

Tuesday, 30 March 2010

Skywest Airlines Limited (SXR)

Winning in the West (Initiating Coverage)

- SkyWest Airlines (SXR.ASX) is a Perth-based regional airline providing regular passenger, charter and freight transport services in Western Australia. The Company is incorporated in the Republic of Singapore and the financial accounts are prepared under International Financial Reporting Standards (IFRS), expressed in Singapore dollars and audited in Australia (Ernst & Young). Skywest is listed on both the London Stock Exchange's Alternative Investment Market (AIM) and Australian Securities Exchange (ASX).
- The Airline commenced operations in 1963 as 'Carnarvon Air Taxis', changing its name to 'Skywest Aviation' in 1979. The airline operated as part of Ansett from 1986 until that Group's demise in 2002. Private investors purchased the airline from the Ansett administrators eventually listing 'Skywest Limited' on the ASX. In January 2005, Singapore based Captive Vision Capital (a subsidiary of Advent Air) gained control of the Company.

Business

- Skywest has three key operating activities:
 1. **Regular Passenger Services.** Skywest operates on regional air routes to 15 destinations (Perth, Kalgoorlie, Esperance, Albany, Geraldton, Kalbarri, Monkey Mia, Carnarvon, Paraburdoo, Exmouth Karratha, Port Headland, Broome, Kununurra and Darwin). On 5 February 2010 Skywest commenced flights between Kalgoorlie and Melbourne. The Company also operates an international flight - Port Headland to Bali. Approximately 40% of the Company's total operating revenue is contributed from regular passenger services (45% from deregulated air routes and 55% from regulated air routes).
 2. **Charter Services.** Skywest operates regular, contracted and ad hoc charter flights to destinations including Windarling, West Angelas, Newman, Brockman, Barimunya, Cloudbreak, Telfer, The Granites and Argyle. Major charter clients include Citic, BHP, Newmont, Portman and Macmahon. Skywest is the primary air charter provider to Rio Tinto, Newcrest, Fortescue Metals and Barmenco. Approximately 59% of the Company's total operating revenue is contributed from charter services.
 3. **Air Freight and Other Services.** Skywest operates an air freight solution to all destinations in alliance with Australian Air Express. Approximately 1% of the Company's total operating revenue is contributed from air freight services and other services.

Fleet

Skywest commenced FY10, with 15 aircraft, but acquired a Fokker F28 MK 0100 jet for \$4.1m (plus \$1.0m refurbishment costs) in early 1H10. The acquisition was funded by a USD\$4.0m aircraft acquisition finance facility (5 year facility with an annual interest rate of 6.2%) from a major UK bank. Additionally, in late 1H10, Skywest acquired another Fokker 27 MK 50 from a European company for US\$2.0m, funded by internal cash flow. Skywest is also currently considering leasing an Airbus A320-200 aircraft.

In Brief

Recommendations

Short Term:	Buy
Long Term:	Buy
Risk:	High
Price:	\$0.35
12 Month Price Target:	\$0.54

Snapshot

Monthly Turnover	\$1.3m
Market Cap	\$69.9m
Shares Issued	199.6m
52 Week High	\$0.39
52 Week Low	\$0.215
Sector	Transportation

Business Description

Skywest Airlines (SXR) is an airline providing regular passenger, charter and freight transport services to regional Western Australia.

Investment Fundamentals (Note: Singapore Dollars)

Note: To calculate the Price Earnings (PE) ratio, we have converted the EPS, which is in Singapore dollars to Australian dollars and divide that number into the current ASX Share Price. We have used an exchange rate of AU\$1.00 = S\$1.23

Year to 30 June	FY08(a)	FY09(a)	FY10(e)	FY11(e)
NPAT (S\$m)	9.2	3.2	14.8	20.6
Adjusted EPS (S¢)	4.6	1.5	7.2	10.0
EPS Growth (%)	30.2	(64.6)	369.3	38.8
PE Ratio (x)	9.9	28.0	6.0	4.3
DPS (S¢)	2.5	0.7	1.5	2.0
Div/Yield (%)	5.8	1.6	3.5	4.6
Franking (%)	0.0	0.0	0.0	0.0

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Skywest

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December 2009

Skywest currently operates 17 aircraft (9 owned and 8 leased) with an average age of 18.5 years. The aircraft are a Fokker F27 MK 50 (which holds 46 passengers) and a Fokker F28 MK 0100, which holds 100 passengers).

