

31 August 2011

Produced by: RBS Equities (Australia) Limited

Regional Express

Buy

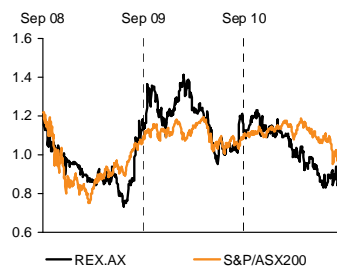
Target price
A\$1.26 (from A\$1.25)

Price
A\$0.965

Short term (0-60 days)
n/a

Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.89	0.95	1.19
Absolute (%)	8.4	1.6	-18.9
Rel market (%)	12.4	11.1	-15.4
Rel sector (%)	13.8	5.3	-11.1



Market capitalisation

A\$106.21m (US\$113.79m)

Average (12M) daily turnover

A\$0.06m (US\$0.06m)

Sector: BBG AP Transport
RIC: REX.AX, REX AU
Priced A\$0.96 at close 30 Aug 2011.
Source: Bloomberg

Analysts

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Buy me

FY12 is the year we have been waiting for. Pel Air is once again profitable, the Victorian Air Ambulance contract has commenced and the AAPA is gaining traction. With earnings growth largely contracted and trading on 4.9x FY12F EPS with an expected 7.9% FY12F yield we maintain our Buy recommendation.

Key forecasts

	FY10A	FY11A	FY12F	FY13F	FY14F
EBITDA (A\$m)	34.20	33.90	45.60 ▲	48.20 ▲	50.90 ▲
Reported net profit (A\$m)	24.60	17.60	21.70 ▲	24.00 ▲	26.80 ▲
Normalised net profit (A\$m) ¹	19.30	17.40	21.70 ▲	24.00 ▲	26.80 ▲
Normalised EPS (c) ¹	17.41	15.66	19.69 ▲	21.86 ▲	24.38 ▲
Normalised EPS growth (%)	-1.56	-10.0	25.70	11.00	11.60
Dividend per share (c)	6.60	7.10	7.60 ▲	8.60 ▲	9.60 ▲
Dividend yield (%)	6.84	7.36	7.88	8.91	9.95
Normalised PE (x)	5.54	6.16	4.90	4.42	3.96
EV/EBITDA (x)	3.57	3.43	2.26	1.77	1.32
Price/net oper. CF (x)	3.52	3.02	3.07 ▼	2.64 ▼	2.55 ▼
ROIC (%)	16.00	9.83	12.90	14.00	15.30

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

Another solid result in what was expected to be a tough year

FY11A PBT of A\$23.9m was in line with RBS forecasts but a small decline on the pcp. In our view it was a very encouraging result given 1) the volatility of oil and economic conditions during the period; 2) Pel Air's ongoing restructure; and 3) the pilot training academy's (AAPA) ongoing ramp-up. The full-year dividend increase to 7.1cps fully franked (vs RBS's 6.6cps) was a positive surprise and driven by higher cash availability (cash balance of A\$19m, up A\$9m on the pcp) due to lower capex obligations during the period.

Outlook statement rosier than usual

In his outlook statement, REX's ever conservative Chairman, Lim Kim Hai, stated that his optimism and confidence in the outlook and potential for the Rex Group was at its highest level in the past nine years and that all subsidiaries in the Group are expected to be profitable in FY12. With Rex's regular passenger transport (RPT) operation's proven resilience to economic conditions, Pel Air's Victorian Air Ambulance contract coming on line this year and the AAPA gaining traction we tend to agree.

Earning upgrades as turnaround businesses improve faster than expected

Following REX's full-year result, we have upgraded our FY12F PBT by 9% to A\$31m as we account for additional fly-in/fly-out earnings in Pel Air and training revenue at the Academy in our forecasts, while our FY13F PBT increases 11% to A\$34m.

