<b>14.3</b>	<b>25.2</b>	<b>33.8</b>	<b>34.0</b>
Aircraft Leasing	(8.4)	(7.0)	(7.2)	(8.2)	(8.2)
Depreciation	(2.4)	(2.4)	(3.8)	(4.2)	(4.2)
	<b>(10.8)</b>	<b>(9.4)</b>	<b>(11.0)</b>	<b>(12.4)</b>	<b>(12.4)</b>
<b>EBIT</b>	<b>(23.9)</b>	<b>4.9</b>	<b>14.2</b>	<b>21.4</b>	<b>21.6</b>
Financing Charges	(0.4)	(0.4)	(0.7)	(0.1)	(0.1)
Pre-Tax Profit	<b>(24.3)</b>	<b>4.5</b>	<b>13.5</b>	<b>21.3</b>	<b>21.5</b>
Tax (expense)/benefit				(1.6)	(6.4)
<b>NPAT</b>				<b>19.7</b>	<b>15.1</b>
<b>Tabulations</b>					
Shares on issue (M)	115.0	115.0	115.0	115.0	115.0
EPS ©	(0.21)	0.04	0.13	0.17	0.13
Price on issue (\$)	1.00	1.00	1.00	1.00	1.00
Net (debt)/cash (\$M), year start				9.4	9.4
Net (debt)/cash (\$M), year end estimate				24.1	24.1
Market value (\$M)				115.0	115.0
Enterprise value (\$M), year start				105.6	105.6
Enterprise value (\$M), year end estimates				90.9	90.9
<b>Multiples</b>					
PER (X)	n/a	25.6	7.5	5.8	7.6
EV multiple (EBITDAR, X), year start				3.1	3.1
EV multiple (EBIT, X), year start				4.9	4.9
EV multiple (EBITDAR, X), year end				2.7	2.7
EV multiple (EBIT, X), year end				4.2	4.2

Source: REX and Tricom Equities.

## Business strategy

### Watch your overheads

The business strategy of REX is more of the same:

- watch your overheads,
- trim your costs (without compromising service, safety and efficiency),
- improve load factors (by matching demand with utilisation and carefully and intensely monitoring all route Kpi's),
- keep fares affordable across all services (regardless of competition or the lack of it)
- maintain conservative balance sheet arithmetic (provides fuel for acquisitions, cash purchase of aircraft and protects against downturns),
- build a closer relationship with regional Australia (your core market, through high standard of service and focused sponsorship activities), and
- look for vertical and horizontal growth opportunities.

### Look for vertical and horizontal growth opportunities

### Difference is three years and almost \$50M

In FY03, REX lost \$24M. In FY06, we forecast REX will generate a NPAT of around \$20M. The difference between the two periods is three years and almost \$45M. From management's perspective, however, it is almost a lifetime and resulted in the development of a very-focused business strategy.

### EBITDAR more than double this year

That strategy should see EBITDAR more than double this year over FY04; an 16% lift in costs over FY03 for an equivalent lift in sales of 31% and a load factor above 65% (c/f 47% in 2003). The Holy Grail would be to consistently achieve a load factor above 70% across the board (as it does on a number of its routes) and which would reinforce its claim as one of the most profitable regional airline carriers in the world.

### Synergies make the acquisition compelling

Added to that, the company has taken a 50% stake in an airfreight company with an option to acquire the remaining 50%. This provides a sensible diversification (horizontal), with the added benefit of stable earnings (balancing out some of the possible volatility that a regional passenger carrier could experience). The synergies between the two businesses make the acquisition compelling on a cost basis alone.

### Anticipate further consolidation of this industry

Other opportunities for REX include smaller regional airline carriers that lack the capital base to continue meeting the ever increasing safety and regulatory standards imposed by CASA. We anticipate further consolidation of this industry over the next two years and believe REX could be a principal player.

## Financials and valuation arithmetic

### Financials

Our estimates for FY06 agree with Prospectus arithmetic, although it is possible to achieve different outcomes based on core assumptions, notably in relation to aviation (oil) gasoline prices and A\$/US\$ exchange rate. For this year FY06) we have adopted both Prospectus assumptions on oil prices and exchange rates:

- average price for oil of US\$79.84/bbl, and
- average US\$/A\$ exchange rate of 75.5c.

The sensitivities are important indicators in relation to movements in either oil and/or exchange rates and could even cancel each other out – for example, lower oil price and lower US\$ exchange rate. Those sensitivities are noted over, including an equally critical assumption and implications in relation to load factors.

Our arithmetic out to FY10 is as follows:

**Tricom forecasts**

Y/E June	FY05	FY06F	FY07F	FY08F	FY09F	FY010F
<b>Revenue (\$M)</b>						
Passenger revenue	125.6	140.2	149.5	162.7	171.0	176.4
Charter revenue	0.8	1.5	1.9	2.2	2.4	2.6
Freight revenue	0.8	0.8	0.8	0.9	0.9	0.9
Other operating		1.9	1.9	1.9	1.9	1.9
Other	9.9	1.8	1.8	2.0	2.1	2.2
<b>Total revenue (\$M)</b>	<b>137.1</b>	<b>146.1</b>	<b>155.9</b>	<b>169.7</b>	<b>178.4</b>	<b>184.1</b>
<b>Costs (\$M)</b>						
Ports	12.3	12.3	12.7	13.3	13.6	13.7
Fuel	19.7	24.0	25.4	27.7	29.2	30.1
Flight costs	4.5	4.6	4.7	5.2	5.4	5.6
Selling	12.2	10.4	10.6	11.1	11.3	11.6
Aircraft	25.4	26.2	27.0	27.9	28.6	29.2
Manpower	38.2	41.1	42.9	45.9	47.3	48.2
Office overheads	8.6	4.3	4.4	4.5	4.6	4.6
<b>Total costs (\$M)</b>	<b>120.9</b>	<b>122.8</b>	<b>127.8</b>	<b>135.6</b>	<b>139.9</b>	<b>143.0</b>
<b>EBITDAR (\$M)</b>	<b>23.4</b>	<b>31.5</b>	<b>36.6</b>	<b>42.8</b>	<b>47.2</b>	<b>49.8</b>
EBITDA (\$M)	16.2	23.3	28.2	34.1	38.5	41.1
Depreciation (\$M)	(3.8)	(4.2)	(7.7)	(8.1)	(8.5)	(7.8)
Borrowing costs (\$M)	(0.7)	(0.1)	1.7	2.2	3.1	4.3
TAX (\$M)		(2.3)	(9.8)	(10.7)	(10.7)	(11.8)
Associates (\$M)		1.8	2.9	3.1	3.2	3.4
<b>NPAT (\$M)</b>		<b>19.7</b>	<b>18.5</b>	<b>25.0</b>	<b>25.0</b>	<b>27.6</b>
EBITDA margin (%)	12%	16%	18%	20%	22%	22%
NPAT margin (%)	0%	13%	12%	15%	14%	15%
<b>Growth (%)</b>						
Passenger revenue (%)		12%	7%	9%	5%	3%
Costs (%)		2%	4%	6%	3%	2%
EBITDA (%)		44%	21%	21%	13%	7%
<b>Operating Statistics/Assumptions</b>						
Passengers	1,038,000	1,135,198	1,188,526	1,270,930	1,314,627	1,335,214
Passenger growth (%)		9%	5%	7%	3%	2%
Revenue/passenger (\$)	121	124	126	128	130	132
Revenue/passenger growth		2%	2%	2%	2%	2%
RPK (M)	399	438	455	487	504	511
ASK (M)	610	666	686	729	746	753
Load factor (%)	65.0%	65.8%	66.3%	66.8%	67.5%	67.9%
Yield (NPAT/ASK)	0.0%	3.0%	2.7%	3.4%	3.4%	3.7%
Routes	37	33	33	35	35	35
Departures	55,653	57,271	57,811	61,359	62,806	63,399
Metro 19 seater	5	4	4	4	4	4
SAAB 34 seater	23 (14 leased)	25 (13 leased)	25 (13 leased)	26 (13 leased)	26 (13 leased)	26 (13 leased)
Charter flight hours	177	312	387	437	467	490
Aircraft in fleet (average)	28	29	29	30	30	30
AUD/USD exchange rate		0.755	0.755	0.755	0.755	0.755
Aircraft fuel price bbl (US\$)		79.84	79.84	79.84	79.84	79.84
Fuel % revenue (%)	14.4%	16.4%	16.3%	16.3%	16.4%	16.3%

Sensitivity (FY06), \$M	Assumption	Change	Impact EBITDA
Passengers	1,135,000	YoY +/-1%	1.4
Load factor (%)	65.7	+/-1%	2.0
Average fare (\$)	125	+/-1	1.1
Crude oil price (US\$)	79.84	+/- US\$5	1.2
AUD/USD exchange rate (US\$)	0.755	+/- USD0.01	0.7
Interest rate (%)	5	+/- 25 basis points	0.02

**Additional core assumptions:**

- In FY08, FY12 and FY15, we assume REX purchases four SAABS and scraps three SAABS for parts. In FY08, FY12 and FY15, we assume REX adds two new routes.
- Added routes provide passenger growth of 7%, 5% and 5% in FY08, FY12 and FY15.
- In FY08, FY12 and FY15, we increase YOY costs by ~6% to reflect increased costs associated with expanding its network.
- CAPEX is set at 2% of sales except in FY08, FY12 and FY15 where it is 4% of sales to reflect capital costs of network expansion.

Source: REX and Tricom Equities.

