

AEROQUEST INTERNATIONAL

February 12, 2010

AQL – TSX \$0.61

Rating:

STRONG BUY

Target Price:

\$1.00

Market Capitalization:

\$20.5 million

DIVERSIFIED INDUSTRIES

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AQL Announces Q1FY2010 Financial Results

In-Line with Expectations, Positive Investment Thesis Remains

- On February 10, 2010, Aeroquest released its Q1FY2010 financial results. The highlight was an increase in revenue of 61% over the prior quarter (\$8.2 million versus \$5.1 million in Q4FY2009) mainly as a result of the Optimal Geomatics acquisition which contributed \$2.2 million. Airborne Geophysics revenue of \$5.8 million reflected a modest increase versus the prior quarter's \$4.9 million. This figure provides further proof that the segment has now stabilized after dipping to a mere \$3.2 million in sales during Q3FY2009.
- EBITDA and earnings came in as expected with the improvement in revenue being partially offset by lower margins. Gross profit margins declined during the quarter to 17% versus 21% in Q4FY2009 primarily due to lower margins on government survey work in Australia and logistical challenges with surveys in Latin America and South East Asia. Management noted that it expects margins within the Airborne Geophysics segment to improve during the second quarter while margins in the Aerial Geomatics segment will be realized over the next 6 months.
- The company remains cautiously optimistic that the contraction in the industry has ended and expansion will progress through FY2010. At quarter-end, the backlog at Aeroquest was \$11.4 million, up from \$10.9 million at the end of the prior quarter. The company also believes that it may soon begin several large fixed wing surveys in North Africa, principally in Egypt and Libya. This business is not included in the backlog figure. These surveys, which could total in excess of \$5 million, may begin as early as this quarter once management is comfortable that it has all the pieces in place to deliver the service.
- We believe that Aeroquest's revenue base and profit picture bottomed in FY2009 and we expect a meaningful improvement through the remainder of FY2010. Consolidated revenue will most certainly grow as a result of the Geomatics acquisition along with an increase in geophysical survey business expected in H2FY2010. Further, this combination should assist the company in returning to cash flow break-even around mid-year.
- We maintain our STRONG BUY rating and \$1.00 target price. The shares currently trade at a large discount to net book value (\$1.19/share) and a modest premium to tangible book value (\$0.47/share). The company maintains a good cash position of \$0.13/share with no long-term debt. Aeroquest is well positioned to demonstrate strong operational improvement with the stabilization of the global economy.

Share Information Summary

Recent Price (C\$)	\$0.61
12 mo. Price Target	\$1.00
52 week Range	\$0.27- 0.85
Average Daily Volume (3 mo.)	37,115
Shares Out – Basic (M)	33.6
Shares Out – Diluted (M)	35.8
Market Cap (C\$M)	\$20.5
Annual Dividend & Yield	N/A
FY End	September 30th

Estimates Summary

FY (Y/E Sep 30)	08A	09A	10E	11E
Rev (\$M)	55.0	28.0	48.0	61.0
EPS (\$/fd shr)	0.09	(0.32)	(0.11)	0.05
P/E	8.8x	NMF	NMF	13.3x
EBITDA (\$M)	11.3	(4.4)	1.3	9.7
EV/EBITDA	0.8x	NMF	11.8x	0.8x

Source: Fraser Mackenzie Limited

Company Profile

Aeroquest is a Canadian provider of airborne geophysical surveys, using electromagnetic, magnetic, gravity and radiometric techniques. The company operates worldwide, using a mix of helicopter and fixed wing aircraft, running surveys for mineral and oil and gas exploration. Following a combination of organic and acquisition-driven growth the company is now one of the world's top three providers of these services.

Q1FY2010 Discussion

Revenue for the quarter of \$8.2 million exceeded expectations growing an impressive 61% over the prior quarter. Roughly two-thirds of this growth came from the Optimal Geomatics acquisition (\$2.2 million in sales). Airborne Geophysics revenue of \$5.8 million reflected a modest increase versus \$4.9 million in Q4FY2009 and \$3.2 million in Q3FY2009. Notably, the company experienced a significant increase in helicopter services revenue (\$2.2 million versus \$0.8 million in Q4FY2009) which was partially offset by a modest decrease in fixed wing operations revenue (\$3.6 million versus \$4.1 million in Q4FY2009).

