04 December 2009

Regional Express Holdings Limited

Company Update

REX has announced that it had secured 2 new air services in North Queensland, underpinning its recent move to develop a hub in Townsville. This, together with its 1Q10 results being in line with expectations, has reinforced our confidence in the outlook for the group and we reiterate our BUY recommendation.

BUY

Price: A$1.21

Code: REX

Key Financial Information

Y/E June		2008A	2009A	2010F	2011F	2012F
Revenue	$m	259.3	247.4	250.8	259.4	282.9
EBITDA	$m	40.4	36.6	41.8	45.1	51.6
Reported NPAT	$m	25.0	23.0	22.1	25.5	30.2
Normalised NPAT	$m	24.4	20.9	22.1	25.5	30.2
EPS (adj)	CPS	20.9	18.5	19.5	22.5	26.6
EPS Growth	%	2.3%	-11.2%	5.2%	15.5%	18.1%
PER	x	6.2	7.0	6.2	5.4	4.5
EV/EBITDA	x	3.3	3.6	3.0	2.7	2.4
DPS	c	6.6	0.0	6.0	7.0	8.0
Yield	%	5.1%	na	5.0%	5.8%	6.6%

Further expansion into Queensland

Queensland Transport announced the awarding of 2 new contracted routes to REX in far north Queensland, previously operated by the failed Macair. The routes, which are subsidised by the QLD government, are contracted for three years and will generate a secure income stream for the group. Having recently established a hub in Townsville, the routes provide REX with economies of scale and strengthen its presence in North QLD.

First Quarter Result in line with expectations

REX recently reported a credible 1Q10 result. Whilst reported NPAT was down 22.9% on the pcp, normalised NPAT, after one-off adjustments, declined 14.6% to $4.1m. (pcp: $4.8m). The result was broadly in line with our expectations of a decline in NPAT to $4.2m.

Australian Airline Pilot Academy (AAPA) on track for ramp up in 2010

Construction of Stage 1 of the new training facilities in Wagga Wagga for AAPA are on track to be completed by 30 March 2010. The facilities will be able to accommodate up to 92 students. We anticipate that AAPA may take up to 80 students in FY10, being a combination of REX cadets and external students, and hence expect its first meaningful contribution to the group in FY11.

Minimal changes to forecasts - retain BUY recommendation

We have made incremental changes to our forecasts for FY10 and FY11, increasing our EPS estimates to 19.5c and 22.5c respectively. Our forecasts imply a FY10 PER of 6.2x and an EV/EBITDA multiple of 3.0x and our DCF valuation has increased to $2.24 per share. The 1Q09 result, together with the expansion into QLD, having increased our confidence in our FY10 forecasts, reinforces our positive recommendation on the REX and we retain our BUY rating.

Stock Data

Market Capitalisation	$137.2m
Issued Capital	113.4m
Volume (monthly average)	1.7m
12-month low	$0.73
12-month high	$1.40

Market Data

Small Ordinaries	2581.5
S&P ASX 200	4792.8
All Ordinaries	4801.8

Valuation & Pricing Data

DCF Valuation	$2.24
EBITDA Multiple	$2.42
PE Multiple	$2.11
12 Month price Target	$1.95

Share Price Drivers

New routes/contracts	↑
Evidence AAPA gaining traction	↑
Further medivac contracts	↑
Outcome of CASA investigation	↑↓
Re-instatement of dividend	↑

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COMPANY UPDATE

Expansion into Queensland

Queensland Transport announced the awarding of new contracts for six government subsidized and regulated routes previously operated by Macair, which was placed in receivership in January 2009

REX has obtained 2 new additional routes in North Queensland to be operated from its hub in Townsville

Following Macair's collapse, QantasLink, Skytrans and West Wing Aviation were awarded temporary emergency contracts to fill the void left by Macair. In October 2009, REX took part in a tender process and yesterday was awarded the 2 routes operated by West Wing Aviation, while QantasLink and Skytrans were awarded contracts to continue on from the emergency service contracts they were operating.

Table 1: New contracts

Route Name	Service	Operator
Northern Route 1	Townsville-Winton-Longreach	Regional Express
Northern Route 2	Townsville-Hughenden-Richmond-Julia Ck-Mt Isa	Regional Express
Northern Route 3	Townsville-Cloncurry-Mt Isa	Qantas Link
Gulf	Cairns-4 stops-Mt Isa	SkyTrans
Western Route 1	Brisbane-3 stops-Thargomindah	SkyTrans
Western Route 2	Brisbane-6 stops-Mt Isa	SkyTrans

Source: Queensland Transport

The routes form part of 'qconnect', a Queensland Government initiative to provide improved public transport throughout regional Queensland. Due to the limited population in these towns, the government subsidise these routes to provide the operator with a commercial return. A monthly subsidy will be paid to operators that will be equivalent to it's required return less passenger income.

