Regional Express Holdings Limited (REX)

Initiate coverage of REX.

Recommendation: Buy 25 May 2007

Investment Rating

Regional Express Holdings (REX) is Australia's largest independent regional airline, established in 2002 from the merger of Hazelton and Kendell. REX is the sole provider in the majority of its routes. Airlines are capital intensive and have traditionally offered poor returns for investors. Rex effectively holds monopoly position in ~60% of its routes, many too small to be profitably serviced by Qantas, Virgin Blue, or Jetstar. The dividend payout-ratio is planned at 30-40%. This is at the high end given airlines have considerable capex requirements. Freefloat is small and share turnover low. Despite this we believe REX offers considerable value given its strong business model and attractive long term prospects.

Event

- We Initiate Coverage of REX.
- Rex is Australia's largest independent regional airline established in 2002 through the merger of Hazelton and Kendell. Regional air travel accounts for less than 8% of all passengers carried in and around Australia and an even smaller amount of air travel revenue.
- Rex holds effective monopoly positions in ~60% of its routes. REX's main competitor Qantaslink operates in only four of REX's 30 routes. Rex services smaller, regional routes avoiding highly competitive dedicated services between capital cities. There is currently little incentive for competitors to set up, with most routes unable to justify more than one provider profitably.

Impact

- We value REX at $3.05 or close to 35% above current share price of $2.28. Our valuation implies a PER of 14.6x FY08 forecast earnings. The dividend payout-ratio is planned at 30-40%. This is at the high end for airlines given considerable capex requirements. We forecast Free Cash Flow of 22 cents per share for FY08 which implies a Free Cash Flow yield of 7% for our intrinsic value or 9.7% at current share price of $2.28.
- Although we believe our valuation is conservative with possible upside, we do not expect the share price to reach our intrinsic value at a fast pace. Forecast earnings growth is strong but not phenomenal. REX's freefloat is small, with original Singaporean investors retaining ~65% of shares post IPO. Turnover is low at 3.9m shares a month or ~$350,000 of share a day. This is too small and illiquid for institutional shareholders.

Recommendation Impact

Recommendation is a Buy

Recommendation Trigger Guide

BUY	ACCUM	HOLD	REDUCE	SELL
	$2.35	$2.55	$3.45	$3.80

Note: Marker indicates price of $2.37 at publication date.

Snapshot

Last Price	$2.37
Market Cap.	$273 million
52 Week High	$2.40
52 Week Low	$0.96
Shares on Issue	115.0 million
Sector	GICS - Transportation

Valuation

Intrinsic Valuation	$3.05

Risk

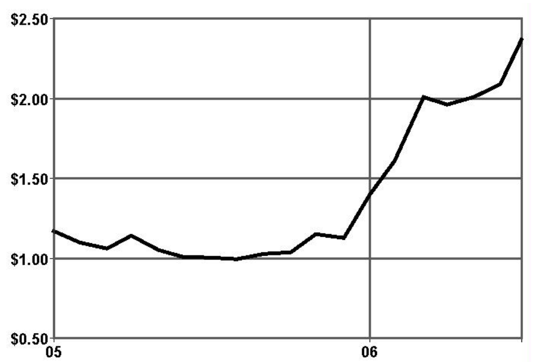
Business Risk	Medium
Pricing Risk	Medium
Company Beta	0.81
Sector Beta	0.96

Investment Fundamentals

Year-end Jun	FY05A	FY06A	FY07E	FY08E
NPAT ($m)	0.0	15.7	21.0	24.0
EPS (¢)	0.0	15.4	18.3	20.9
EPS Growth (%)			19.1	14.2
PE Ratio (x)	0.0	15.4	13.0	11.3
DPS (¢)		5.0	7.0	9.0
Dividend Yield (%)	0.0	2.1	3.0	3.8
Franking (%)		0	100	100

Source: Aspect

Price Chart



Business Description

The Rex Group (REX) provides passenger airline, freight & charter air services. It is essentially the merger of the businesses of two air carriers in Australia, namely the passenger airline businesses of Hazelton and Kendell.

Event Analysis

Initiate Coverage of REX

Rex is Australia's largest independent regional airline established in 2002 through the merger of Hazelton and Kendell. It is the sole provider in the majority of its routes, many too small to be profitably serviced by Qantas, Virgin Blue, or Jetstar. Regional air travel accounts for less than 8% of all passengers carried in and around Australia and an even smaller amount of air travel revenue.

Airlines are capital intensive and traditionally offer poor returns for investors. Strong competition, low operating margins, high fixed costs, low asset turnover, and high capital expenditure requirements result in value destruction on an industry wide basis. Overcapacity in the airline industry is also a problem. That said, we believe there are particulars about REX which will allow solid profits despite the historically unattractive industry.

Rex holds effective monopoly positions in ~60% of its routes. REX's main competitor Qantaslink operates in only four of REX's 30 routes. Rex services smaller, regional routes avoiding highly competitive dedicated services between capital cities. There is currently little incentive for competitors to set up, with most routes unable to justify more than one provider profitably. This is a similar proposition to Rural Press (previously RUP but now FXJ) which, given its niche, was able to operate at considerable profit despite being in an industry under structural decline.

Rex is the largest holder of NSW regional slots at Sydney airport via Hazelton and Kendall legacy slots, with ~45% in peak periods between 7.30am – 9.00am and 5.30pm – 7.00pm. These time slots are highly valuable allowing REX to better price discriminate on tickets despite being a 'one-class carrier'. There is no class structure in terms of service, but the airline price discriminates in terms of flight times, with flights at times most likely to suit business travelers – i.e. peak period - at 1.5 – 2x their midday or tourist-targeted equivalents. The value of slots in REX's two other hubs – Melbourne and Adelaide airport – is considerably less as both airports operate at well below peak capacity.

