

# AEROQUEST INTERNATIONAL LIMITED



## Management's Discussion & Analysis For the three months ending December 31, 2009

*Issued on February 10, 2010*

Management's Discussion and Analysis (MD&A) is intended to help readers understand the dynamics of our business and the key factors underlying our financial results. It explains trends in our financial condition and results of our operations for the three months ended December 31, 2009 ("Q1-F10") compared with our operating results for the three months ended December 31, 2008 ("Q1-F09"). It also compares our balance sheet as at December 31, 2009 to our September 30, 2009 fiscal year-end balance sheet.

The consolidated financial statements presented here are those of the Aeroquest Group of Companies; Aeroquest International Limited and its wholly owned subsidiaries Aeroquest Limited, UTS Geophysics Pty Ltd, Geophex Ltd., Optimal Geomatics Inc., Aeroquest (UK) Limited and AeroKaz LLP (collectively, "the Company"), with all material inter-company balances having been eliminated on consolidation.

Additional information relating to our company is available on our website at [www.aeroquest.ca](http://www.aeroquest.ca) and on the System for Electronic Document Analysis and Retrieval (SEDAR) at [www.sedar.com](http://www.sedar.com). Unless otherwise noted, all amounts noted in this MD&A are in Canadian dollars.

### **1.1 FORWARD-LOOKING STATEMENTS**

Securities laws encourage companies to disclose forward-looking information so that investors can get a better understanding of a company's future prospects and make informed investment decisions. Certain statements in this MD&A are forward-looking statements or information, collectively "forward-looking statements". We are hereby providing cautionary statements identifying important factors that could cause our actual results to differ materially from those projected in forward-looking statements made in this MD&A. Any statements that express, or involve discussions as to, expectations, beliefs, plans, objectives, assumptions or future events or performance (often, but not always, through the use of words or phrases such as "will likely result," "are expected to", "will continue", "is anticipated", "estimated", "intend", "plan", "projection", "could", "may", "believes", "feel", "targeting", "look forward", "goals", "objective", "outlook" and similar expressions) are not historical facts and may be forward-looking and may involve estimates, assumptions and uncertainties which could cause actual results or outcomes to differ materially from those expressed in the forward-looking statements.

Without limitation, information regarding the volatility of the market for our services, worldwide political stability, factors that could result in significant or prolonged disruption to mining and oil & gas exploration worldwide, domestic and international economic conditions, other political and economic situations and uncertainties, changes in foreign currency exchange rates, the impacts of changes in industry priorities and spending on exploration activities related to our services, major technology changes, timing of product introductions, competition, our ability to replace lost revenue of a customer significant to an operating division, our ability to attract and retain key employees, and the possibility

that such efforts will not have as great an impact on our operating results as is currently anticipated, is forward-looking information.

Readers should also refer to our continuous disclosure materials filed with Canadian Securities Regulatory Authorities for additional information with respect to certain of these risk factors, including our most recent Annual Information Form.

Although we believe that the expectations reflected in such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to have been correct. Important factors that could cause actual results to differ materially from our expectations (“**Cautionary Statements**”), including changes in general economic, market and business conditions, fluctuations in the cost of borrowing, political and economic development, our ability to receive timely regulatory approvals, competitive actions of other companies, the occurrence of unexpected events such as equipment failures and other similar events affecting us or other parties whose operation or assets directly or indirectly affect us, and those risks set forth under the heading “Risks & Uncertainties” below.

All subsequent written and oral forward-looking statements attributable to the Company or persons acting on behalf of the Company are expressly qualified in their entirety by the Cautionary Statements. The forward-looking information contained herein is current only as of the date of this document. New factors emerge from time to time, and it is not possible for management to predict all of such factors and to assess in advance the impact of each such factor on our business or the extent to which any factor or combination of factors may cause actual results to differ materially from those contained in any forward-looking statements. We disclaim any intention or obligation to update or revise any forward-looking statements or comments as a result of any new information, future event or otherwise unless such disclosure is required by law.

## **1.2 NON GAAP FINANCIAL MEASURES**

Certain financial measures used in this MD&A do not have any standardized meaning under Canadian generally accepted accounting principles (GAAP). Below is a definition of each of the non-GAAP financial measures used in this MD&A. At the point where each non-GAAP financial measure is first discussed, a table has been provided to reconcile that financial information to the most directly comparable GAAP measure.

### **EBITDA**

Earnings before interest, taxes, depreciation and amortization (EBITDA) is a financial metric used to analyze operating results. We define EBITDA as revenue less cost of sales, cash operating costs, and stock-based compensation expense, and we use it as a benchmark of operating performance. We caution you that EBITDA as calculated by us may not be comparable to similarly titled amounts reported by other companies.

### **APPARENT TAX RATE**

We define apparent tax rate as the total income tax expense (current and future) as a percentage of income before taxes. More information on our income tax expense and the reconciliation between income tax expense and our statutory tax rate is contained in Note 10 to the consolidated financial statements for the year.

## CASH OPERATING COSTS

We define cash operating costs to be those operating expenses in our income statement that involve, or will involve, an inflow or outflow of cash. At present, cash operating costs are the sum of general and administrative expenses, and gain or loss on foreign exchange.

## 2 Our Business, Strategy & Outlook

### 2.1 AEROQUEST'S BUSINESS

We are a world leader in the development and operation of innovative and proprietary airborne geoscience survey platforms serving the mineral and petroleum exploration industries, and the environmental and infrastructure industries. We operate a large fleet of airborne geophysics and geomatics survey systems utilizing two separate delivery platforms; rotary and fixed wing aircraft. Our geophysics survey technologies include time-domain and frequency-domain electro-magnetics (including our proprietary AeroTEM, time-domain electromagnetic technology), gravity, magnetic, and radiometric systems. Our geomatics survey technologies include LiDAR and ortho-rectified digital and film photography. Our combination of geoscience technologies and airborne platforms give us one of the broadest arrays of product and service offerings in our industry in the world today. We are active on virtually all continents assisting our clients in investigating features at or near the earth's surface and to depths of several kilometers beneath the earth's surface.

