27 February 2008

TRICOM

Industrials

BUY

Regional Express Holdings Ltd

Interim results FY08

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ASX code | REX

Last price | $1.22

Fully diluted shares on issue | 121M

Market cap | A$147.6M

52 week hi/low | $2.88 / $1.15

12 month price target[3] | $3.19

Valuation | $3.04

Valuation methodology | DCF

KEY POINTS

- The 1H08 result was disappointing, with NPAT down 10% on pcp;
- Nevertheless, the headline numbers were misleading and didn't acknowledge $4M of unusual expenses ($2.8M feeding through to the bottom line). Adding these costs back, suggested a more respectable result of $13.1M (in fact 13.9% up on 1H07);
- The one off costs relate to an unusual "clustering of major scheduled maintenance" ($3M) and $1M associated with the establishment of the pilot training academy;
- Passenger numbers rose 10%; passenger revenue 5.6% and total revenue up 23.6%;
- ASK's (average seat kilometres) lifted 9.1%; load factors remained close to peak capacity of 70% (at 68.4%) and operating costs rose 29.1%;
- The increase in total revenue and total costs is misleading as both were affected by the first time consolidation of Pel-Air for the current half;
- Fuel costs were up 29%, although remained static as a per cent of total costs;
- Pilot shortages remain a major management challenge with resignations still ahead of new hirings. That is expected to be reversed in March, although it is an industry-wide issue that can only be redressed by adding to the pool. REX is expecting to add 16 newly-trained pilots from its training academy in July 2008 and 20 new pilots every quarter thereafter;
- Cash as at 31 December was $19.4M;
- The company revised down FY08 guidance to be flat on the bottom line.

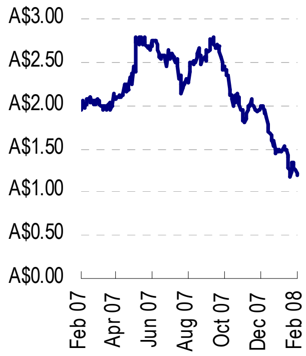
COMMENT

The result at first glance was disappointing, although ironically it was undermined by issues unrelated to the problem of pilot shortages and high fuel costs. Contributing factors were the loss of the Olympic Dam contract (announced last year) and unscheduled maintenance costs. And factoring in the severe problem of pilot losses (60% attrition anticipated in the current year) and associated problems and costs, the result could have been a lot, lot worse.

INVESTMENT VIEW

We have adjusted our forecasts for this year to reflect the current guidance, although maintain our growth trajectory conviction for future years. The share price clearly does not reflect the inherent value and there is a huge disconnect (and we suggest opportunity) between current market judgment and our target price of $3.19. Moreover, with the largest competitor to Pel-Air entering voluntary administration in December and six small regional airlines disappearing over the last 18 months, the opportunities for a well capitalised and managed player like REX remain in the ascendancy.

Share price performance | REX



Year end Jun	2007A	2008F	2009F	2010F
Revenue | A$M	225.2	253.6	285.9	320.0
EBITDA | A$M	39.1	43.4	49.0	55.0
NPAT (reported) | A$M	24.2	24.7	28.7	32.8
NPAT (normalised) | A$M[1]	24.2	24.7	28.7	32.8
EPS (diluted) | cents[2]	20.4	20.4	23.7	27.1
EPS (diluted) | % chg	32.8	0.1	16.3	14.2
PER (diluted) | x[2]	6.0	6.0	5.1	4.5
DPS | cents	6.6	7.0	9.0	11.0
Dividend Yield | %	5.4	5.7	7.4	9.0
Franking | %	100	100	100	100

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.

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PROFIT & LOSS SUMMARY (A$M)

Year end Jun	2007A	2008F	2009F	2010F
Revenue	225.2	253.6	285.9	320.0
Associates/other	0.0	0.0	0.0	0.0
EBITDA	**39.1**	**43.4**	**49.0**	**55.0**
Depreciation & amortization	(5.7)	(7.7)	(7.6)	(7.7)
EBIT	**33.4**	**35.7**	**41.5**	**47.3**
Net interest/(expense)	(0.4)	(0.4)	(0.4)	(0.4)
Pre-tax profit	**33.1**	**35.3**	**41.0**	**46.9**
Tax expense	(9.4)	(10.6)	(12.3)	(14.1)
Minority interests	0.6	0.0	0.0	0.0
Preference dividends	0.0	0.0	0.0	0.0
Adjusted NPAT	**24.2**	**24.7**	**28.7**	**32.8**
Non recurring items	0.0	0.0	0.0	0.0
Reported profit	**24.2**	**24.7**	**28.7**	**32.8**

CASHFLOW SUMMARY (A$M)

