Research Capital
innovation and execution

AIRLINES & AEROSPACE **25 MAY 2009**

AEROMECHANICAL SERVICES LTD.

AMA-TSX: $0.25 — **BUY**

TARGET PRICE: $0.65; PROJECTED RETURN: 160%

JACQUES KAVAFIAN 416.860.7797
jacques.kavafian@researchcapital.com
Susan Cheng ASSOCIATE 416.860.7648

AEROMECHANICAL Q1/F09 UPDATE

EVENT – AEROMECHANICAL PROVIDES FIRST QUARTER UPDATE

- Installed nine AFIRS units, below our estimate of 25 installations, as airlines are deferring spending due to the current economic slowdown.
- Revenues grew to $1.25 million, although below our estimate of $1.7 million, versus Q1/F08 revenues of $0.4 million, largely due to increased monthly recurring revenue.
- EBITDA loss of $(1.3), inline with our expectations of $(1.4) million, versus $(2.0) million for the same quarter last year.

IMPACT – NO CHANGE TO ANNUAL INSTALLATION FORECASTS

While the company installed lower-than-expected AFIRS units this quarter, we believe that the pace should pick up in the latter part of the year as airlines start to gain the benefit of lower oil prices as their hedges roll off, thus helping their bottom lines. In addition, we believe that airline traffic may be stabilizing due to encouraging signs from China and the Middle East. The company now has 160 units installed and we continue to expect a total of 75 units to be installed in F2009 and 88 units in F2010. Our EBITDA estimates for F2009 and F2010 are $(4.6) million and $1.5 million, respectively.

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 nearly a 160% 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 160 units installed.

Financial Metrics (US$)

Share Price:	$0.25	Basic Sh. O/S (mm):	82.5
Target:	$0.65	FD Shares (mm):	90.0
Return:	160%	Market Cap (mm):	$20.6
Div/Distn:	N/A	Enterprise Val (mm):	$20.2
Yield:	N/A	52 Wk. Low-High:	$0.105-$0.97

FY Dec.-31	**F2007A**	**F2008A**	**F2009E**	**F2010E**
Revenue (mm)	$2.0	$3.2	$7.9	$16.4
EV/S	10.2x	6.4x	2.5x	1.2x
Quarterly EPS per Share				
Q1	-0.01	-0.03	-0.02	0.00E
Q2	-0.03	-0.03	-0.02E	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.

ANALYSIS

AeroMechanical reported first quarter earnings, but our focus is on the number of AFIRS units installed and revenue growth: The company reported its Q1/F09 results, a loss of $(0.02) per share, inline with our expectations, versus $(0.03) 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 160 as at the end of Q1/F09. It should be noted that the company installed a total of 193 AFIRS units, but we removed 33 units from that count because of the bankruptcy of Aloha Airlines and two other airlines. The company installed nine units in the quarter, below our expectations of 25, as airlines have deferred spending due to the economic slowdown. Nonetheless, we still expect a total of 75 units to be installed in F2009 and 88 units in F2010. While installations may continue to be slow in Q2, we anticipate that they should pick up in the latter part of the year as we believe airline traffic may be stabilizing and that many airlines are now realizing the full benefits of lower fuel prices as unfavourable hedges start to roll off, thus helping their bottom lines. Airlines are more prone to increase capital spending when they are profitable.

EBITDA in the quarter came in at a loss of $(1.3) million, inline our expectations of $(1.4) million. During the quarter, research and development expenses were high, coming in at $0.2 million, compared to $0.08 million in the same quarter last year, due to the introduction 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 future quarters. We expect margins for the remaining quarters in F2009 to be about 40% as Q1/F09 margins benefited from greater consulting revenues. Going forward, we anticipate margins to improve because of a larger number of installed base and also because of contribution from sales of its fuel management program.

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.

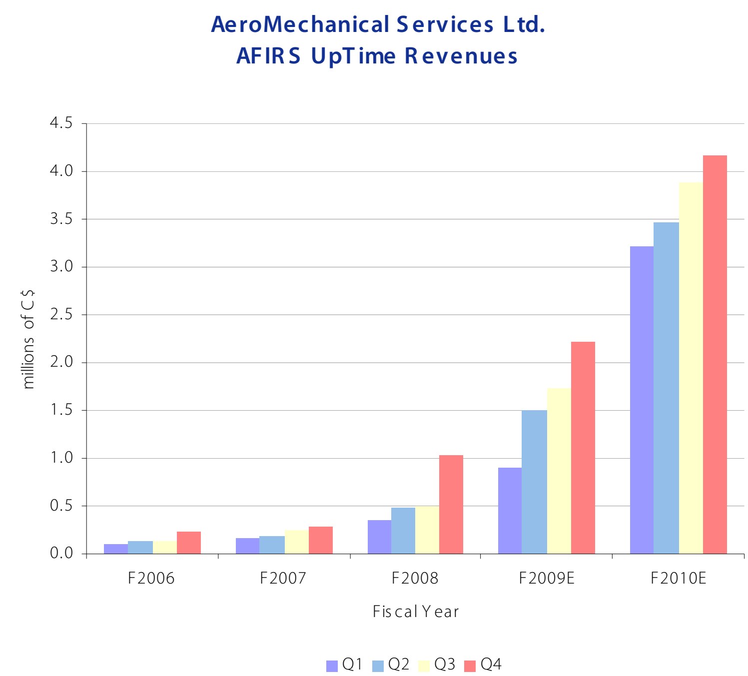

Figure 1. AFIRS UpTime Revenues
Source. Company reports, Research Capital estimates

