



October 9, 2008



| | |
|------------------------|-----------------|
| Recent Price | \$0.92 |
| 12 mo. Price Target | \$2.10 |
| 52-week Range | \$0.60 - \$2.00 |
| S/O Basic (MM) | 34.6 |
| S/O fully diluted (MM) | 38.8 |
| Market Cap (basic, MM) | \$31.8 |
| Avg. Daily Vol. (3 mo) | 81,898 |
| Debt to Equity | N/A |
| Book Value per Share | \$1.39 |
| Ann Dividend & Yield | Nil |
| FY End | September |

Current Estimates

| FY | 08E | 09E | 10E |
|----------------|-------|------|------|
| Rev (\$MM) | 55.8 | 71.1 | 86.5 |
| EPS (\$/share) | 0.06 | 0.11 | 0.18 |
| P/E | 15.3X | 8.4X | 5.1X |
| EBITDA | 11.2 | 15.1 | 20.1 |
| EV/EBITDA | 1.4X | 1.0X | 0.8X |

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. We are forecasting revenues for the period ending September 2008 of \$55.7 million.

Diversified Industries

AEROQUEST INTERNATIONAL LTD.

STRONG BUY

(AQL - TSX \$0.92)

12-mo. Target Price: \$2.10

Market Capitalization (Basic)

\$31.8 Million

Risk Profile

HIGH

Potential ROR

128%

Ready to Rise Above the Clouds

Highlights

- With this note we are reinstating our STRONG BUY recommendation with a \$2.10 twelve month price target (was \$4.00), offering investors a potential return of over 100% from current levels. Our update discusses five recent developments we see as key to Aeroquest's development over the next 12 to 18 months.
- We believe the Geotech lawsuit should be viewed as a nuisance rather than an impediment to business. We cite the fact that Aeroquest has been able to sign an LOI with Anglo American for a long term business relationship as evidence, if the suit were more than minor, we doubt that Anglo would have decided to go ahead.
- Analysis of new capital being raised by junior mining companies points to a slow down and cuts in exploration programs will likely follow. Aeroquest, and its competitors, will see their book to bill ratios fall below one and their backlog of work contract.
- Offsetting a general mining sector slow down is the potential offered by AQL's pending agreement with Anglo. This could see Aeroquest generate \$5.0M of business each year for the next 10 years with Anglo, alone. And, Aeroquest is free to use the Anglo equipment for surveys with other customers.
- That expanding group of customers will include a growing number of oil and gas companies that are starting to make greater use of airborne surveys. The Anglo deal gives Aeroquest an airborne gravity gradiometer that has high value for oil and gas exploration.
- The company has also entered the multi-client airborne survey business. These types of agreement allow Aeroquest to maintain ownership of the data and re-license it to other customers. The first survey will be a 100,000 line kilometre magnetic survey in the Barnett Shale, in Texas. This operational model yields very good margins and with development of a large 'library' the foundation for long-term recurring revenues.
- At recent price levels, the stock is trading at 8.4X our estimated earnings of \$0.11/share for FY2009, at 1.4X EV/EBITDA for FY2008 and at 1.7X P/TBV. With a move into oil and gas, near global delivery capability and the Anglo deal poised to close, the stock is very, very attractively priced.

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Introduction

In this update we are re-instating our STRONG BUY recommendation and revising our 12 month price target to \$2.10 from its previous \$4.00 level.

Aeroquest has undergone a remarkable transformation over the past couple of years through a combination of acquisition, geographical expansion and organic growth. That period also coincided with a period of strong mineral exploration activity that supported rapid expansion of the business. Aeroquest now faces a couple of near-term issues, but is very well positioned to continue with its strategy of building a full-service geophysical survey company operating around the globe.

