RBS
The Royal Bank of Scotland

25 February 2011

Produced by: RBS Equities (Australia) Limited

Regional Express

Looking to FY12

Hold

Target price
A$1.19

Price
A$1.09

Short term (0-60 days)
n/a

REX posted underlying 1H11 PBT of A$11.2m, down 13% on the pcp, but in line with our expectation. We expect 2H11 to show some gradual improvement as the company focuses on yield management, while FY12 should see strong growth as the Victoria Air Ambulance contract commences. We maintain our Hold rating.

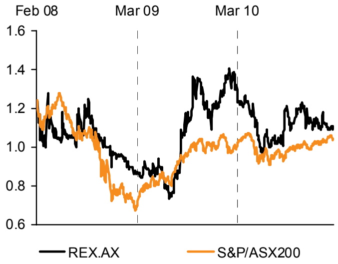
Key forecasts

	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA (A$m)	36.10	34.20	31.80	43.00	46.50
Reported net profit (A$m)	23.00	24.60	14.70 ▼	20.50	22.20
Normalised net profit (A$m)¹	20.10	19.30	14.70 ▼	20.50	22.20
Normalised EPS (c)¹	17.70	17.10	13.10 ▼	18.20	19.70
Normalised EPS growth (%)	-14.8	-3.38	-23.6	39.30	8.25
Dividend per share (c)	0.00	6.60	7.00	7.20	7.50
Dividend yield (%)	0.00	6.06	6.42	6.61	6.88
Normalised PE (x)	6.16	6.38	8.34	5.99	5.53
EV/EBITDA (x)	3.28	4.33	4.48	3.35	2.77
Price/net oper. CF (x)	4.07	4.05	4.35 ▼	6.46 ▲	3.28
ROIC (%)	18.30	16.00	8.61	12.30	12.30

Use of ▲ ▼ indicates that the line item has changed by at least 5%.
year to Jun, fully diluted
1. Pre non-recurring items and post preference dividends
Accounting standard: IFRS
Source: Company data, RBS forecasts

Price performance

	(1M)	(3M)	(12M)
Price (A$)	1.13	1.13	1.30
Absolute (%)	-3.1	-3.5	-16.2
Rel market (%)	-3.6	-8.0	-19.0
Rel sector (%)	-2.2	-6.0	-19.0



Market capitalisation
A$132.17m (US$132.70m)

Average (12M) daily turnover
A$0.06m (US$0.05m)

Sector: BBG AP Transport
RIC: REX.AX, REX AU
Priced A$1.09 at close 25 Feb 2011.
Source: Bloomberg

1H result tough, as we expected

1H10 was relatively tough for REX, with Pel-Air continuing to wind back operations and RPT services battling competition on a key route (Adelaide to Port Lincoln). Reflecting this, underlying PBT declined 13.2% on the pcp (to A$11.2m). We expect 2H11 to be a little better for REX though, as it starts to cycle lower Pel-Air earnings post restructuring and competition on the Adelaide to Port Lincoln route.

Tender update suggests pushed out timetable for JP66

The group is awaiting results on the NT aeromedical service contract and JP66 (Air Defence and Target System contract). We have not factored in earnings from either contract, and while we believe REX is particularly well placed in respect of the JP66 contract, a decision from the Department of Defence could possibly be pushed out to FY12.

FY11 downgraded but its all about FY12

Given the lower-than-expected contribution from Pel-Air, we lower our FY11F PBT to A$20.5m (-6%), while our FY12F PBT declines 3% as we factor in higher-than-expected ASK growth in RPT operations, offset by increased fuel costs. However, with Pel-Air's Victorian Air Ambulance contract due to commence on 1 July 2011, we expect revenue growth of 11% and EBIT grow 54% in FY12.

