

AEROMECHANICAL SERVICES LTD.

AMA-TSX: \$0.24 — **BUY**

TARGET PRICE: \$0.65; PROJECTED RETURN: 171%

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AEROMECHANICAL TURNS CASH-FLOW POSITIVE

EVENT – AEROMECHANICAL SECOND QUARTER RESULTS

- Installed 23 AFIRS units, above our estimate of 15 installations.
- Revenues grew to \$1.3 million versus \$0.6 million in Q2/F08.
- EBITDA loss of \$(1.2) million, better than our expectations of \$(1.5) million, versus \$(2.6) million for the same quarter last year.
- Cash balance of \$0.78 million, up \$0.25 million from last quarter, making this the first quarter in which the company generated positive operating cash flows.

IMPACT – NO CHANGE TO ANNUAL INSTALLATION FORECASTS

We believe that the pace of installations should continue in the latter part of the year as we believe that airline traffic may be stabilizing due to encouraging signs from China and the Middle East. The company now has 183 units installed and we continue to expect a total of 75 units to be installed in F2009 and 88 units in F2010. Our EBITDA estimate for F2009 is slightly adjusted to \$(4.5) million, from \$(4.6) million previously, while our F2010 EBITDA remains at \$1.5 million.

VALUATION – BASED ON PRICE-TO-SALES

Based on a multiple of 3 times price-to-sales, our target price remains at \$0.65.

RECOMMENDATION – BUY

AeroMechanical is a very early-stage growth company and, as such, earnings estimates do not yet reflect its full potential. We remain a **BUY** on the stock as our target price of \$0.65 provides 183% return from current levels.

VALUATION CATALYSTS – FURTHER INSTALLATIONS

We will be watching the flow of orders, and if the pace picks up with backlog growing to over 300 units, we may have to increase our valuation. The company presently has 227 units under contract, with 183 units installed.

Greater interest in data streaming could increase order pace: Since the disappearance of the Air France flight on May 31, 2009, there has been greater interest in the use of data streaming via satellite which provides real time flight information to ground stations. We believe that airlines and aircraft manufacturers such as Airbus may be interested in AFIRS, either to use in conjunction or replace the black box, which could substantially increase AeroMechanical's order backlog and profitability.

Financial Metrics (US\$)

Share Price:	\$0.24	Basic Sh. O/S (mm):	82.5
Target:	\$0.65	FD Shares (mm):	90.0
Return:	171%	Market Cap (mm):	\$19.8
Div/Distn:	N/A	Enterprise Val (mm):	\$19.4
Yield:	N/A	52 Wk. Low-High:	\$0.105-\$060

FY Dec.-31	F2007A	F2008A	F2009E	F2010E
Revenue (mm)	\$2.0	\$3.2	\$7.0	\$15.8
EV/S	9.7x	6.1x	2.8x	1.2x

Quarterly EPS per Share

	F2007A	F2008A	F2009E	F2010E
Q1	-0.01	-0.03	-0.02	0.00E
Q2	-0.03	-0.03	-0.02	0.00E
Q3	-0.03	-0.02	-0.01E	0.00E
Q4	-0.04	-0.02	-0.01E	0.01E
Fiscal year total	-0.11	-0.10	-0.06	0.01
P/E	n.m.	n.m.	n.m.	n.m.

Target Valuation Parameter

3 x 2010 P/S



Courtesy of BigCharts.com

Key Risks

We believe that the largest risk for the company is that it may not install the number of AFIRS units as expected.

Corporate Profile

AeroMechanical Services Ltd. (www.amscanada.com) is a Canadian manufacturer and provider of aeronautical monitoring products to help airlines save on costs and predict mechanical malfunctions before they occur.

Multiple Share Structure

Not applicable.

