

AEROMECHANICAL SERVICES LTD.

AMA-TSX: \$0.18 — BUY

TARGET PRICE: \$0.65; PROJECTED RETURN: 261%

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AEROMECHANICAL UPDATE – OUTLOOK REMAINS POSITIVE

EVENT – STATUS UPDATE

AeroMechanical announced that Shanghai Airlines has installed its second AFIRS unit on Boeing B767. In addition, AeroMechanical held a seminar with various airlines to introduce its new fuel management program, which was received with overwhelming positive response.

IMPACT – INCREASED SALES ACTIVITY EXPECTED

We believe that AeroMechanical's (AMS) outlook continues to be positive, particularly with its new fuel management program which we estimate could save airlines \$0.2-\$0.4 million per aircraft annually by identifying wasteful practices, monitoring fuel burn and calculating the savings or missed opportunities. The company has met with various airlines regarding its new program and has garnered positive feedback. This program will help make AFIRS a much more compelling product, not only by adding more revenue opportunities to AMS, but also by increasing the company's profile in the industry, leading, we believe, to more sales of its AFIRS product. Although fuel prices have declined recently, the rapid rise of fuel last summer caught many airlines off-guard, and many are taking steps to protect against future increases in fuel prices and reduce operating costs.

VALUATION – REMAINS THE SAME

Our target price remains at \$0.65 (Figure 1) as we value the shares based on 15 times estimated 2010 EBITDA. It should be noted that AeroMechanical has 515 aircraft under contract from China, which are not included in our estimates. The company's backlog excluding those from China is of 125 units on an installed base of 150 units. Once installation pace picks up, we may raise the multiple.

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 new target price of \$0.65 provides nearly a 4-fold 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.

Financial Metrics (US\$)

Share Price:	\$0.18	Basic Sh. O/S (mm):	82.5
Target:	\$0.65	FD Shares (mm):	90.0
Return:	261%	Market Cap (mm):	\$14.9
Div/Distn:	N/A	Enterprise Val (mm):	\$10.7
Yield:	N/A	52 Wk. Low-High:	\$0.11-\$1.48

FY Dec.-31	F2007A	F2008E	F2009E	F2010E
Revenue (mm)	\$2.0	\$3.3	\$8.8	\$24.5
EV/S	5.4x	3.3x	1.2x	0.4x

Quarterly EPS per Share

	F2007A	F2008E	F2009E	F2010E
Q1	-0.01	-0.03	-0.01E	0.00E
Q2	-0.03	-0.03	-0.01E	0.00E
Q3	-0.03	-0.02	-0.01E	0.01E
Q4	-0.04	-0.02E	-0.01E	0.01E
Fiscal year total	-0.11	-0.10	-0.04	0.03
P/E	n.m.	n.m.	n.m.	6.0x

Target Valuation Parameter

15 x 2010 EV/EBITDA



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.

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ANALYSIS

AeroMechanical Services EV/EBITDA Valuation

Valuation of Aeromechanical

Estimated 2010 EBITDA	\$	3.5	million
At 15 times EBITDA	\$	52.0	million
Less Net Debt			
Current portion of loans payable	\$	0.0	million
Long-term portion of loans payable	\$	0.2	million
Cash	\$	0.2	million
	\$	0.1	million
Market Value of Equity	\$	51.9	million
Common Shares Outstanding		82.5	million
Market Value per Share	\$	0.63	Per share

Figure 1. Valuation
Source. Research Capital estimates

Installation of AFIRS on the second Shanghai Airlines aircraft completed on February 4. These represent the first installations to enter into revenue service under the agreement signed in 2006 between AeroMechanical and Sky Blue Technology, its customer in China. Under the 8-year term contract, a total of 515 aircraft have been contracted to have AFIRS installed. If AeroMechanical completes the installations and provides service for the full term of the contract, the agreement could generate \$35 million in revenues to the end of 2010 and about \$15 million per year for the remainder of the contract. We note that the timing of such installations at this time remains very uncertain and hence we have not included installations from China in our forecasts. If further orders are received, we will then review our target price and recommendation with a possible view of an upgrade.

