

**AEROQUEST INTERNATIONAL LIMITED  
(TSX-AQL \$0.41)**

**Revised Recommendation: BUY**  
 Previous Recommendation: HOLD  
**Revised 12-month Target: \$0.90**  
 Previous 12-Month Target: \$0.40  
**Risk Rating: ABOVE AVERAGE**

**Q2/09 RESULTS BEAT, UPGRADING TO BUY**

- **Summary:** AQL reported Q2/09 results that beat our estimates, with revenue in the mid-range of management's guidance and stronger margins than we had forecast. The Company guided to Q3/09 revenue of \$6.0 to \$10.0 million (the same guidance provided for Q2/09). While visibility is still limited, we are now somewhat more confident in the revenue and earnings outlook than we were as of our last note. **On that basis, we are raising our 12-month target price to \$0.90/share from \$0.50/share, and upgrading our recommendation to BUY from HOLD.**
- **Q2/09 Results:** AQL reported Q2/09 revenue of \$8.0 million, beating our estimate of \$5.9 million and within management's guidance range of \$6.0 to \$10.0 million. AQL reported a loss per share of \$0.03, or \$0.01 when excluding the impact of acquisition-related amortization. Revenue declined 40% y-y from \$13.3 million in Q2/08, and 30% sequentially from \$11.3 million in Q1/09. While revenue declined significantly from recent levels, the results of the quarter were nonetheless better than we had anticipated. Of particular note, the Company's new fixed-wing gravity systems made a significant contribution to revenue and margins in the quarter.
- **Balance sheet:** AQL finished the quarter with cash and equivalents of \$10.4 million, or net cash per share of \$0.29. With minimal working capital investments or CAPEX expected in H2/09, we expect AQL's balance sheet to show modest improvement over the next few quarters.
- **Outlook:** Management guided to Q3/09 revenue of \$6.0 to \$10.0 million, the same guidance provided for Q2/09.
- **The System Fleet:** During the quarter, AQL added a second fixed-wing gravity system. Its total fleet is now 29 systems (17 helicopter systems, 12 fixed-wing systems). Given management's comments regarding CAPEX, we do not expect AQL to add any additional systems this year.
- **Valuation:** As we still expect negative earnings and nominal EBITDA contribution in FY 2009, we are introducing an EV/Sales valuation approach, using a multiple of 0.6x FY 2009 revenue. This revenue is based on Major Drilling's (TSX-MDI, BUY, \$17.50 target) current and historic multiples. **On this basis, we are increasing our target price to \$0.90/share from \$0.40/share and upgrading AQL to a BUY from a HOLD.**

**Sector: SPECIAL SITUATIONS**  
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Company Statistics	
52-Week Range	\$2.95 - \$0.27
Basic Shares O/S (MM)	33.6
Basic Market Cap (\$MM)	\$13.4
Cash (\$MM)	\$10.4
Total Debt (\$MM)	\$0.6
Net Cash (\$MM)	\$9.8
Net Cash / Share	\$0.29
Management & Directors Ownership	21%

Earnings Summary			
FYE: September	2008A	2009E	2010E
Sales (\$MM)	\$55.0	\$35.9	\$43.0
EBITDA (\$MM)	\$11.3	\$2.2	\$7.9
EBITDA Margin	20.5%	6.2%	18.3%
Diluted EPS	\$0.09	(\$0.12)	(\$0.02)
Adjusted Diluted EPS*	\$0.21	(\$0.02)	\$0.09
P/E	4.7x	nmf	nmf
P/Adj. E*	1.9x	nmf	4.5x
EV/EBITDA	0.3x	1.7x	0.5x

\* Adjusted Diluted EPS excludes acquisition-related amortization.



**Aeroquest International Limited** is a mining and energy services company providing commercial airborne geophysical surveys for use in mineral and oil and gas exploration. Aeroquest is also developing applications for its proprietary time domain electromagnetic systems in the environmental services and ground water exploration industries.