Positive outlook, but preference for others in the sector; Hold maintained

CY11 should be positive for REX, with the Victorian Air Ambulance due to commence on 1 July 2011 and RPT operations showing steady growth. However, given the relative stability of REX's earnings base through the downturn, we see more upside potential elsewhere in the sector. Our blended valuation declines slightly (to A$1.25, from A$1.26), reflecting changes to our earnings and fleet forecasts, while our target price remains unchanged at A$1.19, reflecting a 5% discount to our valuation for lack of liquidity.

Important disclosures can be found in the Disclosures Appendix.

Analysts

Michael Newbold, CFA
+61 2 8259 5663
michael.newbold@rbs.com

Mark Williams
+61 2 8259 6921
mark.williams@rbs.com

RBS Equities (Australia) Limited, ABN 84 002 768 701, AFS Licence 240530
Level 29, RBS Tower, 88 Phillip Street, Sydney NSW 2000, Australia

http://research.rbsm.com

Investment view – solid outlook from consistent performer

1H10 was relatively tough for REX, with Pel-Air continuing to wind back operations and RPT services battling competition on a key route (Adelaide to Port Lincoln). Reflecting this, underlying PBT declined 13.2% on the pcp (to A$11.2m). We expect 2H11 to be a little better for REX though, as it starts to cycle lower Pel-Air earnings after restructuring and competition on the Adelaide to Port Lincoln route.

Reflecting the lower-than-expected contribution from Pel-Air, but improved yield performance, we lower our FY11F PBT to A$20.5m (-6%), while our FY12F PBT declines 3% as we also factor in higher fuel costs. However, with Pel-Air's Victorian Air Ambulance contract due to commence on 1 July 2011, we expect revenue growth of 11% and EBIT grow of 41% in FY12.

Table 1 : Income statement summary and RBS forecast changes

						FY11F			FY12F		
(A$m)	**1H10A**	**1H11A**	**% chg**	**1H11F**	**1HA vs RBS**	**Prev**	**New**	**% chg**	**Prev**	**New**	**% chg**
Revenue	117.6	119.8	1.9%	117.9	1.6%	228.4	231.0	1.1%	254.0	256.1	0.8%
Operating costs	96.1	99.3	3.4%	96.8	2.6%	187.4	192.5	2.7%	202.5	206.6	2.0%
EBITDAR	21.5	20.4	-5.1%	21.1	-3.1%	41.0	38.5	-6.1%	51.6	49.5	-4.0%
Operating leases	3.9	4.1	5.4%	4.2	-1.8%	8.1	6.7	-17.0%	7.8	6.5	-16.8%
EBITDA	17.6	16.3	-7.4%	16.9	-3.5%	33.0	31.8	-3.8%	43.8	43.0	-1.7%
Depreciation	-4.9	-5.5	13.8%	-5.6	-0.9%	-11.6	-11.9	2.3%	-13.8	-14.3	3.9%
EBIT	12.7	10.8	-15.5%	11.3	-4.7%	21.4	19.9	-7.0%	29.9	28.7	-4.0%
Net interest	0.2	0.4	157.7%	0.1	nm	0.3	0.6	107.2%	-0.5	-0.1	nm
PBT	12.9	11.2	-13.2%	11.4	-1.8%	21.7	20.5	-5.5%	29.4	28.6	-2.8%
Tax	-3.3	-3.1	-5.4%	-3.2	-2.8%	-6.1	-5.8	-5.5%	-8.3	-8.0	-3.4%
NPAT	9.6	8.1	-15.9%	8.2	-1.4%	15.6	14.7	-5.5%	21.1	20.5	-2.6%
Significant items	0.0	-0.7	nm	0	nm	0.0	0.0	nm	0.0	0.0	nm
Reported NPAT	9.6	7.4	-23.2%	8.2	-9.9%	15.6	14.7	-5.5%	21.1	20.5	-2.6%
Normalised EPS (c)	8.5	7.2	-15.9%	7.3	-1.9%	13.8	13.1	-5.3%	18.7	18.2	-2.7%
DPS (c)	0.0	0.0	nm	0	nm	7.0	7.0	0.0%	7.2	7.2	0.0%
EBITDA margin	15.0%	13.6%	(1.4pp)	14.3%	(0.7pp)	82.0%	83.3%	(1.3ppt)	79.7%	80.7%	(0.9ppt)
EBIT margin	10.8%	9.0%	(1.8pp)	9.6%	(0.6pp)	3.5%	2.9%	0.6ppt	3.1%	2.5%	0.5ppt
NPAT margin pre sigs	8.2%	6.8%	(1.4pp)	7.0%	(0.2pp)	-2.7%	-2.6%	(0.1ppt)	-3.3%	-3.2%	(0.1ppt)