## Valuation

### We value REX at \$1.33 per share

We value REX using a DCF methodology at \$1.33 per share. Our arithmetic and assumptions are as set out below. Lining REX up against its local peers, it is currently trading on a discount in FY06 of 70% (PER) and a 71% discount to its international peers in that same year.

## Comparatives

### Australian comparatives

Year end	REX		Qantas		Virgin Blue		Skywest
	Jun-05 A\$M Actual	Jun-06 A\$M Forecast	Jun-05 A\$M Actual	Jun-06 A\$M Forecast	Sep-05 A\$M Actual	Sep-06 A\$M Forecast	Jun-05 A\$M Actual
<b>Income</b>							
Revenue	137.1	146.6	12,649.0	13,449.0	1,756.0	1,865.0	73.3
<b>Costs and expenses</b>							
Fuel costs	19.7	24.0	1,932.0	3,014.0	432.0	350.0	9.9
<b>Total costs</b>	<b>113.7</b>	<b>122.8</b>	<b>10,479.0</b>	<b>11,484.0</b>	<b>1,552.0</b>	<b>1,604.0</b>	<b>68.5</b>
EBITDAR	25.2	32.0	2,549.4	2,325.0	380.0	404.0	8.5
EBITDA	18.0	23.8	2,170.0	1,965.0	237.0	261.3	4.8
EBIT	14.2	19.6	1,070.0	888.0	156.8	178.7	1.3
<b>NPAT</b>		<b>19.7</b>	<b>714.0</b>	<b>561.0</b>	<b>107.6</b>	<b>116.8</b>	<b>1.6</b>
<b>Balance sheet</b>							
Total assets	78.0	101.7	18,134.0	18,506.0	2,084.0	1,769.0	38.9
Net assets	50.9	73.3	6,469.0	6,946.0	768.9	582.6	17.5
Net debt/(cash)	(9.4)	(22.6)	3,646.0	3,720.0	32.0	422.0	(6.0)
<b>Margin analysis</b>							
EBITDAR/sales (%)	18%	22%	20%	17%	22%	22%	12%
EBITDA/sales (%)	13%	16%	17%	15%	13%	14%	7%
EBIT/sales (%)	10%	13%	8%	7%	9%	10%	2%
NPAT/sales (%)		13%	6%	4%	6%	6%	2%
Fuel cost % revenue (%)	14%	16%	15%	22%	16%	16%	13%
Fuel % of total costs (%)	17%	20%	18%	26%	20%	20%	14%
<b>Multiple analysis</b>							
Share Price (\$)		1.10	3.79	3.79	1.89	1.89	0.19
Market Capitalisation		126.5	7,192.0	7,192.0	1,981.0	1,981.0	19.0
Enterprise Value		117.1	10,838.0	10,838.0	1,949.0	1,949.0	13.0
EV/EBITDAR multiple (X)		3.7	4.3	4.7	5.1	4.8	1.5
EV/EBITDA multiple (X)		4.9	5.0	5.5	8.2	7.5	2.7
EV/EBIT multiple (X)		6.0	10.1	12.2	12.4	10.9	10.0
PE multiple (X)		6.4	8.9	11.8	17.5	17.0	9.7
<b>Flight Statistics</b>							
	<b>FY05</b>	<b>FY06F</b>	<b>Qantaslink</b>		<b>FY05</b>	<b>FY05</b>	<b>FY05</b>
Passengers carried ('000s)	1,038	1,135	3,058		13,400		301
Load factor (%)	65.4%	65.8%	72.4%		76.8%		56.3%

Source: Tricom Equities and Aegis Equities Research

## Overseas comparables

	Southwest Airlines		Ryanair		Mair		JetBlue		Skywest		
	Dec-04 (US\$m) Historical	Dec-05 (US\$m) Forecast	Mar-05 EuroM Historical	Mar-06 EuroM Forecast	Mar-07 EuroM Forecast	Mar-05 (US\$m) Historical	Mar-06 (US\$m) Forecast	Dec-04 (US\$m) Historical	Dec-05 (US\$m) Forecast	Dec-04 (US\$m) Historical	Dec-05 (US\$m) Forecast
<b>Income</b>											
Revenue	6,530.0	7,480.0	1,336.0	1,719.0	2,045.0	456.0	470.0	1,266.0	1,710.0	1,156.0	1,920.0
EBITDA	1,180.0		329.0	365.0	436.8	19.8		196.0		235.0	
NPAT	313.0	475.6	267.0	306.0	371.0	7.4	(8.9)	47.5	(3.2)	82.0	108.5
<b>Margin analysis</b>											
EBITDA margin (%)	18%		25%	21%	21%	4%		15%		20%	
NPAT margin (%)	5%	6%	20%	18%	18%	2%	-2%	4%	-0.2%	7%	6%
<b>Multiple analysis</b>											
Share Price (\$)	16.6	16.6	7.0	7.0	7.0	5.39	5.39	19.49	19.49	31.91	31.91
Market Capitalisation	13,174.7	13,174.7	5,318.1	5,318.1	5,318.1	111.0	111.1	2,056.2	2,056.2	1,850.8	1,850.8
Net Debt	(0.3)		(190.0)	(82.0)	(145.0)	(60.2)		1,393.8		(470.8)	
Enterprise Value	13,174.41		5,128.11	5,236.11	5,173.11	50.80	111.08	3,450.00	2,056.20	1,380.00	1,850.78
EV/EBITDA multiple (X)	11.2		15.6	14.3	11.8	2.6		17.6		5.9	
PE Multiple (times)	42.1	27.7	19.9	17.4	14.3	15.0	Non meaningful	43.3	Non meaningful	22.6	17.1

Source: Merriam Stockbrokers and Thomson data

## Valuation

### Cash-flow forecasts (\$M)

Y/E June	FY06F	FY07F	FY08F	FY09	FY10	FY11	FY12	FY13	FY14	FY15
EBITDA	24	28	34	36	38	39	44	44	45	49
Provisions	0	0	0	0	0	0	0	0	0	0
Change in working capital	(1)	(0)	(0)	0	(1)	(0)	(1)	(1)	(1)	(1)
Maintenance capex	(5)	(5)	(7)	(4)	(4)	(4)	(8)	(4)	(4)	(9)
Expansion capex	(30)	0	(10)	0	0	0	(12)	0	0	(14)
Tax paid	(6)	(6)	(8)	(8)	(9)	(10)	(11)	(11)	(11)	(12)
Cashflow used in WACC DCF	(18)	17	9	24	25	25	12	29	29	13

	Valuation	12 month target
<b>Valuation summary</b>	\$M	\$M
NPV of forecasts	93	97
Perpetuity [e/(r-g)]	51	57
Total operational NPV	143	153
Add cash	9	22
<b>Shareholder value</b>	<b>153</b>	<b>175</b>
Current Number of Equiv Shares (M)	115	115
<b>Value per share (\$)</b>	<b>1.33</b>	<b>1.53</b>

### WACC Discount Rate

Risk free rate	5.3%
Risk premium	5.5%
Beta	1.30
Cost of equity	12.4%
Cost of debt	9.0%
Tax rate	30.0%
Post-tax cost of debt	6.3%
Target D/(D+E)	20.0%
<b>WACC</b>	<b>11.2%</b>

### Growth Assumptions

Residual / Total	37%
LT growth 2015+	2.0%

### Other Assumptions

Last forecast year	2014
LT inflation	2.5%

## 2 | Regional Express Holdings Ltd

### Short history

In 2002, Regional Express, through Australiawide Airlines Limited, purchased Hazelton Airlines and the turbo-prop business of Kendell Airlines. It commenced operations in August that year as REX.

#### **Born from the regional ashes of Ansett**

It was born from the regional ashes of Ansett, which had a very public and painful demise in 2001 as a domestic Australian carrier. When the Ansett Group failed, it also facilitated the Administration of its regional airline operations (which included Hazelton, Kendell and Skywest). While these companies continued to operate, they were strapped for cash and suffered from an association with Ansett in the public domain.

#### **QantasLink consolidated in Queensland in wake of Ansett collapse**

As a consequence of the demise of Ansett, the Qantas Group, through its regional subsidiary, QantasLink (Eastern, Sunstate and Southern), consolidated its position on the main competitive routes in New South Wales, Victoria and Tasmania. Flightwest Airlines also ceased operations during this period, enabling QantasLink to consolidate in Queensland.

#### **Both airlines were largely complementary**

Hazelton Airlines began operations in 1953 under its founder, Max Hazelton, focusing on regional NSW (and eventually adding Canberra). Don and Eilish Kendell acquired a small airline operator in 1967. It also operated throughout NSW, but covered Victoria, Tasmania and South Australia (flying also into Canberra). However, the route networks of both airlines were largely complementary, with little direct competition.

Hazelton became a publicly listed company and was eventually acquired by Ansett in 2001. Ansett also acquired 100% of Kendell in 1990.

A consortium was formed to acquire the businesses of Hazelton and Kendell following the collapse of Ansett and it entered into discussions with the Administrators, unions, staff and the Federal Government. That business is now Regional Express and it listed on the ASX on 9 November 2005 (ASX:REX) with a market capitalization of \$115M.

### The business of REX

#### **21 routes accounted for 54% of FY05 revenues**

REX has three hubs – Adelaide, Melbourne and Sydney. It carried in excess of 1M passengers on around 50,000 scheduled flights and covering 35 routes in FY05. REX currently has 33 routes and, of these, 21 are not serviced by any other airline. These 21 routes accounted for 54% of FY05 revenues and 11 of the 21 are protected from competition by NSW State Government legislation (representing 31% of FY05 revenue).

