

**AEROQUEST INTERNATIONAL LIMITED
(TSX-AQL \$0.39)**

**Recommendation: BUY
12-Month Target: \$2.00
Risk Rating: ABOVE AVERAGE**

Q4/08 RESULTS

- **Summary:** AQL reported Q4/08 revenue of \$16.0 million and diluted EPS of \$0.05 (adjusted \$0.07). Revenue was in line with our forecast; management had pre-released that result on October 30, 2008. Diluted EPS were stronger than expected (\$0.02 raw, \$0.04 adjusted), as an FX gain more than offset weaker-than-expected gross margins. While we do expect a meaningful decline in global exploration spending, we believe that our earnings estimates for AQL already reflect lower utilization levels and that the stock represents compelling value, given that it trades well below liquidation value on several metrics. We continue to rate AQL a **BUY** with a 12-month target price of \$2.00.
- **FY 2008 Results:** As AQL changed its fiscal year from April 30 to September 30 prior to the end of FY 2007, the results of this quarter lack direct comparability on a y-y basis. For FY 2008, AQL had revenue of \$55.0 million and diluted EPS of \$0.09 (or \$0.21 adjusted).
- **The System Fleet:** AQL finished FY 2008 with 28 systems (17 helicopter, 11 fixed-wing). Management intends to add two more systems (one helicopter, one fixed-wing) for an exit of 30 for Q1/09. Our model assumes no further additions to the fleet during FY 2009, given the uncertain near-term demand outlook.
- **Outlook:** Management continues to see limited revenue visibility beyond Q1/09 (i.e., into next calendar year). Owing to declines in commodity prices and current capital market conditions, we expect exploration spending to decline to US\$7.5 billion in 2009 from US\$10.5 billion (excluding uranium) in 2007.
- **Balance sheet:** AQL finished the quarter with cash and equivalents of \$15.4 million and total debt (capital leases) of \$0.8 million, for a net cash position of \$14.6 million. AQL now trades at a 10% discount to net cash and a 36% discount to tangible book value. During the conference call, management indicated it believes that current receivables are collectible. We believe that AQL, like other mining service companies, represents compelling value, given that it is trading at well below liquidation value.
- We are maintaining our **BUY** recommendation and 12-month target of \$2.00.

Sector: SPECIAL SITUATIONS
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Company Statistics	
52-Week Range	\$3.58 - \$0.32
Basic Shares O/S (MM)	33.5
Basic Market Cap (\$MM)	\$13.1
Fully Diluted O/S (MM)	36.9
Cash (\$MM)	\$15.4
Total Debt (\$MM)	\$0.8
Management & Directors Ownership	21%

Earnings Summary			
FYE: September	2007A**	2008E	2009E
Sales (\$MM)	\$19.9	\$55.0	\$57.4
EBITDA (\$MM)	\$4.6	\$11.3	\$11.6
EBITDA Margin	23.3%	20.5%	20.2%
Diluted EPS	\$0.11	\$0.09	\$0.10
Adjusted Diluted EPS*	\$0.11	\$0.21	\$0.18
P/E	3.5x	4.6x	3.9x
P/Adj. E*	3.5x	1.9x	2.1x
EV/EBITDA	(0.3x)	(0.1x)	(0.1x)

* Adjusted Diluted EPS excludes acquisition-related amortization.
 ** Results reported for fiscal years ending April 30.



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.

Q4/08 AND FY 2008 RESULTS

AQL reported revenue in line with our forecast, while diluted EPS were stronger than expected, owing to an FX gain that more than offset weaker-than-forecast gross margins. Gross margins continue to fall short of expectations, although management indicated that it does expect some improvement in Q1/09. We present the highlights of the quarter in Exhibit 1. As in prior reports, our Adjusted Diluted EPS calculation excludes the negative impact of the amortization of intangibles relating to the two acquisitions.

Exhibit 1. Q4/08 Highlights

	Q4/08E	Q4/08A	Variance	Q3/08A	Q-Q
Revenue (\$mm)	\$16.0	\$16.0	0%	\$14.5	10%
EBITDA (\$mm)	\$3.2	\$3.6	11%	\$2.7	35%
EBITDA Margin	20.1%	22.3%	220bps	18.3%	405bps
Diluted EPS	\$0.02	\$0.05	150%	\$0.01	400%
Adjusted Diluted EPS	\$0.04	\$0.07	75%	\$0.04	75%

Source: Company Reports, Jennings Estimates

We present the quarter-by-quarter highlights in Exhibit 2.