AeroMechanical's new fuel management program, we believe, could be a homerun because the cost-saving opportunities to airlines are too great to be ignored, even at low fuel prices. It is expected that this program could save airlines \$0.2-\$0.4 million per aircraft annually. We believe that fuel management will become a critical element of the airline business from 2010 because the European Union will implement a carbon tax. AeroMechanical's AFIRS is, we believe, one of the few products that can precisely measure fuel consumption, ensuring that airlines not overpay the carbon tax. AMS estimates that airlines could save between \$50 to \$100 per flight hour using AFIRS and implementing its fuel-savings program. We have seen a demonstration of the software and the conclusion we draw is that the product is convincing. With the average aircraft flying about 4,000 hours per year, this equates to a savings of between \$0.2 million to \$0.4 million per aircraft per year. This program is particularly attractive to existing AFIRS users as such customers do not have to pay any additional upfront costs as the program uses data that is already provided by AFIRS box.

The company is refocusing its sales efforts and bringing in new sales people to market its services to the CEO level or key decision makers of airlines. Until recently, its sales efforts have been disappointing despite the significant cost savings to airlines. We believe this was so because the marketing efforts were made towards the maintenance people and engineers, which are lower in the corporate food chain. By refocusing and directly showing top management the cost savings that could be achieved from AFIRS, we believe more AFIRS units will be sold, particularly in the current environment whereby airlines are trying to find ways to cut costs.

New customers could include current ACARS users such as Air Canada and WestJet. With the benefits of its fuel-savings solution now convincingly demonstrated, AMS will be able to go after legacy carriers that currently use the older system known as ACARS. Air Canada, as an example, a user of ACARS, is looking at every way of improving costs. However, even with its powerful technology systems and size, AMS's AFIRS could be able to detect cost-saving areas within Air Canada that the company may not even be aware of the waste. In addition to fuel, which by the way every airline thinks it knows where to save fuel, unless they have AFIRS installed there is a lot of fuel they may be wasting without knowing it. Single engine taxi, weight reduction, slower speed, and reduced usage of the auxiliary power unit are all well known methods, but the exact fuel consumption of each element can only be guessed. AFIRS can measure those and much more very precisely that airlines without AFIRS cannot. It is important to note that a 1% fuel-burn savings equates to a company like Air Canada of \$25 million before taxes, assuming fuel at \$0.70 a litre. The potential savings to Air Canada could be much greater, and that's just on fuel.

Another potential cost saving that companies currently using the ACARS system cannot afford to ignore is the potential from precisely calculating OOOI times (On, Out, Off, In). OOOI time is very important because a lot of an airline's expenses are based on that. This determines crew pay, aircraft and engine reserves, and auxiliary power unit reserves. Without having exact times, airlines may be off by 5 minutes per cycle or up to 20 minutes off per day per aircraft and thus overpay their crew or the rent on aircraft and engines. Taking 10 minutes as an example may not sound like much, but if an airline has 5,000 pilots each inflating their work day by 10 minutes, and assuming 900 hours annual stick time, the airline may be employing 675 more pilots than it actually needs. This waste also extends to cabin crew. Furthermore, the aircraft's usage would be over-allotted by 10 minutes per day, taking the aircraft into maintenance sooner than required. The savings arising by calculating OOOI times accurately can easily amount to a further \$50 per flight hour -- \$0.2 million per plane or higher. In a difficult economy, no airline can afford to ignore cost savings, particularly meaningful savings that AeroMechanical affords. When combining OOOI time savings and fuel savings, AFIRS

can provide stunning cash-cost economies of up to \$500,000 per year per aircraft. Considering that airlines are removing magazines and foot rests from aircraft to reduce weight and thus fuel burn, AeroMechanical provides an opportunity to lower costs in a meaningful way.

The savings we describe above ignore, for the moment, the very high cost of transmitting data using existing ACARS system on the Arinc network, which most legacy airlines use. AMS's AFIRS uses the Iridium satellite network and it is designed to send messages using smaller packets of data, and some airlines that we have spoken with claim that this savings alone makes AFIRS worthwhile, even disregarding the fuel and OOOI time calculation.