Year end Jun	2007A	2008F	2009F	2010F
EBITDA	39.1	43.4	49.0	55.0
Working capital changes	2.1	(3.3)	(4.4)	(5.8)
Net interest paid	(0.4)	(0.4)	(0.4)	(0.4)
Tax paid	(1.9)	(9.4)	(10.6)	(12.3)
Other operating items	0.1	1.3	1.1	1.3
Operating cashflow	**39.0**	**31.5**	**34.7**	**37.8**
Maintenance capex	(33.5)	(4.0)	(7.0)	(11.0)
Distributable cashflow	**5.5**	**27.5**	**27.7**	**26.8**
Dividends	(6.6)	(8.0)	(8.5)	(10.9)
Expansion capex	0.0	0.0	0.0	0.0
Acquisitions	(5.0)	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0
Other investing items	1.4	0.0	0.0	0.0
Free cashflow	**(4.7)**	**19.5**	**19.2**	**15.9**
Equity increase/(reduction)	0.0	0.0	0.0	0.0
Debt increase/(reduction)	1.1	(1.3)	(1.1)	(1.3)
Net change in cash	**(3.6)**	**18.2**	**18.1**	**14.6**

BALANCE SHEET (A$M)

Year end Jun	2007A	2008F	2009F	2010F
Cash	18.6	36.8	54.9	69.5
Receivables	12.4	15.5	19.4	24.2
Inventories	6.7	8.4	10.5	13.2
Investments	0.0	0.0	0.0	0.0
PP&E	110.7	107.0	106.5	109.8
Intangibles	7.4	7.4	7.4	7.4
Other assets	1.6	1.6	1.6	1.6
Total assets	**157.5**	**176.8**	**200.4**	**225.7**
Payables	30.0	31.5	33.1	34.7
Short term debt	2.4	2.4	2.4	2.4
Long term debt	3.2	3.2	3.2	3.2
Other liabilities	1.6	1.6	1.6	1.6
Total liabilities	**157.5**	**176.8**	**200.4**	**225.7**
Minority interests	30.0	31.5	33.1	34.7
Reserves/other	2.4	2.4	2.4	2.4
Shareholders equity	**32.4**	**33.9**	**35.5**	**37.2**

RATIOS AND MULTIPLES

Year end Jun	2007A	2008F	2009F	2010F
Income				
Revenue growth (%)	22.6	12.6	12.7	11.9
EBITDA growth (%)	48.4	11.0	13.1	12.3
EPS growth (%)	32.8	0.1	16.3	14.2
EBITDA margin (%)	17.4	17.1	17.2	17.2
EBIT margin (%)	14.8	14.1	14.5	14.8
Tax rate (%)	28.6	30.0	30.0	30.0
Interest cover (x)	93.9	82.3	95.6	109.1
Balance sheet				
ROIC (%)	20.4	18.8	19.2	19.4
ROE (%)	23.6	20.8	21.0	21.0
ROA (%)	21.2	20.2	20.7	21.0
Net debt/(debt+equity) (%)	(11.3)	(20.8)	(26.6)	(29.1)
Net debt/equity (%)	(12.7)	(26.3)	(36.1)	(41.0)
Capex/depreciation (x)	6	1	1	1
Other				
EPS[1](diluted and norm) (c)	20.4	20.4	23.7	27.1
DPS (c)	6.6	7.0	9.0	11.0
Payout ratio (%)	32.4	34.3	37.9	40.6
Distribution Yield (%)	5.4	5.7	7.4	9.0
Tax deferred (%)	0	0	0	0
OCFPS (c)	32.2	26.0	28.7	31.2
Valuation metrics				
Market cap ($M)	147.6			
Net debt ($M)	(13)	(31)	(49)	(64)
Other asset adj ($M)				
EV ($M)	143	125	107	92
EV/EBITDA (x)	3.8	3.4	3.0	2.7
EFPOWA (M)[1]	102	116	121	121
PER (diluted and norm.) (x)	6.0	6.0	5.1	4.5
PEG (x)	0.2	50.6	0.3	0.3
Price/book value (x)	1.5	1.3	1.1	1.0
Price/OCFPS (x)	3.8	4.7	4.3	3.9
NTA/share ($)	0.8	0.9	1.1	1.2
Price/NTA (x)	1.6	1.3	1.1	1.0

VALUATION

Methodology: DCF[2]	
Risk Free Rate (%)	6.43
Market premium (%)	5.50
Beta (x)	1.20
COE (%)	13.00
WACC (%)	12.60
Valuation ($/share)	$3.04

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

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1 Results review

Highlights

Rex produced a solid 1H08 result, given the challenging circumstances confronting the company in the first six months of this year. One-off costs spoiled solid bottom line arithmetic, although the headline number showed a 10% fall yr-on-yr decline. The company revised its earlier guidance for this year of 10% growth in NPAT, to “flat” yr-on-yr.

There is little doubt in our mind that the continuing challenging environment in regional Australia is telling on the less capitalised and smaller operators and this plays directly into the hands of a cashed up and conservatively capitalised company (ie REX). Notably amongst recent casualties is O’Connor Airlines and freight company, Jetcraft. Against this positive outlook, is the dilemma of skill shortages (namely fully trained pilots) which currently plagues REX (and all other airlines, both locally and internationally). REX is redressing the problem through the establishment of its own training academy, with the first new pilots to be employed by the company in July this year.