Revenue can grow through increases in the average fare, increase in the number of passengers per flight or load factor, increase in the number of flights on existing routes, and increase in the number of routes flown. REX has just finished updating its aircraft from the 19 seat Metro 23 to the 34 seat Saab 340.

Travel alternatives are moderate given Australia's poor rail offering, itself a fascinating story. Private car travel and coach may be cheaper but highly time consuming. Passenger growth has been strong increasing by ~25% p.a. over the past three years with ~1.2m passengers flown in FY06. A cut in fares is the main driver behind impressive passenger growth with current average fare of $139 ~20% below average fares three years ago, despite including a $24-27 fuel levy. This passenger growth coupled with increased seating has seen revenue per departure increase despite average fare declines. Considerable cost reduction has allowed REX to cut fares while increasing margin. Cost control is paramount to airline profitability, particularly regional airlines whose average load factors of 60-65% are well below domestic and international counterparts of 80%plus. Cost per Available Seat Kilometer (ASK) excluding fuel is currently ~18.6cents, or ~22.6cents including fuel, substantially below Revenue per ASK of ~25 cents. REX believes further cost savings are possible.

REX margins are as profitable as most profitable airlines globally, with a profit margin before tax of ~13% in FY06 compared to Qantas ~5% and Virgin Blue ~9%. REX has no direct debt but does lease around half its 29 plane Saab fleet with 25 more to be delivered in the next three years. REX owns 75% of regional charter and freight company Pel-Air and all of charter company Air Link. Air Link and Pel-Air own and operate a variety of aircraft.

We value REX at $3.05 or close to 35% above current share price of $2.28. Our valuation implies a PER of 14.6x FY08 forecast earnings. The dividend payout-ratio is planned at 30-40%. This is at the high end for airlines given considerable capex requirements. We forecast Free Cash Flow of 22 cents per share for FY08 which implies a Free Cash Flow yield of 7% for our intrinsic value or 9.7% at current share price of $2.28.

Although we believe our valuation is conservative with possible upside, we do not expect the share price to reach our intrinsic value at a fast pace. Forecast earnings growth is strong but not phenomenal. REX's freefloat is small, with original Singaporean investors retaining ~65% of shares post IPO. Turnover is low at 3.9m shares a month or ~$350,000 of share a day. This is too small and illiquid for institutional shareholders.

Revenue growth from FY09 onwards is forecast at mid-single digits, slightly above typical mature international airline revenue growth around GDP. Airlines typically trade at a discount to market and will likely remain so, as they require considerable capital to grow. Despite this we believe REX offers considerable value given a strong business model and attractive long term prospects. As a customer, the writer loves the customer service!

Regional Express Holdings Limited (REX)

Profit & Loss ($M)

Year to 30 Jun	2005A	2006A
Sales Revenue	**--**	**170**
Total Revenue ex. Int.	--	173
EBITDA	**--**	**25**
Depreciation & Amort.	--	-4
Goodwill Amortisation	--	--
EBIT	--	21
Net Interest	--	1
Profit Before Tax	--	22
Income Tax	--	-6
Outside Equity Int.	--	--
Profit after Tax	**--**	**16**
Significant Items after Tax	--	--
Reported Profit after Tax	**--**	**16**
Preferred Dividends	--	--

Cash Flow ($M)

Year to 30 Jun	2005A	2006A
Receipts from Customers	139	191
Funds from Operations	4	27
Net Operating Cashflow	**5**	**27**
Capex	-15	-18
Acquisitions & Investments	--	-14
Sale of Invest. & Subsid.	--	--
Net Investing Cashflow	**-7**	**-33**
Proceeds from Issues	4	35
Dividends Paid	--	--
Net Financing Cashflow	**9**	**25**
Net Increase Cash	6	19
Cash at Beginning	1	5
Exchange Rate Adjust.	--	--
Cash at End	**8**	**24**

Ratios and Substantial Shareholders

Year to 30 Jun		2005A	2006A
Profitability Ratios			
EBITDA Margin	%		14.88
EBIT Margin	%		12.41
Net Profit Margin	%		9.27
Return on Equity	%	0.00	22.86
Return on Assets	%	0.00	15.78
Debt/Safety Ratios			
Net Debt/Equity	%	-18.47	-34.28
Interest Cover	x		141.32

Top 5 Substantial Shareholders

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

Balance Sheet ($M)

Year to 30 Jun	2005A	2006A
Cash & Equivalent	9	24
Receivables	7	7
Inventories	3	4
Other Current Assets	4	1
Current Assets	**24**	**36**
Prop. Plant & Equipment	32	46
Intangibles	--	1
Other Non-Current Assets	4	1
Non-Current Assets	**54**	**64**
Total Assets	78	100
Interest Bearing Debt	--	--
Other Liabilities	27	32
Total Liabilities	**27**	**32**
Net Assets	51	69
Share Capital	69	70
Reserves	--	-2
Retained Earnings	-18	2
Outside Equity Int.	--	--
Total Shareholders Equity	**51**	**69**

Previous Research

No Previous Research

Principals & Directors

Principals

Chairman	Mr Kim Hai Lim
CEO/MD	Mr Geoffrey Breust
Company Secretary	Mr Irwin Tan

Directors

Mr Russell Hodge(Non-Executive Director, Pel-Air Operations)

Mr John Wallace Sharp(Deputy Chairman, Independent Director)

Mr David Miller(Executive Director)

Mr Kim Hai Lim(Executive Chairman)

Mr Geoffrey Breust(Managing Director)

Mr James (Jim) Davis(Executive Director Operations)

Mr Thian Soo Lee(Non-Executive Director)

Mr Robert Winnel(Independent Director)

Mr Stephen Jermyn(Non-Executive Director)