**Q2/09 Results:**

We present the highlights of AQL's results in Exhibit 1. While revenue was down sequentially and on a y-y basis, owing to significantly reduced activity in the mineral and petroleum exploration space, the results of the quarter were nonetheless better than we had expected.

**Exhibit 1. Q2/09 Highlights**

	Q2/09E	Q2/09A	Variance	Q2/08A	Y-Y	Q1/09A	Q-Q
Revenue (\$mm)	\$5.9	\$8.0	35%	\$13.3	(40%)	\$11.3	(30%)
EBITDA (\$mm)	(\$1.4)	\$0.1	nmf	\$3.4	(98%)	(\$0.3)	nmf
Diluted EPS	(\$0.07)	(\$0.03)	(57%)	\$0.02	nmf	(\$0.04)	(25%)
Adjusted Diluted EPS	(\$0.04)	(\$0.01)	(75%)	\$0.05	nmf	(\$0.02)	(50%)

Source: Company Reports, Jennings Estimates

Revenue was much stronger than expected, coming in at the mid-point of management's guidance of \$6.0 to \$10.0 million. Overall gross margins for the quarter were better than expected at 41% (v. our forecast 24%), owing to strong margins from the fixed-wing unit, in turn driven by the impact of the Company's new fixed-wing gravity system.

We present divisional highlights in Exhibit 2. Volumes for both businesses dropped significantly y-y and sequentially, with the impact on helicopter operations being more significant than on fixed-wing revenue. This is not surprising. Fixed-wing surveys are less expensive on a per line km basis, so for a mining company managing a reduced budget relative to prior years, fixed-wing surveys can be viewed as a more cost-effective choice for obtaining data, albeit of lower resolution than that offered by helicopter surveys.

Fixed-wing gross margins were the highest for any quarter since AQL acquired its fixed-wing operation (UTS) in 2007. During the quarter, approximately \$3.0 million of revenue came from two new total field gravity systems. These systems contribute higher-than-average margins and should help AQL maintain its overall margins despite lower near-term demand. Also during the quarter, petroleum contributed 50% of total revenue or approximately \$4.0 million.

**Exhibit 2. Helicopter v. Fixed-Wing**

Helicopter	Q2/09A	Q2/08A	Y-Y	Q1/09A	Q-Q
Revenue (C\$m)	\$1.6	\$7.4	(78%)	\$6.9	(77%)
Line Km Flown (000s)	11.4	59.0	(81%)	59.2	(81%)
Revenue/Line Km	\$142.89	\$125.88	14%	\$117.38	22%
Gross Margin	(3%)	42%	(4,503bps)	30%	(3,287bps)

Fixed Wing	Q2/09A	Q2/08A	Y-Y	Q1/09A	Q-Q
Revenue (C\$m)	\$5.9	\$5.6	4%	\$3.8	54%
Line Km Flown (000s)	189.0	362.0	(48%)	316.0	(40%)
Revenue/Line Km	\$31.15	\$15.58	100%	\$12.10	158%
Gross Margin	52%	49%	270bps	12%	3,966bps

