

**AEROQUEST INTERNATIONAL LIMITED  
(TSX-AQL \$0.45)**

**Revised Recommendation: BUY  
12-Month Target: \$1.00  
Risk Rating: ABOVE AVERAGE**

**Q3/09 RESULTS FOLLOW-UP**

- **Summary:** We are maintaining our **BUY** recommendation and 12-month target price of \$1.00/share on AQL. While the Q3/09 results were disappointing, we are encouraged by the increase in backlog subsequent to quarter end and by the potential offered from the proposed acquisition of Optimal Geomatics (TSXV-OPG).
- **Q3/09 Results:** AQL had pre-released its revenue of \$3.7 million on July 29. In its full report, the Company announced a per share loss of \$0.10 v. our estimate of an \$0.08 loss, owing to weaker-than-expected margins. Not surprisingly, the decline in helicopter operations exceeded that of the fixed-wing segment. The former are higher cost projects (on a per line km basis) and are therefore more vulnerable to cutbacks in an environment of limited exploration budgets. At quarter end, the Company had cash and equivalents of \$8.0 million, and total debt of \$0.6 million, for a net cash position of \$7.4 million.
- **Outlook:** AQL's quarter end backlog was \$6.6 million, but by the end of July, had increased to \$8.5 million, an improvement of 29%. Moreover, the Company has quotes outstanding on \$20.0 million of business. We view these as encouraging signs that demand is finally improving, albeit gradually. We believe the Company's cash break-even revenue threshold is now approximately \$5.0 to \$5.5 million, which we view as very achievable in the near-term. Moreover, the proposed acquisition of Optimal Geomatics should diversify Aeroquest's revenue base away from commodity-price sensitive customers and solidly position AQL to benefit from continued stimulus/infrastructure spending in the U.S.
- **Estimates & Valuation:** We have reduced our FY 2009 estimates, but have made minor revisions to our FY 2010 estimates, which are the basis for our valuation. We are therefore leaving our 12-month target price unchanged at \$1.00/share, and we are maintaining our **BUY** recommendation.

**Sector:** SPECIAL SITUATIONS  
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**Company Statistics**

52-Week Range	\$1.90 - \$0.27
Basic Shares O/S (MM)**	36.6
Basic Market Cap (\$MM)	\$16.5
Cash (\$MM)**	\$8.0
Total Debt (\$MM)**	\$0.6
Net Cash (\$MM)	\$7.4
Net Cash / Share	\$0.19
Management & Directors Ownership	19%

**Earnings Summary**

FYE: September	2008A	2009E	2010E
Sales (\$MM)	\$55.0	\$29.1	\$57.3
EBITDA (\$MM)	\$11.3	(\$3.7)	\$8.8
EBITDA Margin	20.5%	(12.6%)	15.3%
Diluted EPS	\$0.09	(\$0.25)	(\$0.01)
Adjusted Diluted EPS*	\$0.21	(\$0.14)	\$0.09
P/E	5.3x	nmf	nmf
P/Adj. E*	2.2x	nmf	5.2x
EV/EBITDA	0.8x	nmf	1.0x

\* Adjusted Diluted EPS excludes acquisition-related amortization.

\*\* Cash and Total Debt are estimates, as of Q3/09 (June 30th).

\*\*\* Share count assumes closing of the OPG transaction.



**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.

**Q3/09 Results:**

We present the highlights of the quarter and comparisons to prior quarters in Exhibit 1. On July 29, AQL released a preliminary revenue estimate for the June quarter of \$3.7 million, which we reflected in our estimate revisions (see our note of August 4). Earnings in Q3/09 still fell short of our loss per share estimate of \$0.08 owing to weaker-than-anticipated margins. For the quarter, AQL reported a blended gross margin of approximately 12% v. our forecast of 18%. Margins are well below peak levels of 40%-45% seen in FY 2008.

While the slowdown in exploration spending from both the mining and petroleum markets is the primary cause of the decline in revenue and earnings, Q3/09 results were further impacted by some start-up delays at certain projects. During its conference call, management indicated that approximately \$1.0 to \$2.0 million in revenue was forgone as a result of these delays; as the issues have been resolved, we expect that revenue to fall into Q4/09.