## The Company's Market

Top 10 routes of REX in FY05 and estimated market share are:

Route	Competitors (number)	Estimated market share
Adelaide – Port Lincoln	2 <sup>1</sup>	70%
Sydney – Lismore	0	100%
Sydney – Griffith	0	100%
Sydney – Orange	0	100%
Sydney – Albury	1	38%
Adelaide – Olympic Dam	0	100%
Sydney – Wagga	1	41%
Sydney – Ballina	2	28%
Sydney – Dubbo	2	37%
Melbourne - Mildura	1	33%

Source: REX

Notes: 1. REX announced on 9 November 2005 that it was transferring passengers from Airlines of South Australia and Emu Airways in the wake of those airlines ceasing services in SA. This follows the decision by QantasLink to replace its partner airline on this route (Airlines of South Australia and Emu) with its own (QantasLink) service.

### Average load factor of 65%

In FY05, REX passenger revenues accounted for 99% of total group revenue, with charter and freight revenues each accounting for 0.5%. REX had capacity of some 610M ASK's<sup>1</sup> and an average load factor of some 65%. The load factor for Skywest<sup>2</sup>, the only other listed regional airline in Australia, in FY05 was 56.3%.

### A marked improvement in its load factors

REX has experienced a marked improvement in its load factors since its first year of operation as REX (47% in FY03). It has been a major focus for the Group to manage its ASK so that capacity matched demand. Since January 2003, the ASK has only been allowed to rise gradually and in line with seasonal and market factors.

### Operating statistics

Year	No. of routes	Scheduled departures	Passengers carried	Operating revenue (\$M)	Average load factors
FY03 <sup>1</sup>	36	51,419	612,403	91.4	47%
FY04	32	51,916	857,548	110.5	62%
FY05	35	56,442	1,047,751	127.2	65%
FY06F	34	57,271	1,135,332	144.7	66%

Source: REX

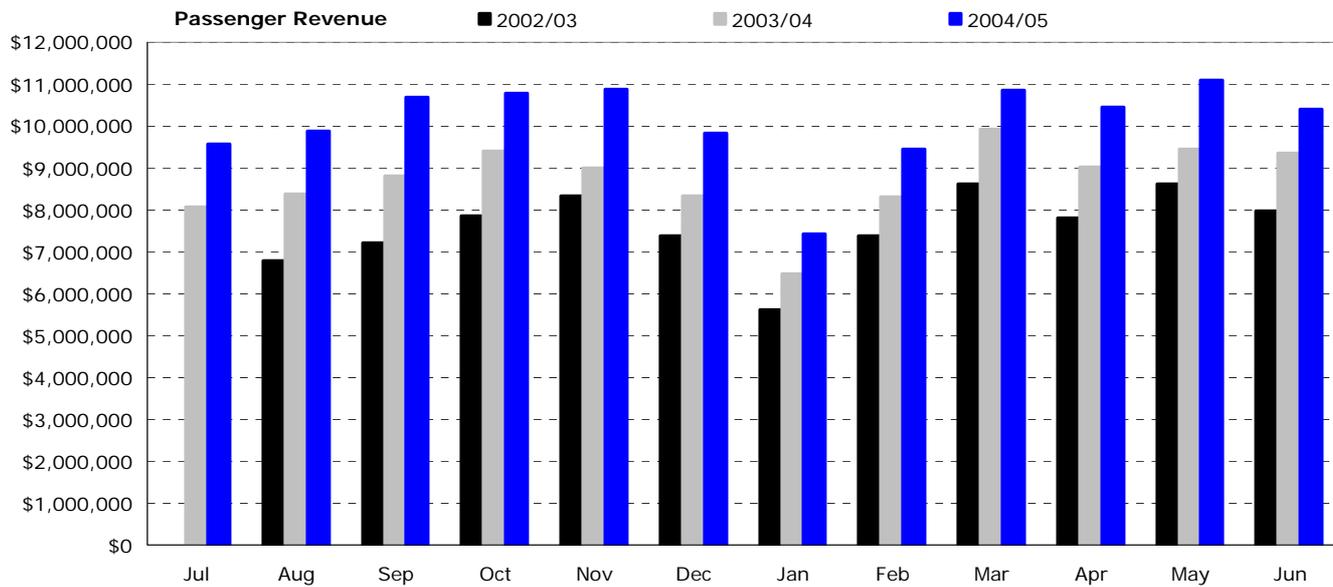
Notes: 1. Commenced August 2002.

The company also manages its 'revenue per departure' (RPD) very tightly, and has maintained a fine balance between its ASK's (capacity) and its revenue line. The net result is that its RPD has expanded since FY03.

<sup>1</sup> Available Seat Kilometres, defined as the total number of seats available for passengers multiplied by the number of kilometres flown. It is a measure of available capacity.

<sup>2</sup> Skywest Limited is a listed Australian regional airline carrier, domicile in Western Australia. It has a very different market profile to REX, although it is arguably the most comparable airline to REX in Australia.

**Passenger revenues**



Source: REX

At present, REX operates over 1100 scheduled flights a week, with an average flight time of about 55 minutes:

**Scheduled flights by REX**

	Date the service started	Number of round trips per week	Competitors
<b>Adelaide to</b>			
Broken Hill	1 August 2002	17	0
Ceduna	1 August 2002	12	0
Coober Pedy	1 August 2002	6	0
Kangaroo Island	1 August 2002	14	1
Mount Gambier	1 August 2002	19	1
Olympic Dam	1 August 2002	17	0
Port Lincoln	1 August 2002	37	1
Whyalla	1 August 2002	21	1
<b>Melbourne to</b>			
Albury	1 August 2002	23	0
Burnie	1 August 2002	18	1
King Island	1 August 2002	7	0
Merimbula	1 August 2002	8	0
Mildura	1 August 2002	25	1
Mount Gambier	1 August 2002	19	1
Portland	1 August 2002	12	0
Wagga Wagga	1 August 2002	14	0
<b>Sydney to</b>			
Albury	1 August 2002	26	1
Armidale	2 September 2004	17	1
Ballina	1 August 2002	24	2
Bathurst	1 August 2002	18	0
Broken Hill	1 August 2002	7	0
Cooma	10 June 2005	6	0
Dubbo	1 August 2002	25	2
Griffith	1 August 2002	25	0
Lismore	1 August 2002	26	0
Merimbula	1 August 2002	20	0
Mildura	1 August 2002	6	0
Moruya	1 August 2002	13	0
Narrandera	1 August 2002	18	0
Orange	1 August 2002	25	0
Parkes	1 August 2002	18	0
Wagga Wagga	1 August 2002	26	1
West Wyalong	28 February 2005	3	0
<b>TOTAL</b>		<b>554</b>	

Source: REX

## Fare structures and sales conduits

The company has a simple 4-fare tariff structure.

- "REX Flex" a fully refundable fare with no restrictions on the ticket. REX Flex is the benchmark upon which the price of all other tickets is set and it has last seat availability.
- "REX Biz" is a discounted "REX Flex" that offers most of the business flexibility without last seat availability.
- "REX Saver" is a more heavily discounted ticket that is non-refundable and non changeable without penalty. This is the cheapest fare that can be purchased by customers via travel agents or the REX Customer Contact Centre, and
- "REX Net" is a deeply discounted ticket that is only available on the REX website.

REX sells its tickets via direct and indirect sales distribution channels. Direct distribution channels include the REX Website and Customer Contact Centre. Indirect distribution channels include travel agents and corporate travel managers:

**Internet bookings accounted for 47% of total bookings**

- In FY05, Internet bookings accounted for 47% of total bookings. Of this, 40% came from direct bookings from the public and 7% from travel agents booking on behalf of their clients. As a distribution channel, the Internet has the lowest cost of sale. When REX first started operations, only 20% of bookings were made directly through the Internet.
- In the same year, bookings through travel agents accounted for 40% of total revenue. Sales through travel agents incur a higher cost of sale as commissions and additional fees are payable.

The Company operates a call centre based in Orange, NSW, which has 43 staff. The Centre makes reservations and takes bookings, although its primary function is to provide pre-and-post sales support. In FY05, the Centre accounted for approximately 13% of total ticket sales.

**REX has its own corporate lounge facilities**

REX has its own corporate lounge facilities in Sydney Airport and will open a new lounge at Adelaide Airport on 2 December 2005. In Melbourne, REX lounge members have access to Virgin's lounge by way of a voucher system. It also operates a Frequent Flyer programme, REX Flyer.

## Hubs, slots and flight logistics

REX has three capital city hubs: Sydney, Melbourne and Adelaide. With the exception of Sydney airport, there are no landing slot constraints at any airport that REX services, including Melbourne and Adelaide Airports (both of which currently function well below their full operational capacity).

**Regional airlines need more flights to move the same number of passengers**

The challenges that face a regional airline are different from those of an international or domestic airline. Significantly, regional airlines need to have more flights to move the same number of passengers as international and domestic carriers. Thus they need more landing slots and have a high number of take offs and landings. Turnaround times are on average 20–30 minutes.

At Sydney airport, aircraft movements are restricted to a maximum of 80 movements per 60-minute period. This is for safety, noise and traffic management reasons.

**REX has over 540 weekly slots secured at Sydney Airport**

REX has over 540 weekly slots secured at Sydney Airport, which were previously allocated to Kendell and Hazelton. This is more than the number of slots secured by QantasLink. Just under half of these slots are available for the peak periods of 7.30am to 9.00am and 5.30pm to 7.00pm. REX is the largest holder of NSW regional slots at Sydney airport and is the third largest holder of slots at Sydney.

## Aircraft fleet and maintenance

### REX operates two aircraft types

REX operates two aircraft types: 4, 19-seater Fairchild Metro 23 airliners and 25, 34-seater Saab 340. The Saab's represent some 89% of the Company's seat capacity.