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ANALYSIS

AeroMechanical reported second quarter earnings and reported a positive cash flow: The company reported its Q2/F09 results of a loss of \$(1.3) million, or \$(0.02) per share, inline with our expectations, versus a loss of \$(2.7) million, or \$(0.03) per share for the same quarter last year. As we do not expect the company to become profitable until F2010, the focus is primarily on the number of AFIRS units in operation, which totalled net 183 as at the end of Q2/F09. The company installed 23 units in the quarter, above our expectations of 15. We still expect a total of 75 units to be installed in F2009 and 88 units in F2010 as installations should pick up in the latter part of the year as we believe airline traffic may be stabilizing.

EBITDA in the quarter came in at a loss of \$(1.2) million, better than our expectations of \$(1.5) million, despite incurring higher research and development expenses of \$0.23 million, compared to \$0.07 million in the same quarter last year. This high expenditure is due to the ongoing design and testing of additional services offered such as Fuel Initiative Reporting System Tracker (FIRST) and Total Fuel Management program. We expect R&D costs to normalize in F2010. Going forward, we anticipate margins to improve because of a larger installed base and also because of contribution from sales of its fuel management program.

Financial position: At June 30, 2009, AeroMechanical had \$0.78 million in cash, which is higher than the \$0.5 million it had at the end of the first quarter, and \$1.9 million in inventory consisting mainly of AFIRS boxes and wiring which should be converted into cash as those are delivered to customers. This quarter represents the first quarter in which the company generated positive operating cash flow as it drew upon its working capital such as accounts receivable and inventory. We believe that the company should be able to continue to generate positive operating cash flows as it continues converting some of its inventory into cash by installing units and collect from customers thereby reducing receivables. In addition, its contracts have an upfront cash component and as it increases the number of units installed, its recurring revenue base will increase hence improving profitability and cash flows. AeroMechanical has no debt to speak of, with only \$0.35 million in government loans and equity of \$(0.48) million. It also has an untapped operating line of \$0.25 million. In addition, its agreement with Sierra Nevada Corporation (“SNC”) to manufacture and market AMS’s AFIRS products under license to the U.S. military market should also help through license fee and royalties and reduced research and development burden as some of the responsibility will shift to SNC.

Revenue keeps growing as the number of installations increase and the company increases the amount of services it provides to its subscribers. Given the recurring nature of its revenues, as well as the high proportion of fixed costs, any new installation dramatically improves the company’s bottom line.

**AeroMechanical Services Ltd.
AFIRS UpTime Revenues**

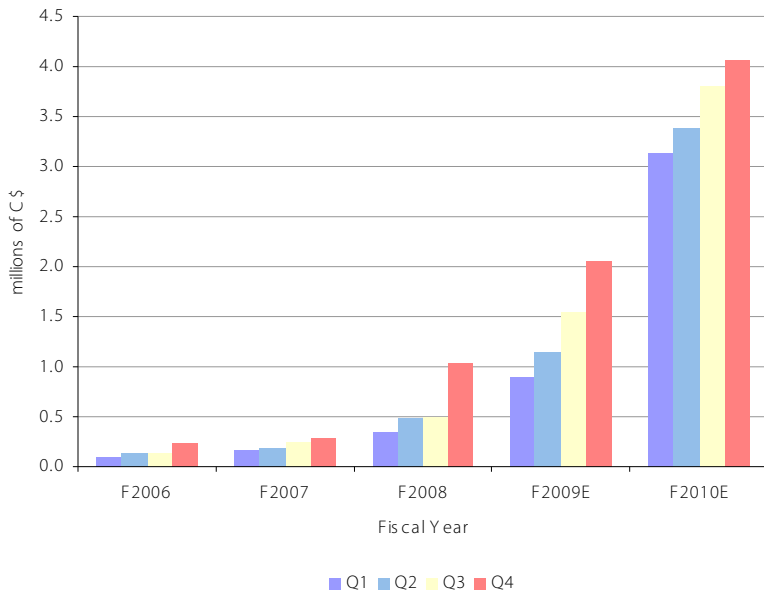


Figure 1. AFIRS UpTime Revenues
Source. Company reports, Research Capital estimates

