

International Water-Guard Industries Inc. (TSX-V: IWG) – Q2 Revenues Inline; Slowdown Hits the Business Aviation Market

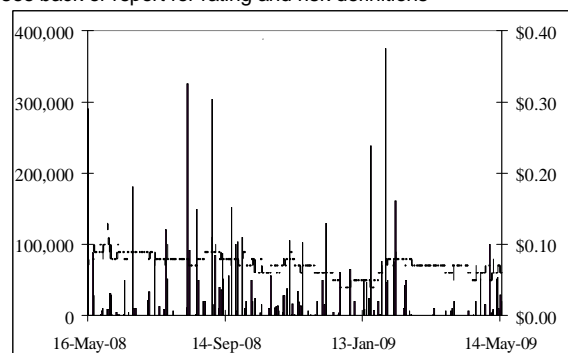
Sector/Industry: Aerospace Products and Services

www.water.aero

Market Data (as of May 20, 2009)

Current Price	C\$0.065
Fair Value	C\$0.30
Rating*	BUY
Risk*	3 (Average)
52 Week Range	C\$0.04 – C\$0.13
Shares O/S	39,340,694
Market Cap	C\$2.56 mm
Current Yield	N/A
P/E (forward)	N/A
P/B	1.01
YoY Return	-27.8%
YoY TSX-V	-59.2%

*see back of report for rating and risk definitions



Q2-2009 Highlights

- The global economic slowdown, credit crunch, and declining corporate profits is negatively impacting the business aviation sector. Q1-2009 shipments of business jets worldwide dropped by 35.7% YOY, from 297 to 191, according to the General Aviation Manufacturers Association. All major business jet manufacturers have significantly cut operations and production guidance for 2009.
- However, as we do not expect a prolonged recession in the developed economies, we expect the global business aviation sector to begin recovering by the end of this year.
- Q2 revenues were up 55% YOY, and were in line with our expectations. Improved revenues and gross margins, offset by an increase in operating costs, resulted in significant YOY improvements in EBITDA and EPS. IWG posted an EBITDA of \$0.08 million, and net profit of \$0.04 million (EPS: \$0.001) in Q2.
- Although Q2 revenues were inline with estimates, a softer outlook on the industry has prompted us to revise downward our revenue and EPS forecasts for 2009 and 2010.
- IWG continues to maintain a very healthy balance sheet. We do not expect any need for equity or debt financings in the near-future.

Financial Summary (YE Sept 30)

(C\$)	2006	2007	2008	2009E	2010E
Revenue	3,662,460	4,484,903	4,156,469	4,814,903	4,292,168
Gross Margin	59.92%	54.91%	53.75%	60.00%	54.75%
Net Income	404,545	808,147	(97,044)	51,225	101,153
EPS (basic)	0.01	0.02	(0.00)	0.00	0.00
Cash	133,529	438,932	940,302	883,007	1,099,857
Assets	1,505,304	2,486,701	2,941,421	2,926,360	3,003,400
Debt to Capital	9.21%	3.43%	3.44%	1.78%	0.83%
ROE	49.62%	53.24%	-4.41%	2.09%	3.95%
ROIC	49.05%	61.22%	-6.11%	3.19%	6.30%