The routes will require minimal capex and will generate a secure income stream for the group

The term of the contract is for 3 years (a continuation of the Macair contract, which began in 2008) starting 01 February 2010 and concluding on 31 March 2013.

The routes will be serviced by REX's existing fleet and therefore the contract will require minimal additional capex. REX currently has 3 Saab 340B Plus aircraft based in Townsville and it is expected that one aircraft will be able to service both Northern Route 1 and 2. It is likely a spare aircraft will be relocated to Townsville to support the services at that hub.

We estimate that the new routes will add revenue of approximately \$2.0m and EBITDA of \$300,000 per annum. Whilst relatively small, the new routes underpin REX's newly established hub in Townsville and add weight to further expansion for the group into Queensland.

Although relatively small, the new routes will underpin further expansion into North Queensland

First Quarter Results

1Q10 was in line with expectations

REX reported a credible 1Q10 result. Whilst reported NPAT was down 22.9% on the pcp, normalised NPAT, after one-off adjustments, declined 14.6% to $4.1m. (pcp: $4.8m). This was in line with our expectations of a decline in NPAT to $4.2m.

Table 2: REX first quarter results summary

1Q10 Results Summary ($M)	1Q09	1Q10	*% Change*	Balnave Estimates	*% Change*
Passengers	354,173	308,482	*-12.9%*	302,263	*2.1%*
ASK's (m)	194	184	*-5.2%*	198	*-7.2%*
Load factor (%)	67.7%	61.8%	*-0.1*	67.0%	*-7.7%*
Average fare ($)	157.0	154.1	*-1.9%*	156.6	*-1.6%*
Revenue					
Passenger Revenue	55.6	47.3	*-14.9%*	47.3	*-0.1%*
Other Revenue	12.0	9.6	*-20.0%*	12.0	*-20.0%*
Total Revenue	67.6	56.9	*-15.8%*	59.3	*-4.1%*
Expenses					
Fuel costs	14.0	7.7	*-45.0%*	8.6	*-10.7%*
Other costs and expenses	46.9	43.5	*-7.2%*	44.8	*-3.0%*
Total Expenses	60.9	51.2	*-15.9%*	53.5	*-4.2%*
Reported PAT	4.8	3.7	*-22.9%*	4.2	*-11.2%*
Normalised PAT	4.8	4.1	*-14.6%*	4.2	*-1.6%*
EPS (¢) –normalised	4.1	3.6	*-11.8%*	3.7	*-1.6%*

Source: Company reports and Balnave Securities

Commentary

- Passenger numbers declined as expected by 12.9% from the pcp due to a combination of a decline in demand and drop in capacity.
- Passenger revenue, impacted by the fall in passenger numbers and a paring back of capacity, declined 14.6% to $47.5m.
- Load factor declined to 61.9%, which was vastly different from our expectations. This was the result of the company seeking, for the first time, to focus on its average fare to maximise profitability, whilst limiting pulling back capacity so as to have "product" available as demand returns.
- Costs fell with the company benefiting from tight cost control and lower fuel costs compared to the pcp. Fuel costs fell by 45% to 7.7m for the quarter. The pcp was impacted by higher fuel costs when the Singapore Jet Fuel Spot Price was between $0.80-$1.00 per litre versus 1Q10 price of around $0.48 per litre.
- One-off costs of circa $800k related to restructuring of Airlink and Pel-Air.
- The result was particularly pleasing in light of the lower than expected load factor. This bodes well for the future performance of the business as demand recovers.

Wagga Wagga Site Visit

We met recently in Wagga Wagga with the GM of Australian Airline Pilot Academy (AAPA), Geoff Cook, the GM of Network Strategy and Sales, Warrick Lodge, and Head of Maintenance, Dale Hall.

Australian Airline Pilot Academy

- Construction of Stage 1 of the new training facilities for AAPA are on track to be completed by 30 March 2010. The facilities will be able to accommodate up to 92 students.
- An audit was recently completed by the Vocational Training Administration Board of NSW and as a result we understand that AAPA will soon become a Registered Training Organisation. This will enable AAPA to train external students.
- AAPA may take up to 80 students in FY10, being a combination of REX cadets and external students. The external component is likely to include training for cadets for other airlines with Chinese airlines a key target market.
- China Southern, Singapore International Airlines, Cathay Pacific and Air Asia currently train pilots in Australia and therefore we expect demand will emerge, particularly given AAPA’s accelerated program, state of the art facilities and exposure students receive to airline processes and procedures.
- We expect AAPA to make its first meaningful contribution to the group in FY11. Our forecasts currently do not reflect any earnings from AAPA, however this is likely to change as the new facilities near completion and the 2010 intake is firmed up.