AFIRS HAS BECOME AN INDISPENSABLE PRODUCT

The biggest event to watch for is the development of its AFIRS product as a complement and an alternative to airlines’ traditional black box. AFIRS’ ability to stream data has the potential to make this an invaluable product that many airlines may want to have. AFIRS has become much more than an aircraft health monitoring system. The product also has satellite



telephone capability, fuel management program, data streaming, and much more can be added, all helped by its 100% coverage on earth using the Iridium satellite network. No other product offers so much and at a cost of just about US\$10 per flight hour.

The original cost-savings benefits that the AFIRS box provides on aircraft health and maintenance have been overshadowed by the overwhelming advantages of the fuel management program, satellite voice communications, and now data streaming. The total estimated cost of installing a unit at US\$75,000 is very small compared with the annual benefits from all the services offered which can amount to about US\$500,000 per aircraft per year. Not to mention the security comfort of having live satellite telephone contact anywhere in the world.

AeroMechanical has built and continues to build AFIRS into indispensable equipment that can now rival established ACARS service providers. The company has survived these difficult economic times and is now poised to prosper. We believe that its pipeline is teeming with prospects and once all the tests are completed that could result in substantial orders.

AeroMechanical Services Ltd. Monthly Recurring Revenues

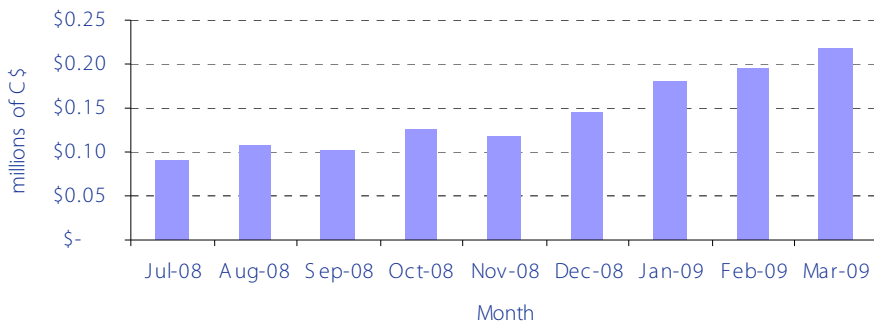


Figure 2. Monthly Recurring Revenues
Source. Company report

We continue to recommend buying AeroMechanical at these levels: The negatives weighing on the stock are largely gone and full efforts are being made to make the company cash-flow positive through the acceleration of installations of outstanding orders. The company presently has a backlog of 44 units, on top of the 183 installed base. The company has several ongoing sales campaigns around the world, such that we expect this backlog to continue to grow. **A critical milestone for the company is if it is able to capture an ACARS user as customer because once that hurdle is crossed, we believe others may follow in quick succession.**