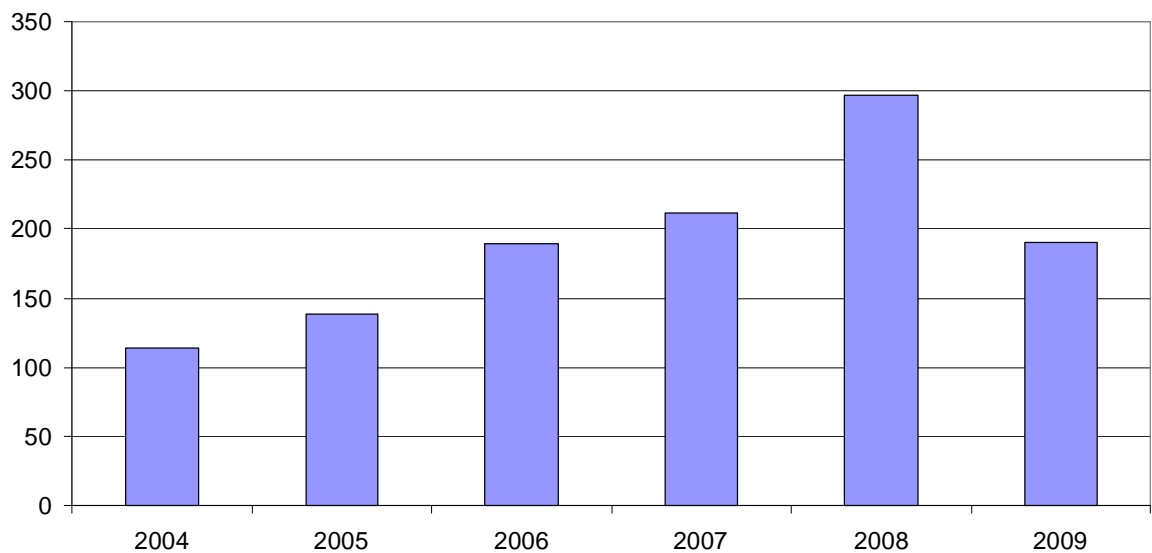
International Water-Guard Industries Inc. ("IWG"), based in Burnaby, BC, Canada, focuses on the design, manufacture, sale, and service of aircraft potable water treatment equipment and systems. IWG has been selling its products to corporate, VIP and military transport manufacturers/operators around the world since 1982. The company is now seeking to break into the largest market of the aircraft industry, the commercial airline sector.

**Slowdown Hits
the Business
Aviation
Market**

In our previous report in February 2009, we had discussed how the strength of the global economy, and corporate profits play a significant role in the growth of the global business jet sector. The global economic slowdown, credit crunch, and declining corporate profits is negatively impacting the business aviation market as customers defer/cancel deliveries due to lack of cash or to preserve cash.

Q1-2009 shipments of business jets worldwide dropped 35.7% YOY, from 297 to 191, according to the General Aviation Manufacturers Association. The following chart shows Q1 shipments since 2004. On a positive note, although Q1-2009 shipments were below 2007 and 2008 levels, they were still above levels seen from 2004 - 06.

Q1 Global Shipments of Business Jets



Source: GAMA

All major business jet manufacturers have significantly cut operations and production guidance for 2009. The following are some examples:

- Bombardier (TSX: BBD) has so far announced 4,400 job cuts (most of them were from business jets) in 2009, and now expects to deliver 25% fewer business jets (versus their previous forecast of 10%), primarily smaller jets, this year compared to last year.
- In March 2009, General Dynamics (NYSE: GD; Gulfstream is a unit of GD) announced it will cut production of large-cabin aircraft and green-aircraft deliveries from a projected rate of 94 to 73, and production of mid-sized aircraft from 30 to 24 in 2009. This move is expected to result in the layoff of 1,200 workers.

However, in early May 2009, Nicholas Chabraja, chairman and CEO of GD, noted that backlog has now stabilized (after they dropped from US\$22.5 billion at the end of 2008, to US\$20.7 billion at the end of March 2009) and that conditions have materially improved since February 2009, noting a rise in flying hours, a thawing pre-owned market and

increased customer interest.

- Textron Inc.'s (Cessna Aircraft Company is a unit of Textron Inc. - NYSE: TXT) cut their workforce by about 30%.
- In April 2009, NORDAM (aerospace component manufacturer with operations in Europe, Singapore and Mexico) announced it is laying off about 140 people at its business jet cabinetry factory in Wichita.

The above clearly indicate that the industry is preparing for a slowdown, which we believe will negatively impact IWG. Although a large order backlog (offset by cancellations and deferrals) will support near-term momentum, we expect 2010, and 2011, to be very challenging for the industry as we expect a significant drop in orders in 2009-10 from 2007-08 levels.

