

**AEROQUEST INTERNATIONAL LIMITED
(TSX-AQL \$0.60)**

Recommendation: BUY
Revised 12-Month Target: \$1.50
 Previous 12-Month Target: \$1.20
Risk Rating: ABOVE AVERAGE

RAISING TARGET

- **Summary** – We are maintaining our **BUY** recommendation and raising our 12-month target on **AQL to \$1.50 from \$1.20**. While the Company recently reported Q2/10 results that were below forecast, the backlog and cash position both improved subsequent to the end of the quarter. We remain optimistic for a recovery in overall exploration spending from both intermediate/major and junior mining companies in 2010, followed by stronger growth in 2011.
- **Q2/10 Results** – AQL reported Q2/10 revenue of \$6.5 million (v. our estimate of \$8.6 million). AQL reported a loss per share of \$0.06, or \$0.04 when excluding the impact of acquisition-related amortization. At quarter end, the Company had cash and equivalents of \$3.6 million, which improved to \$4.9 million at April 30. Management commented that fixed-wing operations were unusually quiet in the quarter, although the backlog for fixed-wing contracts has improved noticeably. This should drive stronger fixed-wing performance in H2/10.
- **Backlog** – At quarter end, backlog totalled \$10.5 million, of which \$4.7 million relates to the former OPG business. Furthermore, owing to awards since quarter end, the backlog improved to \$13.4 million as of April 30.
- **FY 2010 Outlook** – Exploration budgets announced by many intermediate and major mining companies, strong financing activity by junior mining companies and comments from a number of industry sources suggest that demand for airborne geophysical work should improve this year, and we expect that to continue into next year. Management indicated that it expects revenue and margin improvement over the rest of FY 2010 and bottom line profitability for H2/10.
- **Estimate Revisions** – We have tweaked our revenue estimates for FY 2010, and raised them slightly for FY 2011, based on our industry outlook. Based on management’s comments regarding margins, we have raised our margin estimates for both periods, which is the primary driver of the increased earnings estimates.
- **Valuation** – We continue to apply a 7x adjusted EPS multiple (where we excluded the impact of acquisition-related amortization) and 3.5x EBITDA multiple to our FY 2011 estimates. On that basis, we are maintaining our **BUY** recommendation, and **raising our 12-month target to \$1.50 from \$1.20**.

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Company Statistics	
52-Week Range	\$0.85 - \$0.34
Basic Shares O/S (MM)	37.0
Basic Market Cap (\$MM)	\$22.2
Cash (\$MM)	\$3.6
Total Debt (\$MM)	\$0.4
Net Cash (\$MM)	\$3.2

Earnings Summary				
FYE: September	2008A	2009A	2010E	2011E
Sales (\$MM)	\$55.0	\$28.0	\$36.8	\$60.1
EBITDA (\$MM)	\$11.3	(\$4.4)	(\$1.1)	\$15.2
EBITDA Margin	20.5%	(15.7%)	(3.1%)	25.4%
Diluted EPS	\$0.09	(\$0.32)	(\$0.17)	\$0.11
Adjusted Diluted EPS*	\$0.21	(\$0.21)	(\$0.07)	\$0.21
P/E	7.0x	nmf	nmf	5.4x
P/Adj. E*	2.9x	nmf	nmf	2.9x
EV/EBITDA	1.7x	nmf	nmf	1.2x

* 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.

Q2/10 Results:

We present the highlights of the quarter and comparisons to prior quarters in Exhibit 1.

Exhibit 1. Q2/10 Results Highlights

	Q2/10E	Q2/10A	Variance	Q1/10A	Q-Q
Revenue (\$mm)	\$8.6	\$6.5	(25%)	\$8.2	(21%)
EBITDA (\$mm)	(\$1.2)	(\$1.4)	16%	(\$1.4)	(3%)
EBITDA Margin	(13.9%)	(21.4%)	(751)bps	(17.6%)	(382)bps
Diluted EPS	(\$0.06)	(\$0.06)	0%	(\$0.07)	(14%)
Adjusted Diluted EPS	(\$0.03)	(\$0.04)	33%	(\$0.04)	0%

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.