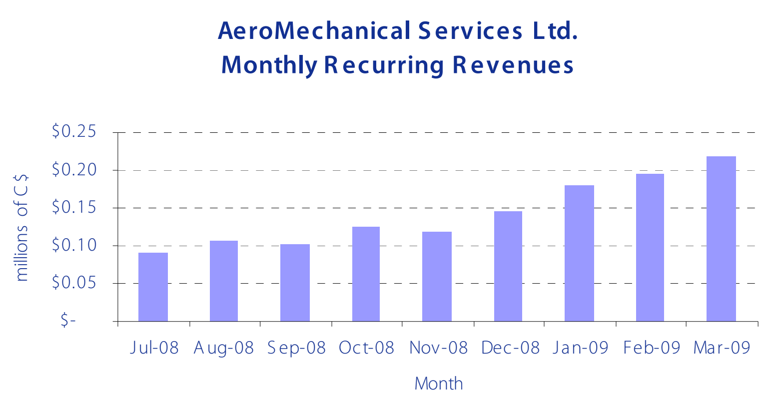

Figure 2. Monthly Recurring Revenues
Source. Company report

High oil prices should help airlines re-engage into thinking of ways to reduce fuel burn. And that is good news for AeroMechanical's fuel management program. Since oil prices had retreated from the highs of last year to US$40, airlines used that to augment their profitability and became largely complacent about the cost of fuel. However, with oil prices now back over $60 a barrel, airlines would now start thinking of the worst in case oil goes back over $100. We believe this fear will make airlines take pre-emptive action to shield themselves in case of another oil shock. AeroMechanical can help airlines reduce fuel burn 3% to 5% and in some cases even more. This could amount to savings of $200,000 or more per plane per year.

Financial position: At March 31, 2009, AeroMechanical had $0.57 million in cash and $2.1 million in inventory consisting mainly of AFIRS boxes and wiring which should be converted into cash as the boxes are delivered for installations. AeroMechanical has no debt to speak of, with only $0.38 million in government loans and equity of $0.55 million. We believe that the company should be able to meets its near-term working capital requirements as its contracts have an upfront cash component, as well as by converting some of its inventory into cash. 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.

However, we believe that if the pace of installations do not pick up or if existing customers do not sign on to its FIRST fuel management program, AeroMechanical may need to raise more capital at the latest by September 2009.