The near term issues are legal action from one of its principal competitors in Canada and a sharp reduction in the amount of capital available to junior mining companies for exploration. These factors are offset by three recent developments. Aeroquest has the makings of a very good deal with Anglo American to take over its geophysical surveying group, is growing a presence in the large market for airborne surveying for oil and gas exploration and has started the process of building a library of data it can license to multiple customers.

In this update we briefly summarize Aeroquest's current set of services, examine the five main developments in its business and review our valuation.

Corporate Background

Aeroquest is one of the world's largest providers of airborne geophysical surveys. Using equipment mounted on or slung beneath helicopters or specially modified fixed wing aircraft, Aeroquest can provide data to mineral and oil and gas exploration companies that delineates surface and sub-surface structures.

The company can provide data from each of the four main types of measurement system used to gather data: electromagnetic, magnetic, gravity and radiometric systems. Aeroquest also performs post-survey services to process and compile survey data and present data in formats that are most useful to its customers.

One of Aeroquest's strengths is that it designs, builds and operates a range of electromagnetic systems, which it calls the AeroTEM. Airborne electromagnetic systems fall into two categories - frequency domain (FD) systems that have moderate depth penetration of the signal, but good resolution and time domain (TD) systems that have deep penetration of the signal, but moderate resolution. Traditionally, FD systems were used from helicopters and TD systems were used on fixed wing aircraft. The AeroTEM system is a time domain system that can be used on a helicopter. Over the past two years Aeroquest has increased the size and thus the power of the AeroTEM systems it has introduced.

Recent Developments

The five key developments that have taken place at Aeroquest over the past couple of months are outlined below.

Legal Action

On August 19, 2008 Aeroquest announced that it had received a statement of claim from cross-town rival Geotech (private). Geotech alleges two things, breach of a number of contractual undertakings between the two companies and misappropriation of confidential information. The claim filed in the Ontario Superior Court of Justice, asks for \$50 million in general and a further \$1.0 million in punitive damages. Geotech claims that a former employee revealed confidential information to Aeroquest, allowing it to accelerate development of a new AeroTEM device as well as actively seeking to recruit staff from Geotech in breach of previous undertakings not to.

On September 22, 2008 Aeroquest filed its statement of defence and a counterclaim. As may have been anticipated, the company deems Geotech's claim to be without merit and refutes all the allegations regarding misappropriation of confidential information. In the spirit of the original statement of claim, Aeroquest filed a counterclaim for \$20 million and \$1.0 million for punitive and exemplary damages.

Clearly, the legal merits of the suit will be determined in the Ontario Court of Justice: although, both parties may negotiate a settlement ahead of a trial. In our view the action of bringing the suit should be seen as a weapon used by a competitor against Aeroquest. It is reasonable to conclude that customers, third party suppliers and other parties negotiating contracts or agreements with Aeroquest will have had concerns about the impact of the suit and this may have caused delays in contract signings or even caused Aeroquest to lose business.

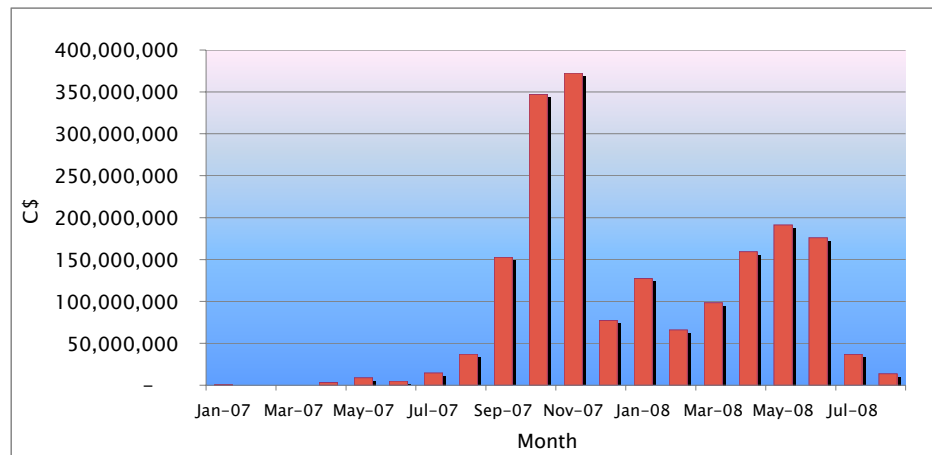
On balance, the suit is probably best viewed as a nuisance rather than a serious impediment to business. We note that Aeroquest has been able to sign a letter of intent with Anglo American for a long-term business relationship, if the suit were viewed as more than minor; we doubt that Anglo would have decided to go ahead.