Source: Company Reports, Jennings Estimates

**The Balance Sheet:**

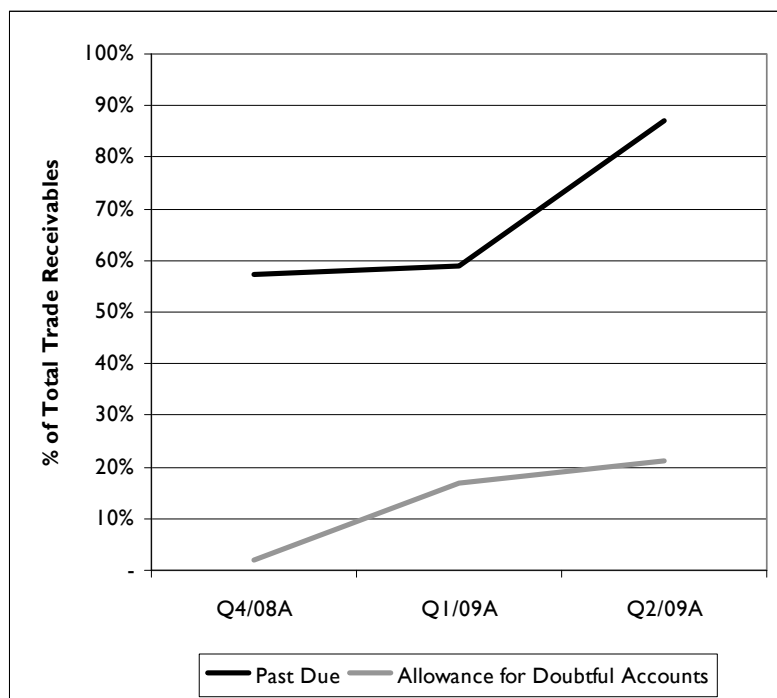
At the end of the quarter, AQL had cash and equivalents of \$10.4 million and capital leases totaling \$0.6 million, for a net cash position of \$9.8 million, or \$0.29/share. At current levels, AQL has an Enterprise Value of only \$3.7 million.

During the quarter, the Company also announced a settlement with Geotech, wherein Geotech acknowledged that the AQL helicopter systems in question do not use any of Geotech’s confidential information and that AQL is free to operate as before. With the lawsuit – and corresponding threat to the balance sheet – behind AQL, we think it is worth noting that AQL trades at the following levels:

- **75% Discount to Replacement Value** – assuming a \$0.5 million/system cost (fixed-wing systems normally cost \$400k, while helicopter systems cost approximately \$550k). The current share price implies an EV/System value of approximately \$126k for Aeroquest. We believe the majority of AQL’s system fleet is quite new (most manufactured in the last two years).
- **30% Discount to Tangible Book Value of \$0.59/share.**

In Q2/09, AQL recorded an allowance for doubtful accounts of just under \$77k. As we demonstrate in Exhibit 3, a significant portion of AQL’s receivables are now considered past due. In particular, approximately \$3.0 million or 43% of total trade receivables (before allowances), are more than 90 days past due. During the conference call held earlier today, management indicated that it has agreed to extended repayment terms for 4-5 mineral exploration customers on approximately \$1.5 million of this category of receivables, and the Company is still working to collect on the \$1.5 million portion for which it has already made an allowance. Management indicated it expects receivables collection to improve in Q3/09.

**Exhibit 3. Receivables Past Due**



Source: Company Reports, Jennings Estimates

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## Backlog and Outlook

Management guided to Q3/09 revenue of \$6.0 to \$10.0 million, in line with Q2/09 guidance. At quarter end, the Company's backlog was \$8.0 million, of which we estimate approximately \$2.8 million or 35% is for petroleum work, with the vast majority of the remainder being mining. While no guidance was provided on gross margins, management did indicate that CAPEX would be less than \$0.5 million for the remainder of FY 2009, and that cash operating costs should decline by ~\$0.8 million/quarter from Q2/09 levels owing to cost reduction measures already implemented.

## The System Fleet

AQL now has 29 systems available for surveying, of which 17 are helicopter-based systems and 12 are fixed-wing systems. AQL also has an 18<sup>th</sup> helicopter-based system that is currently offline awaiting maintenance, which the Company has deferred until there is sufficient demand to warrant redeployment to the field.

## Estimate Revisions

We present our new FY 2009 estimates in Exhibit 4, with a comparison to our prior estimates. While our revenue estimate has not materially changed, our EBITDA estimate is now slightly higher, to reflect stronger fixed-wing margins.