However, as we do not expect a prolonged recession in developed economies, we expect the global business aviation sector to start recovering by the end of this year. We have maintained our positive long-term outlook on the sector based on a resumption in global economic growth and business jet aircraft delivery forecasts. A few factors that we believe help IWG in this downturn are:

- In January 2009, the company announced that it was holding more than \$3 million in shipments and backlog for the year. We believe the backlog, offset by cancellations and deferrals, will support near-term momentum.
- The cut in operations in the large business jet sector (most of IWG's customers are in this sector) has not been as bad as we have seen so far in the low end markets. Although this is encouraging for IWG, considering the soft near-term outlook on the industry, it is likely that the large business jets sector could be negatively impacted going forward.
- The slowdown in the sector is leading to growth in the emergence of used business aircraft, which we believe will benefit IWG.

In addition, IWG continues to work on the development of products for complementary aviation markets to expand its offerings to aircraft operators.

Review of Q2-2009 results

Q2 revenues were up 55% YOY, increasing from \$0.86 million to \$1.33 million, and were in line with our expectations. Revenues were up 49% YOY in the first six months of FY2009. However, revenues in FY2009 are not really comparable to FY2008, as revenues in the first half of 2008 were unusually low due to short-term delays in orders from a major customer. In comparison to revenues in Q2 2007, and the first six months of FY2007, revenues in Q2-2009, and the first six months of FY2009, grew at a compounded annual growth rate (CAGR) of 7.4% and 8.4%, respectively, in line with our annual forecast for FY2009.

	Q2-2007	Q2-2008	Q2-2009	2007 (6 mo)	2008 (6 mo)	2009 (6 mo)
Sales	\$1,149,646	\$856,064	\$1,325,494	\$2,163,330	\$1,710,448	\$2,540,410
Growth YOY	24.2%	-25.5%	54.8%	25.8%	-20.9%	48.5%

Increased YOY sales and a stronger US\$ were the primary revenue drivers in Q2. Although we expect the US\$ (with respect to the C\$) to drop from current levels, we expect it stay well above 2008 levels, and therefore positively benefit IWG in 2009.

Revenue Forecasts – Although Q2 revenues were inline with estimates, a softer near-term outlook on the industry has prompted us to revise downward our forecasts for 2009 and 2010. Our revised forecasts for FY2009, and FY2010, are \$4.81 million, and \$4.29 million, versus our previous forecasts of \$5.26 million and \$4.67 million, respectively.

A stronger US\$ also had a positive impact on gross margins in Q2, as the company reported 64%, versus 50% and 61% in Q2-2008 and Q2-2007, respectively. Gross margins in the six month period in FY2009 were also well above the comparable periods in previous years (as shown in the following table). Even though the US\$ has weakened since the end of Q2, we have raised our gross margin forecast for 2009 from 57.5% to 60%, as we expect the US\$ to stay above 2008 levels for the rest of the year.

Margins	2007-Q2	2008-Q2	2009-Q2	2007-6 mo	2008-6 mo	2009-6 mo
Gross	60.5%	50.1%	64.3%	58.9%	46.0%	63.1%
EBITDA	16.6%	-16.1%	6.1%	15.8%	-14.2%	7.2%
EBIT	15.4%	-18.0%	5.0%	14.6%	-16.0%	6.1%
EBT	15.3%	-18.3%	4.6%	14.4%	-16.4%	5.7%
Net Margin	15.3%	-12.0%	3.0%	14.4%	-10.7%	3.9%
Expenses / Sales	2007-Q2	2008-Q2	2009-Q2	2007-6 mo	2008-6 mo	2009-6 mo
Selling Expenses	7.0%	9.6%	8.7%	7.5%	8.2%	9.6%
R&D	9.2%	22.7%	22.4%	10.1%	19.5%	19.9%
G & A	27.3%	33.4%	26.5%	24.9%	32.0%	25.9%
Stock Option Compensation	0.4%	0.5%	0.6%	0.6%	0.5%	0.5%
Total	43.9%	66.2%	58.2%	43.1%	60.2%	55.9%

Operating costs (which includes selling, research and development, and general and administrative expenses) were up 36% YOY in Q2-2009 (from \$0.56 million to \$0.76 million) and up 38% YOY in the six month period in FY2009. Costs were higher than expected as the company continued to incur costs for new product development and marketing. We have raised our operating cost estimates for 2009 accordingly.