The operating statistics for the company remain excellent, with load factors still very high (a nudge under the critical 70% bar) and fuel costs, while up, remaining dead in line as a proportion of total costs for the company. Pel-Air enjoyed an 18% advance in charter business and Air Link witnessed a 52% rise in passenger traffic.

Interim results

Six months to 31 Dec 2007	1H07 ($M)	1H08 ($M)	% change
Passenger revenue	100.6	106.2	5.6%
Revenue	103.7	128.2	23.6%
EBITDA	**17.5**	**17.0**	**-2.8%**
Depreciation and amortisation	-2.2	-4.0	81.8%
EBIT	**14.6**	**13.0**	**-10.8%**
Finance charges	0.6	0.5	-22.0%
Share of associate	0.8	0.0	-101.6%
Pre tax	**16.1**	**13.5**	**-15.9%**
Tax	-4.6	-3.2	-31.0%
NPAT	**11.5**	**10.3**	**-9.9%**

Source: REX and Tricom Equities

1H08 Key Operating Statistics

Six months to 31 Dec 2007	1H07 ($M)	1H08 ($M)	% change
Passengers ('000s)	703,915	772837	9.8%
ASKs (M)	384.0	419.0	9.1%
Average Fare ($)	143.0	137.4	-3.9%
Average Fare (excl. fuel levy)	119.3	115.0	-3.6%
Load Factor	68.8%	68.4%	-0.4% pts
Revenue/ASK (cents)	26.20	25.3	-3.4%
Total cost/ASK (cents)	23.20	23.6	1.7%
Total cost/ASK (excl fuel) (cents)	18.90	19.2	1.6%

Source: REX and Tricom Equities

Costs and expenses

Six months to 31 December 2007	1H07 ($M)	1H08 ($M)	% change
Flight and port operations	22.43	23.89	6.5%
Fuel costs[1]	16.81	21.74	29.3%
Salaries and employee costs	27.22	37.25	36.8%
Selling and marketing	5.72	4.93	-13.8%
Engineering and maintenance[2]	11.64	19.30	65.8%
Office and general admin	2.34	3.44	46.9%
Finance costs	0.02	0.02	-19.2%
Depreciation and amortisation	2.19	3.98	81.8%
Other	0.82	0.63	-22.9%
	89.2	**115.2**	**29.1%**

Source: REX and Tricom Equities

Notes: 1. Pel-Air was consolidated in the accounts for the first time and we understand accounted for 19% of this growth (REX 10%). 2. There was a "one-off" charge for unscheduled maintenance of $3M. Adding this back suggests a lift of 40%, representing in the main the impact of consolidation of Pel-Air.

Costs and expenses - per cent of total costs

Six months to 31 Dec 2007	1H07 (%)	1H08 (%)
Flight and port operations	25%	21%
Fuel costs	19%	19%
Salaries and employee costs	31%	32%
Selling and marketing	6%	4%
Engineering and maintenance	13%	17%
Office and general admin	3%	3%
Finance costs	0%	0%
Depreciation and amortisation	2%	3%
Other	1%	1%
	100%	**100%**

Source: REX and Tricom Equities

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2 Outlook and valuation

The way ahead

Cash from operation for 1H08 was $18.6M, a rise of $3.3M (22%). We are predicting the cash balance to rise to $37M by year end and this is one of the enduring (and under appreciated) strengths of REX. That said, the market is focusing on short term factors, such as pilot shortages, and this has weighed heavily on the share price.

The guidance is for a flat bottom line year and that is prudent, although skewed by a number of unusual costs. In spite of the higher fuel costs and issues surrounding pilot shortages, it is conceivable that backing these items out, REX would have in fact met its original guidance of 10% uplift on last year. Adding to this is the observation that fares have continued to decline (3.6% in 1H08). If we assumed that fares were in fact increased by a mere 3%, it would lift NPAT by 7.3% in a full year (or for each 1% increase in fares, NPAT rises 2.43%). We would suggest that this metric is not lost on the company and believe there is scope for modest fare increases as a means to improve margins and the overall bottom line.

And while conditions may be challenging due to skill shortages and spike in fuel costs, the impact on other less capitalised players is fatal. Notably, the failure of the largest competitor to Pel-Air in its core two tonne freight market is as significant as the demise of O'Connor Airlines in the regional passenger market late last year. The inevitable consolidation of the industry plays directly into a well capitalised and managed company like REX.

Valuation

Our valuation for REX sits at a nudge above $3.00. We use a DCF methodology and a high WACC (due in the main to the penchant for equity in preference to debt and escalation in interest costs with the 10 year bond rate currently at 6.4%). The valuation has been reduced largely on the back of trimming this year and next year's' forecasts, although we maintain our conviction of strong foreword growth beyond this year for the company.

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As at the time of writing this report, the author owned shares in CompanyNameHere (REX).

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