### SAAB 340

- Maximum cruising speed of 503km/h, with a cruising altitude of 7,500m
- Engines: Two General Electric CT7 turboprops, each of 1735hp
- Maximum seating: 36
- Cabin: Fully pressurised, in flight catering, lavatory, air-conditioning.

### METRO 23

- Maximum cruising speed of 520km/h and cruising altitude of 6,000m
- Engines: Two Garret TPE-331-12 turboprops rated at 1100hp and fitted with reverse thrust propellers, each of 1100hp
- Maximum Seating: 19
- Cabin: Fully pressurised, air-conditioning.

### Fleet has an economic life of between 11-16 years

The Saab 340 is no longer manufactured, although a large fleet of over 440 of these aircraft still exists. Engines and spare parts are readily available and are still being produced and supported by the manufacturer, which continues to manufacture other airplanes. The Company estimates that its fleet has an economic life of between 11-16 years depending on the current age of the aircraft.

### REX has since purchased 10 of these aircraft

The original fleet of aircraft was largely leased, which was due to balance sheet constraints at the time of the formation of REX. REX has since purchased 10 of these aircraft and is seeking to acquire additional Saab 340s from the proceeds of its IPO.

### Number of Aircraft Owned vs Leased (year ending 30 June)

	2002	2003	2004	2005	2006F
<b>Owned</b>					
Metroliners	7	7	6	5	4
Saab 340 (A & B)			4	10	12
Total Owned	7	7	10	15	16
<b>Leased</b>					
Saab 340 (B)	16	16	19	14	13
Total Owned & Leased	23	23	29	29	29

Source: REX and Tricom Equities.

REX has two maintenance centres: the largest is in Wagga Wagga (in NSW) where the Saab 340s are maintained and in Adelaide where the Metro 23s are maintained. The Company has in-house capability to undertake its own:

- 30,000 cycle checks – these are extensive checks after an aircraft has landed 30,000 times;
- "C" checks – these are very extensive checks after an aircraft has flown 4,000 hours; and
- four year checks – these are major overhauls and must take place once every four years.

The Company has an Engine Care and Maintenance Plan (“ECMP”) agreement with General Electric (GE) for the Saab’s CT7 turbo-prop power plant. Under this agreement, GE provides all required parts for regular maintenance and undertakes all the major engine overhauls in the UK and all repairs of defective modules of the engines. This is a power-by-the-hour programme where an insurance premium is paid for each hour used and thereafter all repairs and overhauls are under the warranty of GE.

REX at present maintains sufficient spares in all its hubs. However, in line with the plan to grow the fleet, REX intends to use a portion of the funds raised from its IPO to purchase additional spares and engines.

## Staff, management and Board of Directors

### Staff

The company had 624 employees

AS at June 2005, the company had 624 employees, with flight and cabin crew making up 322 and engineering 109 of the total. Just over 65% of all staff is located in the three capital cities (Sydney, Melbourne and Adelaide) and the rest in regional and rural Australia. All employees are covered by separate enterprise agreements.

#### Number of Employees as at 30 June

	2003	2004	2005
Flight and cabin crew	286	300	322
Engineering	117	108	109
Airport	74	70	69
Finance	20	18	20
Call centre	31	50	43
Management and support	63	59	61
<b>Total</b>	<b>591</b>	<b>605</b>	<b>624</b>

Source: REX

Note: Figures include full time, part time, casual, maternity leave and leave of absence employees (does not include contractors).

### Board of Directors

#### LIM, Kim Hai – Executive Chairman (48)

After a period of 10 years as a Defence Specialist Engineer, Mr Lim left the civil service to start his own businesses. He currently has an extensive portfolio of investments and has business interests in many countries. He is the Chairman of a biomedical company Lynk Biotechnologies Private Limited which has developed a revolutionary platform for transdermal delivery of water-soluble drugs and is also Chairman of WooWorld Private Limited which is a supplier of online and mobile games to telecommunication companies in China, Japan and South East Asia.

Mr Lim became Executive Chairman of REX on 27 June 2003.

#### SHARP, John – Deputy Chairman & Independent Director (50)

Mr Sharp was a member of the House of Representatives of the Commonwealth Parliament for 14 years (1984-1998). He retired from the House of Representatives in 1998 and established his own aviation and transport consulting company, Thenford Consulting. Mr. Sharp is currently Chairman of the Aviation Safety Foundation of Australia, a director of Australian Aerospace, a wholly owned subsidiary of European Aeronautics Defence and Space (EADS) representing Airbus, the aircraft manufacturer ATR, CASA, Eurocopter and Astrium satellites.

Mr Sharp was appointed to the board of REX on 14 April 2005.

**BREUST, Geoffrey – Managing Director (55)**

Mr Breust began his career in the Commonwealth Service in Canberra (20 years) before joining Kendell Airlines in 1988. He became the CEO of Kendell and remained at Kendell until 2000. Mr. Breust then started a business consultancy and did extensive work for AirLink, another regional air services company. He became the Company's CEO in January 2004.

Mr Breust was appointed to the board of REX in 26 August 2004.

**DAVIS, James ('Jim') – Executive Director Operations (53)**

Upon joining Hazelton Airlines in 1999, Mr Davis worked as Flight Operations and Standards Manager. In 2001, Mr Davis was promoted to the Chief Pilot of Hazelton, and held that position when Hazelton was merged into REX in 2002. He became Executive General Manager of Operations in 2003, and oversees all aspects of the operations of the Company comprising flight operations, airport operations and engineering.

Mr Davis was appointed to the board of REX on 26 August 2004.

**LEE, Thian Soo – Non-Executive Director (50)**

Mr Lee has extensive international business experience and currently is the Chairman and owner of several businesses with subsidiaries in SE Asia. These include an aviation component and service company, specialising in military aircraft, as well as a medical equipment supply company. He is also on the board of a biomedical company and a mobile/internet gaming company.

Mr Lee was appointed to the board of REX on 27 June 2003.

**WINNELL, Robert – Independent Director (57)**

Mr Winnell spent 10 years in the NSW and Commonwealth public services before establishing his own building business. In 1988 he formed and became the Managing Director of the Village Building Company, an unlisted public company with a turnover of around \$100M a year. He was previously CEO and President of the ACT Master Builders Association, and has served on a number of advisory committees for the ACT Government.

Mr Davis was appointed to the board of REX on 2 September 2003.

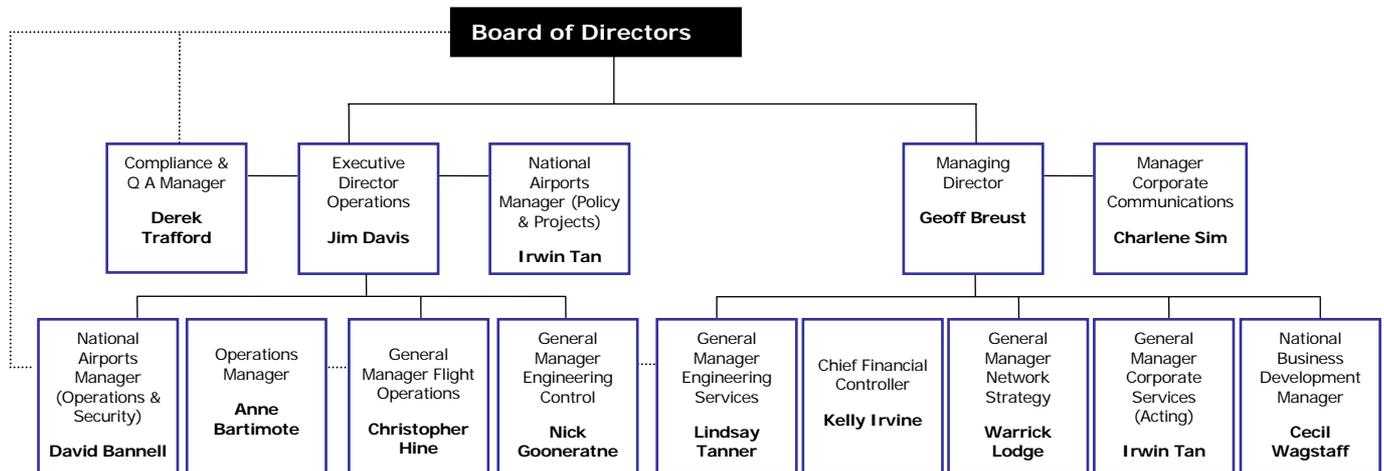
**HODGE, Russell – Non-Executive Director, Pel-Air Operations (59)**

Mr Hodge practiced as a solicitor from 1973 to 1997, specialising in aviation and commercial law. He is Executive Director of Pel-Air Aviation Pty Limited, holding that position from November 1994 to present. He has 30 years experience in aviation regulation, compliance, aircraft financing and the commercial operations of aircraft and airlines.

Mr Hodge was appointed to the board of REX on 9 September 2005.

## Key management executives

The key management executives sit in a line below the Managing Director, in a very flat management structure.



Source: REX

In addition to the two Board members, Geoff Breust and Jim Davis, the other senior key executives are:

### **GOONERATNE, Naomal ('Nick') Priyantha – General Manager: Engineering Control (48)**

Nick is the Primary Maintenance Controller, responsible to CASA. He was trained in the USA and the UK and then joined Air Lanka in 1979 as a licensed aircraft maintenance mechanic and engineer. He joined Saudi Arabian Airlines in 1984 in a similar position. In 1992 Nick joined Hazelton and became a technical support engineer, and later manager. Nick has been with the Company since its inception in 2002.

