

AEROQUEST INTERNATIONAL

AQL – TSX \$0.63

May 13, 2010

Rating:

STRONG BUY

Target Price:

\$1.00

Market Capitalization:

\$23.3 million

DIVERSIFIED INDUSTRIES

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Aeroquest Announces its Q2FY2010 Results

Results Well Below Expectations, but Backlog Improving

- On May 12, 2010, following market close, Aeroquest released its Q2FY2010 results for the period ended March 31, 2010. In summary, the results came in well below our expectations but the outlook going forward looks to be improving.
- Revenue for the quarter of \$6.5 million declined 19% year-over-year and trailed our estimate of \$9.9 million. The Optimal Geomatics division contributed revenues of \$2.4 million which was in line with the previous quarter. However revenue from the Airborne Geophysics division of \$3.7 million fell versus the previous quarter and declined 51% over the same quarter in 2009. Improving margins and lower G&A expenses compared to Q1FY2010 contributed to a loss of \$0.06/share which was mostly in-line with our estimate of a \$0.05/share loss despite the miss in revenue.
- While results were disappointing, the outlook does appear to have improved significantly. The company noted that it was awarded \$8 million in new contracts in March and April, primarily relating to fixed wing services in Australia and Africa. These revenues are expected to be realized in the second half of 2010. At the end of the quarter, the company had \$10.5 million in contract backlog (from \$11.4 million at the end of the prior quarter) which subsequently increased to \$13.4 million as of April 30, 2010. The company also noted on the conference call that it expects to turn profitable in the second half of the year.
- Though we have brought down our forecasts as a result of the lower than expected results, we continue to recommend the stock with a STRONG BUY rating and a \$1.00 target price. We believe that Aeroquest remains well positioned to demonstrate strong operational improvement with the stabilization of the global economy and a return of exploration spending. Our target values the company at a 3.8x EV/EBITDA multiple against our 2011 projections. The shares currently trade at a large discount to net book value (\$1.11/share) and have downside support from tangible book value (\$0.42/share). The company has \$0.10/share in cash with no long-term debt.

Share Information Summary

Recent Price (C\$)	\$0.63
12 mo. Price Target	\$1.00
52 week Range	\$0.34- 0.85
Average Daily Volume (3 mo.)	37,115
Shares Out – Basic (M)	37.0
Shares Out – Diluted (M)	38.9
Market Cap (C\$M)	\$23.3
Annual Dividend & Yield	N/A
FY End	September 30th

Estimates Summary C\$

FY (Y/E Sep 30)	08A	09A	10E	11E
Rev (\$M)	55.0	28.0	▼35.5	▼56.0
EPS (\$/fd shr)	0.09	(0.32)	▼(0.17)	▼0.02
P/E	7.4x	NMF	NMF	32.8x
EBITDA (\$M)	11.3	(4.4)	▼(2.0)	▼8.3
EV/EBITDA	0.5x	NMF	NMF	1.9x

Source: Fraser Mackenzie Limited

Company Description

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.

Q2FY2010 Discussion

We have revised our forecasts for 2001 and 2011 on the back of slower than expected ramp-up in exploration spending (mainly geophysical surveys). The company noted on the conference call that exploration activities in Australia are picking up, however activity in Canada still remains quiet. Looking ahead, we believe that the company's revenue base and profit picture has bottomed and we expect a meaningful improvement during the remaining two quarters of this year. Consolidated revenue will most certainly grow in FY2010 as a result of the Optimal Geomatics acquisition while the geophysics business is expected to strengthen in the second half of this year. We forecast 27% year-over-year revenue growth for FY2010 and 58% growth in 2011 as the geophysics segment recovers. Of particular note, management stated its belief that the company will turn EBITDA positive in April, net income neutral in May and net income positive by June.