Cheap with yield and industry best returns; Buy maintained

We continue to believe REX is cheap, with strong earnings growth (FY12F NPAT +24%), market-leading returns (FY12F ROIC of 14% vs QAN and VBA at 6%), a 7.9% fully franked yield and trading on an FY12F P/E of 4.9x (vs the Small industrials at 12.1x). Reflecting changes to forecasts our blended valuation increases to A\$1.58 while our target price increases to A\$1.26 reflecting a 20% discount to our valuation for lack of liquidity. Buy.

Important disclosures can be found in the Disclosures Appendix.

Five key things to focus on regarding the result

- **FY11A PBT of A\$23.9m was in line** with forecasts and a small decline on the pcp. This was a very encouraging result given 1) the volatility of oil during the period and the uncertain economic conditions; 2) Pel Air was still undergoing a restructure in the period; and 3) the pilot training academy (AAPA) also lost money as it struggled to sign external training candidates.
- **Distribution per share surprised to the upside**, increasing to 7.1cps fully franked (vs RBS 6.6cps). This was driven by higher cash availability cash (cash balance of A\$19m, up A\$9m on the pcp) due to lower capex obligations during the period. With reduced capex anticipated in the short to medium term, we expect ongoing growth in distributions.
- **Pel Air returned to profit** in 4Q11 following its extensive two-year restructure from a low margin high volume freight operator to a more contract based charter, Air Ambulance, Defence and Freight operator.
- **The outlook looks positive** with the ever-conservative Chairman Lim Kim Hai noting that his optimism and confidence in the outlook and potential for the Rex Group was at its highest level in the past nine years. With Rex's regular passenger transport (RPT) operation's proven resilience to economic conditions, Pel Air's Victorian Air Ambulance contract coming on line this year and the AAPA gaining traction we tend to agree.
- **No guidance was provided for FY12** earnings with Management referring once again to the volatility of market conditions, the foreign exchange rate and fuel prices. However, with the outlook positive as noted above, Management stated it expects all subsidiaries in the Group to be profitable in FY12.

Table 1 : Result summary and earnings forecast changes (A\$m)

	FY10A		FY11F			FY12F			FY13F		
	FY10A	FY11A	% chg	RBSF	% diff	Prev	New	% chg	Prev	New	% chg
Total Revenue	227.4	239.1	5%	236.9	1%	266.2	272.8	2%	276.9	285.3	3%
Operating Costs	184.3	196.4	7%	195.1	1%	216.8	221.1	2%	225.0	231.1	3%
Operating EBITDAR	43.1	42.7	-1%	41.9	2%	49.4	51.8	5%	51.9	54.2	5%
Non-cancellable operating leases	8.9	8.9	-1%	6.8	31%	6.5	6.2	-5%	6.8	6.0	-11%
Operating EBITDA	34.2	33.9	-1%	35.1	-4%	43.0	45.6	6%	45.1	48.2	7%
Depreciation	9.9	11.1	12%	11.8	-6%	14.3	13.9	-2%	14.2	13.9	-2%
Operating EBITA	24.2	22.8	-6%	23.3	-2%	28.7	31.7	10%	30.9	34.3	11%
Amortisation	0.1	0.1	37%	0.1	33%	0.1	0.1	32%	0.1	0.1	32%
Operating EBIT	24.2	22.7	-6%	23.3	-2%	28.6	31.5	10%	30.8	34.2	11%
Net Interest expense	0.3	1.2	235%	0.6	86%	(0.1)	(0.5)	598%	0.2	0.2	-6%
Pre-tax profit	24.5	23.9	-3%	23.9	0%	28.5	31.0	9%	31.0	34.4	11%
Taxation	5.2	6.4	23%	6.7	-4%	8.6	9.3	9%	9.3	10.3	11%
Underlying	19.3	17.4	-10%	17.2	1%	19.9	21.7	9%	21.7	24.0	11%
Abnormals (net of tax)	5.3	0.2	-97%	0.0	nm	0.0	0.0	nm	0.0	0.0	nm
Reported NPAT	24.6	17.6	-29%	17.2	2%	19.9	21.7	9%	21.7	24.0	11%