Improved revenues and gross margins, offset by an increase in operating costs, resulted in a significant improvement in EBITDA and EPS in Q2. IWG posted an EBITDA of \$0.08 million, and net profit of \$0.04 million (EPS: \$0.001) in Q2, versus (\$0.14 million) and a net loss of \$0.10 million in Q2-2008. For the six month period in FY2009, the company posted net profit of \$0.10 million (EPS: \$0.003) versus a net loss of \$0.18 million (EPS: -\$0.005) in the comparable period in the previous year.

Our revised EPS forecasts are net profits of \$0.05 million (EPS: \$0.00) in FY2009, and \$0.10 million (EPS: \$0.00) in FY2010, versus our previous estimates of \$0.26 million and \$0.25 million, respectively.

Maintains a strong balance sheet

IWG generated \$0.02 million from operations and spent \$0.01 million on investing activities (on property and equipment) in Q2. The company also paid \$0.01 million toward capital lease obligations in the quarter. Cash outlays were funded by cash from operations and cash on hand.

At the end of Q2, the company had \$0.94 million in cash. Working capital and the current ratio were \$1.87 million and 4.4x, respectively. Debt to capital dropped QoQ from 2.8% to 2.4% due to lower capital lease obligations. IWG continues to maintain a very healthy balance sheet and we do not expect any need for equity or debt financings in the near-future.

Liquidity Analysis	2005	2006	2007	2008	Q2-2009
Working Capital	\$576,218	\$909,496	\$1,387,326	\$1,722,974	\$1,868,354
Current Ratio	1.96	3.33	4.06	4.52	4.44
Debt / Capital	40.6%	9.2%	3.4%	3.4%	2.4%
Interest Coverage Ratio	2.1	8.0	44.1	(11.6)	18.18

Stock Options and Warrants

At the end of Q2-2009, the company had 2.87 million stock options outstanding (all of them are currently ‘out-of-the-money’), with exercise prices ranging between \$0.09 and \$0.21, and a weighted average time to maturity of 35 months. The company also had 5 million warrants with an exercise price of \$0.17 outstanding.

Valuation and Rating

Our DCF valuation dropped slightly from \$0.28 to \$0.27 per share as we lowered our near-term revenue and EPS forecasts. A summary of our DCF model is shown below.

DCF Valuation Model								
	2009E(H2)	2010E	2011E	2012E	2013E	2014E	2015E	Terminal
FFO	(\$45,568)	\$201,835	\$787,714	\$968,349	\$1,202,512	\$1,506,923	\$1,902,657	\$1,690,085
Investment in WC	\$35,417	\$98,084	\$162,520	(\$154,153)	(\$200,399)	(\$260,519)	(\$338,675)	(\$440,277)
CFO	(\$10,152)	\$299,919	\$950,234	\$814,196	\$1,002,112	\$1,246,404	\$1,563,982	\$1,249,807
CAPEX	(\$34,235)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)
FCF	(\$44,387)	\$239,919	\$890,234	\$754,196	\$942,112	\$1,186,404	\$1,503,982	\$1,189,807
PV	(\$41,941)	\$202,413	\$670,593	\$507,249	\$565,746	\$636,112	\$719,989	\$6,328,736
Discount Rate	12%							
Terminal Growth Rate	3%							
Total PV	\$9,588,896							
Cash - Debt	877,303							
Equity Value	\$10,466,199							
Shares O/S (dil)	39,340,694							
Value per share	\$0.27							

The average P/S ratio in the Aerospace and Defense Industry is 0.62, versus IWG’s ratio (based on 2009 revenue forecasts) of 0.53, which shows IWG is also undervalued based on industry average multiples.