Source: Company data, RBS forecasts

Key result takeaways

- Passenger revenue increased 3.7% (to A$102.5m) despite a 1.4% reduction in passengers (to 633k). This shows that REX has achieved significant yield increases over the period, with average fares increasing 5.2% to A$162.
- Total ASKs increased 4.0%, reflecting the new QLD routes, while load factor declined 1.9pt (to 61.2%), also reflecting these new routes. The new Northern 1 and 2 routes are subsidised by the QLD Government and, despite generating commercial rates of return, they operate on average load factors of c20%. This therefore negatively affects group load factor.
- Operating expenses rose 3.8%, driven by a 5% wage increase across the board and additional depreciation resulting from the addition of new aircraft to the fleet. Fuel costs also jumped 4.9% on the pcp. Wage and fuel cost increases have been common themes across the airlines this reporting period, and with the economy slowly recovering, we expect them to remain an ongoing issue.
- REX agreed to purchase five SAAB 340B aircraft currently under lease. These second-hand aircraft are more cost effective to own than to lease (cost cA$1.6m and lease for cA$16k per month), with effective lives of 13-14 years. We expect REX to finance these purchases through cash on balance sheet. One aircraft has now been delivered, with the balance expected in 2H11. REX has also agreed to sell a Beech 1900 for US$2.7m, with transaction completion due in 3Q.
- The company declined to provide earnings guidance given its cautious outlook and conservative nature. We expect 2H11 to be similar to the pcp, though for us the focus is on FY12, when revenues from the Victorian Air Ambulance contract being to flow through.

Tender updates

- The group is awaiting results on the NT aeromedical service contract and JP66 (Air Defence and Target System contract). We have factored in no earnings from either contract, and while we believe REX is particularly well placed in respect of the JP66 contract, a decision from the Department of Defence could possibly be pushed out to FY12.
- Though the Pilot Training Academy now has the relevant accreditations, no mention was made of the status of discussions with foreign carriers in relation to training their cadets. We suspect this to be a case of no comment means no news, with the Chinese still not allowing new training academies despite the growth in their aviation industry.

Table 2 : Operating forecasts

	FY11F		FY12F		FY13F	
(A$m)	**Prev**	**New**	**Prev**	**New**	**Prev**	**New**
ASK growth	2.0%	3.0%	2.0%	2.0%	2.0%	2.0%
Load factor	61.5%	61.2%	62.0%	62.0%	62.0%	62.0%
Yield growth	1.5%	2.5%	1.5%	2.5%	2.0%	2.0%
Oil price – WTI (US/bbl)	82.2	87.2	86.5	91.0	89.6	91.0
Spot AUD/USD	0.98	0.98	1.02	1.02	0.97	0.97

Source: RBS forecasts

2011 outlook positive, though more upside expected in other carriers

We expect steady ASK and earnings growth from REX's RPT operations over 2011, but we believe the ongoing restructuring of Pel-Air operations will weigh on earnings. However, from FY12, we see Pel-Air as the growth driver for the group as its 10-year contract with Ambulance Victoria commences and it continues to tender for new work.

CY11 should be positive for REX with the Victorian Air Ambulance due to commence on 1 July 2011 and RPT operations showing steady growth, but given the relative stability of REX's earnings base through the downturn, we see more upside potential elsewhere in the sector. Our blended valuation declines slightly (to A$1.25, from A$1.26), reflecting changes to our earnings and fleet forecasts, while our target price remains unchanged at A$1.19, reflecting a 5% discount to our valuation for lack of liquidity.