- During FY09, Skywest completed an extensive interior refurbishment of the entire F27 MK 50 fleet. The Skywest F27 MK 50 fleet has also recently been re-equipped with the latest operational and safety equipment, including an enhanced Ground Proximity Warning System and Global Positioning System Non-Precision Approach (GPS-NPA). Skywest is currently completing the upgrading of the Company's F28 MK 0100 fleet with an integrated Global Navigation Satellite System, which will deliver more accurate aircraft tracking performance, enhance safety and increase schedule reliability.

Make	Model	Year	Type	Registered Owner
Fokker BV	F27 MK 50	1991	Turboprop	Skywest
Fokker BV	F27 MK 50	1990	Turboprop	Skywest
Fokker BV	F27 MK 50	1987	Turboprop	Skywest
Fokker BV	F27 MK 50	1987	Turboprop	Skywest
Fokker BV	F27 MK 50	1987	Turboprop	Skywest
Fokker BV	F27 MK 50	1987	Turboprop	Skywest
Fokker BV	F27 MK 50	1987	Turboprop	Skywest
Fokker BV	F28 MK 0100	1995	Turbofan	Capital Lease Aviation
Fokker BV	F28 MK 0100	1994	Turbofan	F100 Pty Ltd
Fokker BV	F28 MK 0100	1994	Turbofan	F100 Pty Ltd
Fokker BV	F28 MK 0100	1993	Turbofan	F100 Pty Ltd
Fokker BV	F28 MK 0100	1992	Turbofan	F100 Pty Ltd
Fokker BV	F28 MK 0100	1991	Turbofan	Capital Lease Aviation
Fokker BV	F28 MK 0100	1991	Turbofan	Capital Lease Aviation
Fokker BV	F28 MK 0100	1991	Turbofan	F100 Pty Ltd
Fokker BV	F28 MK 0100	1994	Turbofan	Skywest
Fokker BV	F27 MK 50	1994	Turboprop	Skywest

Regular Passenger Services

- In 1990, the Federal Government deregulated all domestic interstate air transport. However, the State Governments retained the power to impose economic and public interest regulatory controls on domestic air services. The WA Department of Transport has powers under the Transport Coordination Act 1966 to licence aircraft and place conditions on licences to control where and when airlines may fly within the State. The Western Australian Government exercises its power by permitting two types of air routes:
 1. Deregulated air services; and
 2. Regulated air services.
- Skywest operates regular passenger services on both deregulated and regulated air route markets. There are eight deregulated regular passenger air transport routes (competition is permitted on deregulated routes) in Western Australia (Perth to/from Broome, Kalgoorlie, Kambalda, Karratha, Kununurra, Paraburdoo, Port Hedland and Newman). Skywest estimates that the Company holds an 8% market share in relation to

deregulated regular passenger market in Western Australia.

- Skywest's two main competitors in Western Australia on deregulated regular passenger air routes are QantasLink and Virgin Blue. QantasLink (100% owned subsidiary QAN) provides air services from the following regional airports in Western Australia - Perth, Broome, Kalgoorlie, Karratha, Kununurra, Newman, Paraburdoo and Port Hedland. Virgin Blue provides air services from the following regional airports in Western Australia - Perth, Broome, Kalgoorlie, Karratha, Kununurra, Newman and Port Hedland. Skywest has a code share agreement with Virgin Blue, which allows Skywest sales distribution on the east coast of Australia. Skywest also has interline agreements with Qantas, Air New Zealand and Singapore Airlines.
- There are three types of State Government regulated air services operating in Western Australia:
 - Networks, where services to a number of airports are limited to one airline without any Government subsidy (there are two Networks – Coastal and Northern Goldfields);
 - Protected route where one airline provides a service to and from one airport without any Government subsidy (there is one protected route - Perth and Derby, Strategic Airlines Group holds the licence to operate this service until 30 June 2010);
 - Subsidised air service where one airline provides a service that is subsidised by the Government (there is one subsidised air route, the Kimberley subsidised air service which operates between Broome, Fitzroy Crossing and Halls Creek. Golden Eagle Airlines is subsidised by the WA Government on the Kimberley air route under a shortfall subsidy arrangement until 30 June 2010).

