

**AEROQUEST INTERNATIONAL LIMITED  
(TSX-AQL \$0.59)**

**Recommendation: BUY**  
**Revised 12-Month Target: \$1.20**  
Previous 12-Month Target: \$1.00  
**Risk Rating: ABOVE AVERAGE**

**RAISING TARGET**

- **Summary:** We are raising our 12-month target on AQL to **\$1.20 from \$1.00**. The Company recently reported Q1/10 results that were in line with our revenue expectations, but fell short on the margin front. More importantly, we continue to believe that a recovery in exploration spending is underway.
- **Q1/10 Results:** AQL reported Q1/10 revenue of \$8.2 million, in line with our estimate. AQL reported a loss per share of \$0.07, or \$0.04 when excluding the impact of acquisition-related amortization. Revenue improvement q-q was mainly due to the first quarter contribution from the former Optimal Geomatics (OPG) business. At quarter end, the Company had cash and equivalents of \$4.7 million, and total debt of \$0.1 million, for a net cash position of \$4.6 million. Moreover, management expects a \$2.0 million cash infusion from tax refunds over the next two quarters.
- **OPG Integration:** The integration is mostly complete, and rebranding of the business has commenced. The Company is also in the process of divesting OPG's operations in Vancouver in order to reduce costs further. Management expects improvement in operational efficiencies over the six months as cost rationalization of the former OPG business continues.
- **Backlog:** At quarter end, backlog totalled \$11.4 million, of which \$7.4 million relates to the former OPG business. Not included in the backlog estimate is approximately \$5 million in potential, unsigned contracts in North Africa. Management reports that customer sentiment and quoting activity are much improved, with the caveat that customers are still slow to sign contracts.
- **FY 2010 Outlook:** Management remains optimistic for a stronger exploration spending environment in 2010, but expects recovery to be modest. We continue to expect a significant improvement in overall exploration spending in calendar 2010, but based on comments from AQL and other players in the space, earlier stage exploration spending may lag somewhat, and we expect AQL to return to profitability in Q4/10.
- **Estimates and Valuation:** With the introduction of our FY 2011 estimates, we are rolling our valuation forward. We are applying a 7x adjusted EPS multiple (where we excluded the impact of acquisition-related amortization) and 3.5x EBITDA multiple. We are therefore maintaining our **BUY** recommendation and **raising our 12-month target to \$1.20** from \$1.00.

**Sector: SPECIAL SITUATIONS**

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**Company Statistics**

52-Week Range	\$0.85 - \$0.27
Basic Shares O/S (MM)	36.9
Basic Market Cap (\$MM)	\$21.7
Cash (\$MM)	\$4.7
Total Debt (\$MM)	\$0.6
Net Cash (\$MM)	\$4.0
Net Cash / Share	\$0.10
Management & Directors Ownership	19%

**Earnings Summary**

FYE: September	2009A	2010E	2011E
Sales (\$MM)	\$28.0	\$37.8	\$56.6
EBITDA (\$MM)	(\$4.4)	(\$3.0)	\$12.6
EBITDA Margin	(15.7%)	(8.0%)	22.3%
Diluted EPS	(\$0.32)	(\$0.20)	\$0.07
Adjusted Diluted EPS*	(\$0.21)	(\$0.10)	\$0.17
P/E	nmf	nmf	8.3x
P/Adj. E*	nmf	nmf	3.6x
EV/EBITDA	nmf	nmf	1.4x

\* Adjusted Diluted EPS excludes acquisition-related amortization.



**Aeroquest International Limited** is a mining, 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.

### Q1/10 Results:

We present the highlights of the quarter and comparisons to prior quarters in Exhibit 1. While revenue was in line with our estimates, the net loss was slightly larger than expected owing to weaker than anticipated margins. For the quarter, AQL reported a blended gross margin of approximately 17% v. our forecast of 32%. In addition to the decline in y-y activity, management cited weak pricing for geophysical surveys flown in Australia (for government customers), as well as operational difficulties encountered by the former Optimal Geomatics business. We expect improvement in both areas in the coming quarters.