We believe that we are enter a period of a marked slow down in mineral exploration in Canada and elsewhere. The competition for business will intensify and cause Aeroquest and others to focus on operating costs and equipment utilization. As a result, pursuing a legal action may become secondary to maintaining profitable operations.

Mining Finance Market Conditions

One externally verifiable measure of the health of the airborne survey market is to look at the capital raised by junior mining companies – our definition being a company with a market capitalization of \$300 million or less. Much of this money is directed to exploration activities worldwide, although it is not possible to determine the amount spent on airborne surveys. However, the trend in raising funds provides a glimpse into the relative amount of exploration spending available in future periods. In Appendix A, we list some of the companies that have press released the fact that they used Aeroquest for airborne survey work – the majority are early stage exploration companies.

Exhibit 1 – Junior Mining Financings



Source: FP Data Group

Our analysis uses data from the FP Data Group and covers the period from January 2007 to September 2008. As Exhibit 1 shows funds raised reached a peak of over \$350 million in November 2007 and has remained reasonably buoyant since then. Moreover, the amount of capital raised in June 2008 and July 2008 exceeds the amount raised in the same period in 2007. However, the trend in recent months is down and under the current capital market conditions is likely to remain that way.

On balance, we deem it very likely that there will be a contraction in exploration activity and this will result in Aeroquest (and its competitors) working through their backlog of contracted business. We should expect to see the book-to-bill ratio fall below one through the next few quarters, particularly for the mineral exploration portion of the business.

Fortunately, Aeroquest has a pending deal with Anglo-American that could offset much of this decline and is expanding into oil and gas exploration, which is a

market that is an order of magnitude larger than mining. We discuss these positive developments below.

Anglo-American Transaction

At the end of September 2008, Aeroquest announced it had signed a non-binding letter of intent (LOI) with Spectrem Air. Spectrem is a subsidiary of South Africa's Anglo American group. Anglo is one of the world's largest natural resource companies and a large user of all types of airborne surveying services.

The pending agreement is a long-term outsourcing arrangement under which Aeroquest will take over Spectrem's staff, equipment and facilities, undertake to upgrade the current systems capabilities and in return contract surveying services back to Anglo.

We understand that negotiation of this deal has taken at least nine months and is still subject to final board approvals. We believe that it is reasonable to conclude that given the amount of time that has been invested in negotiations it is likely that the final discussions will be brought to a successful conclusion.

The outsourcing arrangement has three components: an acquisition agreement, a service agreement and a licensing agreement. In essence the agreement is a type of sale and lease back arrangement - with Aeroquest taking on Anglo's survey assets and 'leasing' these back.

Under the acquisition agreement, Aeroquest will purchase a proprietary Anglo Spectrem 2000 airborne surveying system, two AeroTEM systems and the other facilities used to operate Spectrem's airborne survey business. The total cost of the acquisition will be US\$4.0 million. Payment will be made through a combination of future survey credits and potentially up to US\$1.5 million in cash. We note that the deal will give Aeroquest an operational base in southern Africa that can be used for its other survey operations.