We are also introducing our FY 2010 estimates, for which the key assumptions are as follows:

- Helicopter Systems – will generate revenue of \$10.7 million in revenue. Although down slightly from \$10.9 million expected for FY 2009, \$6.9 million of that was generated in Q1/09. We therefore expect gradual, modest volume demand improvement although overall volumes will still be only 39% of FY 2008 levels.
- Fixed-Wing Systems – will generate \$31.1 million, up from \$23.5 million for FY 2009. Our FY 2010 volume estimate is 63% of actual FY 2008 levels.

Our model assumes that no additional systems are added and that all revenue growth comes from higher utilization of the existing fleet. We believe that our estimates are conservative, in that projected volumes are well below the peaks seen in FY 2008, although we caution investors that there is still limited revenue visibility across the mining services space.

## Exhibit 4. FY 2009 Estimates Revised

	FY 2009E		Introducing FY 2010E
	Prior	New	
Revenue (\$mm)	\$36.6	\$35.9	\$43.0
EBITDA (\$mm)	\$0.8	\$2.2	\$7.9
EBITDA Margin	2.3%	6.5%	18.3%
Diluted EPS	(\$0.15)	(\$0.12)	(\$0.02)
Adjusted Diluted EPS	(\$0.04)	(\$0.02)	\$0.09

Source: Jennings Estimates

We present our quarterly estimates in Exhibit 5. Our Q3/09 estimate is slightly lower than the mid-point of management's guidance.

**Exhibit 5. FY 2009 Quarterly Estimates**

	Q1/09A	Q2/09A	Q3/09E	Q4/09E	2009E
Revenue (\$mm)	\$11.3	\$8.0	\$7.5	\$9.2	\$35.9
Growth (y-y)	1%	(40%)	(48%)	(43%)	(35%)
EBITDA (\$mm)	(\$0.3)	\$0.1	\$0.9	\$1.6	\$2.2
EBITDA Margin	(2%)	3%	12%	17%	6%
Diluted EPS	(\$0.04)	(\$0.03)	(\$0.03)	(\$0.01)	(\$0.12)
Adjusted Diluted EPS	(\$0.02)	(\$0.01)	(\$0.00)	\$0.01	(\$0.02)

Source: Company Reports, Jennings Estimates

**Valuation**

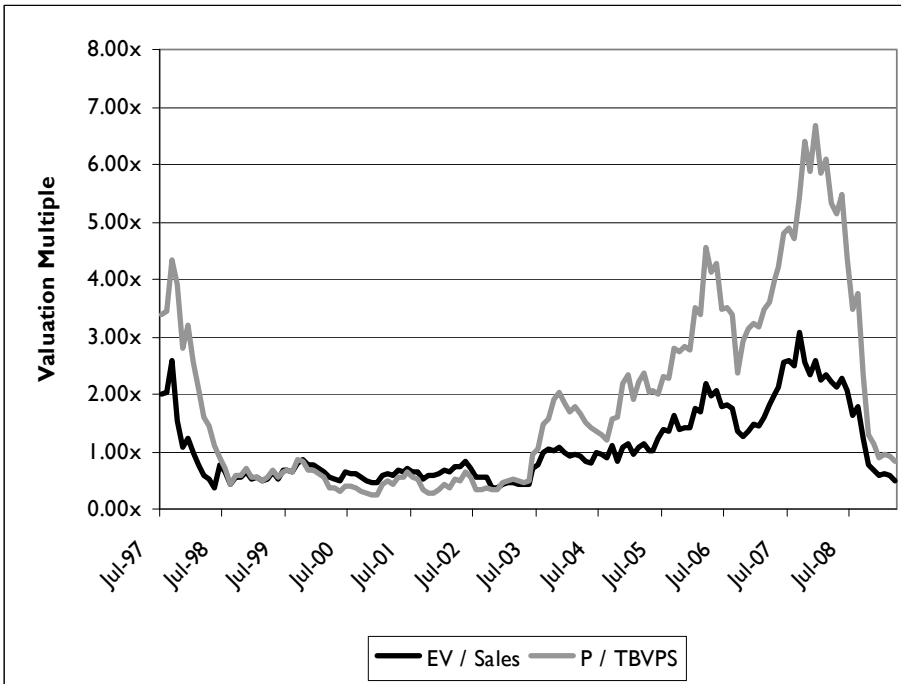
Given our earnings outlook, valuation via P/E and EBITDA are less appropriate at this point. With better-than-expected Q2/09 results, we have somewhat more confidence in the near-term revenue outlook than we had as of our prior note (February 6, 2009). On that basis, we are introducing an EV/Sales valuation estimate for AQL.