### Exhibit 1. Q1/10 Results Highlights

	Q1/10E	Q1/10A	Variance	Q4/09A	Q-Q
Revenue (\$mm)	\$8.2	\$8.2	0%	\$5.1	60%
EBITDA (\$mm)	(\$0.9)	(\$1.4)	68%	(\$1.3)	11%
EBITDA Margin	(10.5%)	(17.6%)	(710)bps	(25.5%)	789bps
Diluted EPS	(\$0.06)	(\$0.07)	17%	(\$0.14)	(50%)
Adjusted Diluted EPS	(\$0.03)	(\$0.04)	33%	(\$0.10)	(60%)

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

We present the breakdown between helicopter-based and fixed-wing operations in Exhibit 2. As shown in the tables below, there has been a recovery in activity for helicopter services, while fixed-wing systems remain challenged.

### Exhibit 2. Operational Breakdown

Helicopter	Q1/10A	Q1/09A	Y-Y	Q4/09A	Q-Q
Revenue (C\$m)	\$2.2	\$6.9	(69%)	\$0.8	185%
Line Km Flown (000s)	22.7	59.2	(62%)	5.4	320%
Revenue/Line Km	\$94.93	\$117.38	(19%)	\$140.19	(32%)
Gross Margin	15%	30%	(1,487)bps	(14%)	2,897bps

Fixed Wing	Q1/10A	Q1/09A	Y-Y	Q4/09A	Q-Q
Revenue (C\$m)	\$3.6	\$3.8	(6%)	\$4.1	(13%)
Line Km Flown (000s)	267.0	316.0	(16%)	351.0	(24%)
Revenue/Line Km	\$13.42	\$12.10	11%	\$11.73	14%
Gross Margin	17%	12%	460bps	25%	(865)bps

We also note the following:

- Additional Q1/10 Details – revenue improvement over the last period was mainly due to the first quarter contribution from Aeroquest Optimal (formerly Optimal Geomatics or OPG), and secondarily, to improved performance from the Helicopter segment. Although margins from Aeroquest Optimal were lower than expected, management anticipates margin improvement over the coming quarters, as cost rationalization of the former OPG business continues and activity levels improve in the rest of the business.
- Integration of Optimal Geomatics – the integration is largely complete, and the rebranding (Aeroquest Optimal) has commenced. The new business line diversifies AQL's revenue base away from commodity-price sensitive customers and into new markets such as infrastructure and energy utility projects, and positions AQL to benefit from ongoing stimulus and infrastructure spending in the U.S. While margins have disappointed, demand continues to be solid, as this segment's backlog increased

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from \$6.7 million at the end of Q4/09 to \$7.4 million at the end of Q1/10. The Vancouver operation has continued to be a cost burden, and a suitable buyer has been identified. Management expects this divestiture to further reduce costs, and the transaction should occur before the end of Q2/10. The Huntsville operation has already been relocated, and the Company is investigating the possibility of sourcing aircraft from AQL's Mississauga location (i.e. bringing this aspect in-house) as an opportunity for additional savings.

- Backlog – at quarter end, contract backlog totaled \$11.4 million (up 5% q-q), of which \$7.4 million relates to the former OPG business. Of the \$3.6 million in geophysics backlog (the original AQL business), \$2.0 million relates to helicopter work (up from \$1.1 million) and \$1.6 million relates to fixed-wing (actually down from \$2.7 million), with \$0.4 million attributed to other business.

Customer sentiment appears to be improving. Management reports that recent tradeshow in Vancouver, Canada (Roundup) and South Africa (Indaba) indicated a very enthusiastic customer base, with a significant number of unsolicited requests for proposals given to AQL. Quoting activity is also higher than in the previous several quarters, with 'quoted-but-un-awarded' contracts now back up to 50-60% of peak 2008 levels, although the business remains very competitive, and customers are still slow to sign contracts.