	Industry	IWG	Fair Value
P/S	0.62	0.53	\$0.08

The P/S ratio of the industry at the same time last year was about 1.24 (twice the

current ratio). We do not believe that current market valuations reflect the fundamentals of the industry, and therefore, to see that IWG's shares are undervalued even based on such conservative industry average multiples, we believe further reinforces our positive outlook on the company as an investment.

Therefore, based on our review of the latest results and our revised valuation models, we reiterate our BUY rating, and maintain our fair value estimate at \$0.30 per share.

Risks The following risks, though not exhaustive, will cause our estimates to differ from actual results:

- Growth of the company is highly dependent on the overall health of the aerospace industry.
- IWG's revenues are dependent on aircraft delivery rates and are subject to industry cycles and customer adoption of its products.
- A significant portion of revenues is non-recurring.
- The company has yet to break into the commercial aircraft sector, the largest market in the aerospace industry.
- Foreign exchange fluctuation risks: Most of IWG's sales are in US dollars.

We continue to rate the shares Risk 3 (Average).

Appendix

STATEMENTS OF OPERATIONS

(in C\$)	2006	2007	2008	2009E	2010E
Sales	3,662,460	4,484,903	4,156,469	4,814,903	4,292,168
COGS	1,467,763	2,022,031	1,922,205	1,925,961	1,759,789
Gross Profit	2,194,697	2,462,872	2,234,264	2,888,942	2,532,379
Expenses					
Selling Expenses	373,683	369,189	328,773	439,962	372,587
Research&Development	425,338	500,718	772,194	998,011	717,974
General & Administration	864,836	1,069,852	1,186,442	1,290,438	1,236,616
Stock Option Compensation	29,745	80,709	18,408	36,112	32,191
EBITDA	501,095	442,404	(71,553)	124,419	173,011
Amortization	39,078	52,414	64,758	66,644	68,491
EBIT	462,017	389,990	(136,311)	57,775	104,520
Interest & Bank Charges	57,472	8,843	11,733	6,550	3,367
Earnings from operations, before undernoted	404,545	381,147	(148,044)	51,225	101,153
Government Assistance					
Gains on settlement of notes and accounts payable	-	-	-	-	-
Gain on sale of commercial division assets	-	-	-	-	-
Write-down of assets and costs	-	-	-	-	-
EBT	404,545	381,147	(148,044)	51,225	101,153
Taxes/(Income Tax Recovery)	-	(427,000)	(51,000)	-	-
Net Earnings for the eperiod	404,545	808,147	(97,044)	51,225	101,153
EPS	0.01	0.02	(0.00)	0.00	0.00

BALANCE SHEETS (in C\$)	2006	2007	2008	2009E	2010E
Assets					
Cash	133,529	438,932	940,302	883,007	1,099,857
Accounts receivable	755,321	721,278	710,770	776,661	692,342
Inventory	388,844	642,232	496,335	509,004	465,087
Prepaid Expenses	21,664	37,969	65,407	35,725	32,643
Current Assets	1,299,358	1,840,411	2,212,814	2,204,397	2,289,928
Equipment & Furniture	205,946	219,290	250,607	243,963	235,472
Deferred Dev Costs and foreign exchange loss		427,000	478,000	478,000	478,000
Future income tax assets					
Total Assets	1,505,304	2,486,701	2,941,421	2,926,360	3,003,400
Liabilities & Shareholders' Equity					
Accounts Payables & Accrued Liabilities	354,383	425,072	449,247	385,192	351,958
Demand / Factoring Loan	-	-	-	-	-
Customer Deposits, Bank and Shareholder's loan					
Current portion of capital lease obligations and loan	35,479	28,013	40,593	23,070	10,216
Current portion of notes payable					
Current Liabilities	389,862	453,085	489,840	408,262	362,174
Convertible Debentures					
Obligations under capital lease and other loan	70,567	42,685	45,206	22,136	11,920
Notes and Loans payable					
Shareholder's Equity					
Share Capital	7,533,289	7,607,553	8,108,202	8,110,452	8,110,452
Contributed surplus	90,319	153,964	165,803	201,915	234,106
Deficit	(6,578,733)	(5,770,586)	(5,867,630)	(5,816,405)	(5,715,252)
Total Liabilities & Shareholders' Equity	1,505,304	2,486,701	2,941,421	2,926,360	3,003,400