**Exhibit 1. Q3/09 Results Highlights**

	<b>Q3/09A</b>	<b>Q3/08A</b>	<b>Y-Y</b>	<b>Q2/09A</b>	<b>Q-Q</b>
Revenue (\$mm)	\$3.7	\$14.5	(75%)	\$8.0	(54%)
EBITDA (\$mm)	(\$2.7)	\$2.7	nmf	\$0.1	nmf
EBITDA Margin	(73%)	18%	nmf	1%	nmf
Diluted EPS	(\$0.10)	\$0.01	nmf	(\$0.03)	233%
Adjusted Diluted EPS	(\$0.08)	\$0.04	nmf	(\$0.01)	700%

Source: Company Reports, Jennings Estimates (Adjusted Diluted EPS excludes acquisition-related amortization).

We present the breakdown between helicopter-based and fixed-wing based operations in Exhibit 2. As shown there, the activity and profitability decline has been severe for both segments, but particularly so for helicopter operations. Helicopter-based surveys are far more expensive on a per line km basis than are fixed-wing surveys. In an environment of reduced exploration budgets, the more expensive survey type has, not surprisingly, seen a greater decline in demand.

**Exhibit 2. Operational Breakdown**

<b>Helicopter</b>	<b>Q3/09A</b>	<b>Q3/08A</b>	<b>Y-Y</b>	<b>Q2/09A</b>	<b>Q-Q</b>
Revenue (C\$m)	\$0.3	\$7.2	(95%)	\$1.6	(80%)
Line Km Flown (000s)	2.7	73.2	(96%)	11.4	(76%)
Revenue/Line Km	\$120.00	\$98.20	22%	\$142.89	(16%)
Gross Margin	(110%)	35%	(14,438bps)	(3%)	(10,724bps)

<b>Fixed Wing</b>	<b>Q3/09A</b>	<b>Q3/08A</b>	<b>Y-Y</b>	<b>Q2/09A</b>	<b>Q-Q</b>
Revenue (C\$m)	\$2.9	\$7.0	(58%)	\$5.9	(51%)
Line Km Flown (000s)	144.0	457.7	(69%)	189.0	(24%)
Revenue/Line Km	\$20.15	\$15.27	32%	\$31.15	(35%)
Gross Margin	19%	42%	(2,330bps)	52%	(3,291bps)

Source: Company Reports, Jennings Estimates

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The third business segment - Other Services - contributed an additional \$0.4 million in revenue during the quarter.

As we noted previously, the results of this quarter were disappointing, but we are encouraged by the recent increase in backlog. Management noted that it increased from \$6.6 million at June 30 to approximately \$8.5 million at July 28. In addition, the Company has quotes out on approximately \$20.0 million of additional business. We view these as positive indicators.

### **The Balance Sheet:**

The Company finished Q3/09 with cash and equivalents of \$8.0 million and total debt of \$0.6 million (capital leases) for a net cash position of \$7.4 million.

This cash level is down from \$10.4 million at the end of the prior quarter and is attributable to weak activity levels. Given continued cost cutting efforts, including a 10% salary cut for senior management, we believe AQL's revenue level required for a cash break-even is approximately \$5.0 to \$5.5 million. Our model implies that this revenue level is achievable, even in the near-term.

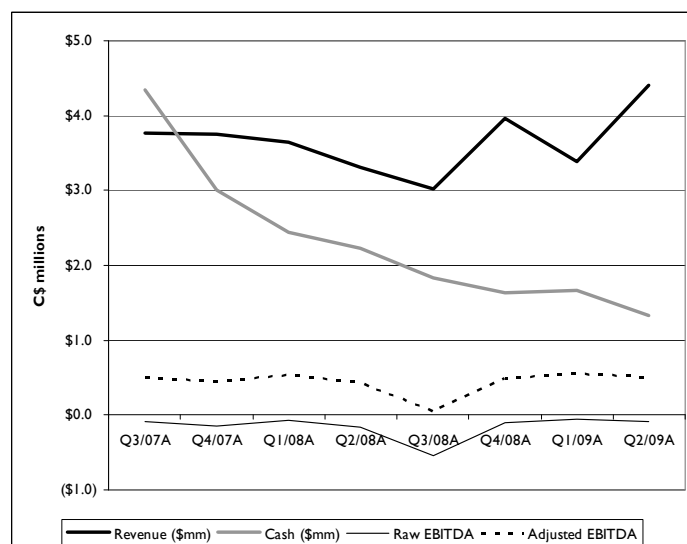
### **The Optimal Geomatics (TSXV-OPG) Acquisition**

On July 29, AQL announced plans to acquire Optimal Geomatics for \$1.3 million in stock (3 million shares of AQL at \$0.43/share, based on AQL's prior closing price). The exchange ratio is to be one share of AQL per 21 shares of OPG and represents an approximate 34% premium to OPG's prior closing price. Based on trailing financials, we estimate that AQL would be paying 0.1x revenue and 0.6x EBITDA, once our estimate of likely overhead savings is adjusted for. OPG's board of directors has unanimously recommended that shareholders accept AQL's offer. A shareholder meeting is expected to be held in mid-September, and the transaction will require approval of 2/3 of voting shareholders in order to proceed.