### **LODGE, Warrick – General Manager: Network Strategy (34)**

Warrick manages a team responsible for scheduling, pricing, revenue management and commercial analysis. His duties include the monitoring of network performance and analysing both existing and new market opportunities. He also manages another team responsible for reservations and sales support. Warrick has more than 10 years regional airline experience and has been with REX since its inception in 2002.

### **IRVINE, Kelly Eva – Chief Financial Controller (34)**

Kelly oversees all aspects of the Company's accounting and finance. On graduating from ANU, Kelly joined Deloitte Touche and later became the Finance Manager for the Corporate Group, part of the Commonwealth Government. Kelly joined REX in 2004.

### **HINE, Christopher Peter – General Manager Flight Operations/Chief Pilot, Grade 2 Check Captain (37)**

Chris has over 6000 hours flying experience with Metroliners and Saab 340 aircraft. He has worked with REX since the Company's inception in August 2002, prior to which, he worked for Kendell Airlines. Chris has also had experience as a lecturer in cockpit systems management for the Bachelor of Applied Science (Civil Aviation) degree at University of South Australia.

**TANNER, Lindsay – General Manager, Engineering Services (41)**

Lindsay has worked in the airframe engineering industry since 1985. He spent 11 years working for the RAAF as an engineer and non-commissioned officer. He joined Kendall in April 1999. He became General Manager of Technical Services upon REX's inception in 2002. He is currently in charge of all aspects of the engineering and fleet maintenance department, including budgetary management and control.

**TAN, Irwin – General Manager (Acting) Corporate Services (31)**

Irwin's background was originally in genetic research after graduating from the University of NSW. He left the field of genetic research when he joined Morrison Express Logistics in 1999 and then Singapore Airlines in 2001. He was later transferred to Singapore Airlines Cargo as an executive where he took on various appointments. He joined REX in July 2005.

**BANNELL, David Christopher – National Airports Manager (Operations and Security) (51)**

David recently joined REX following careers in the customs and forwarding industry and aviation. He is a licensed customs agent. David's joined Ansett Australia in 1986, where he held various management positions. Prior to joining REX, David was contracted to Sydney Airport Corporation working on projects at the Sydney Domestic Terminal T2. He is responsible for terminal operations, ground support equipment the Company's security program and airport services policy, contracts and procedures.

## Pel-Air

### Background and synopsis

REX and Pel-Air Aviation Pty Limited entered into an agreement whereby REX will acquire 50% of the shares of Pel-Air for \$12M (\$24M 100%), on condition that:

- The IPO is successfully executed (achieved);
- Pel-Air has net tangible assets of no less than \$20M as at 30 June 2005;
- The current shareholders of Pel-Air sign a put and call option<sup>3</sup>; and
- Payment of \$12M made to Pel-Air.

The agreement is effective from 1 July 2005 and Pel-Air will be treated as an associate for the FY06 year.

#### **Pel-Air is an airfreight business**

Pel-Air is an airfreight business that also provides services to the Commonwealth Government.

#### **Strong cashflow positive**

It fits a number of criteria for REX, namely: the business offers both synergies and horizontal integration; it is strong cashflow positive; the multiples are attractive; management is well experienced and will remain with the business (thus removing execution risk) and the earnings are relatively stable.

The synergies are difficult to quantify but include the following:

#### **Access to hub facilities at Darwin and Brisbane airports**

- Access for REX to Pel-Air hub facilities at Darwin and Brisbane airports. This provides quick leverage for REX in the event that it decided to provide passenger services from (to) these airports.
- Correspondingly, Pel-Air can benefit from hangar and operating facilities provided by REX (Sydney, Melbourne, Adelaide and other regional airports) for its existing operations, as well as use these facilities in the event that it expands its business.
- While both aircraft fleets are not uniform, with some modification it is possible that both companies could utilise surplus craft at certain times.
- The company's can cross-sell services, which is particularly advantageous for REX as it now can offer both regional passenger and extensive freight services (these services were previously limited).

#### **Maintenance workshops and these could be used by Pel-Air**

- REX offers extensive maintenance services in its Wagga Wagga and Adelaide maintenance workshops and these could be used by Pel-Air (where a large amount of this work is currently outsourced). There could also be some integration of the existing maintenance services across the full fleet.
- Staff training would be uniform and there would also be certain head office and accounting (payroll) functions which could be integrated.

#### **REX acquired Pel-Air on a forecast PER of 5.4x FY07**

We estimate on the arithmetic presented below, that REX acquired Pel-Air on a PER of 8.4x FY06 (enterprise multiple of 3.9x) and PER of 5.4x FY07 (enterprise multiple of 2.8x).

<sup>3</sup> The call option gives the Company the right but not the obligation to acquire the rest of Pel-Air over a 24 month period after the completion of the Sales Agreement. In return for this right, the agreement also allows the remaining shareholders of Pel-Air to exercise a put option to sell their existing shares to REX for cash and new shares of REX if FY06 NPAT meets pre-agreed targets.

## Brief history of Pel-Air

### **Pel-Air was incorporated in 1984**

Pel-Air was incorporated in 1984 as an air charter company, specializing in the transportation of freight in and around eastern Australia. It owns, operates and maintains the aircraft it charters to air freight forwarding companies. It does not provide freight services to the public.

Soon after its incorporation, Pel-Air started specialist passenger and freight services for Queensland Mines and in 1989, to Telfer for Newcrest Mines.

### **In 1994, Pel-Air acquired Newcastle Aviation**

In 1994, Pel-Air acquired Newcastle Aviation, which almost doubled its fleet size.

### **In 1996, Pel-Air won a contract with the Commonwealth Government**

In 1996, Pel-Air won a contract with the Commonwealth Government. The contract is to provide the Australian Defence Force (ADF) with jet aircraft services for ADF training support and involved the provision of target towing, low level attack simulation, radar controller training, Air Force pilot combat training and the carriage of military personnel.

### **In 2000, the company won a United Nations contract**

In 2000, the company won a United Nations contract for the provision of aircraft for the transportation of personnel and for Medic-vac (medical evacuations) from East Timor. This contract ended in 2002. Consequent to this, Pel-Air now provides Medic-vac services throughout Australasia and the Pacific and undertakes this business in partnership with CareFlight International.

## Business structure and operations

Pel-Air is in the business of chartering aircraft. Its clients are charged on a per trip or per hour basis, the cost of which will vary depending on aircraft type and regularity of service. Its three principal markets are:

1. The overnight air freight service
2. Specialist services to the ADF, and
3. Specialist medical evacuation services throughout Australasia and the Pacific.

Pel-Air's main revenues and clients are:

Source of revenue	Main client serviced	Aircraft	Approximate contribution to revenues (historic)
East coast Australia and other regional Australian routes <sup>1</sup>	Australian air Express, TNT, Toll, Pacific Aviation	Metroliners, Westwinds, Brazilia	63%
Military	ADF	Westwinds, Lear Jets Westwinds	28%
Medical evacuation services		Westwinds	6%

Source: REX

Notes: 1. encompasses Townsville in north Queensland to Hobart in Tasmania and Darwin-Alice Springs–Melbourne Darwin-Alice Springs-Melbourne. These are all freight charter routes.

### **Pel-Air employs 105 staff**

Pel-Air employs 105 staff, made up of 65 pilots, 19 engineers, 16 administration staff and five senior managers. The employees are based in several locations across Australia with larger numbers in Sydney, Brisbane, Darwin and Nowra.

### **Six customers account for over 90% of revenue**

The company's six major customers account for over 90% of its revenue. They include four major freight forwarders (Australian air Express, TNT, Toll and Pacific Aviation), the Commonwealth Government (for the ADF) and CareFlight International.

Its freight includes, overnight express mail, newspapers, select perishables, components, spare parts and occasionally dangerous goods.

**Military contract has four years to run**

Pel-Air's military contract has another four years to run until 2009, with an option for a further two years at the discretion of the Government.

**Charters aircrafts on fuel cost adjustment basis**

The company's direct exposure to rising fuel prices is not significant as it charters aircrafts on a fuel cost adjustment basis.

## Fleet profile and maintenance

Pel-Air owns a fleet of 23 aircraft as described below:

Number	Type	Comment	Ownership
8	Westwinds	Jet engine, 2-tonne payloads/ Medivac and passenger charter	6 aircraft mortgaged
10	Metroliner 111's	Turbo-prop, 2-tonne payloads	2 aircraft mortgaged
4	Lear Jets	Heavily modified to meet Navy requirements	All aircraft mortgaged
1	Brazilia	Turbo-prop, 3.7-tonne payloads	100% owned

Source: REX

Pel-Air has been operating Westwinds for over 20 years and is the world's largest operator of Westwinds.

The Metroliners are well known in Australia and REX also maintains a significant fleet of passenger configured Metroliners. Pel-Air's Metroliners have been modified to carry freight only.

The company operates a Lear Jet fleet based in Nowra, NSW that is contracted to the ADF. The Lear Jets and some Westwinds have been heavily modified to meet the requirements of the ADF and associated scientific organisations. These include the carriage and in flight testing of special electronic warfare equipment such as generic threat simulators. Pel-Air has also modified a Westwind for Medic-vac work.

Pel-Air recently acquired an Embraer Brazilia in order to cater for the growing freight market

**No aircraft is on operating or financial leases**

No aircraft is on operating or financial leases.

**Pel-Air has two major maintenance facilities**

Pel-Air has two major maintenance facilities: Darwin services all non-military Westwinds and Nowra services all military aircraft. The facilities in Darwin and Nowra are approved to undertake a significant amount of maintenance, including all major checks on the airframes and almost all work except specialist engine work. Pel-Air has a workshop in Sydney where its Garret 731 turbofan engines are maintained.