The Company continues to work on signing potential contracts for \$5.0 million in fixed-wing petroleum systems in North Africa, specifically Egypt and Libya. Although progress has been slower than expected, supply agreements have been obtained and additional personnel are being sent to the region.

- FY 2010 Outlook – management remains optimistic for a stronger exploration spending environment in 2010, but expects recovery to be modest. During the conference call, management commented that they believe an increase in helicopter systems demand will likely come from juniors and be split evenly between precious metals and base metals work.
- Balance Sheet – at quarter end, the Company had cash and equivalents of \$4.7 million and little debt (\$0.1 million in capital leases). Capital conservation and operational efficiency continue to be the Company's focuses as economic conditions improve. Management expects tax refunds to contribute \$2.0 million in cash by late Q2 or early Q3/10.

### Our Outlook and Estimate Revisions

Based on our review of exploration spending announcements by key mining companies, we continue to believe that calendar 2010 will prove to be a far more active year for exploration activity than 2009 was. Many companies, particularly intermediate-size mining companies, have announced exploration budgets for 2010 that actually exceed 2008 levels (2008 was the peak exploration spending year). That optimism is tempered somewhat by the nature of AQL's business in the mining sector, which tends to focus on earlier stage exploration work. We therefore think the recovery in airborne geophysical demand will lag the recovery in exploration drilling. Nonetheless, we believe a recovery is underway, which will benefit AQL in FY 2011. We believe that FY 2010 (ending September 2010) will be stronger than FY 2009, but that utilization and pricing levels will lag FY 2008 levels until FY 2011.

We have reduced our utilization and pricing assumptions for FY 2010 to reflect a more gradual recovery, but we are introducing FY 2011 estimates. Our FY 2011 estimates assume that the Fixed-Wing segment's utilization and pricing levels return to FY 2008 levels. Our model assumes that the Helicopter segment's utilization returns to 80% of FY 2011 levels, with pricing in line with our FY 2010 estimates. As Helicopter surveys are roughly 9-10x as expensive on a per line kilometre basis relative to Fixed-Wing surveys (while being more detailed), we believe the recovery in the Helicopter segment will lag that of the Fixed-Wing segment.

We present our prior and revised estimates in Exhibit 3.

**Exhibit 3. Prior & Revised Estimates**

	FY 2010E		FY 2011E
	Prior	New	Intro
Revenue (\$mm)	\$53.1	\$37.8	\$56.6
EBITDA (\$mm)	\$5.9	(\$3.0)	\$12.6
EBITDA Margin	11%	(8.0%)	22%
Diluted EPS	(\$0.05)	(\$0.20)	\$0.07
Adjusted Diluted EPS	\$0.05	(\$0.10)	\$0.17

Source: Jennings Capital Inc. (Adjusted Diluted EPS excludes acquisition-related amortization)

**Valuation**

We previously valued AQL based on a 0.6x revenue multiple and 3.0x EBITDA multiple applied to our FY 2010 estimates.

With the introduction of our FY 2011 estimates, we are rolling our valuation forward. We are applying a 7x adjusted EPS multiple (where we excluded the impact of acquisition-related amortization) and a 3.5x EBITDA multiple. We view these as conservative multiples, but justifiable given the revenue/earnings volatility of this business.

We present our implied valuation estimates in Exhibit 4.

**Exhibit 4. Implied Valuation Estimates**

Approach	Multiple	Impl. Value
2011E EBITDA	3.5x	\$1.24
2011E Adj. P/E	7.0x	\$1.19
<b>Average</b>		<b>\$1.21</b>

Source: Jennings Capital Inc. (Adjusted Diluted EPS excludes acquisition-related amortization)

We are therefore maintaining our **BUY** recommendation, and are **raising our 12-month target on AQL to \$1.20** from \$1.00.

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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. 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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