### 2.2 SELECTED COMPARATIVE QUARTERLY FINANCIAL INFORMATION

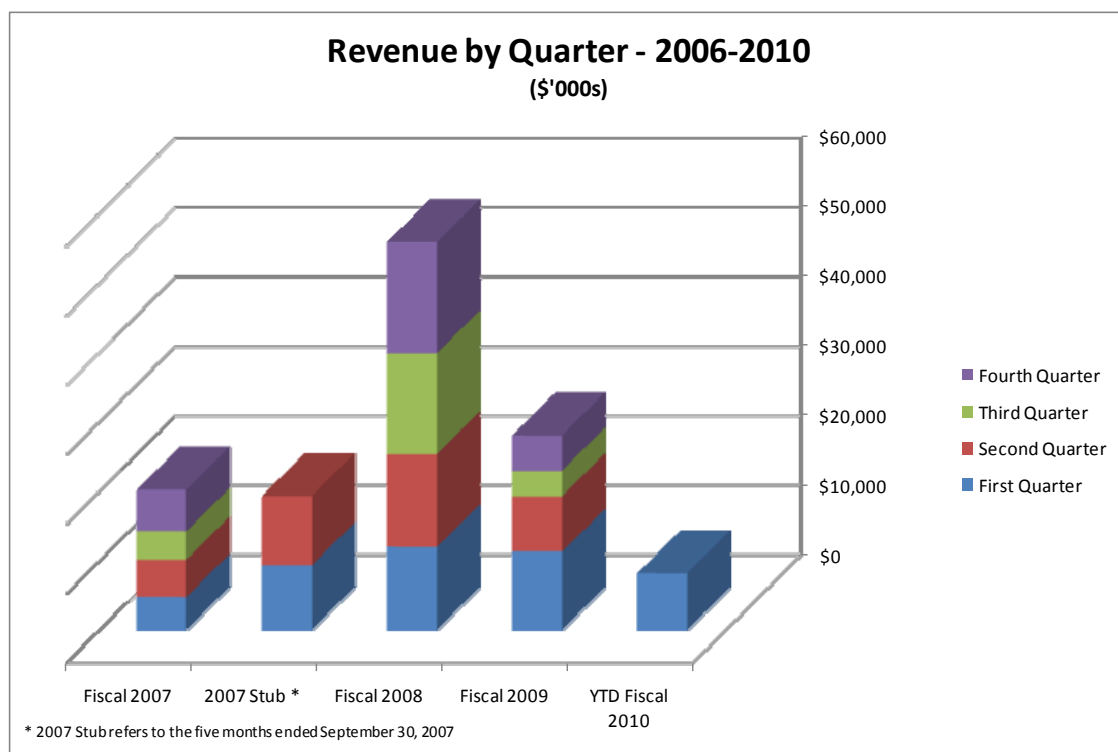
(Financials in 000's except /share data)								
	Q1-Dec 09	Q4-Sep 09	Q3-Jun 09	Q2-Mar 09	Q1-Dec 08	Q4-Sep 08	Q3-Jun 08	Q2-Mar 08
Revenue	\$ 8,174	\$ 5,099	\$ 3,651	\$ 7,963	\$ 11,298	\$ 16,017	\$ 14,537	\$ 13,295
Operating profit/(loss)	\$ (3,193)	\$ (6,362)	\$ (4,601)	\$ (1,698)	\$ (2,008)	\$ 2,024	\$ 590	\$ 1,613
Net income	\$ (2,266)	\$ (4,657)	\$ (3,498)	\$ (953)	\$ (1,514)	\$ 1,603	\$ 304	\$ 815
Weighted average common shares	36,776	33,725	33,627	33,613	33,597	33,785	34,662	32,553
Earnings per share (basic)	\$ (0.06)	\$ (0.14)	\$ (0.11)	\$ (0.03)	\$ (0.04)	\$ 0.05	\$ 0.01	\$ 0.03
Earnings per share (diluted)	\$ (0.07)	\$ (0.13)	\$ (0.11)	\$ (0.03)	\$ (0.04)	\$ 0.05	\$ 0.01	\$ 0.03
Operating cash flow/share	\$ (0.04)	\$ (0.05)	\$ (0.06)	\$ 0.02	\$ 0.03	\$ 0.05	\$ 0.06	\$ 0.09
Total assets	\$ 56,162	\$ 57,740	\$ 60,240	\$ 64,624	\$ 68,660	\$ 69,540	\$ 71,537	\$ 72,053
Long term liabilities	\$ 136	\$ 224	\$ 252	\$ 316	\$ 486	\$ 470	\$ 502	\$ 562
Systems available for use at period end *	28	29	27	28	27	28	27	23
Fixed-wing systems	9	10	10	11	10	11	11	9
Helicopter systems	17	17	17	17	17	17	16	14
AeroTEM systems included in above	13	13	13	13	13	13	11	8
Geomatics systems	2	2	-	-	-	-	-	-
Line kilometres flown during period								
Helicopter systems	22,700	5,400	2,700	11,400	59,150	74,100	73,200	59,000
Fixed-wing systems	267,000	351,000	144,000	189,000	316,000	520,000	457,700	362,000
Contract back-log (CAD\$ thousands)								
Helicopter systems	\$ 2,000	\$ 1,100	\$ 100	\$ 1,000	\$ 2,700	\$ 6,900	\$ 5,100	\$ 5,900
Fixed-wing systems	\$ 1,600	\$ 2,700	\$ 5,600	\$ 5,600	\$ 9,700	\$ 9,200	\$ 11,900	\$ 11,400
Geomatics	\$ 7,400	\$ 6,700	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Other	\$ 400	\$ 400	\$ 900	\$ 1,400	\$ 1,600	\$ 1,900	\$ -	\$ -
Total Backlog	\$ 11,400	\$ 10,900	\$ 6,600	\$ 8,000	\$ 14,000	\$ 18,000	\$ 17,000	\$ 17,300

\* excluding gamma ray spectrometers

The effect of the current economic recession and resulting uncertainty continues to negatively affect exploration spending. As a result, our Q1-F10 revenue declined by \$2.1 million to \$8.2 million from \$11.3

million in Q1-F09. Gross profit in Q1-F10 was \$1.4 million, a decline of \$1.5 million from the \$2.9 million reported in Q1-F09. Q1-F10 net loss was \$2.3 million compared with Q1-F09 loss of \$1.5 million. The decline in profitability is due to several factors working at once, including reduced year-over-year revenue, reduced gross margin due to the fixed cost component of cost of sales applied to a lower revenue base, foreign currency losses, and other general and administrative expenses that, while lower on a run-rate basis from the prior quarter, are now spread over a smaller base of revenue.