In addition to providing services, Aeroquest is committed to using its capital to build an additional airborne surveying system. Furthermore, we understand that under the proposed agreement, Aeroquest will obtain an airborne gravity gradiometer - one of only 10 or so devices of this type available worldwide. Being able to offer its customers this type of airborne survey would provide Aeroquest with a very strong competitive advantage. And, a gravity gradiometer can be used not only for mineral, but also for oil and gas exploration work. The acquisition agreement will also see Aeroquest acquire a DC-3 fixed wing aircraft that will be fitted with upgraded airborne surveying systems.

A key question is the amount of capital that Aeroquest will have to invest to meet its equipment construction commitments under the agreement. Aeroquest will

need to spend about US\$12 million over the two-year period following closing of the deal, which may take place as early as October 31, 2008. Aeroquest currently has cash of \$16.9 million (the equivalent of \$0.49 per share), its operations are cash flow positive and it thus has sufficient resources to meet its commitments.

The service agreement commits Aeroquest to providing Anglo with up to 50,000 line kilometres each year for the next ten years of airborne surveys at pre-determined rates. Using a rate of \$100 in revenue per line kilometre, we estimate the base agreement equates to about \$5.0 million of sales per year. There is scope for Aeroquest to do much more work than this. Moreover, the service contract is intended to run for an initial term of ten years, with subsequent renewal periods of five years.

The final component of the transaction is a licensing deal that gives Aeroquest access to Spectrem's intellectual property (IP) on its proprietary surveying systems on a perpetual and non-exclusive basis – although the licence will be exclusive while the services agreement is in force. Aeroquest will pay a yearly royalty fee for access to the IP. Under this type of arrangement any intellectual property developed by Aeroquest will remain its property.

The agreement provides Aeroquest with a long-term work commitment that should be worth in excess of \$50 million over the initial term of the agreement as well as access to proprietary technology and the ability to expand its service delivery capability in Africa. We are excluding the financial implications of this deal from our financial projections until such time as it closes.

The Oil and Gas Market Opportunity

Until recently the main market for Aeroquest was mineral exploration, which has relied on airborne geophysics for decades. The volume of geophysical activity in mineral exploration is largely driven by the amount of capital available to exploration companies. As we noted above the volume of this work is likely to decline over the coming months.

The new opportunity for Aeroquest is airborne surveying for oil and gas exploration. Geophysical surveys are particularly useful for covering large areas and identifying structural features, before carrying out seismic surveys. We understand that about 25% of the current backlog of signed contracts comprises work for oil and gas companies.

Licensing Airborne Geophysical Data

On October 1, 2008 Aeroquest announced that it was getting into the multi-client survey business. Multi-client or participation surveys involve signing up multiple clients with an interest in acquiring survey data over areas of common interest. Clients pay a proportionate share of the costs and the data collected becomes the property of the acquirer for re-licensing to other clients. Sometimes the companies commissioning the survey retain exclusive use of the data for a period of time, in other cases the data can be re-licensed immediately.

It is unclear what the pricing model will be for the survey data, but we deem it likely that the data will be re-licensed for close to its original acquisition cost – making this an attractive business model. Given the time it takes to collect data – as much as six months followed by final processing – clients may be prepared to pay close to full cost for re-licensed data to get immediate access.

As Aeroquest builds a library of data it should be able to generate recurring revenues as clients choose to licence previously acquired data on a non-exclusive basis. This potentially provides a base of recurring revenue and may increase margins, as the direct cost of sales will be low. Over time Aeroquest will be able to re-license each of the four types of airborne survey data.

Aeroquest has formed a new subsidiary company for the data licensing business and is carrying out its first project in the Fort Worth Basin, in Texas. The survey is a 100,000 line kilometre magnetic survey to be flown by a fixed wing aircraft over the Barnett Shale formation.

Valuation and Recommendation

We have updated our financial model to reflect the change of fiscal year end, our assessment of the current state of the mineral exploration market, the expansion in the number of AeroTEM units in operation and the growth of UTS's fixed wing fleet.