Network Strategy

- REX uses a software system called Aviator, which contains flight history dating back to 2002 and enables a timely comparison of data to allow for pricing changes depending on load factors at a given point in time. The system allows the effective management of scheduling and pricing to maximise yields and profitability.
- Management indicated that for the first time its focus has been on the average fare as oppose to simply load factors, to maximise profitability. The group has also limited pulling back capacity so as to have “product” available as demand returns.
- Performance of new routes from Melbourne-Griffith and Townsville-Mackay is sound but are expected to take some time to gain traction with customers.
- Further expansion into QLD is likely, particularly following the awarding of the Macair routes. We expect that new routes may considered out of the company’s hub in Townsville.

Maintenance

- REX undertakes the bulk of its maintenance from its maintenance centre in Wagga Wagga.
- The group has significant in-house maintenance capabilities which drives significant cost savings and minimises maintenance problems across the network.

Forecast Changes

We have made minor changes to our forecasts to reflect the 1Q results and the incremental impact from the new routes in north Queensland.

FY09 Results Summary	FY10			FY11		
($M)	**Old**	**New**	% Change	**Old**	**New**	% Change
Revenue	254.2	250.8	-1.4%	260.2	259.4	-0.3%
EBITDA ($m)	41.6	41.8	0.4%	43.3	45.1	4.2%
Underlying NPAT	22.0	22.1	0.5%	24.2	25.5	5.6%
EPS (¢) –normalised	19.4	19.5	0.5%	21.4	22.5	5.3%

FINANCIAL SUMMARY

Regional Express Holdings	Price	1.21
	Market Cap	137.2

Year end 30 June

Profit & Loss ($m)	2009A	2010F	2011F	2012F
Sales Revenue	**247.4**	**250.8**	**259.4**	**282.9**
EBITDA	**36.6**	**41.8**	**45.1**	**51.6**
Depreciation	-9.1	-9.8	-10.2	-10.7
Amortisation	-0.1	-0.1	-0.1	-0.1
EBIT	**27.3**	**31.8**	**34.9**	**40.8**
Net Interest Expense	0.3	0.7	1.1	1.7
NPBT	**27.8**	**31.1**	**36.0**	**42.5**
Tax expense	-6.9	-9.0	-10.4	-12.3
NPAT - underlying	**20.9**	**22.1**	**25.5**	**30.2**
Significant items	2.1	0.0	0.0	0.0
Reported NPAT	**23.0**	**22.1**	**25.5**	**30.2**

Valuation ratios	2009A	2010F	2011F	2012F
EPS (cps)	18.5	19.5	22.5	26.6
P/E (x)	6.5	6.2	5.4	4.5
PER Rel - All Ind.	-47%	-56%	-59%	-59%
PER Rel - Small Ind.	-51%	-59%	-60%	-60%
Enterprise Value ($m)	123.4	123.4	123.4	123.4
EV / EBITDA (x)	3.4	3.0	2.7	2.4
EV / EBIT (x)	4.5	3.9	3.5	3.0
DPS (cps)	0.0	6.0	7.0	8.0
Dividend Yield (%)	na	5.0%	5.8%	6.6%
Franking (%)	100%	100%	100%	100%
CFPS (cps)	26.5	33.0	31.0	35.2
P / CFPS (x)	4.6	3.7	3.9	3.4

Cash Flow ($m)	2009A	2010F	2011F	2012F
Operating EBITDA	**36.6**	**41.8**	**45.1**	**51.6**
- Interest & Tax Paid	-6.6	-8.3	-9.3	-10.6
+/- change in Work. Cap.	1.6	4.5	-0.2	-0.6
- other	-1.8	-0.5	-0.5	-0.5
Operating Cashflow	**29.8**	**37.4**	**35.2**	**39.9**
- Capex	-9.1	-11.0	-9.0	-9.0
- Aquisitions/divestments	-8.6	-18.5	-6.0	-10.0
- other	1.5	1.5	0.0	0.0
Free Cashflow	**13.6**	**9.4**	**20.2**	**20.9**
- Ord Dividends	-7.4	0.0	-6.8	-7.9
- Equity /other	-4.1	0.0	0.0	0.0
Net Cashflow	**2.1**	**9.4**	**13.3**	**13.0**
Cash at beginning of period	15.1	15.5	24.9	38.2
+/- borrowings / other	-1.8	0.0	0.0	0.0
Cash at end of period	**15.5**	**24.9**	**38.2**	**51.2**