Exhibit 2. Operational Breakdown

Helicopter	Q2/10A	Q2/09A	Y-Y	Q1/10A	Q-Q
Revenue (C\$m)	\$2.5	\$1.6	51%	\$2.2	14%
Line Km Flown (000s)	20.1	11.4	76%	22.7	(11%)
Revenue/Line Km	\$122.54	\$142.89	(14%)	\$94.93	29%
Gross Margin	16%	(3%)	1,880bps	15%	80bps

Fixed Wing	Q2/10A	Q2/09A	Y-Y	Q1/10A	Q-Q
Revenue (C\$m)	\$1.2	\$5.9	(79%)	\$3.6	(66%)
Line Km Flown (000s)	88.0	189.0	(53%)	267.0	(67%)
Revenue/Line Km	\$13.81	\$31.15	(56%)	\$13.42	3%
Gross Margin	5%	52%	(4,699)bps	17%	(1,194)bps

Source: Company Reports, Jennings Capital Inc.

We also note the following:

- Additional Q2/10 Details – Management commented that fixed-wing operations were unusually quiet in the quarter, although the backlog for fixed-wing contracts improved noticeably during March and April (\$6.4 million of \$8.0 million in contract awards). This should drive stronger fixed-wing performance in H2/10.
- Backlog – At quarter end, contract backlog totalled \$10.5 million, of which \$4.7 million relates to the former OPG business. Of the \$5.8 million in geophysics backlog (the AQL business pre-acquisition of Optimal), \$1.7 million relates to helicopter work (down from \$2.0 million), \$3.8 million relates to fixed-wing (up from \$1.6 million), with \$0.3 million attributed to other business. Owing to awards since quarter end, the backlog had improved to \$13.4 million as of April 30.
- FY 2010 Outlook – As we have noted previously, and confirmed by AQL management, industry fundamentals are improving. Intermediates and majors have announced calendar 2010 spending plans that materially exceed 2009 expenditures and, in a number of cases, even surpass 2008 levels (a record year for spending). While management did not provide revenue guidance, it did indicate that it expects revenue and margin improvement over the rest of FY 2010 and bottom line profitability for H2/10.

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- Balance Sheet – At quarter end, the Company had cash and equivalents of \$3.6 million and little debt (\$0.4 million in capital leases). As with the backlog, the Company's cash position had improved to \$4.9 million at April 30.

Our Outlook

We remain optimistic for a strong recovery in overall exploration spending from both intermediate/major and junior mining companies.

Intermediates and Majors

The vast majority of intermediate and major mining companies have announced 2010 exploration budgets that exceed actual 2009 spending and, in a number of cases, actually exceed their 2008 spending, which was the peak year for exploration spending.

We present our tracking group and their announced budget plans in Exhibit 3. We caution readers that each company defines its budget coverage differently (i.e. some include brownfield work, some do not), and so these budgets are not directly comparable between companies. However, we think it is worthwhile to consider the trend within each company.

Industry sources say that those majors that experienced severe balance sheet stress over the past few years are still cautious. We think they may not resume large scale spending until calendar 2011. Moreover, airborne geophysics is a small component of the global mineral exploration market, so these budget announcements do not necessarily imply an immediate increase in spending on AQL's services. Nonetheless, they do represent a reversal of the spending decline seen in 2009, and as more spending is directed toward grassroots exploration, we expect a positive impact on AQL's mining revenue.