The outperformance in sales was neutralized by a decline in margins to 17.1% versus 20.7% in the prior quarter. Broken down by segment, margins were 16.2% in Airborne Geophysics, 14.5% in Aerial Geomatics and 66.1% in Contract R&D. The company cited lower margins on government survey work in Australia and logistical challenges with surveys in Latin America and South East Asia. Management noted that it expects margins within the Geophysics segment to improve during the second quarter while margins in the Geomatics segment will be realized over the next 6 months. We note that Aeroquest has a significant amount of fixed costs embedded within cost of sales and hence will benefit from operating leverage as revenues regain momentum.

EBITDA at (\$1.4) million and earnings (\$0.06/share) were in-line with expectations. We have made only modest revisions to our forecasts going forward as indicated in the table below.

Exhibit 1 – Results and Forecasts (\$ Millions)

FYE September 30	2008A	Q1A	Q2A	Q3A	Q4A	2009A	Q1A	Q1E	2010 New	2010 Old	2011 New	2011 Old
Revenue	55,046	11,298	7,963	3,651	5,100	28,012	8,175	6,500	47,975	48,500	61,000	61,000
Cost of sales	34,351	8,370	4,710	3,217	4,042	20,339	6,779	5,038	35,712	35,300	40,070	39,600
Gross margin	20,695	2,928	3,253	434	1,058	7,673	1,395	1,463	12,262	13,200	20,930	21,400
	37.6%	25.9%	40.9%	11.9%	20.7%	27.4%	17.1%	22.5%	25.6%	27.2%	34.3%	35.1%
Expenses												
G&A expenses	9,442	4,351	3,083	2,295	2,116	11,845	2,668	2,900	10,468	10,800	10,800	10,800
Development expenses	80	-	-	-	-	-	-	-	-	-	-	-
Foreign Exchange Loss	(1,059)	(1,206)	(25)	691	308	(232)	81	-	81	-	-	-
Stock option expense	960	104	135	108	108	456	85	113	385	450	400	450
EBITDA	11,272	(322)	60	(2,660)	(1,475)	(4,396)	(1,439)	(1,550)	1,328	1,950	9,730	10,150
Capital asset depreciation	2,814	802	1,011	1,155	932	3,900	880	950	3,580	3,800	3,600	3,800
Impairment charges	-	-	-	-	2,880	2,880	-	-	-	-	-	-
Intangibles amortization	4,035	885	747	785	1,075	3,493	875	900	3,575	3,600	3,600	3,600
EBIT	4,423	(2,008)	(1,698)	(4,601)	(6,362)	(14,669)	(3,194)	(3,400)	(5,827)	(5,450)	2,530	2,750
Other costs/(income)	(224)	(56)	(85)	(5)	19	(127)	(103)	(9)	(151)	(28)	(122)	(67)
EBT	4,647	(1,952)	(1,613)	(4,596)	(6,381)	(14,542)	(3,090)	(3,391)	(5,676)	(5,422)	2,652	2,817
Total Taxes	1,804	(438)	(659)	(1,097)	(1,725)	(3,920)	(824)	(1,119)	(1,651)	(1,789)	849	930
Net Income	2,843	(1,514)	(953)	(3,499)	(4,657)	(10,622)	(2,266)	(2,272)	(4,024)	(3,633)	1,803	1,887
Earnings per unit												
Basic	\$ 0.09	\$ (0.05)	\$ (0.03)	\$ (0.10)	\$ (0.14)	\$ (0.32)	\$ (0.06)	\$ (0.06)	\$ (0.11)	\$ (0.10)	\$ 0.05	\$ 0.05
Diluted	\$ 0.09	\$ (0.05)	\$ (0.03)	\$ (0.10)	\$ (0.14)	\$ (0.32)	\$ (0.06)	\$ (0.06)	\$ (0.11)	\$ (0.10)	\$ 0.05	\$ 0.05