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 in F2010 through the acceleration of installations of outstanding orders. The company presently has a backlog of 67 units, on top of the 160 installed base. The company has several ongoing sales campaigns around the world, such that we expect this backlog to continue to grow, although at a slower pace than previously anticipated. **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$)	2005	2006	2007	2008	2009E	2010E
Assumptions:						
AFIRS installed units, beginning of period			*66*	*61*	*151*	*226*
AFIRS units installed during period			*28*	*90*	*75*	*40*
AFIRS units installed during period under new acctg rule			*0*	*0*	*0*	*48*
AFIRS installed units, end of period			*94*	*151*	*226*	*314*
AFIRS UpTime revenue	0.34	0.60	0.71	2.02	6.34	14.73
Year-over-year	*2028.9%*	*76.4%*	*17.3%*	*184.2%*	*214.8%*	*132.2%*
Sales revenue	0.17	0.49	1.28	1.16	1.58	1.67
Year-over-year	*77.8%*	*190.2%*	*161.4%*	*-9.3%*	*36.1%*	*5.7%*
Total revenues	**0.51**	**1.09**	**1.99**	**3.18**	**7.93**	**16.40**
Cost of sales	0.42	0.73	1.35	2.16	4.57	6.94
Gross margin	**0.09**	**0.37**	**0.64**	**1.02**	**3.35**	**9.47**
Gross margin as %	**18.0%**	**33.4%**	**32.1%**	**32.0%**	**42.3%**	**57.7%**
Expenses:						
Salaries and benefits	1.62	2.19	4.10	5.16	4.43	4.51
Marketing	0.19	0.60	1.08	1.01	0.89	1.00
Stock-based compensation	0.08	0.46	0.53	0.70	0.50	0.52
Research and development	0.19	0.39	0.25	0.75	0.48	0.34
General and administrative	0.00	0.00	1.40	1.50	1.70	1.60
Depreciation	0.03	0.06	0.09	0.17	0.15	0.16
Interest and bank charges	0.30	0.03	0.02	0.04	0.03	0.03
Foreign exchange currency loss	0.00	0.02	0.04	0.02	0.00	0.00
Stock exchange fees	0.03	0.01	0.00	0.00	0.00	0.00
Third-party contracts	0.09	0.00	0.00	0.00	0.00	0.00
Other	0.02	0.00	0.00	0.18	0.00	0.00
	3.23	4.90	7.50	9.54	8.19	8.17
Earnings before taxes	(3.13)	(4.54)	(6.87)	(8.52)	(4.83)	1.30
Income taxes	0.00	0.00	0.00	0.00	0.00	0.49
Net income (loss)	**$ (3.1)**	**$ (4.5)**	**$ (6.9)**	**$ (8.5)**	**$ (4.8)**	**$ 0.8**
Basic EPS	$ (0.17)	$ (0.13)	$ (0.11)	$ (0.10)	$ (0.06)	$ 0.01
Diluted EPS	$ (0.17)	$ (0.13)	$ (0.11)	$ (0.10)	$ (0.06)	$ 0.01
Diluted EPS before one-time items	**$ (0.17)**	**$ (0.13)**	**$ (0.11)**	**$ (0.10)**	**$ (0.06)**	**$ 0.01**
Weighted average common shares	20.1	45.1	64.3	82.3	82.5	82.5
EBITDA	**$ (2.8)**	**$ (4.4)**	**$ (6.7)**	**$ (8.1)**	**$ (4.6)**	**$ 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$)	2005	2006	2007	2008	2009E	2010E
ASSETS						
Current:						
Cash and cash equivalents	$ 0.08	$ 2.69	$ 1.95	$ 0.80	$ 0.35	$ 0.59
Restricted cash	0.00	0.28	0.28	0.25	0.25	0.25
Accounts receivable	0.18	0.29	0.62	1.16	1.20	1.50
Prepaid expenses	0.05	0.23	0.35	0.31	1.17	0.86
Inventory	0.28	0.43	1.81	1.79	1.80	1.50
	0.60	3.93	5.01	4.32	4.77	4.70
Capital assets	0.12	0.22	0.25	0.26	0.38	0.40
Rental assets	0.67	0.77	0.98	1.35	1.50	1.98
Intangible assets	0.00	0.03	0.03	0.03	0.03	0.03
	$ 1.39	**$ 4.95**	**$ 6.28**	**$ 5.96**	**$ 6.69**	**$ 7.12**
LIABILITIES						
Current:						
Accounts payable and accrued liabilities	1.39	0.50	1.22	1.56	4.50	4.00
Current portion of unearned revenue	0.03	0.10	0.23	1.29	1.50	1.00
Current portion of deferred lease inducement	0.00	0.01	0.01	0.00	0.00	0.00
Current portion of loans payable	0.08	0.12	0.05	0.11	0.04	0.04
Current portion of obligation under capital lease	0.00	0.02	0.02	0.02	0.04	0.03
	1.51	0.75	1.54	2.98	6.08	5.07
Unearned revenue	0.22	0.29	0.69	0.81	2.84	3.05
Deferred lease inducement	0.00	0.02	0.00	0.00	0.00	0.00
Loans payable	1.39	0.35	0.38	0.29	0.20	0.10
Obligation under capital lease	0.00	0.03	0.02	0.03	0.04	0.04
Warranty	0.01	0.01	0.01	0.00	0.01	0.02
	3.13	1.45	2.65	4.11	9.17	8.27
SHAREHOLDERS' EQUITY						
Share capital	8.38	17.05	23.99	28.98	28.98	28.98
Contributed surplus	0.27	1.38	1.43	3.19	3.68	4.20
Deficit	(10.39)	(14.93)	(21.79)	(30.32)	(35.15)	(34.34)
	(1.74)	3.51	3.63	1.85	(2.48)	(1.15)
	$ 1.39	**$ 4.95**	**$ 6.28**	**$ 5.96**	**$ 6.69**	**$ 7.12**

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

RELEVANT DISCLOSURES APPLICABLE TO: AEROMECHANICAL SERVICES LTD.

LIST OF DISCLOSURE TERMS:

1. Within the last 3 years, Research Capital Corporation has managed or co-managed an offering of securities by the subject issuer.
2. Within the last 3 years, Research Capital Corporation has received compensation for investment banking and related services from the subject issuer.
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.

ANALYST CERTIFICATION

Each analyst of Research Capital Corporation whose name appears in this report hereby certifies that (i) the recommendations and opinions expressed in this research report accurately reflect the analyst's personal views and (ii) no part of the research analyst's compensation was or will be directly or indirectly related to the specific conclusions or recommendations expressed in this research report.

Toronto 416.860.7600 Montreal 514.399.1500 Vancouver 604.662.1800 Calgary 403.265.7400 Regina 306.566.7550