- The air route Network arrangements operate with two different airlines (Skywest and Skippers) given an exclusive licence to operate on the two different networks (the licences to operate the Networks were awarded following a competitive tender process). The Network Licences commenced on 1 January 2006 and are approved to operate until 30 June 2010. Under the Transport Coordination Regulations 1985, the airlines are required to provide comprehensive statistics to the Western Australian Department of Transport each month so that service levels may be monitored.
- Skywest has an exclusive licence issued by the State Government for the Coastal Network of Western Australia, which includes Albany, Carnarvon, Esperance, Geraldton, Kalbarri, Learmonth (Exmouth) and Monkey Mia (Shark Bay). The Coastal Network represents approximately 65% of Skywest's regular air passenger volumes. Skippers Aviation operates the Northern Goldfields Network, which includes Laverton, Leinster, Leonora, Meekatharra, Mt Magnet and Wiluna.

Charter

- Skywest's charter income has experienced significant growth during the past five years, expanding from 18% of total operating revenue in FY05 to a current 59% of total operating revenue. The air charter contracts predominantly involve the flying of mine workers from Perth and the south-west of the state to the mining sites in the north and north-west of the state. Skywest estimates that the Company holds a 32% market share in relation to 'fly in, fly out' charter services in Western Australia.
- Demand for air charter contracts in Western Australia is predominantly associated with mining and resource companies and are typically for a minimum of three years, due to the high 'start-up' costs. Apart from Skywest, three key operators (Qantaslink, National Jet Systems and Skippers Aviation) compete in the air charter market in Western Australia. Skywest maintains reasonable capacity to provide regular, scheduled and ad hoc charter services for resource and mining companies with 'fly-in, fly-out' requirements. Key issues in winning tenders in the air charter market, apart from price, are safety and reliability.
- Key charter contracts held by Skywest include:
 - Regular charter service, on the three year contract basis to the Argyle Diamond Mine (Rio Tinto), renewed in early 2H09.
 - Regular air charter service (2-3 flights per week), on a three year contract to the Telfer gold mine and production facility (Newcrest Mining), which commenced in early 2H08.
 - Regular charter service (2-3 flights per week), on a three year contract to the Windarling iron ore mine (Portman).
 - Regular air charter service (6+ flights per week), on a three year contract (plus two year option) to the Cloudbreak iron ore mine (Fortescue Metals Group), which commenced in 1 June 2008.
 - Regular air charter service (15+ flights per week), on a three year contract (plus two year option) to the West Angelas and Barimunya mines (Rio Tinto), which commenced in early 1H09 (the contract contains provisions allowing for price adjustments to reflect changes in jet fuel prices).
 - Regular charter service, on twelve month contract (with a term extension option, to Karratha (Citic Pacific Mining), announced mid 2H10 (with anticipated revenues of AU\$10.4m per year).
- The Company has continued to adopt, with substantial success, a strategy of focusing services on the resources sector. While, Skywest's earnings may dip in the short term, when major charter contracts are won (as occurred with the Rio Tinto contract during FY09), due to ramp-up expenses (aircraft leasing, recruiting staff and associated costs). The short term fall in load factors as the new aircraft are entered into operation, are offset by the subsequent significant increase in capacity utilisation, yield and earnings, in the following months.

Air Freight & Other Services

- Skywest undertakes air freight services, in conjunction with Australian Air Express (a joint venture between Qantas and Australia Post Corporation) to all key destinations in Western Australia. Skywest also offers 'Skywest Holidays', packaged holidays in alliance with a major tourist operator.
- Skywest has the following key strengths:
 - **Branding.** Skywest has operated a reliable conventional airline service to all of Western Australia's major regional airports for more than 45 years. Skywest is a well-known and well-respected brand by customers and regulators in Western Australia. Effectively, Skywest is considered as Western Australia's 'state airline', providing a natural and significant barrier to entry to potential competitors. Skywest is also the only integrated airline operating in Western Australia, with most competitors predominantly operating to the RPT passenger market or air charter market.
 - **Stability of Earnings.** Currently, more than 59% of Skywest's earnings are derived through air charter services to the mining industry, which provides an advantage to the Company through certainty of load and revenue, as well as lower operating expenses and lower administrative overheads.
 - **Sole Operator Routes.** Skywest is the sole permitted airline operator on the Coastal Network. Skywest for the length of the licence has reasonable certainty of passenger volumes and earnings on the Coastal Network, due to the Company's experience in operating the air route during the past ten years.
 - **Resource and Mining Industry.** The robust mining boom in Western Australia has led to significant opportunities for Skywest, particularly in relation to flight charter work. Currently, across Western Australia, there are more than 600 commercial mineral projects underway; including 1,250 operating mine sites and 175 operational processing plants, employing more than 75,000 people. Additionally, there is an estimated \$100 billion in mining, oil and gas projects underway or planned in the near term for the north west of the State.
 - **Geographic.** Western Australia is the largest state in Australia. The majority of the Western Australian population is located in Perth and the south-west region of the State, while the major employment opportunities are associated with the large resource and mining projects in the north-west of the State. Additionally, the majority of Western Australia's key regional centres are separated by vast distances, which make road transport an uncompetitive alternative.