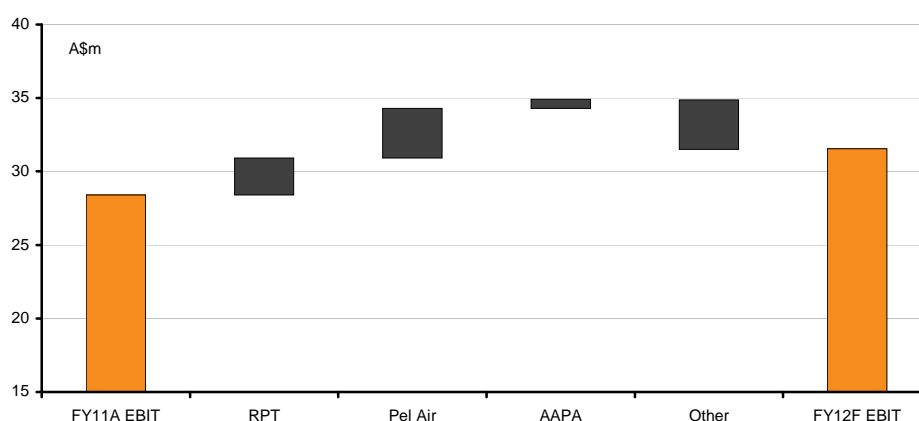
Source: Company data, RBS forecasts

Divisional breakdown

- **REX's RPT** operations saw FY11 EBIT increase 1% on the pcp (to A\$29m), driven by largely flat capacity which helped to buoy yields (+7% on the pcp). Capacity remained flat as reductions due to higher landing charges at Burnie and Mount Gambier airports were offset by new capacity on Melbourne-based routes. Cost/ASK increased ahead of forecasts (+7.8%) led by higher staffing (due to new EBAs effective 1 July 11) and depreciation expenses. REX continues to run ahead of piloting needs to clear excess leave balances and provide a buffer in the event of increased pilot attrition (12.2% in FY11, in line with historical average).
- Delivering ahead of an expected small loss, **Pel Air** saw a solid increase in both contracted and ad hoc fly-in/fly-out activity with contracted revenues doubling in the 2H and ad hoc revenues increasing 80% on the pcp. Pel Air signed a FIFO contract with Ivanhoe Resources during the period and also restructured its arrangements with Australian Air Express. We estimate that new contracts contributed an additional A\$3m to revenue during the period while ad hoc work (which should be largely recurring) contributed A\$2m.

- AAPA** recorded a small loss for FY11 but broke even in 4Q11 as it continued to gain traction. 114 cadets have now passed through its doors with 18 graduating during the period, 66 now flying with REX/Pel Air and 38 still undergoing training. During the period, the AAPA achieved accreditation by the relevant authority from the United Arab Emirates to deliver Multi-Crew Pilot Licence flight training to cadets in conjunction with the Alpha Aviation Group. Six cadets commenced training in August with 60 per year expected under the agreement. We expect this to contribute cA\$5m to revenue pa and cA\$0.8m to earnings.

Figure 1 : FY11A to FY12F earnings bridge



Source: Company data, RBS forecasts

Key trends to focus on

- Review of RPT operations.** The enroute rebate subsidy will be removed effective 1 July 2012 and a carbon tax imposed on the same date which will create a cost impost for REX and indeed all airlines. We expect REX to conduct a full review of its network with a view to possibly exiting routes (or reducing capacity on certain routes) which it believes will not sustain the required pricing increases to absorb these cost imposts. Such routes may include Taree, Grafton, Bathurst and Moruya given their already high price sensitivity. We estimate these two measures are likely to add between A\$4-6 per ticket to REX's airfares.
- Results from outstanding tenders.** During the period Pel Air tendered for the ADF Jet Support contract (for which it is the incumbent). The tender outcome is expected imminently with the contract extension under which Pel Air is currently operating due to expire on 30 September. Pel Air is also awaiting an outcome on the JP66 contract (due for commencement on 1 July 2012) and expects further increases in mining fly in/fly-out operations and foreign charter work over the year. We have not factored in wins from any of these tenders into our numbers to date and as such any wins present upside risk to our forecasts.

