

AEROMECHANICAL SERVICES LTD.

AMA-TSX V: \$0.46 — **BUY**

TARGET PRICE: \$1.50; PROJECTED RETURN: 226%

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RAISING TARGET PRICE FROM \$0.65 TO \$1.50

EVENT – AFIRS BECOMING A VALUABLE AIRLINE TOOL

As part of its strategy of increasing functionality of its AFIRS box, AeroMechanical entered into an agreement with GuestLogix Inc. (GX1-TSX V) to allow airline customers to process real-time credit and debit card transactions during flights, using AeroMechanical's real-time satellite technology. We are raising our target price from \$0.65 to \$1.50.

IMPACT – ANOTHER USE OF AEROMECHANICAL'S SERVICES

With mechanical health monitoring, fuel management, data streaming in case of emergency, and now real-time credit card validation, we believe that airlines now have more reasons to consider installation of AFIRS. GuestLogix already has, as customers, some of the world's top airlines, including all the big airlines in the U.S.

The focus of AeroMechanical thus far has been all aspects of an airplane in front of the cockpit door. This agreement extends the focus to the passenger cabin, an area where many airlines are emphasizing, given the environment of low ticket prices, to generate increased revenues. In addition, the press release announcing this agreement emphasizes China, which leads us to believe that there could potentially be an order announcement coming from China.

This is just another reason, combined with the data streaming technology, that we believe takes AeroMechanical's profile to new heights and we believe this could eventually translate into OEM involvement, making installations easier and thus substantially lowering installation costs, which in our view have been an impediment to growth.

VALUATION – BASED ON LONG-TERM P/E RATIO

Based on earnings potential of \$0.24 in 2013 (see discussion on next page) discounted at 25%, we derive a target price of \$1.50 per share.

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 provides 226% 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 231 units under contract, with 183 units installed.

Financial Metrics (US\$)

Share Price:	\$0.46	Basic Sh. O/S (mm):	90.0
Target:	\$1.50	FD Shares (mm):	96.0
Return:	226%	Market Cap (mm):	\$414
Div/Distn:	N/A	Enterprise Val (mm):	\$19.4
Yield:	N/A	52 Wk. Low-High:	\$0.105-\$0.48

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

20 x 2013 EPS discounted at 25%



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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With the recent spotlight on the use of data streaming via satellite to provide real-time flight information to ground stations, we believe that airlines and aircraft manufacturers may be interested in AFIRS as a means of augmenting the black box, which could substantially increase AeroMechanical's order backlog and profitability.

All the new features added to the AFIRS box have another benefit. AFIRS was first conceived as a maintenance tool targeted to the mechanics. However, maintenance operations departments have been the biggest targets for cost-cutting in non-essential functions. The fuel management program, data streaming, and now credit card validation bring the decision-making to other departments that are not as budget-constrained. Credit card validation, which falls under the marketing department, is especially favoured as a means of achieving higher revenues to airlines and thus could have access to a larger budget.

We are raising our target price to take into account all the latest functionality of AFIRS and the recent equity issue whereby the company raised \$1.67 million, of which \$167,000 was subscribed by insiders and employees. We believe this additional cash gives the company sufficient time to garner orders.

Until now we had valued AeroMechanical at 3 times 2010 revenues, but we believe this understates the company's potential. The market in which AeroMechanical operates consists of 51,000 western-built civilian aircraft, in addition to as many military aircraft. To illustrate the profit potential, if AeroMechanical were to gain 5,000 installations and generate an average of US\$2,000 in revenue per month, it would generate annual revenues of US\$120 million only from monthly recurring fees and at 75% margin, this would represent a pre-tax earnings of US\$90 million. The total potential revenue would be even greater due to the sales of AFIRS boxes, but even disregarding that, the potential profitability is US\$90 million.

At 5,000 installations, the company, we estimate, would have approximately 3% of the addressable market, including civilian and military.

Given this potential, we must look at the stock's potential based on a timeline that goes well beyond 2010. The technology is proven, as demonstrated by the 30 or so customers the company has. We believe that the pace of orders will accelerate as the company adds functionality and the economy improves. The possibility of one or more OEM involvement is increasingly likely. All these events, if they were to occur, would have an important positive impact on the share price.

We believe that AeroMechanical can have 2,000 units installed by 2013, from which it could generate \$0.24 earnings per share (each 1,000 units is \$0.12 per share). At that time, a high-growth company with vast potential could trade at 20 times future earnings or more for a price of \$4.80. Discounting this to present at 25% per year gives us a target price of \$1.50 per share.

AeroMechanical Services Ltd.
Consolidated Statement of Earnings

For the year ended December 31 (in millions C\$)	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
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
	7.50	9.54	8.11	7.88
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 1. Income Statement
Source. Company reports, 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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