



## AEROMECHANICAL SERVICES LTD.

AMA-TSX: \$0.39 — BUY

TARGET PRICE: \$0.65; PROJECTED RETURN: 67%

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### AFFORDABLE DATA STREAMING A REALITY

#### EVENT – AIRBUS SEEKS A MODERN ALTERNATIVE TO BLACK BOX

In France's *Le Monde* newspaper, Airbus' Chief is quoted in a September 4, 2009 article saying that Airbus wants an alternative to the flight data recorder known as the black box to allow for satellite data transmission.

#### IMPACT – OUTLOOK CONTINUES TO BE PROMISING

AeroMechanical Services has the technology to stream live data to a ground station in case of emergency, making the traditional black box redundant. This technology is presently in use on an aircraft and various tests showed its efficacy.

Although the breakthrough data streaming technology is unlikely to generate any revenue to AeroMechanical, the high profile the company achieves from media exposure, in our view, may result in orders for its AFIRS product.

#### 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 a 67% 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.

**Greater interest in data streaming could increase order pace:** In recent weeks, 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:	\$0.39	Basic Sh. O/S (mm):	82.5
Target:	\$0.65	FD Shares (mm):	90.0
Return:	67%	Market Cap (mm):	\$32.2
Div/Distrn:	N/A	Enterprise Val (mm):	\$19.4
Yield:	N/A	52 Wk. Low-High:	\$0.105-\$0.53

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](http://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.

This report has been created by Analysts that are employed by Research Capital Corporation, a Canadian Investment Dealer. For further disclosures, please see last page of this report.

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## AFIRS IS BECOMING AN INDISPENSABLE PRODUCT

In addition to the high profile garnered by its revolutionary technology allowing for data streaming during emergencies, AFIRS' primary benefits remain operating costs savings to airlines from maintenance related issues and fuel management. Those two items alone could save airlines anywhere from \$35 per hour to \$100 per flight hour or more. Considering that some aircraft types fly 4,000 hours or more per year, the annual savings per aircraft are substantial. AFIRS also has satellite telephone capability and many more services can be added over time. All this is provided with no coverage gaps anywhere in the world using the Iridium satellite network.

The original design of AFIRS was to obtain cost savings from maintenance, but this has been overshadowed by the overwhelming advantages of the fuel management program, satellite voice communications, and now data streaming. The estimated cost of installing an AFIRS unit (including labour) at approximately US\$100,000 earns a payback of about nine months because of the annual savings from all the services offered amount to over US\$400,000 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. Over time, it is likely that the company will add further functionality to constantly improve the product.

Although the current media frenzy is all about its live data streaming capability, that is not where we believe revenue will be generated. The article in *Le Monde* online appeared on September 4<sup>th</sup> in which Airbus CEO Thomas Enders is quoted as saying the black box is "obsolete." The article can be seen on the following link:

[http://www.lemonde.fr/societe/article/2009/09/04/airbus-envisage-la-fin-des-boites-noires\\_1235663\\_3224.html](http://www.lemonde.fr/societe/article/2009/09/04/airbus-envisage-la-fin-des-boites-noires_1235663_3224.html)

The reasons that we believe data streaming is unlikely to generate much revenue is that generally all airlines operate safely. And as such, they do not need data streaming on a recurring basis. Since the company only charges for services rendered and since data streaming would only be used in case of critical emergencies, a very unlikely occurrence, the revenue potential is negligible, if any. However, the service provides an attractive add-on to its existing services.

What's important about this technology is that it gives the company a high profile which also highlights the other benefits of AFIRS from which the company generates its revenue. The more people know about AFIRS, the likelihood of sales increases. AeroMechanical is a small company with limited means to advertise like first tier electronics suppliers. The media exposure provided by its data streaming technology is valuable from a marketing point of view.

**As the number of services provided by AFIRS continues to expand, the selling argument becomes easier to make, which we believe will make the company grow exponentially.**

**We continue to recommend buying AeroMechanical at these levels:** As the company becomes cash-flow positive through the acceleration of installations of outstanding orders, confidence in the execution should increase, resulting in a greater number of orders and higher share price. 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**

<b>For the year ended December 31 (in millions C\$)</b>	<b>2007</b>	<b>2008</b>	<b>2009E</b>	<b>2010E</b>
<b>Assumptions:</b>				
<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>
<b>Total revenues</b>	<b>1.99</b>	<b>3.18</b>	<b>6.99</b>	<b>15.83</b>
Cost of sales	1.35	2.16	3.67	6.66
<b>Gross margin</b>	<b>0.64</b>	<b>1.02</b>	<b>3.32</b>	<b>9.18</b>
<b>Gross margin as %</b>	<b>32.1%</b>	<b>32.0%</b>	<b>47.5%</b>	<b>58.0%</b>
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
<b>Net income (loss)</b>	<b>\$ (6.9)</b>	<b>\$ (8.5)</b>	<b>\$ (4.8)</b>	<b>\$ 0.8</b>
Basic EPS	\$ (0.11)	\$ (0.10)	\$ (0.06)	\$ 0.01
Diluted EPS	\$ (0.11)	\$ (0.10)	\$ (0.06)	\$ 0.01
<b>Diluted EPS before one-time items</b>	<b>\$ (0.11)</b>	<b>\$ (0.10)</b>	<b>\$ (0.06)</b>	<b>\$ 0.01</b>
Weighted average common shares	64.3	82.3	82.5	82.5
<b>EBITDA</b>	<b>\$ (6.7)</b>	<b>\$ (8.1)</b>	<b>\$ (4.5)</b>	<b>\$ 1.5</b>

Figure 1. Income Statement

Source: Company reports, Research Capital estimates

**AeroMechanical Services Ltd.  
Consolidated Balance Sheet**

<b>For the year ended December 31 (in millions C\$)</b>	<b>2007</b>	<b>2008</b>	<b>2009E</b>	<b>2010E</b>
<b>ASSETS</b>				
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>
<b>LIABILITIES</b>				
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>
<b>SHAREHOLDERS' EQUITY</b>				
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 2. 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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