Table 3 : FY11F blended valuation

Methodology	Valuation	Comment
DCF	1.65	
P/B	1.22	Based on three-year rolling average 0.9x P/NTA
PE	0.80	Based on three-year rolling average 6.1x EPS
EV/EBITDAR	1.34	Based on three-year rolling average 4.2x EV/EBITDAR
Average	1.25	Blended valuation
Target price	1.19	Reflects 5% discount for lack of liquidity

Source: RBS forecasts

Key upside risks to our valuation and target price include REX winning additional tenders and faster-than-expected growth in RPT operations, while downside risks include a return to softening economic conditions that would negatively affect demand and yields, a decline in the AUD given the exposure to USD costs, and a sustained increase in the oil price above our forecast.

REX – financial summary

Year to 30 Jun (A$m)	AIFRS	AIFRS	AIFRS	AIFRS	AIFRS
Income statement	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**
Divisional sales	245.6	225.6	229.1	254.2	266.8
Total revenue	247.0	227.5	231.0	256.1	268.7
EBITDA	36.1	34.2	31.8	43.0	46.5
Depreciation	-9.1	-10.0	-11.9	-14.3	-14.3
EBITA	27.0	24.2	19.9	28.7	32.2
Amortisation/impairment	0.0	0.0	0.0	0.0	0.0
EBIT	27.0	24.2	19.9	28.7	32.2
Associate income	0.0	0.0	0.0	0.0	0.0
EBIT(incl associate profit)	27.0	24.2	19.9	28.7	32.2
Net interest expense	0.3	0.3	0.6	-0.1	-0.4
Pre-tax profit	27.3	24.5	20.5	28.6	31.8
Income tax expense	-7.3	-5.2	-5.8	-8.0	-9.6
After-tax profit	20.1	19.3	14.7	20.5	22.2
Minority interests	0.0	0.0	0.0	0.0	0.0
NPAT	20.1	19.3	14.7	20.5	22.2
Significant items	2.9	5.3	0.0	0.0	0.0
NPAT post abnormals	23.0	24.6	14.7	20.5	22.2

Cash flow statement	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**
EBITDA	36.1	34.2	31.8	43.0	46.5
Change in working capital	4.9	1.2	-0.5	-15.8	1.1
Net interest (pd)/rec	0.3	0.3	0.6	-0.1	-0.4
Taxes paid	-9.0	-7.6	-5.8	-8.0	-9.6
Other oper cash items	-2.0	2.3	2.2	0.0	0.0
Cash flow from ops (1)	30.4	30.4	28.3	19.1	37.6
Capex (2)	-28.5	-61.9	-21.2	-13.3	-13.7
Disposals/(acquisitions)	11.7	2.5	5.8	0.0	0.0
Other investing cash flow	0.0	0.0	0.0	0.0	0.0
Cash flow from invest (3)	-16.8	-59.4	-15.4	-13.3	-13.7
Incr/(decr) in equity	-3.6	-0.4	0.0	0.0	0.0
Incr/(decr) in debt	-1.8	24.3	-1.5	-3.0	-3.0
Ordinary dividend paid	-7.4	0.0	-7.3	-7.9	-8.1
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0
Other financing cash flow	-0.5	-0.1	0.0	0.0	0.0
Cash flow from fin (5)	-13.3	23.8	-8.8	-10.9	-11.1
Forex and disc ops (6)					
Inc/(decr) cash (1+3+5+6)	0.3	-5.1	4.1	-5.2	12.8
Equity FCF (1+2+4)	1.9	-31.5	7.2	5.7	23.9