The maintenance for the Metroliners is outsourced to various third party facilities based in Melbourne, Brisbane and Sydney. The servicing of the Brazilia is also outsourced to a facility in Brisbane.

## Financials

### REX acquired Pel-Air on an EV multiple of under 3X

We have made some calculations on the historic and prospective earnings for Pel-Air, as we understand the business model. On the basis of our forward arithmetic, REX acquired Pel-Air on an EV multiple of under 3X in FY07 (underpinned by our forecasts and assumptions on cost synergies).

#### Pel-Air arithmetic

Y/E June	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
	\$M							
Sales	28.4	29.7	30.7	31.5	32.8	34.4	36.2	38.0
<b>Costs</b>								
Maintenance	(8.4)	(8.3)	(8.4)	(7.9)	(6.5)	(6.8)	(7.2)	(7.5)
Other costs	(13.1)	(15.0)	(15.5)	(15.7)	(15.3)	(16.1)	(16.9)	(17.7)
<b>Costs</b>	<b>(21.5)</b>	<b>(23.3)</b>	<b>(23.9)</b>	<b>(23.6)</b>	<b>(21.8)</b>	<b>(22.9)</b>	<b>(24.0)</b>	<b>(25.2)</b>
<b>EBITDA</b>	<b>6.8</b>	<b>6.4</b>	<b>6.9</b>	<b>7.9</b>	<b>11.0</b>	<b>11.6</b>	<b>12.1</b>	<b>12.7</b>
Depreciation	(1.5)	(1.6)	(1.6)	(2.2)	(2.3)	(2.3)	(2.4)	(2.5)
<b>EBIT</b>	<b>5.3</b>	<b>4.8</b>	<b>5.2</b>	<b>5.7</b>	<b>8.7</b>	<b>9.2</b>	<b>9.7</b>	<b>10.3</b>
Interest received	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Interest paid	(0.7)	(0.5)	(0.4)	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)
FX gains, profit on sale of assets	1.9	0.4						
<b>Pre-tax</b>	<b>6.7</b>	<b>4.8</b>	<b>4.9</b>	<b>5.3</b>	<b>8.3</b>	<b>8.8</b>	<b>9.3</b>	<b>9.8</b>
Tax	(1.2)	(1.6)	(1.5)	(1.6)	(2.5)	(2.6)	(2.8)	(2.9)
<b>NPAT</b>	<b>5.5</b>	<b>3.2</b>	<b>3.4</b>	<b>3.7</b>	<b>5.8</b>	<b>6.1</b>	<b>6.5</b>	<b>6.9</b>
<b>Rex share of associate (\$M)</b>				<b>1.8</b>	<b>2.9</b>	<b>3.1</b>	<b>3.2</b>	<b>3.4</b>
Paid (\$M)			24.0	24.0	24.0	24.0	24.0	24.0
add debt (at time of acquisition) (\$M)			10.2	10.2	10.2	10.2	10.2	10.2
subtract cash (at time of acquisition) (\$M)			3.2	3.2	3.2	3.2	3.2	3.2
<b>Equity value (acquisition cost) (\$M)</b>			<b>31.0</b>	<b>31.0</b>	<b>31.0</b>	<b>31.0</b>	<b>31.0</b>	<b>31.0</b>
<b>Multiple analysis (x)</b>								
EV/EBITDA (X)			4.5	3.9	2.8	2.7	2.6	2.4
EV/EBIT (X)			6.0	5.4	3.6	3.4	3.2	3.0
EV/NPAT (X)			9.3	8.4	5.4	5.1	4.8	4.5

Source: REX and Tricom Equities

Notes: The forecasts for Pel-Air are based on our own assumptions and from FY07 (notably) and beyond we have assumed some benefits of consolidation following the union with REX. In particular, stemming from the use of REX's maintenance services for the Metroliners.

## 3 | Airline Industry And Market Dynamics

### Airline passenger industry

#### Short history, dimensions and some sobering observations

##### Dominated by three large domestic carriers

The Australian passenger airline industry is dominated by three large domestic carriers<sup>4</sup>, four small to medium sized regional carriers and around 25 other smaller carriers (focused on a number of specific regional markets).

Outside of QantasLink (Airlink, Sunstate Airlines and Eastern Australia Airlines), which is the largest regional airline, there are a number of carriers<sup>5</sup> providing regional air services in Australia, including:

- Macair Airlines Pty Ltd (operating since 1992 and focuses on regional [north] Queensland and northern NSW);
- Tasair (1998, Tasmania);
- Brindabella (2003 as a carrier [previously provided aircraft maintenance]; Newcastle and Albury, NSW);
- Air Link Pty Ltd (regional NSW);
- Airnorth Regional (NT, top end of Queensland and WA);
- Regional Express ([REX], August 2002, regional NSW, Victoria, Tasmania and SA);
- Alliance Airlines (July 2002, Queensland);
- O'Connor Airlines (SA, Victoria); and
- Skywest (regional WA).

##### 37.8M passengers were carried in Australia

In the 12 months to December 2004, almost 37.8M domestic and regional passengers were carried in Australia by domestic airline carriers. Regional airline passengers made up 4.6M of this total (or 12.3%). We estimate that REX carried about 1M passengers over this period, or 22% of all passengers carried on regional routes (second to QantasLink with just over 60% of passengers).

The statistics for the total Australian passenger airline industry (FY04), are as follows:

#### Aviation Traffic Statistics for 2003-2004

	International <sup>1</sup>	Domestic <sup>2</sup>	Regional <sup>2</sup>
Passengers carried (M)	18.131	62.169	7.955
Freight carried ('000 tonnes) <sup>3</sup>	611,210	104,427	1,533
Total hours flown ('000 hours)	272.4	481.0	243.6
Aircraft departures (M)	50.151	249.531	239.654
Passenger load factor	n/a	79.9	62.7

Source: Bureau of Transport and Regional Economics, Digest of Statistics 2003-04 (DGST 14/122), Commonwealth Department of Transport and Regional Services.

Notes: 1. Sum of traffic carried into and out of Australia by all international airlines. 2. Sum of traffic arriving and departing from Australian airports. 3. Freight statistics are incomplete due to non-reporting by major all-cargo carriers and most regional airlines.

<sup>4</sup> OzJet – the latest foray into the domestic (not regional) air market – announced on 11 November it had been granted a licence to fly in Australia. It will initially target the Melbourne – Sydney corridor.

<sup>5</sup> A comprehensive summary of these airlines is provided in: Turbulent Times: Australian Airline Issues 2003, Research Paper No. 10, Department of the Parliamentary Library, Appendix 1: Principal Regional Airlines, Australia, May 2003 [www.aph.gov.au/library/pubs/rp/2002-03/03RP10.pdf].

**Local industry has had a chequered .....history**

Of the regional carriers, only two (SKW and REX) are listed on the ASX. While Qantas is listed, Virgin Blue is substantially owned by Patrick Corporation (ASX:PRK) following a takeover proposal in early calendar 2005.

The local (mainly “domestic”) industry has had a chequered and colourful history, particularly in recent years, notably:

- The painful demise of Ansett Australia (and subsequent demise and revival of its affiliates – Kendell, Hazelton and SKW),
- Failure of Compass Airlines (Mark I) and Compass Mark II
- The acquisition of Impulse Airlines in 2001. Impulse achieved break-even on 48% load factors and 8%+ margins on passenger routes in early 2000. It held a unique position in Australian aviation history as it became the third new trunk route jet operator in Australia after deregulation in 1989. However, it competed head-to-head with QAN and Ansett in the domestic trunk routes and became the victim of a turf war in late calendar 2000 in the eastern States. It eventually was swallowed up by QAN in May 2001.
- Launch of VBA in 2000;
- Qantas also launched its budget airline, Jetstar, in May 2004 to compete head-to-head with VBA in the low-cost domestic routes; and
- On 11 November 2005, OzJet announced that it had been granted a licence to provide domestic passenger services, beginning with the Sydney-Melbourne trunk route.

**More than 70 domestic airlines have disappeared**

Over the last 20 years, more than 70 domestic airlines have disappeared through liquidation, bankruptcy, receivership, merger or been the subject of a takeover.

**Experienced massive attrition**

In a report to the Australian Parliament in December 2003 (Regional Aviation and Island Transport Services: *Making Ends Meet*) it was highlighted that the industry (notably the regional operators) has experienced massive attrition and it identified several common factors, including:

- high operating costs (including excessive government taxes and charges),
- declining service levels, poor interconnectivity (interoperability with other carriers)
- competition (predatory behaviour of major airlines),
- access to finance, and
- high cost of new aircraft and marginal routes.

Some of these issues are fleshed out below, however in concert they imply a classic case of market failure and a clear argument for Government intervention.

## Government policy – a case of two extremes

### **There are few barriers to entry**

There are few barriers to entry to the airline industry but those that exist are particularly high. The industry in Australia is relatively unregulated and the Australian Government fosters an 'open skies' policy. That said, the history of the industry, strong spirit of competition and high costs associated with establishing and operating aircraft (including meeting stringent safety and increasing security requirements) suggests that survivors will need deep pockets, patience and a much focused business strategy.

### **Some State Governments regulate and subsidise certain regional routes**

Ironically, some State Governments<sup>6</sup> regulate and subsidise certain regional routes to remove the threat of competition and thus make these services viable where the commercial norms fail:

- NSW, SA and Victoria regulate marginal routes (don't provide subsidies);
- Queensland subsidises the provision of services on marginal routes and it ensures that everyone is within 200kms of an air service; and
- NT maintains a number of strategic aerodromes.