We embarked on a significant cost reduction program beginning in our last fiscal year and continuing on into fiscal 2010 and the restructuring costs associated with these efforts are also reflected in our results. In particular, Headcount reductions totaling 60 per cent of our staff took place in January, March and July of 2009 resulting in an annualized \$3.5 million reduction to our payroll burden. Other reductions to senior management salaries will also help to reduce our run rate operating costs. We have also begun the process of rationalizing the cost structure in our newly acquired Optimal Geomatics subsidiary. These issues are discussed in more detail throughout this MD&A.



### 2.3 BUSINESS STRATEGY

Our strategy is to become the preferred supplier of airborne geoscience survey technologies and services in the world. Our strategy has three components:

1. **Establish ourselves internationally** – Ours is a global industry with global opportunities; if we want to be the one that people turn to in order to get help in capitalizing on these opportunities, then we

have to be ready and able to go anywhere. To date, we have successfully surveyed in well over 40 countries around the globe and have completed surveys and positioned systems on every continent where commercial natural resource exploration activities occur.

2. **Find new applications for our technologies** – We will continue to develop various new markets where we can take advantage of the technologies we understand like in the Energy, Environmental Services and Infrastructure industries.

3. **Explore other, complementary, technologies** – Specifically, we are looking for new technologies that are either complimentary with our existing technologies, or complimentary with our existing service delivery model. Aerial geomatics technologies are examples of such complimentary technologies. Aerial geomatics is similar to geophysics surveying except that the objects of interest in geomatics are at the earth's surface, whereas the objects of interest in geophysics are usually buried beneath the earth's surface. At the end of our fiscal 2009 year, we negotiated and closed the purchase of Optimal Geomatics Inc., giving us capabilities in two important remote sensing technologies; LiDAR and aerial photography.

## **2.4 OUTLOOK**

Global spending in both mineral and petroleum exploration has slowed and we expect it to remain below the levels of 2007 and 2008 for the balance of fiscal 2010, albeit at higher levels than in 2009. Commodity prices are at levels that would normally stimulate exploration so we remain optimistic about the medium and long terms, but in the short term the exploration opportunities remain slower than normal as our customers manage their cash positions and continue to adopt a 'wait and see' attitude. We have downsized our business to reflect this reality and are working to maintain breakeven or better positions in each of our regional offices.

The aerial geomatics segment remains positive as government organizations (especially in the United States) have ramped up spending in this market through various stimulus programs and incentives. This level of spending is reflected in the healthy backlog that we have in this business segment.

Notwithstanding the cautious optimism for the future, we remain focused on closely managing our costs. In the last twelve months, we have aggressively reduce our cost structure including global workforce reductions of approximately 70 persons, or approximately 50% of our geophysics survey staff, and the closure of one regional office in F2009. These decisions were not made lightly but were required to properly size our operations to the forecasted business in the near future. This process of closely managing our cost structure continued into fiscal 2010. With the acquisition of Aeroquest Optimal, we are now presented with an opportunity to integrate back office operations, eliminate one set of public company costs and rationalize the cost structures between the geophysics and geomatics operations. We will continue to focus on operational efficiencies and carefully managing our cash as economic conditions improve.

We continue to look for other businesses that may be combined with our own to enhance our product offerings, geographical presence and range of technologies. We continue to believe that this market will present us with corporate acquisition opportunities that allow us to compress our strategic plan; allowing us to accomplish more in a shorter time frame.

Looking forward beyond one year, our objective is to use our short term tactics to position ourselves to react quickly once the recovery in our core markets takes hold. We believe that the current market pressures that exist in the minerals and oil & gas markets are short term and ongoing depressed exploration expenditures are not realistic in the medium or long term.

### **3 Fourth Quarter Operating Results**

#### **3.1 OVERVIEW AND HIGHLIGHTS**

With the acquisition of Optimal Geomatics Inc. on September 30, 2009, we have begun to report our revenues, cost of sales and margins in the following three business segments:

- 1) Airborne Geophysics – the former Aeroquest Surveys and UTS/Aeroquest (the former UTS Geophysics) businesses;
- 2) Aerial Geomatics – comprising Aeroquest Optimal (the former Optimal Geomatics business); and
- 3) Contract R&D – Aeroquest Sensor Technologies (the former Geophex Ltd. business).

The Airborne Geophysics segment is further split into fixed wing and helicopter modes to distinguish between the two modes of airborne exploration.

The global economic recession and the resulting impact on mineral and petroleum exploration continued to negatively impact our revenue and backlog in the fourth quarter. In Q1-F10, we recorded a decline in consolidated revenue of 28 per cent over Q1-F09. In the Airborne Geophysics segment, helicopter services declined by 69 per cent to \$2.2 million and fixed wing services declined by 6% per cent to \$3.6 million from their levels in Q1-F09. The Aerial Geomatics segment contributed \$2.2 million in Q1-F10. The Contract R&D segment contributed \$0.2 million in revenue for the quarter, a decline of \$0.3 million or 59% from Q1-F09. A more detailed discussion on these variances is provided below.