Source: Company filings, Fraser Mackenzie estimates

The company's cash position declined to \$4.7M (\$0.13/share) which essentially traced the EBITDA deficit for the period. As at December 31, 2009, Aeroquest had virtually no long-term debt as well as a portion of unused credit facilities. We expect that Aeroquest's cash position will stabilize around mid-FY2010 as the company returns to cash flow break-even. Notably, Aeroquest expects to receive in excess of \$2 million of cash over the next few months from the carryback of tax losses.

Looking ahead, we believe that the company's revenue base and profit picture has bottomed and we expect a meaningful improvement during this fiscal year. While growth in geophysical survey revenue during Q1FY2010 was modest versus the prior quarter, we have seen substantial improvement from the lows reached in Q3FY2009 where airborne geophysics revenue was a mere \$3.2 million. Consolidated revenue will most certainly grow this year as a result of the Optimal Geomatics acquisition along with an increase in geophysical survey business expected in the latter half of the year. We forecast 71% year-over-year revenue growth for FY2010 which is roughly two-thirds driven by the acquisition and one-third via growth in geophysical survey sales.

The growth we foresee for the company across FY2010 and FY2011 is supported by several factors as summarized below:

- Recent evidence that the global economy has begun to stabilize
- A surge in commodity prices over the last several months (i.e. gold at historic highs)
- Senior and intermediate mining companies have been successful in raising capital within 2009
- Equity financings for junior mining companies increased to ~\$1.6 billion in Q2FY2009 (third highest in 12 quarters)
- With greater cash and financial flexibility among these companies, demand for airborne geophysical surveys should increase significantly
- An increased level of quote activity across Aeroquest's customer base

Longer term trends which support our favourable view on Aeroquest include:

- A decrease in major mineral discoveries over the past couple of decades while many of the larger operating mines/fields are nearing end of life. Hence, there is an accelerating need to find new discoveries in underexplored regions of the world thereby necessitating the need for the Aeroquest services.

Valuation

In our view, Aeroquest shares represent compelling value with the shares trading at a substantial discount to net book value of \$1.19/share. Investors also enjoy considerable downside support based on the company's tangible book value of \$0.47/share. Aeroquest has a strong balance sheet with \$0.13/share of cash and virtually no long-term debt. Our \$1.00/share target values Aeroquest at 20x next year's earnings (FY2011) and 2.5x EBITDA.

Conclusions and Recommendation

Aeroquest has a committed management team that has faced up to the past year's difficult operating environment. They have cut costs, reduced headcount and acted to conserve cash to allow the business to survive the economic downturn. The current set of results further confirms that business has seen a bottom – past actions have positioned the company to weather drops in demand thus providing investors with an opportunity to take a position ahead of any pick-up in activity.

We maintain our STRONG BUY rating and our \$1.00 target price.

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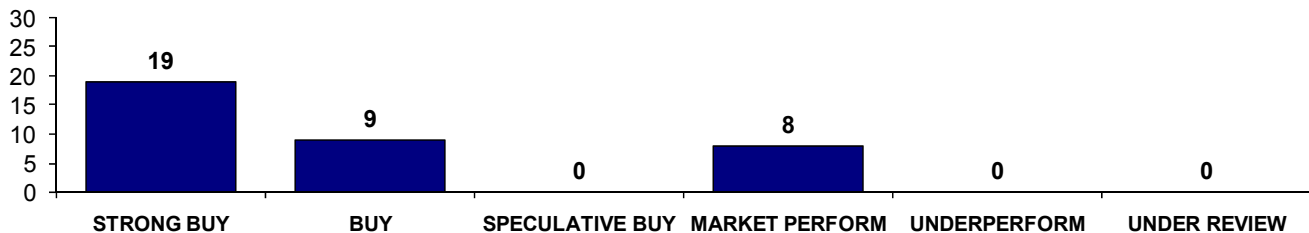
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