### **The harsh reality of maintaining a viable and regular service where passenger traffic is modest**

The background to these discriminatory policies was the hardship created in regional Australia by the collapse of Ansett as well as the harsh reality of maintaining a viable and regular service where passenger traffic is modest. In the December 2003 Parliamentary report, for instance, a number of anecdotes were provided in respect of NSW regional centres. Notably, it was observed:

- Routes with volumes of more than 100,000 passengers per annum could support two airlines, each using 36-seat aircraft and operating three services per day (examples were routes between Sydney and Coffs Harbour, Albury, Dubbo and Wagga Wagga);
- Routes with volumes of 65-100,000 passengers per annum could support one operator full time and another with a partly committed aircraft (both using 36-seat aircraft). Examples here were routes between Sydney and Ballina, Tamworth, Port Macquarie and Armidale;
- A route volume of 35-65,000 passengers could only support one airline (36-seat aircraft) and 6-35,000 only one aircraft operating a 19-seat aircraft.
- Routes of less than 6,000 passengers could only support one operator using a 12-seat aircraft.

These observations were reinforced in other submissions regarding similar traffic statistics in other parts of regional Australia.

### **In the USA..... the median service is based on one airline only**

In the USA, over 75% of airports with 10-20,000 departures have only one main airline, whereas communities with populations of 100,000 or less, the median service is based on one airline only. This limited level of service occurs, despite the fact that routes are not regulated or licensed and generally experience far more favourable market and operating conditions than which prevail in Australia.

<sup>6</sup> A comprehensive summary of all State Government policies in relation to regional passenger airline services is provided in the Parliamentary Report 2003 (referred to elsewhere in this document); Appendix F- Aviation policies of Australia's States and Territories.

## Civil Aviation Safety Authority

### **Regulation of airline safety falls to CASA**

Regulation of airline safety in Australia falls to the Civil Aviation Safety Authority (CASA), which was established on 6 July 1995 as an independent statutory authority.

Its primary function is to conduct the safety regulation of civil air operations in Australia and the operation of Australian aircraft overseas. It is also required to provide safety education and training programmes, cooperate with the Australian Transport Safety Bureau, and administer certain features of the Civil Aviation (Carriers' Liability) Act 1959.

### **Antipathy between the smaller regional operators and the policies of CASA**

The Parliamentary Inquiry in 2003 suggested a degree of antipathy between the smaller regional operators and the policies of CASA, particularly as those policies impose compliance costs on the operators. For example, the decision by CASA to require all aircraft with nine seats or more to add ground proximity warning systems (GPWS) would cost about \$100,000 for each aircraft. REX stated that the cost would be \$5.2M to comply fully and lamented "that the upgrade did nothing to improve operational effectiveness or earning capacity of the aircraft.....".

### **Such edicts by CASA were tantamount to unfair competition**

On the same issue, Macair stated that GPWS "never saved a life yet in Australia ....It caused us to retire our Bandeirante fleet....it is \$150,000 an aircraft". The analogy was clearly drawn between the larger carriers (such as QAN) which can absorb the same fixed cost over larger aircraft and that such edicts by CASA were tantamount to unfair competition.

### **Fertile ground for industry consolidation**

The irony for REX, though, is that it now has the size and capital structure to weather such cost imposts, while its smaller competitors struggle to justify the ongoing compliance costs. This provides fertile ground for industry consolidation.

## Size matters

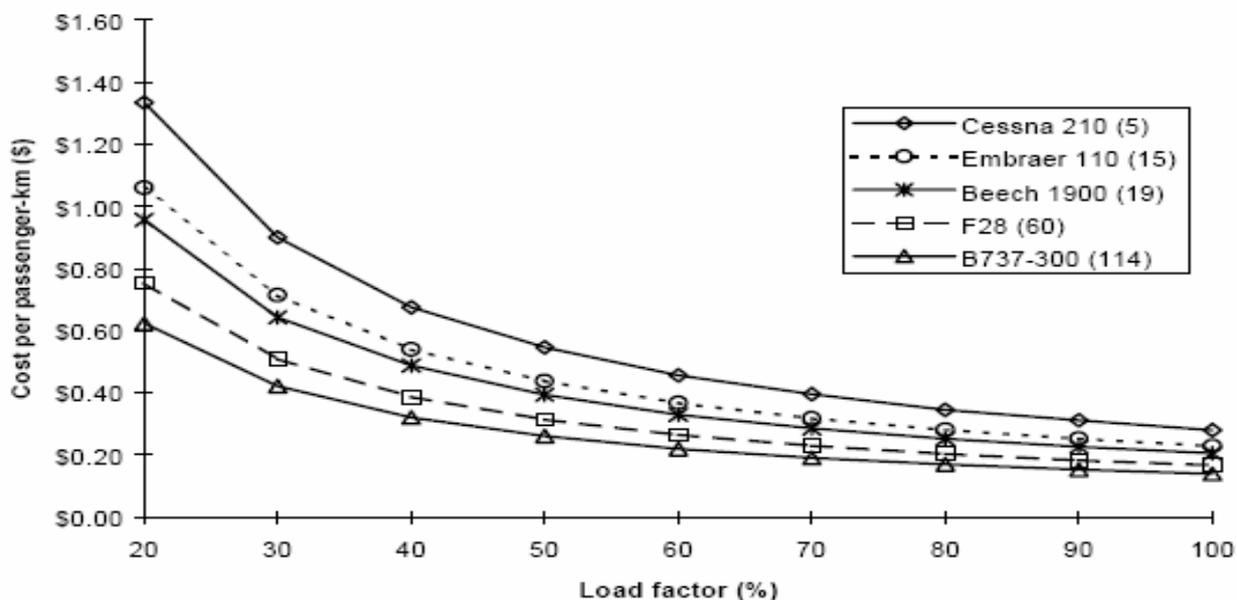
QAN also provided some sobering statistics in its submission to the Government inquiry on the relative cost of operating regional air services in Australia, viz:

- The crew costs per seat on a 36-seat aircraft are four times per seat greater than for a 260-seat aircraft;
- The maintenance costs per seat on a 36-seat aircraft are more than twice those of a 260-seat aircraft
- Aircraft ownership costs for the 36-seat aircraft are more than 50% higher than the 260-seat aircraft; and
- Landing and enroute charges for the 36-seat aircraft are more than 40% higher per seat than that for a 260-seat aircraft.

The correlation between aircraft size, costs and load factors is illustrated below:

**Cost per passenger-km for different load factors**

Note 1. Parenthetical figures indicate number of seats.



Note 2. Results for the Saab 340 A, with 34 seats were effectively the same as for the F28 with 60 seats. The Saab has not been shown on this graph for clarity.

Source: Bureau of Transport and Regional Economics (2000), Working Paper 41, 'Regional Aviation Competitiveness'.

The configuration of aircraft operating in regional Australia varies significantly, for instance:

- The smallest aircraft used by QAN in regional Australia is the Dash 8 100-200 series, which (like the Saab 340 operated by REX [34] seats) has 36 seats. It also operates BAe 146 (58-79 seats) aircraft and Boeing 717 aircraft (115-117);
- REX operates Saab 340 and Metroliners (19 seats);
- Macair operates Saab 340's (34), Fairchild Metroliner (19) and Cessna Grand Caravans (14);
- Airnorth Regional operates Metroliners (19) and Embraer 120 Brasilias (30);
- Alliance Airlines operates Fokker 100 twinjet aircraft (100);
- Skywest operates Fokker 100 (97) and Fokker 50 (46) aircraft.
- O'Connor Airlines operates Jetstream 32 aircraft (19) and Cessna Conquest's (9).

## Interoperability (interline agreements) between airlines

**REX has an agreement with VBA but not with QAN.**

Many airlines offer partner or interline arrangements, which provide seamless arrangements for passengers that may travel, for instance, to a number of different routes and using several different airlines. It can provide one stop ticketing and baggage forwarding that are a natural advantage for passengers whose travelling requirements are difficult and complex. REX has such an agreement with VBA but does not have a reciprocal agreement with QAN.

**Such agreements could add "30%" to revenues**

These agreements are highly beneficial to regional operators as evidence has suggested that as much as 20% of regional passenger loads are generated from partner carriers. In its submission to the 2003 Parliamentary Inquiry, REX stated that it had established these arrangements with 19 international carriers and added that such agreements could add "30%" to revenues.

REX lamented that its unilateral arrangement with QAN had limited benefit to REX and that a bilateral agreement would provide substantial benefits to the company.

## Regional airports and charges

**Regional passengers are paying up to 11 taxes from the three levels of government**

The Federal Government is criticised by the industry for adding to the complexity and number of taxes and charges imposed on the operators (either directly or indirectly). In its submission to the Australian Parliament Inquiry, in December 2003, REX advised that "many of its regional passengers are paying up to 11 taxes from the three levels of government". The charges imposed by the Commonwealth were identified as:

- Airservice costs (4.3%)
- Airport terminal and landing charges (6.2%)
- GST (9%)
- Noise levy (\$3.60 per ticket; Adelaide and Sydney), and
- Terrorism insurance levy (\$2.50-10.00).

**Government charges and taxes add up to 50% of a regional airfare**

Collectively, the impact of all Government charges and taxes add up to as much as 50% of a regional airfare and as much as 60% where the ticket is heavily discounted.