Valuation and target price increase given upgrades

As a result of changes to forecasts, our blended valuation increases to A\$1.58 (from A\$1.47) while our target price increases to A\$1.26 (from A\$1.25), reflecting a 20% discount to our valuation for lack of liquidity. 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.

Table 2 : Valuation and target price

Methodology	Valuation	Comment
DCF	1.94	
P/B	1.29	Based on 3-year rolling average 0.9x P/NTA
P/E	1.12	Based on 3-year rolling average 5.7x EPS
EV/EBITDAR	1.98	Based on 3-year rolling average 4.2x EV/EBITDAR
Average	1.58	Blended valuation
Target price	1.26	Reflects 20% discount for lack of liquidity

Source: RBS forecasts

REX – financial summary

Year to 30 Jun (A\$m)	AIFRS	AIFRS	AIFRS	AIFRS	AIFRS	Closing price (A\$)	0.95	Price target (A\$)	1.26	
Income statement	2010A	2011A	2012F	2013F	2014F	Valuation metrics				
Divisional sales	224.4	230.6	264.3	276.8	290.0	Preferred methodology	DCF/multiples	Val'n (A\$)	\$ 1.58	
Total revenue	227.4	239.1	272.8	285.3	298.5	DCF valuation inputs				
EBITDA	34.2	33.9	45.6	48.2	50.9	Rf	5.25%	10-year rate	5.25%	
Depreciation	-10.0	-11.2	-14.0	-14.0	-14.0	Rm-Rf	6.00%	Margin	2.0%	
EBITA	24.2	22.7	31.5	34.2	37.0	Beta	2.15	Kd	7.25%	
Amortisation/impairment	0.0	0.0	0.0	0.0	0.0	CAPM (Rf+Beta(Rm-Rf))	18.1%	Ke	18.1%	
EBIT	24.2	22.7	31.5	34.2	37.0	E/EV*Ke+D/EV*Kd(1-t)		NPV cash flow (A\$m)	209.9	
Associate income	0.0	0.0	0.0	0.0	0.0	Equity (E/EV)	50.0%	Minority interest (A\$m)	0.0	
EBIT(incl associate profit)	24.2	22.7	31.5	34.2	37.0	Debt (D/EV)	50.0%	Net debt (A\$m)	-3.2	
Net interest expense	0.3	1.2	-0.5	0.2	1.4	Interest rate	7.25%	Investments (A\$m)	0.0	
Pre-tax profit	24.5	23.9	31.0	34.4	38.3	Tax rate (t)	30.0%	Equity market value (A\$m)	213.1	
Income tax expense	-5.2	-6.4	-9.3	-10.3	-11.5	WACC	11.6%	Diluted no. of shares (m)	110.1	
After-tax profit	19.3	17.4	21.7	24.0	26.8			DCF valuation (A\$)	1.94	
Minority interests	0.0	0.0	0.0	0.0	0.0					
NPAT	19.3	17.4	21.7	24.0	26.8	Multiples	2011A	2012F	2013F	2014F
Significant items	5.3	0.2	0.0	0.0	0.0	Enterprise value (A\$m)	116.2	103.0	85.1	67.3
NPAT post abnormals	24.6	17.6	21.7	24.0	26.8	EV/Sales (x)	0.5	0.4	0.3	0.2
						EV/EBITDA (x)	3.4	2.3	1.8	1.3
Cash flow statement	2010A	2011A	2012F	2013F	2014F	EV/EBIT (x)	5.1	3.3	2.5	1.8
EBITDA	34.2	33.9	45.6	48.2	50.9	PE (normalised) (x)	6.1	4.8	4.3	3.9
Change in working capital	1.2	1.1	-1.1	2.2	0.8	PEG (normalised) (x)	2.5	2.0	1.8	1.6
Net interest (pd)/rec	0.3	1.2	-0.5	0.2	1.4	At target price	2011A	2012F	2013F	2014F
Taxes paid	-7.6	1.0	-9.3	-10.3	-11.5	EV/EBITDA (x)	4.4	3.0	2.4	2.0
Other oper cash items	2.3	-1.6	0.0	0.0	0.0	PE (normalised) (x)	8.1	6.4	5.8	5.2
Cash flow from ops (1)	30.4	35.6	34.6	40.2	41.6	Comparable company data (x)	2012F	2013F	2014F	
Capex (2)	-61.9	-29.2	-13.4	-13.8	-14.2	Qantas Airways	EV/EBITDA	3.1	3.0	2.6
Disposals/(acquisitions)	2.5	6.6	0.0	0.0	0.0	Year to 30 Jun	EV/EBIT	8.2	7.3	5.5