Our cash balances declined to \$4.7 million at the end of Q1-F10 from \$6.1 million at the end of Q4-F09. Cash flow from operations in Q1-F10 was negative using \$1.4 million of cash. As discussed below, \$0.8 million of this balance related to cash flow from operations before changes in working capital and \$0.6 million relates to changes in non-cash working capital in the quarter. Capital expenditures for the quarter were less than \$0.1 million, reflecting our efforts to minimize cash outflows. We expect capital expenditures to remain modest for the balance of fiscal 2010.

#### **3.2 AIRBORNE FLEET SUMMARY**

Beginning in the fall of 2008, we slowed the pace of expansion in anticipation of the slowing economy. In this most recent quarter, there were no new additions to the geophysics survey fleet. However, we lost the services of one fixed wing aircraft which was damaged during an emergency landing in Australia. While there were only minor injuries to the pilot, the aircraft itself was damaged to the point that it could not be repaired. The aircraft was fully insured and a full pay-out under the insurance was received in February, 2010. We expect to replace the aircraft over the next several quarters or as demand dictates. Our active fleet is now comprised of 29 systems; 17 helicopter based and 12 fixed wing based. With the acquisition of Aeroquest Optimal, we have now added two new LiDAR and orthophotogrammetry systems.

## AIRBORNE FLEET SUMMARY

	Helicopter	Fixed wing	Total
<b>Geophysics</b>			
<b>AeroTEM</b>	13		13
<b>Impulse/GEM-2A</b>	2		2
<b>Magnetics</b>			
single sensor	1	5	6
multi-sensor	1	3	4
<b>Gravity</b>			
(+ multi-sensor mag)		2	2
<b>Geomatics</b>		2	2
<b>Total</b>	17	12	29

### 3.3 REVENUE BY GEOGRAPHIC SEGMENT

While the economic slowdown has impacted our volume of business, we continue to be active around the globe. As of December 31, 2009, we had positioned helicopter systems in North and South America, Europe, Africa and Australasia. During the same period, we operated fixed wing units in Australia & the South Pacific, Africa and North America.

Since we embarked upon our international expansion beginning in 2007, our revenue outside of Canada has grown significantly. As well, our Canadian based revenue has also declined in recent quarters due to the economic slowdown. With the acquisition of Aeroquest Optimal, we have also begun reporting our revenue from the United States as a separate segment as the overwhelming percentage of Aeroquest Optimal's business is currently in the United States.

The result is that revenue outside of Canada in Q1-F10 represented over 76 per cent of our total revenue. Of the 27 per cent of revenue that is outside of Canada, Australia and the United States, no country represents more than 10 per cent of revenue.

## REVENUE BY GEOGRAPHIC SEGMENT

Three Months Ended December 31, 2009

(thousands of Canadian dollars)	Canada	Australia	USA	RoW	Total	
<b>Airborne Geophysics</b>						
<b>Helicopter services</b>	\$ 1,611	\$ -	\$ -	\$ 544	\$ 2,155	26%
<b>Fixed wing services</b>	271	1,622	-	1,691	3,584	44%
<b>Total Geophysics</b>	1,882	1,622	-	2,235	5,739	70%
<b>Aerial Geomatics</b>	-	-	2,217	-	2,217	27%
<b>Contract R&amp;D</b>	-	-	218	-	218	3%
<b>Total Revenue - Aeroquest Group</b>	\$ 1,882	\$ 1,622	\$ 2,435	\$ 2,235	\$ 8,174	100%
	23.0%	19.8%	29.8%	27.3%	100%	

## 3.4 CONSOLIDATED RESULTS

### OPERATING STATEMENTS

(in thousands of Canadian dollars)	Three Months		Change	
	Q1-F10	Q1-F09	\$	%
<b>Revenue</b>				
Airborne Geophysics				
Fixed Wing	3,584	3,823	(239)	(6%)
Helicopter	2,155	6,943	(4,788)	(69%)
Total Airborne Geophysics	5,739	10,766	(5,027)	(47%)
Aerial Geomatics	2,217	-	2,217	N/A
Contract R&D	218	532	(314)	(59%)
	<b>8,174</b>	<b>11,298</b>	<b>(3,124)</b>	<b>(28%)</b>
<b>Cost of sales</b>				
Airborne Geophysics				
Fixed Wing	2,985	3,360	(375)	(11%)
Helicopter	1,824	4,844	(3,020)	(62%)
Total Airborne Geophysics	4,809	8,204	(3,395)	(41%)
Aerial Geomatics	1,896	-	1,896	N/A
Contract R&D	74	166	(92)	(55%)
	<b>6,779</b>	<b>8,370</b>	<b>(1,591)</b>	<b>(19%)</b>
<b>Gross profit</b>	<b>1,395</b>	<b>2,928</b>	<b>(1,533)</b>	<b>(52%)</b>
<b>Gross margin</b>				
<i>Airborne Geophysics</i>				
<i>Fixed Wing</i>	16.7%	12.1%		
<i>Helicopter</i>	15.4%	30.2%		
<i>Total Airborne Geophysics</i>	16.2%	23.8%		
<i>Aerial Geomatics</i>	14.5%	0.0%		
<i>Contract R&amp;D</i>	66.1%	68.8%		
<b>Gross profit margin %</b>	<b>17.1%</b>	<b>25.9%</b>		
General & administrative expense	2,668	4,350	(1,682)	(38.7%)
Foreign exchange (gain) loss	81	(1,205)	1,286	(106.7%)
<b>Total cash operating costs</b>	<b>2,749</b>	<b>3,145</b>	<b>(396)</b>	<b>(12.6%)</b>
<i>% of revenue</i>	24.3%	28.1%		
Stock-based compensation expense	84	104	(20)	(19.2%)
EBITDA	(1,438)	(321)	(1,117)	348.0%
<i>EBITDA as a % of revenue</i>	<i>(2.6%)</i>	<i>(2.4%)</i>		
Depreciation of capital assets	880	802	78	9.7%
Amortization of intangible assets	875	885	(10)	(1.1%)
<b>Operating profit/(loss)</b>	<b>(3,193)</b>	<b>(2,008)</b>	<b>(1,185)</b>	<b>59.0%</b>
<i>Operating profit as a % of revenue</i>	<i>(28.3%)</i>	<i>(14.9%)</i>		
Interest and other expense (income)	(103)	(56)	(47)	83.9%
Provision for income taxes	(824)	(438)	(386)	88.1%
<b>Net income</b>	<b>\$ (2,266)</b>	<b>\$ (1,514)</b>	<b>\$ (752)</b>	<b>49.7%</b>
Earnings per share - basic	\$ (0.06)	\$ (0.04)	\$ (0.02)	