Exhibit 3. Intermediate/Major Mining Company Exploration Budgets

Company	Market Cap. (\$billions)	Ticker	Currency	2008A	2009E/A	2010E	2010E v. 2009E/A	2010E v. 2008A
Gold								
Barrick Gold	\$45.0	ABX-TSX	US\$	\$216.0	\$141.0	\$175.0	24%	(19%)
Goldcorp	\$34.1	G-TSX; GG-NYSE	US\$	\$148.0	\$110.0	\$145.0	32%	(2%)
Newmont	\$27.6	NMC-TSX; NEM-NYSE	US\$	\$214.0	\$187.0	\$205.0	10%	(4%)
Kinross	\$13.4	K-TSX; KGC-NYSE	US\$	\$60.3	\$83.1	\$102.0	23%	69%
Agnico-Eagle	\$10.2	AEM-TSX; NYSE	US\$	\$72.0	\$54.0	\$76.0	41%	6%
Yamana	\$8.6	YRI-TSX; AUJ-NYSE	US\$	\$81.5	\$65.6	\$77.5	18%	(5%)
Eldorado Gold	\$9.6	ELD-TSX	US\$	\$19.7	\$18.4	\$35.0	90%	78%
Iamgold	\$7.3	IMG-TSX; IAG-NYSE	US\$	\$83.5	\$345.7	\$213.9	(38%)	156%
Alamos Gold	\$1.8	AGI-TSX	US\$	\$5.8	\$9.7	\$19.8	104%	241%
Base Metals								
BHP	\$115.3	BLT-LN; BHP-ASX; NYSE	US\$	\$658.0	\$695.0	\$500.0	(28%)	(24%)
Vale	\$93.1	VALE-NYSE	US\$	\$436.0	\$564.0	\$621.0	10%	42%
Rio Tinto	\$74.9	RTP-NYSE; RIO-ASX; LSE	US\$	\$1,134.0	\$514.0	TBA	TBA	TBA
Freeport-McMoRan	\$33.7	FCX-NYSE	US\$	\$248.0	\$72.0	\$100.0	39%	(60%)
Teck Resources	\$21.6	TCK-NYSE; TCK.A-TSX; TCK.B-TSX	US\$	\$135.0	\$33.0	\$33.0	-	(76%)
Inmet	\$2.9	IMN-TSX	C\$	\$8.0	\$8.0	\$12.0	50%	50%
Lundin Mining	\$2.5	LUN-TSX	US\$	\$38.9	\$22.6	\$20.0	(12%)	(49%)
FNX Mining	\$1.3	FNX-TSX	C\$	\$25.2	\$10.2	\$29.0	184%	15%

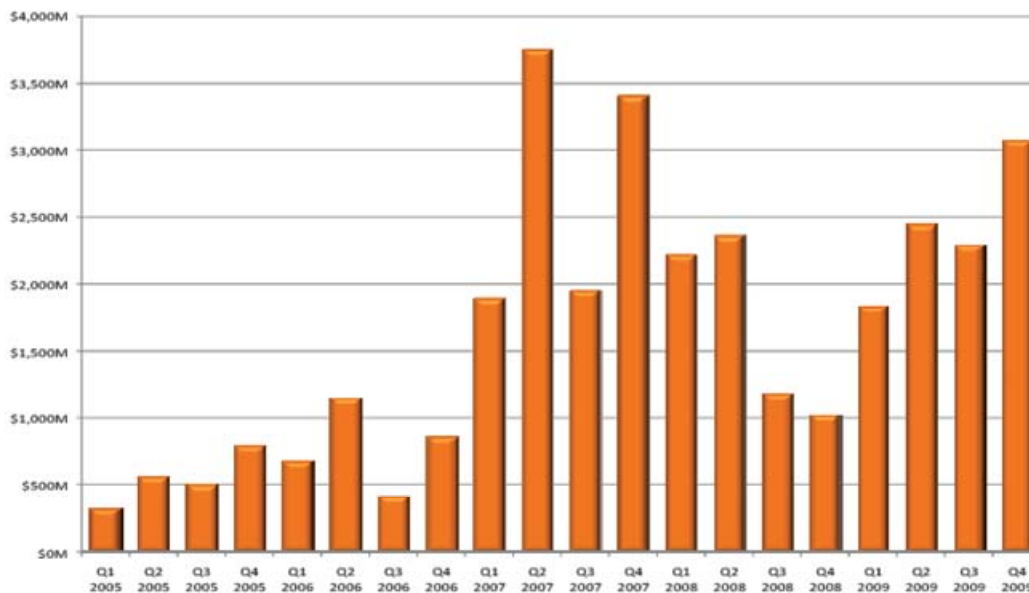
Source: Company Reports, Jennings Estimates, Thomson One