Other investing cash flow	0.0	0.0	0.0	0.0	0.0		PE	7.0	5.6	4.4
Cash flow from invest (3)	-59.4	-22.5	-13.4	-13.8	-14.2		PEG	1.2	0.9	0.7
Incr/(decr) in equity	-0.4	3.0	0.0	0.0	0.0	Virgin Blue Holdings	EV/EBITDA	4.1	3.7	3.2
Incr/(decr) in debt	24.3	0.0	-3.0	-3.0	-3.0	Year to 30 Jun	EV/EBIT	10.5	7.6	5.7
Ordinary dividend paid	0.0	-7.3	-8.0	-8.5	-9.6		PE	10.2	5.7	4.1
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0		PEG	1.8	1.0	0.7
Other financing cash flow	-0.1	0.0	0.0	0.0	0.0	Per share data	2011A	2012F	2013F	2014F
Cash flow from fin (5)	23.8	-4.3	-11.0	-11.5	-12.6	No. shares	112.9	111.6	111.5	111.5
Forex and disc ops (6)						EPS (cps)	15.8	19.7	21.9	24.4
Incr/(decr) cash (1+3+5+6)	-5.1	8.7	10.2	14.9	14.8	EPS (pre-goodwill) (c)	15.8	19.7	21.9	24.4
Equity FCF (1+2+4)	-31.5	6.4	21.2	26.4	27.4	EPS (normalised) (c)	15.7	19.7	21.9	24.4
						Dividend per share (c)	7.1	7.6	8.6	9.6
Balance sheet	2010A	2011A	2012F	2013F	2014F	Dividend payout ratio (%)	46.0	39.1	39.9	39.9
Cash & deposits	10.3	19.0	29.2	44.1	58.9	Dividend yield (%)	7.5	8.0	9.1	10.1
Trade debtors	9.5	10.0	11.4	11.9	12.5	Growth ratios	2011A	2012F	2013F	2014F
Inventory	7.7	10.4	11.8	12.4	13.0	Sales growth	2.8%	14.6%	4.7%	4.8%
Investments	0.0	0.0	0.0	0.0	0.0	Operating cost growth	3.4%	11.2%	4.5%	4.6%
Goodwill	7.3	7.5	7.5	7.5	7.5	EBITDA growth	-0.9%	34.6%	5.7%	5.7%
Other intangible assets						EBITA growth	-6.1%	39.0%	8.4%	8.1%
Fixed assets	174.8	185.7	185.1	184.9	185.1	EBIT growth	-6.1%	39.0%	8.4%	8.1%
Other assets	9.1	6.9	6.9	6.9	6.9	NPAT growth	-9.7%	24.4%	10.9%	11.6%
Total assets	218.8	239.6	252.0	267.8	283.9	Normalised EPS growth	-10.0%	25.7%	11.0%	11.6%
Short-term borrowings	0.0	1.9	1.9	1.9	1.9	Operating performance	2011A	2012F	2013F	2014F
Trade payables	18.3	19.4	22.1	23.2	24.2	Asset turnover (%)	25.1	26.9	26.6	26.3
Long-term borrowings	26.0	27.1	24.1	21.1	18.1	EBITDA margin (%)	14.7	17.2	17.4	17.6
Provisions	0.4	0.5	0.5	0.5	0.5	EBIT margin (%)	9.8	11.9	12.4	12.8
Other liabilities	23.5	29.9	28.9	31.1	32.0	Net profit margin (%)	7.6	8.2	8.7	9.2
Total liabilities	68.2	78.8	77.5	77.8	76.7	Return on net assets (%)	14.1	18.1	18.0	17.8
Preference shares						Net debt (A\$m)	10.0	-3.2	-21.1	-38.9
Hybrid equity						Net debt/equity (%)	6.2	-1.8	-11.1	-18.8
Share capital	74.7	74.7	74.7	74.7	74.7	Net interest/EBIT cover (x)	-19.6	58.5	-189.7	-26.9
Other reserves	0.0	-0.2	0.3	1.4	2.5	ROIC (%)	9.8	12.9	14.0	15.3
FCTR						Internal liquidity	2011A	2012F	2013F	2014F
Unrealised gains/losses						Current ratio (x)	0.8	1.0	1.2	1.5
Retained earnings	76.0	86.3	99.5	113.9	130.0	Receivables turnover (x)	23.6	24.7	23.7	23.7
Other equity	0.0	0.0	0.0	0.0	0.0	Payables turnover (x)	10.4	10.5	10.1	10.1
Total equity	150.6	160.8	174.4	190.0	207.2					
Minority interest	0.0	0.0	0.0	0.0	0.0					
Total shareholders' equity	150.6	160.8	174.4	190.0	207.2					
Total liabilities & SE	218.8	239.6	252.0	267.8	283.9					