Balance sheet	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**
Cash & deposits	15.5	10.3	14.5	9.3	22.1
Trade debtors	8.3	9.5	15.6	17.5	18.4
Inventory	7.5	7.7	0.3	15.4	16.1
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	7.3	7.3	7.3	7.3	7.3
Other intangible assets					
Fixed assets	126.4	174.8	178.3	177.3	176.7
Other assets	3.5	9.1	9.1	9.1	9.1
Total assets	168.5	218.8	225.1	235.9	249.7
Short-term borrowings	1.7	0.0	0.0	0.0	0.0
Trade payables	14.9	18.3	15.8	17.5	18.4
Long-term borrowings	0.0	26.0	24.5	21.5	18.5
Provisions	0.5	0.4	0.4	0.4	0.4
Other liabilities	26.1	23.5	26.3	25.8	27.6
Total liabilities	43.1	68.2	67.0	65.2	64.8
Preference shares					
Hybrid equity					
Share capital	75.0	74.7	74.7	74.7	74.7
Other reserves	-1.0	0.0	0.5	0.8	1.1
FCTR					
Unrealised gains/losses					
Retained earnings	51.4	76.0	82.8	95.3	109.0
Other equity	0.0	0.0	0.0	0.0	0.0
Total equity	125.4	150.6	158.1	170.7	184.8
Minority interest	0.0	0.0	0.0	0.0	0.0
Total shareholders' equity	125.4	150.6	158.1	170.7	184.8
Total liabilities & SE	168.5	218.8	225.1	235.9	249.7

Closing price (A$)	**1.09**	**Price target (A$)**		**1.19**
Valuation metrics				
Preferred methodology	DCF/multiples	Val'n (A$)	$	1.25
DCF valuation inputs				
Rf	5.25%	10-year rate		5.25%
Rm-Rf	6.00%	Margin		2.0%
Beta	2.15	Kd		7.25%
CAPM (Rf+Beta(Rm-Rf))	18.1%	Ke		18.1%
E/EV*Ke+D/EV*Kd(1-t)		NPV cash flow (A$m)		196.0
Equity (E/EV)	50.0%	Minority interest (A$m)		0.0
Debt (D/EV)	50.0%	Net debt (A$m)		10.0
Interest rate	7.25%	Investments (A$m)		0.0
Tax rate (t)	30.0%	Equity market value (A$m)		186.0
WACC	11.6%	Diluted no. of shares (m)		112.9
		DCF valuation (A$)		**1.65**

Multiples	**2010A**	**2011F**	**2012F**	**2013F**
Enterprise value (A$m)	147.8	142.2	144.4	128.6
EV/Sales (x)	0.7	0.6	0.6	0.5
EV/EBITDA (x)	4.3	4.5	3.4	2.8
EV/EBIT (x)	6.1	7.1	5.0	4.0
PE (normalised) (x)	6.4	8.3	6.0	5.5
PEG (normalised) (x)	2.6	3.3	2.4	2.2

At target price	**2010A**	**2011F**	**2012F**	**2013F**
EV/EBITDA (x)	4.7	4.9	3.6	3.0
PE (normalised) (x)	7.0	9.1	6.5	6.0

Comparable company data (x)		**2011F**	**2012F**	**2013F**
Qantas Airways	EV/EBITDA	3.9	3.5	3.3
Year to 30 Jun	EV/EBIT	9.9	7.3	6.8
	PE	10.2	7.0	6.4
	PEG	1.4	1.0	0.9
Virgin Blue Holdings	EV/EBITDA	6.3	4.2	3.6
Year to 30 Jun	EV/EBIT	21.2	8.2	6.4
	PE	30.0	7.8	5.8
	PEG	3.3	0.9	0.6

Per share data	**2010A**	**2011F**	**2012F**	**2013F**
No. shares	112.9	112.9	112.9	112.9
EPS (cps)	21.8	13.1	18.2	19.7
EPS (pre-goodwill) (c)	21.8	13.1	18.2	19.7
EPS (normalised) (c)	17.1	13.1	18.2	19.7
Dividend per share (c)	6.6	7.0	7.2	7.5
Dividend payout ratio (%)	38.6	53.6	39.6	38.1
Dividend yield (%)	6.1	6.4	6.6	6.9