In Q1-F10, consolidated revenue was \$8.2 million, down \$3.1 million or 28 per cent over Q1-F09. In Airborne Geophysics, revenue from helicopter services was \$2.2 million, down \$4.8 million or 69 per cent over Q1-F09 while revenue from fixed wing services was \$3.6 million, down \$0.2 million or 6 per cent over Q1-F09. Revenue from helicopter services showed a marked decline due to the impact of the current economic downturn. Our traditional customers in mineral exploration have delayed or cancelled many of their surveys due to a combination of the current economic slump and tight capital markets hindering their ability to raise necessary exploration capital. Fixed wing services also experienced a similar decline but not to the extent of helicopter services – which are more expensive on a per line kilometer basis and thus tend to be the survey method most at risk in times of tight exploration spending.

Revenue from Aerial Geomatics was \$2.2 million, representing the newly acquired Optimal Geomatics business. Revenue from Contract R&D was \$0.2 million in Q1-F10, down \$0.3 million or 59 per cent over Q1-F09.

Cost of sales was \$6.8 million in Q1-F10, or 83 per cent of revenue, compared to \$8.4 million or 74 per cent of consolidated revenue in Q1-F09. Gross margin in Q1-F10 declined by 8 percentage points to 17 per cent, compared with 26 per cent in Q1-F09, primarily the result of lower business volumes.

Aerial Geomatics gross profit in the quarter was 14 per cent which was below our expectations. A large part of the lower margin was due to a higher than normal percentage of revenue that was subcontracted to third parties. In these cases, no markup is permitted on this revenue when it is part of a contract with the United States government or its agencies.

In Airborne Geophysics, gross margin in helicopter services was 15 per cent in Q1-F10, as compared to 30 per cent in the Q1-F09. This margin decline is primarily attributable to the significant decline in helicopter survey revenue without a comparable decline in the fixed cost component of operations staff, which forms part of cost of sales. However, the margin is an improvement over the negative gross margin reported in the fourth quarter of fiscal 2009 as revenue levels improved over last quarter. As previously indicated, we have continued to reduce operational headcount that will mitigate this margin pressure somewhat in future quarters.

Gross margin in Airborne Geophysics fixed wing services was \$0.6 million, or 17 per cent of revenue in the current quarter as compared to 12 per cent in Q1-F09. Both Q1-F10 and Q1-F09 had lower than expected margins but for different reasons. The decline in Q1-F10 margins results from both a decline in volume and decline in pricing. The pricing decline is due to lower priced government contract work in Australia accounting for approximately 50 per cent of the margin difference in Q1-F10. Q1-F09 gross margin weakness was due to operational inefficiencies in start-up costs related to a new gravity survey meter that was acquired during that period.

### **3.5 CASH OPERATING COSTS**

Cash operating costs in Q1-F10 totaled \$2.7 million, a decline of \$0.4 million, or 13 per cent from the \$3.1 million reported in Q1-F09. This decrease is primarily due to:

- A \$1.2 million reduction in bad debt expense from \$1.4 million in Q1-F09 to \$0.2 million in Q1-F10; and
- A reduction in other general and administrative expense of \$1.2 million as the impact of the workforce reductions undertaken in the last half of the year begins to reflect in reduced general and administrative expense.

Offset by:

- An increase in the foreign exchange expense of \$1.3 million (\$0.1 million loss in Q1-F10 compared with a \$1.2 million gain in Q1-F09) due to the depreciation in the United States dollar in the quarter as much of our revenue is denominated in United States dollars, and

- The inclusion in this quarter of one quarter's worth of cash operating costs at Aeroquest Optimal, which totaled approximately \$0.7 million.

In other words, without the effect of the acquisition of Aeroquest Optimal, cash operating costs in the quarter would have been down \$1.2 million, or 39 per cent, from the same quarter last year.

### **3.6 OPERATING PROFIT AND EBITDA**

EBITDA in Q1-F10 was negative \$1.4 million, a decline of \$1.1 million over the negative EBITDA of \$0.3 million reported in Q1-F09.

Depreciation and amortization charges totaled \$1.7 million in Q1-F10, roughly equal to the \$1.7 million reported in Q1-F09.

The increase in depreciation & amortization on capital assets acquired in the Optimal Geomatics transaction was offset by reduced depreciation in other areas of the business as assets become fully depreciated.

As a result, operating loss in Q1-F10 was \$3.2 million compared with an operating loss of \$2.0 million in Q1-F09.

### **3.7 NET INCOME**

Net loss for Q1-F10 was \$2.3 million, or \$0.06 per share compared to net loss of \$1.5 million, or \$0.04 per share in Q1-F09.

Our provision for recovery of income taxes for Q1-F10 was \$0.8 million generating an apparent tax rate of 27 per cent in the quarter, an increase over the 22 per cent apparent tax rate reported in Q1-F09.

## **4 Liquidity and Capital Resources**

Our cash balances declined by \$1.4 million from \$6.1 million at September 30, 2009 to \$4.7 million at December 31, 2009. Most of this change in liquidity was the result of cash flow from operations consuming \$1.4 million of cash.