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 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 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 31 Aug 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	848 (12)	551 (3)
Hold	416 (7)	226 (4)
Sell	80 (6)	48 (0)
Total (IB%)	1344 (10)	825 (3)

Source: RBS

Trading recommendations (as at 31 Aug 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	1 (100)	1 (100)
Trading Sell	0 (0)	0 (0)
Total (IB%)	1 (100)	1 (100)

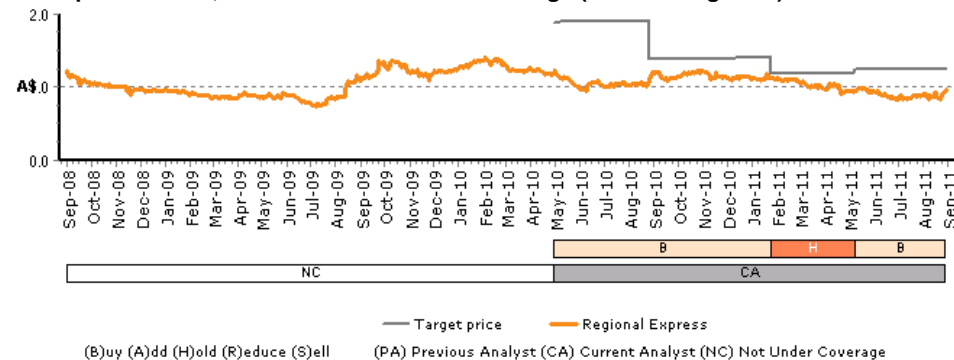
Source: RBS

Valuation and risks to target price

Regional Express (RIC: REX.AX, Rec: Buy, CP: A\$0.965, TP: A\$1.264): 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 30 Aug 2011)



Trading recommendation history (as at 31 Aug 2011)

Date	Rec	Analyst
	n/a	

Source: RBS

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

Regulatory disclosures

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