Exhibit 2. FY 2008 Quarter-by-Quarter

	Q1/08A	Q2/08A	Q3/08A	Q4/08A	2008A
Revenue (\$mm)	\$11.2	\$13.3	\$14.5	\$16.0	\$55.0
EBITDA (\$mm)	\$1.6	\$3.4	\$2.7	\$3.6	\$11.3
EBITDA Margin	14.3%	25.9%	18.3%	22.3%	20.5%
Diluted EPS	\$0.00	\$0.02	\$0.01	\$0.05	\$0.09
Adjusted Diluted EPS	\$0.03	\$0.05	\$0.04	\$0.07	\$0.21

Source: Company Reports

The FX gain of \$1.2 million in the quarter is an asset translation gain. Most of AQL's revenue is now in U.S. dollars. Owing to the increase in the U.S. dollar during the period, the Canadian dollar value of the receivables and cash held in U.S. dollars also increased during the period. In Exhibit 3 below, we present adjusted results that exclude this gain. While EBITDA (excluding the FX gain) was below forecast, per share earnings were in line.

Exhibit 3. Adjustments for FX Gain

	Q4/08A	2008A
Revenue (\$mm)	\$16.0	\$55.0
EBITDA (\$mm)	\$2.4	\$10.2
EBITDA Margin	15.0%	18.6%
Diluted EPS	\$0.02	\$0.07
Adjusted Diluted EPS	\$0.04	\$0.19

Source: Jennings Estimates

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THE BALANCE SHEET

AQL finished FY 2008 with cash and equivalents of \$15.4 million and total debt (all in the form of capital leases) of \$0.8 million, for a net cash position of \$14.6 million or approximately \$0.40/share.

The Company also has \$8.6 million in receivables, and during the conference call, management indicated that it believes those receivables to be collectible. On that basis, we estimate that AQL has net working capital of \$0.49/share.

We believe that AQL is undervalued on its balance sheet alone.

Q1/09 GUIDANCE AND OUTLOOK

The backlog at quarter end was \$18.0 million, of which approximately 26%, or \$4.7 million, relates to petroleum services work, and \$13.3 million relates to mining services work. We view the growth of the petroleum services segment as very encouraging, as diversifying AQL's revenue base away from mining services by finding new applications for its technology has been a priority for management.

Management reiterated its Q1/09 guidance for revenue between \$13.0 and \$15.0 million. This guidance was originally provided on October 30, 2008. As Q1/09 represents the October-December quarter, it can be viewed as the last of the spending by mining companies relating to their 2008 budgets (set primarily in late 2007/early 2008).

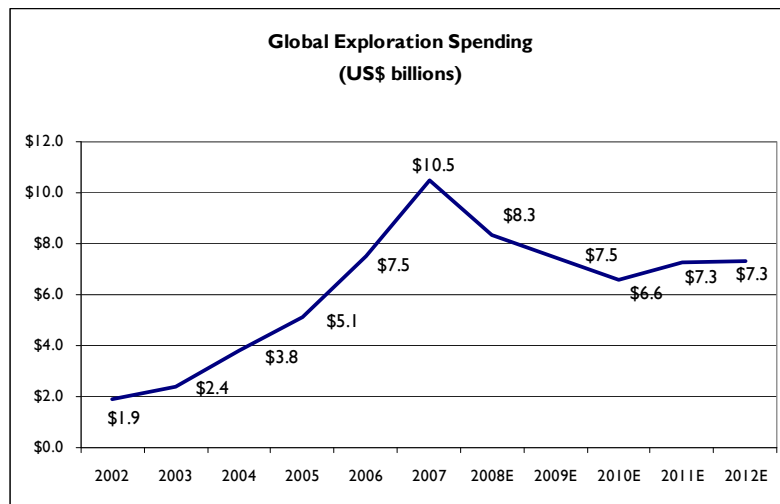
Management indicated it had little revenue visibility into calendar 2009 (its Q2 – Q4 period), given the decline in commodity prices and the current macroeconomic environment.

OUR EXPLORATION SPENDING OUTLOOK

We recently revised our forecast for exploration spending (see our note of November 26, 2008) and present the highlights in Exhibit 4. Our estimates are based on regression models, in turn derived from the historical relationship between commodity prices and global exploration spending (based on data from 1993 forward).

To summarize our view, we believe that investors are overestimating the likely extent of the decline in exploration spending. In particular, we believe that the market is overlooking the importance of gold (42% of total exploration spending in 2007, more than copper (21%), nickel (8%) and zinc (7%) combined (36%)). With gold still at very high levels by historical standards (US\$700-\$800/oz.), we believe that significant investments in gold exploration will continue. While spending will decline from 2007 highs, we believe it will still be in the US\$7-\$8 billion range, approximating the levels seen in 2006. By contrast, with mining services stocks trading at below liquidation value, we believe investors are implicitly assuming a far more severe decline.