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Junior Mining Companies

The obvious key to exploration spending by junior mining companies is access to capital. As presented in Exhibit 4, financings by junior mining companies are approaching levels not seen since pre-meltdown. Q4/09 financings were at their highest level since Q4/07 and the 3rd highest level over the past five years. Based on this chart, we estimate that total junior financings in 2009 were at almost 90% of 2007 levels. This suggests that junior mining companies – in aggregate – have ample firepower to ramp up spending. As with intermediates and majors, the transition to increased spending on grassroots exploration and by extension, AQL’s services, is somewhat less direct.

Exhibit 4. Junior Mining Company Financings



Source: Thomson Financial
 Note: "Junior Miners" for the chart above are defined as metals and mining companies raising <\$75M total proceeds. Exchanges included: TSX, TSX-V, ASX, AIM, HONGK, LSE, SINGP, NASDAQ, JQH, TOKYI, AMEX, NYSE

On this basis, we are optimistic for an increase in exploration spending in 2010, followed by stronger growth in 2011, as majors that exercise caution this year return and as more speculative mining projects obtain better access to capital.

Estimate Revisions

During yesterday’s conference call, management estimated that owing to cost cutting initiatives of the past few years, the revenue level required to return to pre-recession gross margin levels is approximately \$4 to \$5 million from each of the helicopter and fixed-wing businesses. Management also indicated that it is targeting bottom line profitability in H2/10.

We have only tweaked our revenue estimates for FY 2010, and raised them slightly for FY 2011, based on our industry outlook. Based on management’s comments regarding margins, we have raised our margin estimates for both periods, which is the primary driver of the increased earnings estimates. We present our prior and revised estimates in Exhibit 5.

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Exhibit 5. Prior and Revised Estimates

	FY 2010E		FY 2011E	
	Prior	New	Prior	New
Revenue (\$mm)	\$37.8	\$36.8	\$56.6	\$60.1
EBITDA (\$mm)	(\$3.0)	(\$1.1)	\$12.6	\$15.2
EBITDA Margin	(8.0%)	(3.1%)	22.3%	25%
Diluted EPS	(\$0.20)	(\$0.17)	\$0.08	\$0.11
Adjusted Diluted EPS	(\$0.10)	(\$0.07)	\$0.17	\$0.21

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

We present our quarterly breakdown in Exhibit 6.

Exhibit 6. Quarterly Estimates

	Q1/10A	Q2/10A	Q3/10E	Q4/10E	2010E
Revenue (\$mm)	\$8.2	\$6.5	\$9.9	\$12.2	\$36.8
EBITDA (\$mm)	(\$1.4)	(\$1.4)	\$0.1	\$1.6	(\$1.1)
EBITDA Margin	(17.6%)	(21.4%)	1.2%	12.9%	(3.1%)
Diluted EPS	(\$0.07)	(\$0.06)	(\$0.04)	(\$0.01)	(\$0.17)
Adjusted Diluted EPS	(\$0.04)	(\$0.04)	(\$0.01)	\$0.01	(\$0.07)

Valuation

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

We present our implied valuation estimates in Exhibit 7.

Exhibit 7. Implied Valuation Estimates

Approach	Multiple	Value
2011E EBITDA	3.5x	\$1.45
2011E Adj. P/E	7.0x	\$1.47
Average		\$1.46

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 to \$1.50/share from \$1.20/share.**

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Companies

Aeroquest International Limited

Ticker

TSX-AQL

I, **Russell Stanley**, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that I have not, am not, and will not receive, directly or indirectly, compensation in exchange for expressing the specific recommendations or views in this report.

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. On February 16, 2010 we increased our target price to C\$1.20. Share price at that time was C\$0.59.

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Revised Monthly

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