Following an equity offering at the beginning of the year, the company has \$16.9 million of cash and is cash flow positive. Although, on signing the Anglo deal Aeroquest will enter into commitments to spend about \$12.0 million over two years - comfortably within its capabilities.

Our updated revenue and earnings estimates are as follows:

| FY2008 | Q1FY08A | Q2FY08A | Q3FY08A | Q4FY08E | FY2008E |
|-----------------|----------------|----------------|----------------|----------------|----------------|
| Revenues (C\$M) | 11.2 | 13.3 | 14.5 | 16.8 | 55.8 |
| EPS (C\$) | 0.00 | 0.03 | 0.01 | 0.02 | 0.06 |

| FY2009 | Q1FY09E | Q2FY09E | Q3FY09E | Q4FY09E | FY2009E |
|-----------------|----------------|----------------|----------------|----------------|----------------|
| Revenues (C\$M) | 16.2 | 17.2 | 18.6 | 19.1 | 71.1 |
| EPS (C\$) | 0.02 | 0.03 | 0.03 | 0.03 | 0.11 |

| FY2010 | Q1FY10E | Q2FY10E | Q3FY10E | Q4FY10E | FY2010E |
|-----------------|----------------|----------------|----------------|----------------|----------------|
| Revenues (C\$M) | 19.9 | 21.4 | 22.3 | 22.8 | 86.5 |
| EPS (C\$) | 0.04 | 0.04 | 0.05 | 0.05 | 0.18 |

Source: Company reports and Fraser Mackenzie estimates

Our discounted cash flow valuation for Aeroquest is \$2.10 per share. At current price levels the stock is trading at 8.4 times our earnings estimate of \$0.11/share for FY2009, at 1.4 times enterprise value to our estimate of EBITDA for FY2008 and at 1.7 times price to tangible book value. With an expansion into oil and gas, growing global delivery capability and the Anglo deal poised to close; the stock is very attractively priced.

Appendix A – Sample Customers over the Period January 2007 to September 2008

The following table has been compiled from press releases of companies announcing that they had used Aeroquest for airborne survey work. The majority of these companies are early stage, Toronto Venture Exchange-listed exploration concerns with a strong dependency on a ready supply of external capital to fund capital expenditure commitments. As we note above the supply of that capital has become more limited.

| Name | Ticker | Date | Country | Notes |
|----------------------------------|--------------|------------|----------|-----------------------|
| Noront Resources, Hawk Uranium | NOT-V, HUE-V | 26/09/2008 | Canada | Geotech also involved |
| New Island Resources | NIS-V | 15/09/2008 | Canada | |
| Freewest | FWR-V | 15/09/2008 | Canada | Geotech also involved |
| Amarc Resources | AHR-V | 07/09/2008 | Canada | |
| Ascot Resources | AOT-V | 06/09/2008 | Canada | |
| Forum Uranium | FDC-V | 24/07/2008 | Canada | |
| First Nickel Inc | FNI-V | 26/06/2008 | Canada | |
| Probe Mines | PRB-V | 23/04/2008 | Canada | |
| Lomiko Resources | LMR-V | 09/03/2008 | Canada | |
| Dajin Resources | DJI-V | 14/02/2008 | Canada | |
| Kaminak Gold | KAM-V | 15/01/2008 | Canada | |
| Hawthorne Gold, Eureka Resources | HGC-V, EUK-V | 07/01/2008 | Canada | |
| Kivalliq Energy Corp. | KIV-V | 06/01/2008 | Canada | |
| Copper Ridge Explorations | KRX-V | 27/11/2007 | Canada | |
| Matamec Exploration | MAT-V | 12/11/2007 | Canada | Data-reinterpretation |
| Fancamp Exploration | FNC-V | 11/10/2007 | Canada | |
| Inspiration Mining Corp. | ISM-T | 24/08/2007 | Canada | |
| El Nino Ventures | ELN-V | 13/08/2007 | DR Congo | |
| Rockgate Capital | RGT-V | 26/06/2007 | Canada | |
| Sheffield Resources | SLD-V | 19/06/2007 | Canada | |
| Excellon Resources | EXN-V | 18/06/2007 | Mexico | |
| BC Gold Corp | BCG-V | 13/06/2007 | Canada | |
| Niogold Mining | NOX-V | 29/05/2007 | Canada | |
| Capella Resources | CPS-V | 09/05/2007 | Canada | |
| Benton Resources | BTC-V | 26/04/2007 | Canada | Geotech also involved |
| Samatana Diamonds | STA-V | 10/04/2007 | Canada | |
| Konigsberg Corp | KGBC-OTCBB | 23/01/2007 | Canada | |
| Playfair Mining | PLY-V | 09/01/2007 | Canada | |