## CASH & WORKING CAPITAL CHANGES

(in thousands of Canadian dollars)	Three Months		
	Q1-F10	Q1-F09	Change
<b>Operating activities</b>			
<b>Net Income/(Loss)</b>	<b>\$ (2,266)</b>	<b>\$ (1,514)</b>	<b>\$ (752)</b>
<b>Non-cash operating items</b>			
Depreciation/Amortization	1,754	1,687	67
Future taxes	(386)	(291)	(95)
Stock based compensation	85	104	(19)
<b>Operating cash before change in non-cash working capital</b>	<b>(813)</b>	<b>(14)</b>	<b>(799)</b>
Change in non-cash working capital	(601)	1,111	(1,712)
<b>Cash flow from operations</b>	<b>(1,414)</b>	<b>1,097</b>	<b>(2,511)</b>
<b>Investing activities</b>			
Capital asset purchases	(163)	(2,040)	1,877
Proceeds from disposal of capital assets	330	(86)	416
Long term investments acquired	(90)	-	(90)
<b>Cash flow from investing</b>	<b>77</b>	<b>(2,126)</b>	<b>2,203</b>
<b>Financing Activities</b>			
Capital lease payments	(142)	(85)	(57)
Redemption of shares	-	(57)	57
Proceeds from issuance of shares	4	-	4
<b>Cash flow from financing</b>	<b>(138)</b>	<b>(142)</b>	<b>4</b>
Net change in cash for the period	(1,475)	(1,171)	(304)
Cash - beginning of period	6,146	15,373	(9,227)
<b>Cash - end of period</b>	<b>\$ 4,671</b>	<b>\$ 14,202</b>	<b>\$ (9,531)</b>

Cash and short-term investments are currently invested in liquid Canadian dollar, Australian dollar or U.S. dollar denominated bank guaranteed securities with maturities no greater than three months.

### 4.1 OPERATING ACTIVITIES

Operating activities consumed approximately \$0.8 million of cash in the quarter, while changes in working capital consumed \$0.6 million of cash, and capital expenditures used less than \$0.1 million. Operating cash flow is tracking lower as a result of the reduced revenue, net income and lower non-cash operating expenses. The net change in working capital is composed of an increase in non-cash current assets of \$1.8 million offset by an increase in current liabilities of \$1.2 million

Our cash balances declined in Q1-F10 by \$1.4 million compared with a decline in cash of \$1.2 million in Q1-F09. This change is primarily as a result of the change in operating cash flow between the two periods. In Q1-F09 we had positive cash flow from operations of \$1.0 million while in Q1-2010 we had negative cash flow from operations of \$1.4 million. This \$2.4 million swing was mitigated by a \$1.9 million reduction in capital expenditures between the two periods.

As business volumes slowed in the quarter, we experienced a lengthening in payment terms with our customers. However, our principal suppliers, notably helicopter and aircraft operators and fuel providers, still required timely payment of their invoices. This change, combined with the reduction in deferred revenue resulting from business that was pre-paid and flown in the quarter comprised the majority of the changes in our non-cash working capital position. The other major change was an

increase of \$0.6 million in our income taxes recoverable. We expect to receive close to \$2 million in tax loss recoveries from the Canadian and Australian government later this fiscal year.

## 4.2 INVESTING ACTIVITIES

Investment activities in Q1-F10 generated \$0.1 million of cash. This was due to proceeds received on disposal of capital assets of \$0.3 million offset by capital asset expenditures of \$0.2 million. We expect capital expenditures to remain modest for the balance of the year (especially when compared to the prior year). Q1-F09's capital expenditures were \$2.0 million, primarily related to the acquisition of the first of two total field gravity survey units that were purchased last year.

## 4.3 FINANCING ACTIVITIES

The bulk of the financing activities in Q1-F10 were the payments under our capital leases of \$0.1 million.

F09 financing activities included \$0.1 million of cash consumed in the purchase of our shares under our Normal Course Issuer Bid which was in place for most of the first quarter of fiscal 2009 (see Section 9 below). There was no share buyback activity in the most recent quarter and there has been none since the first quarter of F2009.

## 4.4 CAPITAL RESOURCES

We have separate credit facilities in place for our Canadian and Australian operations. At September 30, 2009, no amounts had been drawn on either facility.

We believe that cash, cash flow from operations and unused operating facilities will be sufficient to fund our working capital, capital expenditure requirements and debt service costs (if applicable) for the near future.

## 4.5 SUMMARY FINANCIAL POSITION

As of December 31, 2009, we had current assets of \$17.1 million and current liabilities of \$7.4 million. Net working capital was \$9.7 million, a decrease of \$0.9 million from September 30, 2009.

### SUMMARY CASH FLOW

(in thousands of Canadian dollars)	31-Dec-09	30-Sep-09	Change from prior year-end	
<b>Cash</b>	<b>\$4,671</b>	\$6,146	(\$1,475)	(24%)
Non-cash current assets	<b>12,523</b>	10,696	1,827	17%
<b>Current assets</b>	<b>17,194</b>	16,842	352	2%
Less: Current liabilities	<b>7,450</b>	6,238	1,212	19%
<b>Net working capital</b>	<b>\$9,744</b>	\$10,604	(\$860)	(8%)
Current ratio	<b>2.3</b>	2.7		(15%)

## **5 Risks and Uncertainties**

### **5.1 Foreign Currency Exchange Risk**

We record transactions and prepare our financial statements in Canadian dollars. For Q1-F10, we maintained operations in Canada, Australia, and the United States with business conducted in other countries as well. International operations are considered financially and operationally self-sustaining. Accordingly, the assets and liabilities of our foreign subsidiaries are translated into Canadian dollars at period end exchange rates. Revenue and expense items of our foreign subsidiaries are translated into Canadian dollars at monthly exchange rates.

Significant portions of our contract survey expenditures are denominated in the same currency as our revenue on these contract surveys and therefore, a natural hedge exists for much of this exposure. However, a net exposure exists for Australian and United States dollars cash flows that can affect earnings as the Canadian dollar exchange rate changes in relation to these currencies.

Other comprehensive income includes a currency translation adjustment related to our net investment in self-sustaining subsidiaries.