AeroMechanical Services Ltd.
Consolidated Statement of Earnings

For the year ended December 31 (in millions C\$)	2007	2008	2009E	2010E
Assumptions:				
<i>AFIRS installed units, beginning of period</i>	66	61	151	226
<i>AFIRS units installed during period</i>	28	90	75	40
<i>AFIRS units installed during period under new acctg rule</i>	0	0	0	48
<i>AFIRS installed units, end of period</i>	<u>94</u>	<u>151</u>	<u>226</u>	<u>314</u>
Total revenues	1.99	3.18	6.99	15.83
Cost of sales	1.35	2.16	3.67	6.66
Gross margin	0.64	1.02	3.32	9.18
Gross margin as %	32.1%	32.0%	47.5%	58.0%
Expenses:				
Salaries and benefits	4.10	5.16	4.36	4.45
Marketing	1.08	1.01	0.50	0.72
Stock-based compensation	0.53	0.70	0.41	0.52
Research and development	0.25	0.75	0.85	0.40
General and administrative	1.40	1.50	1.71	1.60
Depreciation	0.09	0.17	0.15	0.16
Interest and bank charges	0.02	0.04	0.03	0.03
Foreign exchange currency loss	0.04	0.02	0.07	0.00
Stock exchange fees	0.00	0.00	0.00	0.00
Third-party contracts	0.00	0.00	0.00	0.00
Other	0.00	0.18	0.03	0.00
	<u>7.50</u>	<u>9.54</u>	<u>8.11</u>	<u>7.88</u>
Earnings before taxes	(6.87)	(8.52)	(4.79)	1.30
Income taxes	0.00	0.00	0.00	0.49
Net income (loss)	\$ (6.9)	\$ (8.5)	\$ (4.8)	\$ 0.8
Basic EPS	\$ (0.11)	\$ (0.10)	\$ (0.06)	\$ 0.01
Diluted EPS	\$ (0.11)	\$ (0.10)	\$ (0.06)	\$ 0.01
Diluted EPS before one-time items	\$ (0.11)	\$ (0.10)	\$ (0.06)	\$ 0.01
Weighted average common shares	64.3	82.3	82.5	82.5
EBITDA	\$ (6.7)	\$ (8.1)	\$ (4.5)	\$ 1.5

Figure 3. Income Statement

Source: Company reports, Research Capital estimates

**AeroMechanical Services Ltd.
Consolidated Balance Sheet**

For the year ended December 31 (in millions C\$)	2007	2008	2009E	2010E
ASSETS				
Current:				
Cash and cash equivalents	\$ 1.95	\$ 0.80	\$ 0.66	\$ 1.36
Restricted cash	0.28	0.25	0.25	0.25
Accounts receivable	0.62	1.16	0.50	0.80
Prepaid expenses	0.35	0.31	0.63	0.33
Inventory	1.81	1.79	1.75	1.50
	<u>5.01</u>	<u>4.32</u>	<u>3.80</u>	<u>4.24</u>
Capital assets	0.25	0.26	0.40	0.42
Rental assets	0.98	1.35	1.41	1.89
Intangible assets	0.03	0.03	0.03	0.03
	<u>\$ 6.28</u>	<u>\$ 5.96</u>	<u>\$ 5.63</u>	<u>\$ 6.57</u>
LIABILITIES				
Current:				
Accounts payable and accrued liabilities	1.22	1.56	4.00	4.00
Current portion of unearned revenue	0.23	1.29	1.50	1.00
Current portion of deferred lease inducement	0.01	0.00	0.00	0.00
Current portion of loans payable	0.05	0.11	0.04	0.04
Current portion of obligation under capital lease	0.02	0.02	0.05	0.04
	<u>1.54</u>	<u>2.98</u>	<u>5.59</u>	<u>5.08</u>
Unearned revenue	0.69	0.81	2.27	2.49
Deferred lease inducement	0.00	0.00	0.00	0.00
Loans payable	0.38	0.29	0.23	0.13
Obligation under capital lease	0.02	0.03	0.06	0.06
Warranty	0.01	0.00	0.01	0.02
	<u>2.65</u>	<u>4.11</u>	<u>8.16</u>	<u>7.77</u>
SHAREHOLDERS' EQUITY				
Share capital	23.99	28.98	28.98	28.98
Contributed surplus	1.43	3.19	3.59	4.11
Deficit	(21.79)	(30.32)	(35.11)	(34.29)
	<u>3.63</u>	<u>1.85</u>	<u>(2.53)</u>	<u>(1.20)</u>
	<u>\$ 6.28</u>	<u>\$ 5.96</u>	<u>\$ 5.63</u>	<u>\$ 6.57</u>

Figure 4. Balance Sheet
Source. Company reports, Research Capital estimates



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3. The research analyst or a member of the research analyst's household owns shares and/or options to acquire shares of the subject issuer.
4. As at this date, Jacques Kavafian made several visits to AeroMechanical's headquarters in Calgary at Research Capital Corporation's expense.

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