Source: Company Press Releases (Marketwire)

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CORPORATE DIRECTORY

| CAPITAL MARKETS | MAIN 416-955-4777 EXTENSION |
|-------------------------------------|--|
| EQUITY RESEARCH | |
| DIVERSIFIED INDUSTRIES | |
| Paul Bradley | pbradley@frasermackenzie.com 244 |
| John Mould | jmould@frasermackenzie.com 233 |
| Peter Prattas | ppratras@frasermackenzie.com 251 |
| John Safrance | jsafrance@frasermackenzie.com 248 |
| ENERGY | |
| Jeffrey C. Li | jli@frasermackenzie.com 232 |
| Vic Vallance | vvallance@frasermackenzie.com 225 |
| LIFE SCIENCES | |
| David Denduk | ddenduk@frasermackenzie.com 229 |
| Kimberly Johnston | kjohnston@frasermackenzie.com 241 |
| METALS AND MINING | |
| Gary Baschuk | gbaschuk@frasermackenzie.com 228 |
| Andrew Edelberg | aedelberg@frasermackenzie.com 239 |
| COORDINATOR & PUBLISHING | |
| David Fernandez | dfernandez@frasermackenzie.com 239 |
| SALES ■ TORONTO | |
| Lui Barbati | lbarbati@frasermackenzie.com 224 |
| Tom Eveson | teveson@frasermackenzie.com 245 |
| Mark Knapp | mknapp@frasermackenzie.com 231 |
| Bruce Krugel | bkrugel@frasermackenzie.com 242 |
| James R. Muir | jmuir@frasermackenzie.com 227 |
| Cameron Ross | cross@frasermackenzie.com 243 |
| TRADING | |
| Mike Baker | mbaker@frasermackenzie.com 250 |
| Brian Bosse | bbosse@frasermackenzie.com 223 |
| Yvonne Nevala | ynevala@frasermackenzie.com 240 |
| Mark Stableforth | mstableforth@frasermackenzie.com 249 |
| INVESTMENT BANKING | |
| Philip Benson | pbenson@frasermackenzie.com 233 |
| Kumail Gangjee | kgangjee@frasermackenzie.com 231 |
| Steve Nevard | snevard@frasermackenzie.com 235 |
| Mark Polubiec | mpolubiec@frasermackenzie.com 200 |
| Sally Smart | ssmart@frasermackenzie.com 222 |
| J.C. St-Amour | jc@frasermackenzie.com 234 |
| COMPLIANCE | |
| Jack Bensimon | jbensimon@frasermackenzie.com 234 |
| ADMINISTRATION | |
| Valerie Gomez | vgomez@frasermackenzie.com 221 |

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Head Office

83 Yonge Street, Suite 200 ■ Toronto, Ontario ■ M5C 1S8 ■ Bus 416-955-4777 ■ Fax 416-955-0203 ■ Toll Free 1-877-955-4777

Investment Banking

47 Colborne Street, Suite 201 ■ Toronto, Ontario ■ M5E 1P8 ■ Bus 416-955-0990 ■ Fax 416-955-4630