While our foreign exchange policy does permit active hedging of any portion of our net foreign currency cash flow beyond the natural hedges identified and discussed above, no active hedges were employed in the quarter or the year. As a result, we do not employ any financial derivative products.

### **5.2 INTEREST RATE RISK**

We did not have any interest bearing debt in either Q1-F10 or Q1-F09 and had positive cash balances during these periods. Interest rate volatility had minimal impact on our operations only to the extent that the interest rate received on our cash balances was negatively affected by the overall decline in interest rates in the Canada, Australia and the United States.

### **5.3 LITIGATION**

We are involved in various claims and litigation arising in the normal course of business. While the outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in our favour, we do not currently believe that the outcome of adverse decisions in any pending or threatened proceedings related to those or other matters or amount which may be required to pay by reason thereof would have a material adverse impact on our financial position, results of operations or liquidity.

## **6 Off-Balance Sheet Arrangements**

We have not entered into any off balance sheet arrangements, other than previously disclosed, that have, or are reasonably likely to have, an impact on the current or future results of operations or the financial condition of our company.

## 7 Acquisition of Optimal Geomatics Inc.

At the end of our 2009 fiscal year we announced completed the acquisition of Optimal Geomatics Inc. (TSX-V:OPG). Under the terms of the Arrangement Agreement, the transaction was effected by way of a Plan of Arrangement completed under the Canada Business Corporations Act. Optimal shareholders received 1 common share of Aeroquest for each 21 common shares of Optimal owned and resulted in Aeroquest issuing approximately 3.0 million common shares to Optimal shareholders.

The acquisition has been accounted for under the purchase method of accounting and has been included in the balance sheet of the Company on September 30, 2009. The details of the consideration given and the fair value of net assets acquired, in Canadian dollars, are as follows:

Net Assets Acquired at Fair Values ('000s):

Cash	\$ 529
Accounts receivable	2,269
Inventory	7
Work in progress	48
Prepays	267
Capital assets	429
Other assets	254
Accounts payable and accrued liabilities	(1,484)
Capital lease obligations	(247)
Deferred revenue	(192)
<b>Total net assets acquired, net of cash</b>	<b>\$ 1,351</b>

Consideration provided was a combination of shares of the Company along with cash expended in deal costs as follows:

Acquisition costs	\$ 594
Less: Cash acquired	(529)
Cash cost of acquisition	65
Shares of Aeroquest International (2,989,192 shares @ \$0.43)	1,285
<b>Total Purchase Price</b>	<b>\$ 1,351</b>

## 8 Share Capital

### 8.1 Stock Option Plan

At December 31, 2009, we had 36,860,936 Common Shares issued and outstanding and as at the same date the Common Share stock options held by directors, officers, employees, consultants, and brokers were as follows:

	Number of options	Exercise price	Expiry date
Issued options held by directors, officers and consultants under the Company Stock Option Plan	5,000	\$ 0.50	March 1, 2010
	15,000	\$ 2.00	June 30, 2010
	7,500	\$ 0.50	June 30, 2010
	250,000	\$ 0.50	February 9, 2011
	367,500	\$ 0.60	June 30, 2011
	3,000	\$ 0.75	October 3, 2011
	15,000	\$ 0.75	October 13, 2011
	141,000	\$ 2.34	September 30, 2012
	50,000	\$ 1.70	July 16, 2013
	391,666	\$ 0.42	January 18, 2014
	65,000	\$ 0.38	February 26, 2014
	628,000	\$ 0.45	August 4, 2014
	140,000	\$ 0.55	October 20, 2014
	Total outstanding	2,078,666	\$ 0.68
Total exercisable	1,166,000	\$ 0.86	

## 8.2 Restricted Stock Unit Plan

At December 31, 2009 there were 370,833 RSU's outstanding. No RSU's were granted in either Q1-F10 or Q1-F09. 169,166 previously granted RSU's were converted to Common Shares in Q1-F10 (173,335 previously granted RSU's vested in Q1-F09 and were converted to Common Shares). In both cases, the vested RSU's represented one third of the existing RSU's granted in 2006 and 2007.

## 8.3 Normal Course Issuer Bid

In Q1-F09, we purchased 75,000 shares for cancellation for a total consideration of \$0.1 million pursuant to a Normal Course Issuer Bid ("NCIB"). The share capital value and outstanding shares have been adjusted to reflect this cancellation. The NCIB expired in December, 2008 and was not renewed.

## 9 Internal Controls and Disclosure Controls & Procedures

We maintain a system of internal controls over financial reporting designed to safeguard assets and ensure that financial information is reliable. We also undertake ongoing evaluations of the effectiveness of our internal controls over financial reporting and, where appropriate, implement enhancements. We also file annual and quarterly certifications in accordance with National (formerly Multilateral) Instrument 52-109 certifying that our CEO and CFO have reviewed our financial statements and MD&A to ensure that they do not contain an untrue fact or omit a material fact, and that they present fairly the financial position, results of operation and cash flows of our company.

We also maintain a system of disclosure controls and procedures designed to ensure the reliability completeness and timeliness of the information we disclose in all of our public disclosure documents, including this MD&A. These controls are designed to ensure that information required to be disclosed by Aeroquest is recorded, processed, summarized and reported on a timely basis, as required by law, and is accumulated and communicated to Aeroquest's senior management and board of directors to allow

timely decisions on required disclosure. In addition, our Audit Committee and Board of Directors provide an oversight role with respect to all public disclosure and review all financial statements, press releases, and MD&A, including this one. Our annual and quarterly certifications also confirm that disclosure controls exist, that we have evaluated their effectiveness, and that we have reported to you our conclusions about their effectiveness, especially during the period covered by this MD&A.

NI 52-109 also contains the requirements that we, on an annual basis:

- evaluate the effectiveness of Internal Controls over Financial Reporting ('ICFR');
- evaluate the effectiveness of Disclosure Controls & Procedures ('DC&P')
- use a control framework in the design of their ICFR and such framework must be disclosed; and
- disclose all material weaknesses, their financial impact (actual or potential), and plans or actions to remediate such weaknesses.