Risks

- Skywest is impacted by the following important risk factors:
 - **Fuel costs.** Skywest is exposed to global movements in fuel costs, and adopts a policy of managing fuel cost risk by purchasing fuel hedges at various times during the financial year. In late 1H10, Skywest decided to enter into a cashless collar in respect of 25% of the Company's overall fuel requirements at current spot market rates for the period 1 January 2010 to 30 June 2010. Additionally, Skywest includes a fuel surcharge

to the cost of regular passenger tickets and includes provisions in long-term charter contracts for movements in fuel prices.

- **Foreign Currency.** Skywest derives income in Australian dollars and incurs staff, fuel, advertising, engineering and flight operation costs in Australian dollars. However, the Company leases aircraft and purchases aircraft components & parts in US dollars and Euros. Skywest reports the Company's financial results in Singapore dollars. Additionally, borrowings are denominated in both US dollars and Australian dollars.
- **Regulatory.** The Australian airline industry is subject to extensive and detailed regulation, predominantly by the Civil Aviation Safety Authority (CASA), the Federal Government statutory authority responsible for the regulation of civil aviation. Skywest holds an Air Operator's Certificate, High Capacity Air Operators licence and Maintenance Certificate of Approval. Any loss of these licences or approvals would have a significant impact on Skywest's operations. Therefore, Skywest has internal review programs established for Engineering, Flight Operations and Ground Operations to provide the Company's senior management with regular updates. Skywest's exclusive licence for the Coastal Network, issued by the Western Australian Government, expires on 30 June 2010. The Company has commenced discussions with the Western Australian Government for renewal of the Coastal Network licence and early indications are positive but the outcome ultimately remains uncertain.
- **Aircraft and maintenance.** Skywest operates an efficient aircraft maintenance program but the average age of the Company's Fokker air fleet is 18.5 years. Fokker was a Dutch aircraft manufacturer that went into bankruptcy in 1996 (Fokker's operations were split up and sold). Fokker parts are now manufactured by the Netherlands-based company, Stork Aerospace Group (recently renamed Fokker Aerospace Group). Skywest holds an extensive inventory of airframe and engine parts at the Company's maintenance facility (at Perth's domestic airport). However, there is some limited risk that Skywest may have difficulty procuring spare parts in the future.
- **Staff costs.** Skywest employs a diverse group of specialists including pilots, flight attendants, airframe & avionics technicians/engineers, accounting & administration staff and senior management, which totalled 337 as at 30 June 2009. Skills shortages and rapid wages increases can occur in the aviation industry during periods of rapid economic growth. However, Skywest in 2H09, completed an Enterprise Bargaining Agreements (EBA) with the Company's pilot and engineering employees. The EBA associated with the pilots provides labour cost certainty for the airline during FY10, while the EBA associated with the engineers provides labour cost certainty for the next three years.

Historical Finance Performance

- During the past four difficult years in the aviation industry Skywest has been able to maintain profitability, while many regional airlines, globally, have incurred substantial losses. Skywest has significantly benefited from the strong demand for air services from the resource and mining sector. In FY08 Skywest operated 1,566 air charter services, over the next twelve months, despite a 9.8% fall in RPT passenger volumes, charter flights

increased by 67% to 2,614. Additionally, in the three years prior to the impact of the global financial crisis, the solid demand from the mining sector resulted in robust growth in operating revenue, earnings and scale of operations for Skywest. To alleviate the capacity pressure the Company has adopted the policy of increasing capacity by acquiring aircraft (using sale & lease arrangements) and leasing aircraft from other airlines (cross-hiring).

- Substantial slowing in global economic growth, volatile movements on financial markets and reduced consumer expenditure during 2009, negatively impacted the Company. In FY09, Skywest recorded NPAT of S\$3.2m, but in a year when the global aviation industry lost more than US\$6 billion, being profitable was a significant achievement for the Airline. Additionally, despite the depreciation of the Australian dollar and surging aviation fuel price Skywest was able to maintain the Company's gross profit margin at 56.5%. The ability of the Company to maintain profitability in FY09 was mainly due to senior management immediately initiating major strategic changes (including a restructuring of operations) when the impact of the global financial crisis first became apparent. During FY09, Skywest's senior management shifted the strategic focus of the Company from pursuit of high growth to fiscal conservatism and consolidation.

