

AEROMECHANICAL SERVICES LTD.

AMA-TSX: \$0.24 — **BUY**

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

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RAISING PROFILE TO A NEW LEVEL

EVENT – STRATEGIC MANUFACTURING AND MILITARY PARTNERSHIP

AeroMechanical (“AMS”) announced that it reached an agreement with Sierra Nevada Corporation (“SNC”), a prime systems integrator and electronic systems provider, to manufacture and market AMS’s AFIRS products under license to the U.S. military market.

IMPACT – INCREASED WORKING CAPITAL AND CASH EXPECTED

Under the agreement, SNC will (1) pay AMS a license fee and royalty on all future AFIRS sale to the military segment, (2) provide funds, personnel, and expertise, and (3) share other revenue opportunities with AMS stemming from the sale of AFIRS to military organizations. While the revenue potential from this is not disclosed, we believe there is an upfront cash component, as well as short-term license fee potential, which will allow AMS to meet its short-term working capital requirements, and the royalties will increase its recurring revenues. More importantly, AMS will gain greater credibility with large airlines because of the backing from SNC, a respected name in the aerospace field.

This agreement is very positive news for AMS, not only for the upfront cash component of the license, but because it also elevates the company’s profile.

VALUATION – REMAINS THE SAME

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

RECOMMENDATION – BUY

AMS 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 3-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:	\$0.24	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):	\$10.7
Yield:	N/A	52 Wk. Low-High:	\$0.11-\$1.15

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.	8.0x

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

AeroMechanical Services Ltd. Consolidated Statement of Earnings

For the year ended December 31 (in millions C\$)	2005	2006	2007	2008E	2009E	2010E
Assumptions:						
AFIRS installed units, beginning of period			66	67	157	292
AFIRS units installed during period			28	90	135	190
AFIRS units installed during period under new acctg rule			0	0	0	187
AFIRS installed units, end of period			94	157	292	669
Revenues as reported:						
Rental revenue	0.34	0.60	0.71	2.22	7.61	23.19
Year-over-year	2028.9%	76.4%	17.3%	213.3%	242.6%	204.7%
Sales revenue	0.17	0.49	1.28	1.06	1.23	1.29
Year-over-year	77.8%	190.2%	161.4%	-17.5%	16.3%	5.0%
	0.51	1.09	1.99	3.28	8.84	24.48
Cost of sales	0.42	0.73	1.35	2.01	3.78	12.70
Gross margin	0.09	0.37	0.64	1.27	5.06	11.78
Gross margin as %	18.0%	33.4%	32.1%	38.7%	57.2%	48.1%
Expenses:						
Salaries and benefits	1.62	2.19	4.10	4.89	4.89	4.96
Marketing	0.19	0.60	1.08	1.08	1.20	1.12
Stock-based compensation	0.08	0.46	0.53	0.72	0.54	0.54
Research and development	0.19	0.39	0.25	0.54	0.38	0.34
General and administrative	0.00	0.00	1.40	1.67	1.38	1.35
Depreciation	0.03	0.06	0.09	0.17	0.16	0.16
Interest and bank charges	0.30	0.03	0.02	0.04	0.02	0.02
Foreign exchange currency loss	0.00	0.02	0.04	0.04	0.00	0.00
Stock exchange fees	0.03	0.01	0.00	0.00	0.00	0.00
Third-party contracts	0.09	0.00	0.00	0.00	0.00	0.00
Other	0.02	0.00	0.00	0.01	0.00	0.00
	3.23	4.90	7.50	9.15	8.57	8.49
Earnings before taxes	(3.13)	(4.54)	(6.87)	(7.88)	(3.52)	3.29
Income taxes	0.00	0.00	0.00	0.00	0.00	1.20
Net income (loss)	\$ (3.1)	\$ (4.5)	\$ (6.9)	\$ (7.9)	\$ (3.5)	\$ 2.1
Basic EPS	\$ (0.17)	\$ (0.13)	\$ (0.11)	\$ (0.10)	\$ (0.04)	\$ 0.03
Diluted EPS	\$ (0.17)	\$ (0.13)	\$ (0.11)	\$ (0.10)	\$ (0.04)	\$ 0.03
Diluted EPS before one-time items	\$ (0.17)	\$ (0.13)	\$ (0.11)	\$ (0.10)	\$ (0.04)	\$ 0.03
Weighted average common shares	20.1	45.1	64.3	82.3	82.5	82.5
EBITDA	\$ (2.8)	\$ (4.4)	\$ (6.7)	\$ (7.6)	\$ (3.3)	\$ 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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