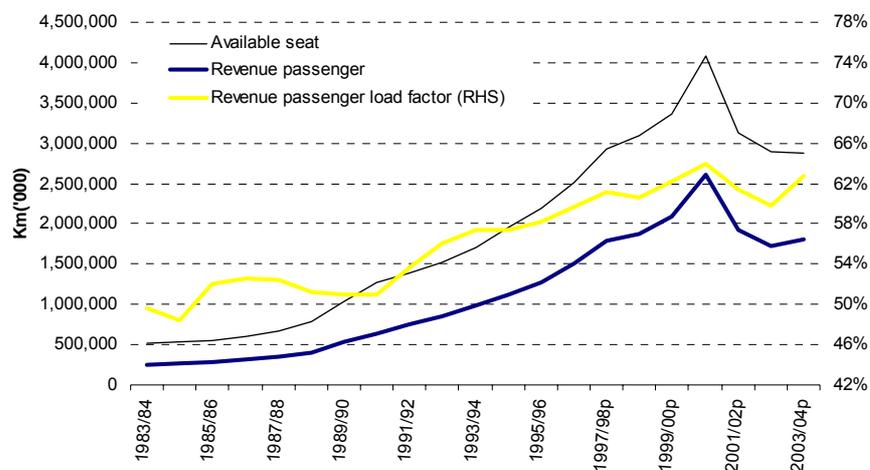
## Airline passenger market

### A short history and some perspective

**Regional carriers recorded an average annual growth rate of 7.4%**

Regional airlines began operations in Australia in 1967 and in that year 29,000 passengers were carried to a number of regional destinations. The number of passengers carried on regional airlines in FY04 was just under 4M. Between FY84 and FY04, regional carriers recorded an average annual growth rate of 7.4% (c/f domestic carriers of 5.5%). Moreover, revenue passenger kilometres (RPK's) increased to 1,807M over that same period (annual increase of 10.3%).

#### Major performance indicators, 1983/84 to 2003/04



Source: Department of Transport and Regional Services. Bureau of Transport and Regional Economics Digest of Statistics, 2003/04.

Notes: p= Provisional data.

**Regional passenger traffic was 32% below the peak year FY01**

The market has seen a marked improvement in passenger traffic following the adverse impact of 9/11, SARS, ongoing drought in regional Australia and the demise of Ansett. Significantly, following the collapse of Ansett, regional passenger traffic fell during FY02 and FY03 and was 32% below the peak year FY01 in FY03. Passenger numbers rose 5.8% in FY04. However, recent BTRE estimates show that passenger growth has generally been negative at airports where the throughput is under 10,000 passengers per year.

There are a number of reasons why passenger numbers are increasing and are likely to increase:

**Real airfares have fallen**

- Real airfares have fallen (see below) and we believe this trend will continue;
- Airfares are price elastic (although REX has suggested they are asymmetric in that they are elastic down but inelastic when increased);

**Income elasticity of 2x**

- Incomes have grown along with the general prosperity in Australia (we note that some studies have suggested an income elasticity of 2x for airfares); and

**Increasing load factor**

- Regional Australia is undergoing a renaissance in the wake of the decentralisation of the baby boomer generation ("sea changers").

The increasing load factor (62.7%<sup>7</sup> for the industry in FY04 [REX 65.4% in FY05]) has also added to the prosperity of airline carriers, although the mix

<sup>7</sup> As a rough rule of thumb, load factors of 60-70% are suggested to be adequate on regional routes to reasonably cover costs and provide a commercial margin (although in some instances 50% has been found to be adequate).

of passengers carried can make a large difference to the bottom line. For instance, some routes attract more business passengers who are prepared to pay higher fares. In Australia, recent research has suggested that around 65% of regional air travel was undertaken by business travellers. International evidence has indicated that business and government travellers can represent up to 50% of air travellers but provide up to 80% of revenue.

**Relatively high cross elasticity in operation**

The mode of travel in regional Australia depends on several factors, including distance, comfort and cost. It is recognised that there is a relatively high cross elasticity in operation and movements in airfares can result in substitution between air and road travel. Significant factors in this dynamic are the recent heavy declines in airfares in Australia and improved (and improving) quality of our access roads. Nevertheless, in Australia, air travel is favoured for distances in excess of 400kms (representing over 90% of all travel).

**Real air fares (for the deeply discounted seats) have fallen 28% since 1992**

### Prices – going one way

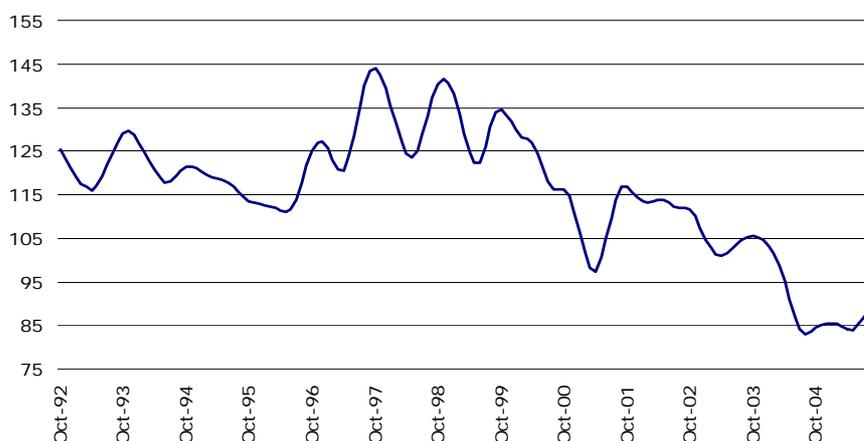
We are not aware of a regional airfare price index, although the Bureau of Transport and Regional Economics provides an index of domestic airfares, which covers the “top 70 routes” in Australia. In this sense it would also include major regional destinations in its database.

As the chart below shows, real air fares (for the deeply discounted seats) have fallen 28% since 1992, a compound average decline of 2.5% per annum. Moreover, since October 2003, these fares have fallen nearly 14% (or at a compound rate of 7.2% per annum).

**REX fares were 21% lower than in 2002**

REX noted in its Prospectus, that its fares in FY05 were 21% lower than when it began operations in 2002. This is spite of oil prices rising by 157% since 2002. Over the same period, REX increased passenger traffic by 85%.

**Australian domestic airfare indexes 13 Month Moving Average**



Source: Bureau of Transport and Regional Economics; Domestic air fare indexes.

The price elasticity of demand is thought to be above -1 but the range is -0.5 to -1.58. There is no definitive study that we are aware of in Australia, although that which we have observed shows the elasticity moves markedly with fare types – with discounted fares inelastic and full paying business fares elastic. This goes against conventional wisdom, however, as intuition would suggest the reverse (business people have to fly, whereas discount passengers are discretionary travellers). Notwithstanding, elasticities obviously differ by route and certain demographic makeup, which suggests a single metric for the entire regional market would be misleading.

<sup>8</sup> Frontier Economics, Report prepared for Gilbert + Tobin, June 2003: Virgin Blue Application for Declaration of the Airside Service at Sydney Airport.

## Airfreight industry and market

### **Pel-Air is an air charter operator**

Pel-Air is an air charter operator that specialises in supplying aircraft to the airfreight industry and for specialist purposes, such as defence support and medical evacuations. It is paid per aircraft per flying hour, rather than by the amount of freight or passengers on board. Other airline freight services, provided by the largely passenger carriers, can be described as “air cargo” services. There are a number of salient differences between the two services, but principally it entails:

- The passenger airlines offer air cargo services as an add-on to their core passenger services;
- Air cargo is usually not time sensitive, whereas air express freight is normally an overnight service, with aircraft chartered for this specific purpose. This is not a strict definition, as the passenger carriers offer regular passenger services and can meet tight (and overnight) deadlines.
- Pel-Air, and its main competitor in the two tonne turbine market, Jetcraft, dedicates aircraft for the airfreight industry, whereas the air cargo services offered by the passenger carriers are generally infill.

### **There are two large air charter companies in Australia**

There are two large air charter companies in Australia that specialise in the two tonne market – Pel-Air and Jetcraft Air Cargo. Jetcraft has been around for 15 years and operates 13 aircraft – one Metro 23 (freight capacity up to 2,300kgs), nine Metro 3 (up to 2,000kgs) and three Caravans (1,550kgs). Its principal contract is with Toll Holdings (ASX:TOL).

As an over-simplification, the market can be divided into three broad segments:

- The trunk routes are plied by the bigger freighter aircraft (the Boeing 727's, for instance);
- The two tonne turbine market (as distinct from the trunk corridor market) is largely dominated by Pel-Air and Jetcraft. Regional carriers (like REX) operate smaller aircraft as well and carry some freight, although these services are peripheral to their passenger services; and
- There are a number of smaller operators that operate piston aircraft and provide feeder services into the main freight hubs (Bathurst to Sydney, for instance).

### **Provides services between the major airports on the east coast**

Pel-Air provides services between the major airports on the east coast – Cairns, Townsville, Brisbane, Sydney, Melbourne and Hobart. It also carries freight from Melbourne, to Darwin via Alice Springs and provides services to Adelaide.

### **Size and growth profile would have limited appeal to potential market entrants**

Due to the nature and size of the industry, this is not an industry that is particularly price sensitive and competition in the two-tonne and below market segment is mooted, due to the few operators in the industry. The number of players is clearly a function of barriers to entry which are high and getting higher. And those barriers have to be weighed against the size of the market and thus opportunity. There are no estimates that we are aware of for this business, although we calculate the two-tonne market to be worth around \$30-35M+ per year, with modest organic growth. This size and growth profile would have limited appeal to potential market entrants.

There is some capacity for consolidation at the smaller end, due largely to increasing safety and security requirements of the Commonwealth Government that have to be absorbed and privatisation of airports (and thus access cost increases).

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As at the time of writing this report, the author holds shares in Regional Express Limited (REX), which were acquired as part of the REX IPO, in November 2005.

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