Details	FY06 (a)	FY07 (a)	FY08 (a)	FY09 (a)
Operating Revenue (S\$)	96.3	130.4	183.8	181.3
<i>Growth</i>	-	35.4%	41.0%	(1.3%)
Cost of Sales (S\$)	45.8	55.5	78.0	78.9
Gross Profit (S\$)	50.5	74.9	105.8	102.4
Gross Profit margin	52.4%	57.4%	57.6%	56.5%
Net Admin & Other Expenses (S\$)	39.2	54.8	83.1	86.0
EBITDA (S\$)	11.3	20.1	22.7	16.4
<i>EBITDA margin</i>	11.7%	15.4%	12.3%	9.1%
NPAT (S\$)	4.0	7.2	9.2	3.2
NPAT margin	4.2%	5.5%	5.0%	1.8%
Total Aircraft	9	12	15	15

Future Financial Performance

- Skywest financial performance during FY10 will still be impacted by the negative effects of the global financial crisis and weak global economic conditions. Evidence of this impact is still apparent in the Company's figures for the six months to 31 December 2009, for RPT passenger volumes, which are down 6.6% to 182,000. However, strong encouragement that conditions are improving for regional air travel is evident from the Company's data for the month of December 2009 which indicates a 5.2% increase in RPT passenger volumes to 27,000. Additionally, passenger volumes for Perth airport in the December 2009 Quarter indicate that domestic passenger volumes increased by 2.5% and international passenger volumes increased by 15.4%.
- Skywest produced an outstanding 1H10 result, with revenue up by 10.1% to S\$107.1m, NPAT of S\$7.1m

(after a loss in 1H09) and EPS of 3.6 Scps. Skywest noted that the strong 1H10 result was due to “the importance of maintaining the business strategy of providing an excellent airline service to the coastal towns of Western Australia combined with scheduled charter for the world’s major mining and resource companies”.

- Skywest is also adopting a strategy of attempting to lower distribution costs by functional use of a call-centre and the internet (www.skywest.com.au) for RPT passenger bookings (currently 47% via travel agents, 41% web and 12% call centre based). During 1H10, Skywest’s senior management remained committed to a continual focus on optimisation of revenue through load factors (increased from 52.9% to 55.7%) and yield.
- However, the ‘hidden’ strength in Skywest’s recovery from the global economic crisis is illustrated by the extremely robust expansion in air charter services achieved in 1H10. During 1H10, Skywest’s air charter services, compared to the previous corresponding period, increased by more than 17% to 1,431.
- In FY10, we are forecasting that Skywest will achieve operating revenue growth of 20.4% to S\$218.3m, EBITDA growth of 70.7% to S\$28.0m and NPAT growth of 368.8% to S\$15.0m. We believe the driving force for strong revenue and earnings growth will be Skywest’s charter operations to the mining & resource sector.

Details	1H09	1H10	Change
RPT Passengers Volumes ('000)	195	182	(6.6%)
Revenue Passenger Kilometres (RPK), ('000)	155,735	146,955	(5.6%)
RPT Available Seat Kilometres (RPT ASK), ('000)	294,423	263,929	(10.4%)
Load Factor	52.9%	55.7%	2.8%
Charter Available Seat Kilometres (Charter ASK)	277,883	324,586	16.8%
Charter Services	1,222	1,431	17.2%

Note: Skywest also benefits from the Company selling a block booking seats on a regular passenger flight, which increases charter revenue but keeps the load factor artificially low.

Growth Initiatives

- The main growth opportunities for Skywest are:
 1. Increased resource and mining air charter contracts. Skywest aggressively competes for contract air charter work associated with major mining and resource projects. The Company has established a strong reputation for reliability among the major international mining groups and is well placed to win more tenders in the medium term. Skywest is currently bidding on two major mining air charter contracts that potentially could add AU\$10m per annum to operating revenue. We understand that Skywest’s Airbus A320-200 aircraft will be used to provide additional capacity for a major mining client (which will further boost revenues and lower cross hire costs);
 2. Increased services and frequency on existing RPT passenger routes. Western Australia’s population is

currently increasing by 3.1% per annum. The vast distances between regional centres in Western Australia still offers strong opportunities for air services, including freight contracts. Skywest recently signed a air freight contract with Western Australian Newspapers Holdings (WAN) to deliver ‘The Western Australian’ newspaper to regional centres.