Another critical benefit of AFIRS that is not necessarily measurable in dollars and cents is the satellite phone with 100% coverage around the world. Many large legacy airlines presently may go through patches of the planet without communication capability because ground antennas may not be present. AMS's AFIRS provides affordable satellite phone to its airline users, and many customers, such as Shanghai Airlines and Zoom until it went bankrupt, use AFIRS as a communications device. Given all these benefits, we believe that airlines using ACARS may be persuaded to use AFIRS in parallel, thus dramatically expanding AMS's market presence.

AMS currently has 150 installed units and this number will grow as the company brings its backlog into service. However, given that the company initially focused on smaller and new airlines because those airline did not have ACARS and thus were easier to capture, those same airlines may be at greater risk in this tough economic times. Some of its existing customers such as CanJet and Sunwing are growing and thus may buy more AFIRS units; others may contract or go out of business. This makes it critical for the company to go after larger airlines, and its new fuel management program is the product that takes this over the hump and be competitive even with those using ACARS.

We continue to recommend buying AeroMechanical at these levels. Full efforts are being made to make the company cash-flow positive by the third quarter of 2009 through the acceleration of installations of outstanding orders. The company presently has a backlog of 125 units on top of the 150 installed base. Its present backlog is sufficient to get the company to a cash-flow positive state; however, it has several ongoing sales campaigns around the world, such that we expect this backlog to grow this year. **A critic 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\$)	2005	2006	2007	2008				2008E	2009				2009E	2010				2010E	
				Q1	Q2	Q3	Q4E		Q1E	Q2E	Q3E	Q4E		Q1E	Q2E	Q3E	Q4E		
Assumptions:																			
AFIRS installed units, beginning of period			66	94	77	111	132	67	157	192	227	252	157	292	371	511	590	292	
AFIRS units installed during period			28	10	34	21	25	90	35	35	25	40	135	40	70	40	40	190	
AFIRS units installed during period under new acctg rule			0	0	0	0	0	0	0	0	0	0	0	39	70	39	39	187	
AFIRS installed units, end of period			94	104	111	132	157	157	192	227	252	292	292	371	511	590	669	669	
Revenues as reported:																			
Rental revenue	0.34	0.60	0.71	0.27	0.326	0.44	1.18	2.22	1.49	1.78	2.02	2.32	7.61	4.16	6.13	6.10	6.80	23.19	
Year-over-year	2028.9%	76.4%	17.3%	92.2%	70.5%	71.6%	882.0%	213.3%	450.2%	446.6%	358.6%	95.9%	242.6%	179.6%	243.7%	202.0%	193.2%	204.7%	
Sales revenue	0.17	0.49	1.28	0.13	0.27	0.35	0.31	1.06	0.16	0.33	0.41	0.32	1.23	0.17	0.35	0.44	0.34	1.29	
Year-over-year	77.8%	190.2%	161.4%	-81.7%	-4.2%	524.2%	26.0%	-17.5%	24.1%	22.3%	18.6%	5.0%	16.3%	5.0%	5.0%	5.0%	5.0%	5.0%	
	0.51	1.09	1.99	0.40	0.596	0.79	1.49	3.28	1.65	2.11	2.44	2.64	8.84	4.32	6.48	6.54	7.14	24.48	