Profitability ratios	2009A	2010F	2011F	2012F
EBITDA Margin (%)	17.9	20.3	21.6	24.0
EBIT Margin (%)	11.0	12.7	13.4	14.4
ROE (%)	16.9	15.2	15.6	16.2
ROA (%)	13.4	12.6	14.9	15.6
ROIC (%)	13.1	13.6	14.4	15.9

Balance Sheet ratios	2009A	2010F	2011F	2012F
Net Debt (cash)	-13.8	-21.5	-44.9	-46.2
Net Gearing (%)	0.0	0.0	0.0	0.0
Interest Cover (x)	na	na	na	na
NTA per share ($)	1.04	1.24	1.40	1.60
Price / NTA (x)	1.2	1.0	0.9	0.8
EFPOWA (m)	112.7	113.4	113.4	113.4

Growth ratios	2009A	2010F	2011F	2012F
Sales revenue ($m)	-4.6%	1.3%	3.4%	9.1%
EBITDA ($m)	-9.4%	14.1%	8.1%	14.3%
EBIT ($m)	-15.2%	16.5%	9.5%	17.0%
NPAT ($m)	-16.5%	5.9%	15.5%	18.1%
EPS (cps)	-11.2%	5.2%	15.5%	18.1%
DPS (cps)	-100%	na	16.7%	14.3%

Balance Sheet	2009A	2010F	2011F	2012F
Cash	15.5	34.9	48.2	61.2
Inventories	7.5	8.8	9.1	9.9
Debtors	11.1	11.3	11.7	12.7
PPE	126.4	145.4	140.7	161.2
Intangibles	7.3	7.2	7.1	7.0
Other assets	3.0	3.0	3.0	3.0
Total Assets	**170.7**	**210.6**	**219.8**	**255.0**
Borrowings	1.7	13.4	3.3	15.1
Trade Creditors	31.1	37.1	37.6	38.9
Other Liabilities	12.6	12.6	12.6	12.6
Total Liabilities	**45.3**	**63.1**	**53.5**	**66.6**
NET ASSETS	**125.4**	**147.5**	**166.3**	**188.5**

Interim Analysis	1H09A	2H09A	1H10F	2H10F
Revenues	135.8	111.6	121.3	138.1
EBITDA	19.0	17.6	18.7	23.0
EBITDA margin (%)	14.0%	15.8%	15.0%	16.7%
EBIT	14.3	13.0	13.8	18.1
EPS	9.3	10.2	10.1	12.4
DPS	0.0	0.0	0.0	6.0

Board of Directors / Substantial Shareholders		
Board of Directors	**Shareholding**	**%**
Lim Kim Hai - Executive Chairman	18.5	16.3%
The Hon. John Sharp - Deputy Chairman	0.4	0.4%
James Davis - Managing Director	0.2	0.2%
Russell Hodge - Independant Director	1.1	1.0%
David Miller - Executive Director	0.1	0.1%
Lee Thian Soo - Non-Executive Director	11.4	10.1%
Substantial Shareholders	**Shareholding**	**%**
Kim Hai Lim	18.5	16.3%
Joe Tiau Tjoa	16.2	14.3%
Thian Soo Lee	7.7	6.8%
Joo Chye Chua	7.5	6.6%
Hui Ling Tjoa	5.8	5.1%
Top 20 Shareholders	**86.4**	**76.2%**

Valuation	2010F	2011F
Normalised EBITDA multiple (x)		
EBITDA ($m)	41.8	45.1
Target EBITDA multiple (x)	6.2	5.5
Net Debt (cash) ($m)	-13.8	-13.8
Implied Valuation	274.3	263.0
Per Share	**2.42**	**2.32**
Target PE Multiple		
EPS (c)	19.5	22.5
PE Target (x)	10.8	9.1
Per Share	**2.11**	**2.05**

Discounted Cash Flow

Cost of equity	16.6%	WACC	16.6%
Cost of debt	7.5%	Terminal Growth Rate	3.0%
Net Debt/ Net debt + equity	0.0%	Per Share	$ **2.24**

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Stock Recommendations:

BUY - Minimum expected upside is 20% over 12 months.

ACCUMULATE – Minimum expected upside over 12 months is below 20% but above 10% over 12 months.

HOLD - Expected upside is below 10% over 12 months.

REDUCE - Applied when there is expected downside on the stock over 12 months.

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