Exhibit 4. Exploration Spending Forecast (US\$ billions)



Source: Metals Economics Group, Jennings Estimates

OTHER HIGHLIGHTS OF THE QUARTER/CONFERENCE CALL

- Buyback to Expire – management indicated that its board has elected not to renew the share buyback in order to conserve cash. During Q4/08, AQL bought back 1.1 million shares at an average cost of approximately \$1.75/share. For FY 2008, AQL bought back 1.7 million shares at an average cost of \$1.96/share.
- Management Changes – the founders of UTS Geophysics, acquired by AQL in July 2007, are reducing their roles to part-time levels beginning next calendar year. They will remain active in the Company and, in particular, will help integrate the Spectrem acquisition. Mr. Neil Goodey (COO) will remain on AQL’s board, while Mr. Nino Tuffili (Operations Director of UTS) will resign. Mr. Tuffili will be replaced by Mr. John Hick, a lawyer with 25 years of mining industry experience. Mr. Hick is already a director of a number of listed mining companies including Silver Eagle Mines Inc. (TSX-SEG), First Uranium Corp. (TSX-FIU) and Carpathian Gold Inc. (TSX-CPN). We believe his industry experience and contacts will help AQL.
- Spectrem Transaction – management still expects to have definitive agreements signed before the end of this month. However, owing to regulatory requirements relating to the maintenance requirements of aircraft in South Africa, the transaction will likely not close until mid-calendar year 2009. Given this transaction is in the non-binding LOI stage, we had not included it in our FY 2009 estimates, and based on this update, we do not expect it to make a meaningful contribution to AQL’s results for FY 2009.

ESTIMATE REVISIONS

We have made the following changes to our estimates:

- Warrants – we had previously assumed that warrant conversions would generate \$6.4 million in cash for AQL in Q4/09. As the conversion prices of those warrants (most at \$2.45/share) make them all well out of the money and above our 12-month target price, we now assume those warrants will go unexercised.

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- Revenue – we have tweaked our utilization assumptions for both the helicopter and fixed-wing operations, although these changes are minor. We believe we have already reflected a likely decline in utilization in our estimates. In particular, we note that by the end of Q1/09, AQL will have expanded its fleet of active systems from 19 at the end of Q1/08 to 30 at the end of Q1/09. This represents growth of 58%. By comparison, we expect total revenue growth of 4% in FY 2009. This divergence in growth rates reflects our expectation for reduced utilization on a per system basis.
- Gross Margin – in light of the results of the quarter, we have reduced our blended gross margin estimate for FY 2009 from 43.0% to 40.0%. This is driven primarily by lower gross margin assumptions for the helicopter operations. Although we still expect improvement in this area, we expect it to take a few quarters before margins approach traditional levels. Ideally, we believe margins for the business should be closer to 45.0%.

We present the highlights of our FY 2009 estimates in Exhibit 5a, and a comparison to our prior estimates in Exhibit 5b. We note the following:

- Q1/09 - revenue estimate is within management's guidance range (\$13.0 to \$15.0 million). While we expect that the Q1/09 results will likely include an FX gain at least as large as the \$1.2 million in Q4/08, we have made no specific assumptions there.
- FY 2009 – our diluted EPS estimate actually increases, while our adjusted EPS estimate is unchanged.

Exhibit 5a. Revised Estimates

	Q1/09E	Q2/09E	Q3/09E	Q4/09E	2009E
Revenue (\$mm)	\$14.1	\$14.3	\$14.4	\$14.6	\$57.4
EBITDA (\$mm)	\$1.8	\$3.2	\$3.3	\$3.3	\$11.6
EBITDA Margin	12.6%	22.2%	22.9%	22.8%	20.2%
Diluted EPS	(\$0.00)	\$0.03	\$0.03	\$0.04	\$0.10
Adjusted Diluted EPS	\$0.02	\$0.05	\$0.06	\$0.06	\$0.18

Source: Company Reports, Jennings Estimates

Exhibit 5b. Prior v. New Estimates

	2009E	
	Prior	New
Revenue (\$mm)	\$59.5	\$57.4
EBITDA (\$mm)	\$13.3	\$11.6
EBITDA Margin	22.4%	20.2%
Diluted EPS	\$0.09	\$0.10
Adjusted Diluted EPS	\$0.18	\$0.18

Source: Jennings Estimates

VALUATION AND RECOMMENDATION

With a very healthy balance sheet, we note that AQL trades at the following:

- A 10% discount to net cash (\$13.1 million market cap. v. \$14.6 million in net cash).
- A 36% discount to tangible book value per share of \$0.61.
- On an EV/System basis, a negative \$54k v. a replacement cost of \$500k.

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In other words, Aeroquest is now trading well below liquidation value. At this point, the market is putting a negative value on the operating business, which we believe will continue to generate strong revenue and earnings in FY 2009.

Given that our FY 2009 estimates have not materially changed, we are making no change to our target at this point. We are maintaining our **BUY** recommendation and our 12-month target price of \$2.00.

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Companies	Ticker
Aeroquest International Limited	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.

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