3. New RPT passenger routes. Skywest recommenced flights between Kalgoolie and Melbourne in February 2010. Further opportunities will arise in the medium term to add new RPT passenger routes within Western Australia and to other states, with improved economic conditions.

Cash, Planes, Parts and Property

- As at 31 December 2009, Skywest balance sheet included net tangible assets of 21.0 Scps. The Company’s assets included S\$10.7m in cash & cash equivalents, S\$39.3m in aircraft & anti-collision system, S\$19.0m in aircraft rotables and S\$46.2m in capitalized aircraft maintenance. Skywest adopts a conservative policy with regard to the depreciation of aircraft using a period of six years as the useful life, compared to a typical useable life of 25 years. Additionally, during the past four years capital expenditure (predominantly growth capex) has average a reasonable S\$14.7m per annum. We understand that during 2H10, Skywest is undertaking a complete overhaul of two Fokker F100 engines, at an estimated total cost of AU\$3.2m.

Capital Management

- As at 31 December 2009, Skywest had debt of S\$7.9m, increasing by US\$4.0m during 1H10. Skywest’s debt is secured over the assets and undertakings of the Company, with a combined effective interest rate of 7.5%, prior to the new borrowings.
- Skywest undertakes the sale and lease back of aircraft through the associated AIM-listed company Aviation Plc. In FY07, Skywest paid as a dividend all of the ordinary shares in Aviation Plc to Skywest’s shareholders. Jeff Chatfield is the Chairman of Aviation Plc. Aviation Plc through a 100% owned subsidiary undertakes the ownership and leasing of a portfolio of commercial jet aircraft to a wide customer base of regional and international airlines. The Company currently owns three Fokker F100 passenger jet aircraft, one Airbus A320-200 and two Airbus A321-200’s (the aircraft are leased to Australian, American and European airlines). The aim of creating Aviation Plc was to ensure that Skywest would always have an accommodating leasing company to assist growth. Leasing aircraft provides operational leverage so as to give Skywest flexible access to more aircraft. Additionally, leasing aircraft allows Skywest to transfer the ownership risk of the aircraft to Aviation Plc.

Capital Structure

- On 11 January 2010, the Company had 195,600,000 shares on issue (excluding 4,000,000 Treasury shares). Additionally, there are 3,040,000 warrants on issue, to the

Company's directors and senior management, which expire on 18 November 2011 (at an exercise price of GBP0.1025).

- Under the Singapore Companies Act, the Company cannot hold in 'treasury' more than 10% of the total number of issued shares and it is unable to exercise any rights in respect of the Treasury shares that would normally attached to the shares (no voting rights and no dividend). However, the Company is entitled to dispose of or cancel the Treasury shares at any time.

Valuation

- We have undertaken a discounted cash flow valuation (DCF) of Skywest, using a weighted average cost of capital of 16.5%. We have adjusted our valuation with regard to Skywest due to the uncertainty of the Australian dollar and Singapore dollar exchange rate in the current volatile financial markets. Our valuation of Skywest using this methodology is AU54.0 cps. Additionally, we have used an earnings multiple valuation methodology, using a multiple of 6.5x FY11 EPS, we value Skywest at AU53.0cps.

Recommendation

- The regional aviation industry in Australia is typically characterised by low profit margins and high operating costs. During the past four decades, numerous small regional passenger and freight airlines have gone into liquidation, bankruptcy or receivership due to a combination of under-capitalisation, high operating costs, volatile fuel costs and aggressive competition.
- However, Skywest is operating in an extremely attractive long term macroeconomic environment, where significant demand for air services is required by the resource and mining sector. The contracted 'fly-in fly-out' air charter services provide a solid base of recurring revenue. Additionally, the Company is leveraged to the high growth Western Australian economy, which has been less affected than other major regions by the slowdown in economic conditions (Western Australia's economic growth has averaged 5.2% pa during the past decade). The medium to long term outlook for Western Australia's economy remains strong, with minerals and petroleum being produced in commercial quantities worth approximately US\$44 billion annually. Western Australia is also ideally positioned to leverage significant growth from the rapidly expanding economies of India, China and Asia.
- Skywest receives a significant portion of the Company's total regular passenger revenue from regulated air routes, while the Company expands operations on deregulated air routes in Western Australia. The Company has a robust earnings profile supported by recurring cash flows from government regulated air routes and air charter contracts. The Company's business model is low risk, due to the long term nature of the air charter contracts. Skywest also has the unique advantage of being able to sell regular passenger tickets combined with block

bookings to the Company's resource customer base. Skywest has a long history of operating in Western Australia, and has established a well-respected brand, which is a natural barrier to entry for competitors. We believe the Company is currently undervalued by investors and will achieve significant EPS growth in the medium term. Our recommendation on Skywest is buy.