Growth ratios	**2010A**	**2011F**	**2012F**	**2013F**
Sales growth	-8.1%	1.6%	11.0%	5.0%
Operating cost growth	-8.6%	3.1%	7.0%	4.3%
EBITDA growth	-5.5%	-7.0%	35.5%	7.9%
EBITA growth	-10.5%	-17.7%	44.3%	12.2%
EBIT growth	-10.5%	-17.7%	44.3%	12.2%
NPAT growth	-3.8%	-23.6%	39.3%	8.2%
Normalised EPS growth	-3.4%	-23.6%	39.3%	8.2%

Operating performance	**2010A**	**2011F**	**2012F**	**2013F**
Asset turnover (%)	29.1	25.8	27.6	27.5
EBITDA margin (%)	15.1	13.9	16.9	17.4
EBIT margin (%)	10.7	8.7	11.3	12.1
Net profit margin (%)	8.6	6.4	8.1	8.3
Return on net assets (%)	16.0	12.6	16.8	17.4
Net debt (A$m)	15.7	10.0	12.2	-3.6
Net debt/equity (%)	10.4	6.4	7.2	-1.9
Net interest/EBIT cover (x)	-69.8	-32.0	220.4	83.7
ROIC (%)	16.0	8.6	12.3	12.3

Internal liquidity	**2010A**	**2011F**	**2012F**	**2013F**
Current ratio (x)	0.7	0.8	1.1	1.3
Receivables turnover (x)	25.3	18.2	15.3	14.8
Payables turnover (x)	11.5	11.6	12.7	12.3

Source: Company data, RBS forecasts

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For research produced by Nedbank Capital, a Buy implies upside in excess of 20%, A Sell implies an expected return less than 10%, and a Hold implies a return between 10% and 20%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research produced by Nedbank Capital and for research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 25 Feb 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	765 (13)	492 (3)
Hold	431 (7)	238 (1)
Sell	116 (1)	64 (0)
Total (IB%)	1312 (10)	794 (2)

Source: RBS

Trading recommendations (as at 25 Feb 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	0 (0)	0 (0)
Trading Sell	0 (0)	0 (0)
Total (IB%)	0 (0)	0 (0)

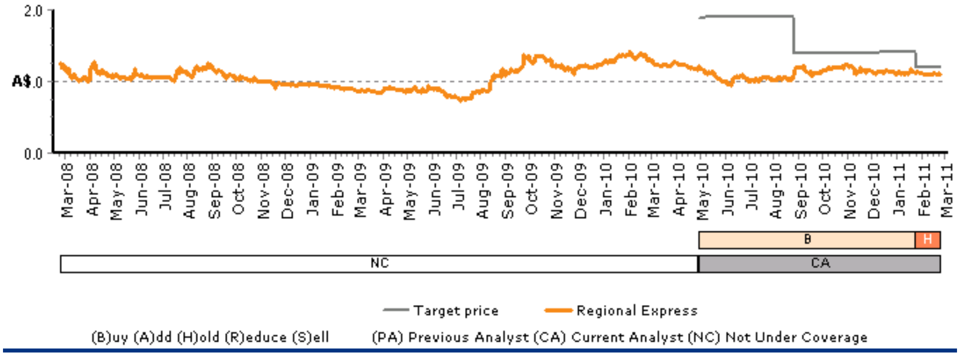
Source: RBS

Valuation and risks to target price

Regional Express (RIC: REX.AX, Rec: Hold, CP: A$1.090, TP: A$1.188): Our target price for REX is based on a blended DCF/multiples valuation. Key downside risks to our target price include a return to softening economic conditions that would have a negative impact on demand and yields, a decline in the AUD given the exposure to USD costs, and a sustained increase in the oil price above our forecast.

Regional Express coverage data

Stock performance, recommendations and coverage (as at 24 Feb 2011)



Michael Newbold, CFA started covering this stock on 28 Apr 10. New recommendation structure from 7 November 2005. Source: RBS

Trading recommendation history (as at 25 Feb 2011)

Date	Rec	Analyst
	n/a	

Source: RBS

Regulatory disclosures

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