Cost of sales	0.42	0.73	1.35	0.34	0.71	0.26	0.70	2.01	0.71	0.93	1.02	1.12	3.78	2.37	3.88	3.15	3.30	12.70	
Gross margin	0.09	0.37	0.64	0.06	(0.12)	0.53	0.80	1.27	0.93	1.19	1.41	1.52	5.06	1.96	2.59	3.39	3.84	11.78	
Gross margin as %	18.0%	33.4%	32.1%	14.7%	-19.5%	67.0%	53.4%	38.7%	56.8%	56.2%	58.0%	57.6%	57.2%	45.3%	40.0%	51.9%	53.8%	48.1%	
Expenses:																			
Salaries and benefits	1.62	2.19	4.10	1.20	1.21	1.24	1.24	4.89	1.20	1.21	1.24	1.24	4.89	1.22	1.23	1.26	1.25	4.96	
Marketing	0.19	0.60	1.08	0.28	0.27	0.24	0.29	1.08	0.30	0.30	0.30	0.30	1.20	0.28	0.28	0.28	0.28	1.12	
Stock-based compensation	0.08	0.46	0.53	0.03	0.55	0.09	0.05	0.72	0.14	0.14	0.14	0.14	0.54	0.14	0.14	0.14	0.14	0.54	
Research and development	0.19	0.39	0.25	0.08	0.07	0.34	0.05	0.54	0.10	0.10	0.10	0.10	0.38	0.09	0.09	0.09	0.09	0.34	
General and administrative	0.00	0.00	1.40	0.50	0.43	0.34	0.40	1.67	0.35	0.35	0.35	0.35	1.38	0.34	0.34	0.34	0.34	1.35	
Depreciation	0.03	0.06	0.09	0.04	0.04	0.05	0.04	0.17	0.04	0.04	0.04	0.04	0.16	0.04	0.04	0.04	0.04	0.16	
Interest and bank charges	0.30	0.03	0.02	0.01	0.01	0.01	0.01	0.04	0.01	0.01	0.01	0.01	0.02	0.01	0.01	0.01	0.01	0.02	
Foreign exchange currency loss	0.00	0.02	0.04	0.00	0.01	0.02	0.00	0.04	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Stock exchange fees	0.03	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Third-party contracts	0.09	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Other	0.02	0.00	0.00	0.01	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
	3.23	4.90	7.50	2.15	2.59	2.34	2.07	9.15	2.12	2.13	2.16	2.16	8.57	2.10	2.11	2.14	2.14	8.49	
Earnings before taxes	(3.13)	(4.54)	(6.87)	(2.09)	(2.71)	(1.81)	(1.27)	(7.88)	(1.19)	(0.95)	(0.75)	(0.63)	(3.52)	(0.15)	0.48	1.25	1.71	3.29	
Income taxes	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.17	0.44	0.60	1.20	
Net income (loss)	\$ (3.13)	\$ (4.54)	\$ (6.87)	\$ (2.09)	\$ (2.71)	\$ (1.81)	\$ (1.27)	\$ (7.88)	\$ (1.19)	\$ (0.95)	\$ (0.75)	\$ (0.63)	\$ (3.52)	\$ (0.15)	\$ 0.31	\$ 0.81	\$ 1.11	\$ 2.09	
Basic EPS	\$ (0.17)	\$ (0.13)	\$ (0.11)	\$ (0.03)	\$ (0.03)	\$ (0.02)	\$ (0.02)	\$ (0.10)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.04)	\$ (0.00)	\$ 0.00	\$ 0.01	\$ 0.01	\$ 0.03	
Diluted EPS	\$ (0.17)	\$ (0.13)	\$ (0.11)	\$ (0.03)	\$ (0.03)	\$ (0.02)	\$ (0.02)	\$ (0.10)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.04)	\$ (0.00)	\$ 0.00	\$ 0.01	\$ 0.01	\$ 0.03	
Diluted EPS before one-time items	\$ (0.17)	\$ (0.13)	\$ (0.11)	\$ (0.03)	\$ (0.03)	\$ (0.02)	\$ (0.02)	\$ (0.10)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.04)	\$ (0.00)	\$ 0.00	\$ 0.01	\$ 0.01	\$ 0.03	
Weighted average common shares	20.1	45.1	64.3	82.2	82.2	82.3	82.5	82.3	82.5	82.5	82.5	82.5	82.5	82.5	82.5	82.5	82.5	82.5	
EBITDA	\$ (2.8)	\$ (4.4)	\$ (6.7)	\$ (2.0)	\$ (2.6)	\$ (1.7)	\$ (1.2)	\$ (7.6)	\$ (1.1)	\$ (0.9)	\$ (0.7)	\$ (0.6)	\$ (3.3)	\$ (0.1)	\$ 0.5	\$ 1.3	\$ 1.8	\$ 3.5	

Figure 2. Income Statement
Source: Research Capital estimates



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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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