During the conference call, management reiterated its expectation that this transaction should close in late September. Moreover, shareholders controlling approximately 29% of the outstanding stock of OPG have already committed to support the proposed transaction via lock-up agreements.

Optimal Geomatics is a geospatial mapping company based in Vancouver, B.C. The Company specializes in gathering, analyzing, interpreting, distributing and using geographic information. To date, OPG has served primarily energy utilities and government entities/agencies, with the vast majority of its revenue currently coming from work in the United States. OPG has consistently generated quarterly revenue of \$3.0 to \$4.0 million for the past eight quarters, while losses – and its cash burn – have persisted (see Exhibit 3). However, we estimate that OPG's EBITDA would have been positive, absent the costs of being a stand-alone public company. AQL management expects this transaction to be immediately accretive.

**Exhibit 3. OPG Trailing Results**



Source: Company Reports, Jennings Estimates

During the AQL conference call, management indicated that OPG's backlog is now at its highest on record, owing in part to ongoing stimulus spending on infrastructure in the U.S. AQL management believes the companies are an operational and cultural fit and that integration with AQL should be very manageable.

We view this transaction positively, as it diversifies AQL's revenue base away from commodity-price sensitive customers. This represents a continuation of the strategy put in place a few years ago, which began with AQL's expansion from being almost entirely mining focused, to include the petroleum space as well. We believe that petroleum work now contributes approximately 50% of the Company's backlog. Assuming the OPG acquisition closes – which we believe it will – it will expand AQL's presence into new markets such as infrastructure and energy utility projects.

**Estimate Revisions**

We have revised our estimates to reflect the results of this quarter and management's comments during the conference call held August 6. We present our prior and revised estimates in Exhibit 4. On a net basis, we have reduced our Q4/09 revenue and margin estimates (hence the change in FY 2009E seen below), but have only tweaked our FY 2010 estimates.

**Exhibit 4. Prior & Revised Estimates**

	FY 2009E		FY 2010E	
	Prior	New	Prior	New
Revenue (\$mm)	\$30.9	\$29.1	\$57.6	\$57.3
EBITDA (\$mm)	(\$1.2)	(\$3.7)	\$8.9	\$8.8
EBITDA Margin	(4%)	(13%)	16%	15%
Diluted EPS	(\$0.19)	(\$0.25)	\$0.00	(\$0.01)
Adjusted Diluted EPS	(\$0.08)	(\$0.14)	\$0.10	\$0.09

Source: Jennings Estimates (Adjusted Diluted EPS excludes acquisition-related amortization)

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Our quarterly estimates are reflected in Exhibit 5. We are reducing our Q4/09 revenue estimate to \$6.2 million from \$8.0 million. This still represents a strong sequential improvement from Q3/09, albeit at a more cautious pace.

**Exhibit 5. Quarterly Estimates**

	Q1/09A	Q2/09A	Q3/09A	Q4/09E	2009E
Revenue (\$mm)	\$11.3	\$8.0	\$3.7	\$6.2	\$29.1
Growth (y-y)	1%	(40%)	(75%)	(61%)	(47%)
EBITDA (\$mm)	(\$0.3)	\$0.1	(\$2.7)	(\$0.8)	(\$3.7)
EBITDA Margin	(3%)	1%	(73%)	(12%)	(13%)
Diluted EPS	(\$0.04)	(\$0.03)	(\$0.10)	(\$0.06)	(\$0.25)
Adjusted Diluted EPS	(\$0.02)	(\$0.01)	(\$0.08)	(\$0.03)	(\$0.14)

Source: Jennings Estimates (Adjusted Diluted EPS excludes acquisition-related amortization)

**Valuation**

As we have not materially changed our estimates for FY 2010, we are maintaining our **BUY** recommendation and our 12-month target price of \$1.00/share.

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**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. On May 5, 2009 we upgraded our recommendation to **BUY** and increased our target price to C\$0.90. Share price at that time was C\$0.41. On August 4, 2009 we increased our target price to C\$1.00. Share price at that time was C\$0.38.

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*Revised Monthly*

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