STATEMENTS OF CASH FLOWS

(in C\$)	2006	2007	2008	2009E	2010E
Operating Activities					
Net earnings for the period	404,545	808,147	(97,044)	51,225	101,153
Items not involving cash					
Income tax recovery		(427,000)	(51,000)		
Gain on liabilities and sale of commercial division			(6,500)		
Unrealized foreign exchange and other gains			(6,500)		
Compensation related to stock option plan	29,745	80,709	18,408	36,112	32,191
Write-downs					
Interest accrued (on NP, on shareholder loan)					
Amortization and equipment write-down	39,078	52,414	64,758	66,644	68,491
	473,368	514,270	(71,378)	153,981	201,835
Changes in non-cash operating working capital					
Accounts receivable	(246,545)	34,043	17,008	(65,891)	84,319
Inventory	(105,922)	(253,388)	145,897	(12,669)	43,917
Prepaid expenses	10,264	(16,305)	(27,438)	29,682	3,082
Accounts payable and accrued liabilities	128,363	70,689	24,175	(64,055)	(33,235)
Customer Deposits		-	-	-	-
	(213,840)	(164,961)	159,642	(112,932)	98,084
Cash from from (used in) operations	259,528	349,309	88,264	41,048	299,919
Investing activities					
Purchase of furniture and equipment	(107,791)	(65,758)	(47,173)	(60,000)	(60,000)
Proceeds on sale of commercial division					
Deferred Development Costs					
Purchase of equipment and leaseholds	(107,791)	(65,758)	(47,173)	(60,000)	(60,000)
Financing activities					
Proceeds (repayments) of demand loans	(367,900)	(4,146)			
Proceeds (repayments) of payables and leases	(29,862)	(31,202)	(33,801)	(40,593)	(23,070)
Convertible debenture issued					
Issue of common share for cash	24,750	57,200	494,080	2,250	
	(373,012)	21,852	460,279	(38,343)	(23,070)
Increase (decrease) in cash	(221,275)	305,403	501,370	(57,295)	216,849
Cash beginning of period	354,804	133,529	438,932	940,302	883,007
Cash end of period	133,529	438,932	940,302	883,007	1,099,857

Buy – Annual expected rate of return exceeds 12% or the expected return is commensurate with risk

Hold – Annual expected rate of return is between 5% and 12%

Sell – Annual expected rate of return is below 5% or the expected return is not commensurate with risk

Suspended or Rating N/A— Coverage and ratings suspended until more information can be obtained from the company regarding recent events.

Fundamental Research Corp. Risk Rating Scale:

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3 (Average Risk) - The company operates in an industry that has average sensitivity to systematic risk. The industry may be cyclical. Profits and cash flow are sensitive to economic factors although the company has demonstrated its ability to generate positive earnings and cash flow. Debt use is in line with industry averages, and coverage ratios are sufficient.

4 (Speculative) - The company has little or no history of generating earnings or cash flow. Debt use is higher. These companies may be in start-up mode or in a turnaround situation. These companies should be considered speculative.

5 (Highly Speculative) - The company has no history of generating earnings or cash flow. They may operate in a new industry with new, and unproven products. Products may be at the development stage, testing, or seeking regulatory approval. These companies may run into liquidity issues, and may rely on external funding. These stocks are considered highly speculative.

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