In the first quarter of fiscal 2009, we engaged external advisors to assess the impact of these changes on our current evaluation of ICFR and disclosure control and procedures. As a result, our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures and internal control over financial reporting, and determined that they were effective as of September 30, 2009.

## **10 Critical Accounting Policies and Estimates**

Here and in our Consolidated Financial Statements (including the Notes) we have identified the accounting policies and estimates that are critical to the understanding of our business and the results of our operations.

### **10.1 ACCOUNTING POLICY CHANGES**

On October 1, 2008, we adopted new Canadian accounting recommendations for goodwill and intangible assets. The new recommendations provide guidance on when expenditures qualify for recognition as intangible assets. Our results of operations were not materially affected by the new recommendations.

On October 1, 2008, we adopted new CICA Handbook Section 1000, Financial Statement Concepts which was amended to focus on the capitalization of costs that truly meet the definition of an asset and de-emphasizes the matching principle. The results of operations of the Company were not materially affected by these new pronouncements.

### **10.2 FOREIGN ACCOUNTING STANDARDS**

The results of operations of our subsidiary UTS Geophysics Pty Ltd. are prepared in accordance with Australian equivalents to International Reporting Standards (AIFRS) and then adjusted to Canadian GAAP standards for consolidation. Our Geophex Ltd. subsidiary results are reported under United States GAAP and are adjusted to Canadian GAAP standards for consolidation.

### **10.3 USE OF ESTIMATES**

In the preparation of our financial statements we are required to make some estimates of the fair value of certain transactions, or the likely impact of certain events on our results of operations. The following is a summary of the areas that require the most significant use of estimates:

#### *BAD DEBT EXPENSE*

We are required, each reporting period, to make an estimate of the likelihood that we will collect all of the accounts receivable owed to us. This requires that we exercise some judgment about the timing and likelihood of payment on accounts that have become past due and record a provision for those accounts where there is significant risk of collection. We review all outstanding accounts receivable on at least a monthly basis to establish whether or not any action is required.

#### *FOREIGN CURRENCY TRANSLATION*

We record revenue in Canadian, Australian, and United States dollars, as well as in Euros and, at times, other currencies. Changes in the exchange rates between currencies may create a change in the revenue, or profit on a survey between the time we record revenue and the time we disburse for costs. In addition, we translate all amounts into Canadian dollars for the purposes of financial reporting.

Foreign currency accounts are translated into Canadian dollars as follows:

- At the transaction date, each asset, liability, revenue, and expense is translated into Canadian dollars by the use of the monthly average exchange rate.
- At the period end date, monetary assets, and liabilities are translated into Canadian dollars by using the exchange rate in effect at that date.

The resulting foreign exchange gains and losses are included in income in the current period.

#### *GOODWILL AND INTANGIBLE ASSETS*

Goodwill represents the difference between the price paid and the fair value attributed to tangible and intangible assets upon the acquisition of businesses. Goodwill is not amortized but tested for impairment annually or more frequently if changes in circumstances indicate a potential impairment. The impairment test first consists of a comparison of the fair value of the reporting unit to which goodwill is assigned with its carrying amount. When the carrying amount of a reporting unit exceeds its fair value, the fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. Any impairment loss is charged to earnings in the period in which the loss is incurred. We use a combination of the discounted cash flow method and the market value method to determine the fair value of reporting units.

Intangible assets are amortized over the useful life of the underlying asset. No amortization is recorded where the asset has an infinite life or is not determinable. Any intangible assets not subject to amortization are tested annually for any impairment. Long lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by

which carrying amounts of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell.

Amortization is recorded on a straight line basis over the estimated useful life of the assets. Customer relationships and technology are amortized over seven years, sales backlog is amortized over one year and any trade names are not amortized until a decision is made to phase out the trade name at which point in time a fair value assessment of the name is performed.

### *INCENTIVE COMPENSATION*

We have Incentive Plans of which all employees are members. One such Incentive Plan establishes Target and Stretch performance levels against which the performance of the Company and its senior managers are measured. Each quarter we accrue an amount equal to one quarter of the estimated Incentive Plan payout, based on the Company meeting its Target performance levels. The actual amount paid could be different from the amounts estimated in interim periods requiring an adjustment, usually in the fourth quarter of the year.

The fair value of stock-based compensation is estimated using a Black-Scholes option pricing methodology. The principal assumptions required for the Black-Scholes methodology are assumptions about the expected life of the options, and the expected volatility and dividend policy of the underlying stock over the expected life of the options.

### **10.4 INTERNATIONAL FINANCIAL REPORTING STANDARDS ('IFRS')**

In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian public and publicly accountable companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with IFRS over a five year period ended in 2011. On May 9, 2008, the Canadian Securities Administrators issued CSA Staff Notice 52-320 which provided guidance on disclosure related to each financial reporting period in the three years before the first year for which a public company prepares its financial statements in accordance with IFRS. As we will begin reporting our financials under IFRS in our September 30, 2012 fiscal year, the staff notice requires disclosure on the key elements and timing of our IFRS changeover plan beginning in this interim MD&A.

There are several phases to that we will have to complete on the path to implementing IFRS:

- The initial impact assessment and scoping phase including the identification of significant differences between existing Canadian GAAP and IFRS as relevant to the Company's specific instance;
- The key elements phase including the identification, evaluation and selection of accounting policies necessary for the changeover to IFRS. As well, this phase includes other operational elements such as information technology, internal control over financial reporting and training;
- Finally, the embedding phase that will integrate the solutions into our underlying financial systems and processes that are necessary for the Company to changeover to IFRS.

We have engaged third party consultants to assist in this process. As of December 31, 2009, we have completed the initial impact assessment and have begun work on the key elements phase. However, we are not yet in a position to quantify the result (if any) of this study but will continue to report on this process in subsequent MD&A.