Major Drilling International (TSX-MDI, BUY, 12-Month Target \$17.50) is, in our view, the best valuation comparable for AQL at this point. While there are notable differences in the two businesses – MDI offers contract drilling, while AQL offers airborne geophysical services – MDI is the largest, most liquid TSX-listed pureplay on the mining services space and has been a public company throughout the last exploration spending cycle (unlike Aeroquest, which became a public company in 2004, and Energold Drilling Corp. (TSXV-EGD, BUY, 12-Month Target \$3.00), which only transitioned from being an exploration company to a drilling company in 2004).

MDI has an April fiscal year end, so we calculate the average of its FY 2009 and FY 2010 EV/Sales multiples based on our revenue estimates (currently 0.6x and 0.8x, for an average of 0.7x). This approximates an October year end, which is roughly equivalent to AQL's September fiscal year end. However, MDI last closed at \$15.39. Our \$17.50 12-month target on MDI implies an EV/Sales ratio of 0.7x for FY 2009 and 1.0x for FY 2010, for an average of 0.85x.

We present below (Exhibit 6) a chart illustrating how MDI's EV/Sales ratio has varied dramatically over the last 11-12 years. For information purposes, we have also included MDI's Price/Tangible Book Value-Per Share for the same period. As reflected below, MDI's EV/Sales peaked at 3.1x (September 2007), and bottomed at 0.4x in November 2002. For the entire period (1997 to 2008), MDI's average EV/Sales ratio was 1.1x. While MDI's current multiples are notably higher than the lows reached in November 2002, we also note that MDI's financial and operating condition were not as strong in 2002 as they are now. The fleet was much older then, the Company was far more highly levered, and it had barely broken even on an EBITDA basis in FY 2002. We therefore believe MDI warrants a higher EV/Sales ratio now than it received then. On this basis, MDI's current EV/Sales is low on an historic basis, making our valuation approach for AQL reasonably conservative.

**Exhibit 6. Historic MDI Multiples**



Source: Reuters, Company Reports, Jennings Estimates

Given AQL's smaller size and lower liquidity offered, we believe that AQL should receive a discount to MDI's multiple. We therefore apply a 0.6x EV/Sales multiple (a 29% discount to MDI's EV/Sales multiple, based on our target price for MDI) to our FY 2009 revenue estimate of \$35.9 million. This implies a per share value of \$0.93.

**We are therefore raising our 12-month target price to \$0.90/share from \$0.40/share, and upgrading our recommendation to BUY from HOLD.**

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### Companies

Aeroquest International Limited

### Ticker

TSX-AQL

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**Note:** We initiated coverage on **Aeroquest International Limited** on October 18, 2007 with a **STRONG BUY** recommendation, an **ABOVE AVERAGE** risk rating and a C\$6.50 target price. Share price at that time was C\$2.91. On November 1, 2007 we changed our recommendation to **BUY** as a result of changes to our internal stock rating system. Share price at that time was C\$3.60. On December 10, 2007 we increased our target price to C\$7.00. Share price at that time was C\$2.99. On February 15, 2008 we decreased our target price to C\$6.50. Share price at that time was C\$2.75. On July 18, 2008 we decreased our target price to C\$5.00. Share price at that time was C\$1.95. On October 31, 2008 we decreased our target price to C\$2.00. Share price at that time was C\$0.60. On February 6, 2009 we downgraded our recommendation to **HOLD** and reduced our target price to C\$0.40. Share price at that time was C\$0.36.

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*Revised Monthly*

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