- **Note:** We have made the assumption that now Skywest is listed on the ASX the Company's dividend policy will be gradually lifted to pay approximately 35% of NPAT as dividends annually, by FY14.

E.L & C Baillieu Stockbroking Ltd

SkyWest Airlines Ltd (SXR)

Date	30-Mar-10	Short Term Recomm.	BUY
Share Price (AUD)	\$0.35	Long Term Recomm.	BUY
Issued Shares (m)	199.6	Valuation (AUD)	\$ 0.54
Market Cap (AUD 'm)	69.9	Price Target (AUD)	\$ 0.54

Analyst: Ross Macmillan

Business Description

Skywest (SXR) is a regional airline providing regular passenger, charter and freight services in Western Australia. SXR is based in Perth and listed on the ASX but the Company is incorporated in Singapore. The financial accounts are prepared under IFRS in Singapore dollars and audited in Australia.

Note

Note: Accounts are in Singapore dollars

To calculate the Price Earnings (P/E) ratio, we have converted the EPS, which is in Singapore Dollars to Australian Dollars and divided that number into the current ASX share Price for Skywest (which is in Australian Dollars). We have used an exchange rate of AU\$1 = S\$1.23.

Financial Performance (\$m)

Year End:	Jun-07(a)	Jun-08(a)	Jun-09(a)	Jun-10(f)	Jun-11(f)
Operating revenue	130.4	183.8	181.3	218.3	254.7
EBITDA	20.1	22.7	16.4	27.7	40.1
Depreciation	8.0	10.3	11.3	6.7	10.3
EBITA	12.1	12.4	5.2	21.0	29.7
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	12.1	12.4	5.2	21.0	29.7
Net interest exp.	0.6	0.4	(0.1)	(0.1)	(0.8)
Pre-tax Profit	12.7	12.8	5.1	20.9	29.0
Tax	4.7	3.6	2.0	6.1	8.4
NPAT	8.0	9.2	3.2	14.8	20.6
Equity profits	0.0	0.0	0.0	0.0	0.0
Outside equity Int.	(0.8)	0.0	0.0	0.0	0.0
Reported NPAT	7.2	9.2	3.2	14.8	20.6
Significant Items	0.0	0.0	0.0	0.0	0.0
NPAT (+SI)	7.2	9.2	3.2	14.8	20.6

Cash Flow (\$m)

Year End:	Jun-07(a)	Jun-08(a)	Jun-09(a)	Jun-10(f)	Jun-11(f)
Profit before Income Tax	12.7	12.8	5.1	21.0	29.7
Adjustments & other	8.6	10.7	5.7	4.9	12.2
Income Tax Paid	(0.1)	(2.4)	(1.5)	(2.0)	(6.1)
Net Cash from Operations	21.2	21.0	9.3	23.9	35.9
Net Capital expenditure	(19.4)	(18.9)	(11.8)	(30.9)	(25.7)
Other	(17.3)	(0.0)	0.1	(1.9)	(2.0)
Investing Cash Flow	(36.7)	(18.9)	(11.7)	(32.8)	(27.7)
Proceeds from issues	1.9	0.5	(0.7)	(1.5)	0.0
Net Borrowings	5.2	1.6	(3.7)	7.5	0.0
Dividends	(1.7)	(5.1)	(1.4)	(1.9)	(4.0)
Other	0.0	0.0	0.0	0.0	0.0
Financing Cash Flow	5.4	(5.7)	(5.9)	4.1	(4.0)
Net Change in Cash	(10.2)	(3.6)	(8.3)	(4.8)	4.2
Cash at Begin. of Year	24.5	14.5	13.8	9.2	4.4
Exchange Rate Adj.	0.2	0.1	4.0	0.0	0.0
Cash at End of Year	14.5	13.8	9.2	4.4	8.6

Balance Sheet (\$m)

