Source: The Bull, 27 Jan 15

Steady performer REX could be poised for stronger take-off

By Tony Featherstone

http://www.thebull.com.au/premium/a/51570-steady-performer-rex-could-be-poised-for-stronger-take-off.html

The investment media has scrambled to find stock winners and losers from the oil price's dramatic slide. But the magnitude and timing of such events on corporate earnings is seldom clear cut, and the temptation is to look too widely for stocks that are leveraged to oil.

I prefer focusing on good-quality companies at attractive valuations, and treating gains from a lower oil price as another tailwind rather than the sole reason to buy. It's too risky to base an investment decision solely on a commodity as volatile and unpredictable as oil.

Regional Express Holdings (REX) fits my criteria. The regional airline has been a steady performer for years, at least compared with its larger aviation peers, and is due for greater market recognition. It's also well placed to acquire smaller airlines in this tough market.

REX operates a fleet 95 aircraft in most of the states, and is Australia's largest independent regional airline. That provides more than 80 per cent of earnings; the charter plan and pilot-training divisions make up the rest.

Chart 1: Regional Express Holdings (REX)

Source: ASX

Generally, I avoid airline stocks. There are just too many turn-offs: large capital requirements to buy and maintain planes; hard-to-predict fuel costs; a combative industrial-relations setting; and high sensitivity to unfavourable currency movements. Another layer of unpredictability comes from weather, regulatory risk, terrorism and plane crashes.

Most airlines do not have a clear, sustainable competitive advantage; the industry is commoditised and has falling profit margins; and customers have low switching costs because they can easily move between airlines to get a better price.

Qantas Airways has an average, annualised 10-year total shareholder return (including dividends) of minus 1.5 per cent to January 21, 2015. It is, however, sharply higher this year (thanks to the lower oil price) and has latent value in in its frequent-flyer program, which is arguably worth more than airline itself.

Virgin Australia Holdings has a 10-year annual return of minus 11.2 per cent. Two of four brokers in consensus forecasts compiled by Morningstar have sell recommendations, and two have holds. It is hard to find too many supportive brokers, even with a lower oil price.

REX said in November it had made more accumulated pre-tax profit in the past nine years than Qantas or Virgin and described itself as the country's profitable passenger airline.

REX delivered consistently high Return on Equity (ROE) between FY06 and FY12, averaging almost 17 per cent. That is good for a small-cap industrial company, let alone one in an unpredictable aviation industry that is often characterised by heavy losses.

But REX's ROE tumbled to 6.7 per cent in FY13 and 4.1 per cent in FY14 as horrid conditions crunched the airline industry. Deputy chairman John Sharp said in November that REX's drop in profitability had "to be viewed in the light of one of the most toxic environments Australian aviation has seen, which saw the demise of three Australian regional carriers and losses of over $4 billion by Australia's two major carriers".

REX's exposure to struggling regional economies, hit hard by the downturn in resource investment and fewer fly-in/fly-out workers, compounded its problems. That it made a $10.7 million pre-tax profit in FY14, albeit 44 per cent down on a year earlier, was a reasonable effort given the savage deterioration in its market.

Sharp also said: "Rex Group is now well poised to take advantage of the upturn of the economy when that happens. Our passenger numbers have stopped declining and fuel prices have remained low during the first part of this financial year."

REX is also well positioned to capitalise on any consolidation of smaller airlines, or expand as other competitors leave routes. Net gearing of 11.7 per cent in FY14, and interest cover of 19.2 times is conservative – it has more than enough firepower to buy weakened small competitors. It bought $56 million of productive assets in FY14, positioning it for faster growth when the economy finally improves.

The ROE should return to double digits in the next year or two as lower fuel costs help in the short term and as the economy gradually improves. Longer term, REX's investment in equipment and expansion in Queensland, after being awarded five routes it applied for, are good signs.

The company has plenty of ground to make up. Its five-year average annualised total shareholder return is almost zero, according to Morningstar. It has recovered from a 52-week low of 69 cents to $1.09, largely because of the lower oil price and after being oversold.

REX might finally take flight as the market becomes convinced the worst is over for the airline sector, that lower oil prices will last longer than expected, and that its expanding presence in regional aviation will create a higher ROE than in the past few years. But it suits experienced investors who are comfortable with micro-cap stocks.

Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations or offer financial advice. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at January 21, 2015.