Exhibit 1 – Results and Forecasts (C\$ Millions)

FYE September 30	2008A	Q1A	Q2A	Q3A	Q4A	2009A	Q1A	Q2A	Q2E	2010 New	2010 Old	2011 New	2011 Old
Revenue	55,046	11,298	7,963	3,651	5,100	28,012	8,175	6,487	9,900	35,461	47,975	56,000	61,000
Cost of sales	34,351	8,370	4,710	3,217	4,042	20,339	6,779	5,269	7,821	27,053	35,712	36,745	40,070
Gross margin	20,695	2,928	3,253	434	1,058	7,673	1,395	1,218	2,079	8,408	12,262	19,255	20,930
	37.6%	25.9%	40.9%	11.9%	20.7%	27.4%	17.1%	18.8%	21.0%	23.7%	25.6%	34.4%	34.3%
Expenses													
G&A expenses	9,442	4,351	3,083	2,295	2,116	11,845	2,668	2,423	2,700	9,891	10,468	10,600	10,800
Development expenses	80	-	-	-	-	-	-	-	-	-	-	-	-
Foreign Exchange Loss	(1,059)	(1,206)	(25)	691	308	(232)	81	100	-	181	81	-	-
Stock option expense	960	104	135	108	108	456	85	85	100	370	385	400	400
EBITDA	11,272	(322)	60	(2,660)	(1,475)	(4,396)	(1,439)	(1,390)	(721)	(2,033)	1,328	8,255	9,730
Capital asset depreciation	2,814	802	1,011	1,155	932	3,900	880	875	900	3,555	3,580	3,600	3,600
Impairment charges	-	-	-	-	2,880	2,880	-	-	-	-	-	-	-
Intangibles amortization	4,035	885	747	785	1,075	3,493	875	857	900	3,532	3,575	3,600	3,600
EBIT	4,423	(2,008)	(1,698)	(4,601)	(6,362)	(14,669)	(3,194)	(3,122)	(2,521)	(9,121)	(5,827)	1,055	2,530
Other costs/(income)	(224)	(56)	(85)	(5)	19	(127)	(103)	(131)	(15)	(250)	(151)	(57)	(122)
EBT	4,647	(1,952)	(1,613)	(4,596)	(6,381)	(14,542)	(3,090)	(2,991)	(2,506)	(8,871)	(5,676)	1,112	2,652
Total Taxes	1,804	(438)	(659)	(1,097)	(1,725)	(3,920)	(824)	(723)	(802)	(2,440)	(1,651)	356	849
Net Income	2,843	(1,514)	(953)	(3,499)	(4,657)	(10,622)	(2,266)	(2,268)	(1,704)	(6,431)	(4,024)	756	1,803
Earnings per unit													
Basic	\$ 0.09	\$ (0.05)	\$ (0.03)	\$ (0.10)	\$ (0.14)	\$ (0.32)	\$ (0.06)	\$ (0.06)	\$ (0.05)	\$ (0.17)	\$ (0.11)	\$ 0.02	\$ 0.05
Diluted	\$ 0.09	\$ (0.05)	\$ (0.03)	\$ (0.10)	\$ (0.14)	\$ (0.32)	\$ (0.06)	\$ (0.06)	\$ (0.05)	\$ (0.17)	\$ (0.11)	\$ 0.02	\$ 0.05

Source: Company filings, Fraser Mackenzie estimates

Valuation

In our view, Aeroquest shares represent compelling value with the shares trading at a substantial discount to net book value of \$1.11/share. Investors also enjoy considerable downside support based on the company's tangible book value of \$0.42/share. Aeroquest has a strong balance sheet with \$0.10/share of cash and virtually no long-term debt. Our \$1.00/share target values Aeroquest at 3.8x EV/EBITDA against our 2011 forecast.

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 backlog 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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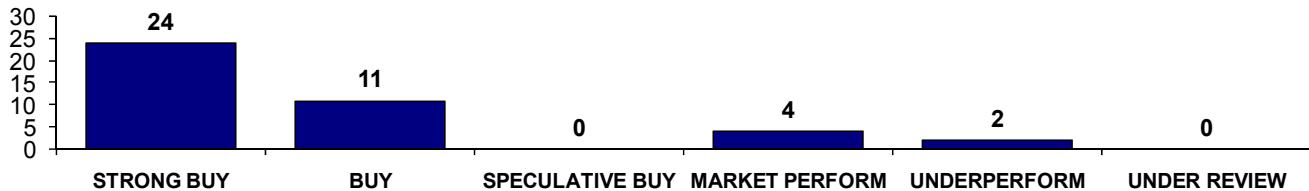
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