Year End:	Jun-07(a)	Jun-08(a)	Jun-09(a)	Jun-10(f)	Jun-11(f)
Cash	14.5	13.8	9.2	4.4	8.6
Receivables	12.3	23.3	22.5	26.2	30.6
Inventories	1.2	3.3	3.6	3.8	4.0
Other	4.6	0.7	0.2	5.7	6.0
Current Assets	32.7	41.0	35.5	40.1	49.2
Invest in Assoc.	0.0	0.0	0.0	0.0	0.0
Prop. plant & equip	42.6	50.7	44.7	68.9	84.3
Intangibles (net)	17.3	17.2	17.2	17.2	17.2
Other	0.0	0.0	0.0	1.4	1.5
Non-current Assets	59.9	67.9	61.9	87.5	103.0
Total Assets	92.6	108.9	97.5	127.6	152.1
Payables	28.2	35.2	29.5	34.4	36.6
Borrowings	0.0	3.6	1.0	2.0	2.0
Provisions & other	7.8	9.8	8.6	11.4	10.3
Current Liabilities	36.1	48.6	39.1	47.9	48.9
Payables	0.0	0.0	0.0	0.0	0.0
Borrowings	5.3	3.3	2.1	8.0	8.0
Provisions & other	3.7	5.2	5.4	4.5	7.1
Non-current Liabilities	9.0	8.5	7.5	12.5	15.1
Total Liabilities	45.1	57.1	46.7	60.3	64.0
Net Assets	47.6	51.9	50.8	67.3	88.1
Share capital	43.0	43.6	43.0	43.8	43.8
Reserves	2.4	2.2	0.1	1.8	6.0
Retained profits	2.0	6.1	7.9	21.7	38.3
Shareholders equity	47.5	51.9	50.8	67.3	88.1
Outside equity int.	0.0	0.0	0.0	0.0	0.0
Total Equity	47.5	51.9	50.8	67.3	88.1

Ratios

Year End:	Jun-07(a)	Jun-08(a)	Jun-09(a)	Jun-10(f)	Jun-11(f)
EBITDA Margin (%)	15.4	12.3	9.1	12.7	15.7
EBIT Margin (%)	9.3	6.7	2.9	9.6	11.7
NPAT Margin (%)	5.5	5.0	1.7	6.8	8.1
Return Op. Inv. Cap. (%)	11.1	12.7	4.8	17.7	20.1
Return on Equity (%)	15.1	17.7	6.2	22.0	23.3
Net Debt to Equity (%)	(19.4)	(13.2)	(11.9)	8.3	1.6

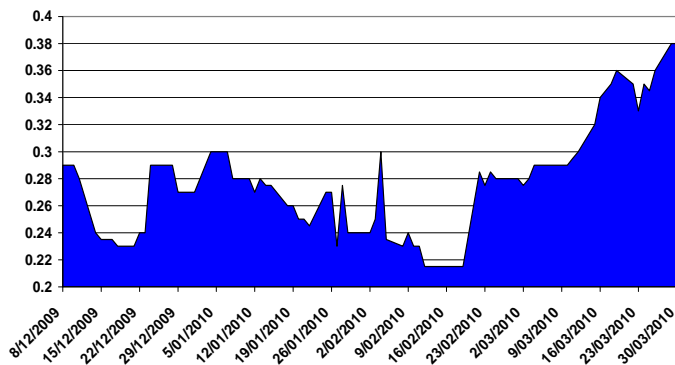
Valuation

Year End:	Jun-07(a)	Jun-08(a)	Jun-09(a)	Jun-10(f)	Jun-11(f)
Basic EPS	3.6	4.6	1.6	7.4	10.3
Adjusted EPS	3.3	4.3	1.5	7.2	10.0
EPS Growth (%)	-	30.2	(64.6)	369.3	38.8
P/E Ratio (x)	12.9	9.9	28.0	6.0	4.3
DPS (c)	3.5	2.5	0.7	1.5	2.0
Yield (%)	8.2	5.8	1.6	3.5	4.6
Franking (%)	0.0	0.0	0.0	0.0	0.0

Board of Directors

Chairman	Jeff Chatfield
Director	Ron Aitkenhead
Director	Seah Kian Peng
Director	John Jost

Share Price Performance



Recommendations

Buy: Share price expected to appreciate by more than 10% during next twelve months.

Accumulate: Share price expected to appreciate by more than 10% during next twelve months, however further short-term weakness possible.

Hold: Share price expected to trade between +10% and -10%.

Lighten: Share price expected to fall by more than 10% during next twelve months, however share price may appreciate marginally in short term.

Sell: Share price expected to fall by more than 10% during next twelve months.

Source: E.L & C Baillieu Stockbroking

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