

International Water-Guard Industries Inc. (TSX-V: IWG) – Markets showing signs of recovery; Working capital alone accounts for \$0.05 per share

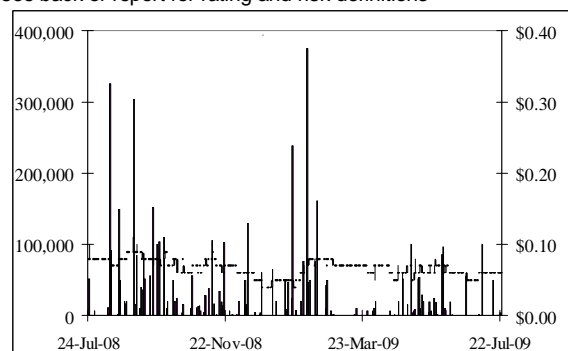
Sector/Industry: Aerospace Products and Services

www.water.aero

Market Data (as of July 29, 2009)

Current Price	C\$0.055
Fair Value	C\$0.30
Rating*	BUY
Risk*	3 (Average)
52 Week Range	C\$0.04 – C\$0.11
Shares O/S	39,340,694
Market Cap	C\$2.16 mm
Current Yield	N/A
P/E (forward)	N/A
P/B	0.85
YoY Return	-31.3%
YoY TSX-V	-47.8%

*see back of report for rating and risk definitions



Q3-2009 Highlights

- Markets have risen significantly since our previous report in May 2009. The S&P 500 Aerospace & Defense Industry Index is up 41% from its lows in March 2009. The recent rise in markets, we believe, is an indication that a recovery could begin by the end of this year.
- Q3 revenues dropped by 11% YOY, from \$1.29 million, to \$1.15 million. We were expecting a 7% YOY decrease in revenues. Revenue growth of 49% YOY for the first six months of FY2009, helped the company achieve 23% YOY growth for the nine month period.
- Q3 revenues dropped primarily due to the decrease in sales of water treatment units, offset by a stronger US\$, and an increase in sales of service and replacement parts, and water system components – which is encouraging.
- IWG reduced its operating costs by 9% YOY in Q3, in response to the reduced sales trend.
- Lower operating costs, offset by a drop in our revenue forecasts, resulted in a net increase in our FY2009 EPS forecast from \$0.05 million (EPS: \$0.00), to \$0.11 million (EPS: \$0.00). We have maintained our FY2010 EPS forecast at \$0.11 million (EPS: \$0.00).
- Working capital alone, at the end of Q3, accounted for \$0.05 per share; implying the market currently values the company's business at less than \$0.01 per share at current prices.

Financial Summary (YE Sept 30)

(C\$)	2006	2007	2008	2009E	2010E
Revenue	3,662,460	4,484,903	4,156,469	4,667,110	4,290,151
Gross Margin	59.92%	54.91%	53.75%	60.00%	54.75%
Net Income	404,545	808,147	(97,044)	113,168	105,018
EPS (basic)	0.01	0.02	(0.00)	0.00	0.00
Cash	133,529	438,932	940,302	976,262	1,094,460
Assets	1,505,304	2,486,701	2,941,421	2,983,382	3,057,261
Debt to Capital	9.21%	3.43%	3.44%	1.74%	0.82%
ROE	49.62%	53.24%	-4.41%	4.57%	4.02%
ROIC	49.05%	61.22%	-6.11%	7.15%	6.51%

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.

**Markets
showing signs
of recovery**

Since our previous report in May 2009, there have been several positive developments – markets have risen, the Dow Jones Industrial Average is up 39% from its lows, and up 4% YTD, and the S&P TSX Composite is up 42% from its lows, and up 19% YTD. The chart below shows the recent rise in the S&P 500 Aerospace & Defense Industry Index, which is up 41% from its lows.



Source: Capital IQ

In addition, in July 2009, the Bank of Canada stated that it expects Canada to generate economic growth for the July-September period; which would mark an end to the recession. As we discussed in our previous reports, the strength of the economy, and corporate profits play a significant role in the growth of the global business jet sector; which is IWG's key market at this time. In our previous report, we had projected the global business aviation sector to begin recovery by the end of this year, along with the recovery of global economic growth. The recent rise in markets, we believe, is an indication that the recovery could be well in line with our prediction, and positively benefit IWG.

**IWG versus the
Aerospace and
Defense
Industry**

The following table shows some of IWG's key valuation metrics and financial ratios, versus the Aerospace and Defense Industry. The table suggests that IWG is in a favorable position in all the aspects (highlighted in blue), including revenue multiples, liquidity/debt ratios and gross margins, except net margins and earnings multiples. The fact that IWG falls behind on net margins and earnings multiples (compared to industry average ratios) should not be a concern to investors as we believe IWG's current earnings do not reflect the company's true fundamentals. As gross margins are relatively much higher for IWG, the company has the potential to significantly improve its net margins and earnings through revenue growth.

		Aerospace and Defense Industry	IWG
Revenue multiples	TEV/LTM Revenues	0.70	0.36
	P/S	0.63	0.59
Margins	Gross Margins	21.1%	60.0%
	Net Margins	4.8%	2.4%
Earnings multiples	TEV/EBITDA	6.20	8.65
	P/E	13.40	24.33
	Return on Capital	10.60%	7.15%
Liquidity/Debt Ratios	Current Ratio	1.10	6.08
	Debt/Capital	40.2%	2.0%

Note: IWG's revenue and earnings multiples, and margins were calculated based on our FY2009 forecasts.

Source: Capital IQ and FRC

Recent Developments

- In June 2009, the company announced the **delivery of its first IWG-A6 water treatment units to Gulfstream Aerospace (General Dynamics - NYSE: GD) for the G650**. IWG had announced in June 2008, that Gulfstream selected the A6 unit for use as standard on every G650. The G650, priced at about US\$60 million, is Gulfstream's largest, fastest and most expensive business jet. According to Gulfstream, the aircraft's first flight will occur this year, with deliveries to begin in 2011. According to an article in Aviation Week and Space Technology, Gulfstream says its order book for 200+ aircraft remain firm.

We believe this is very significant for IWG for two reasons – 1) The G650 has had a good initial market response (in terms of demand) so far; 2) IWG's units will be fitted as standard on every G650.

- In June 2009, the company also announced that it has been awarded a “2008 Supplier of the Year” award by Gulfstream. This is the **third consecutive Gulfstream supplier of the year award** that IWG has received.

Review of Q3- 2009 results

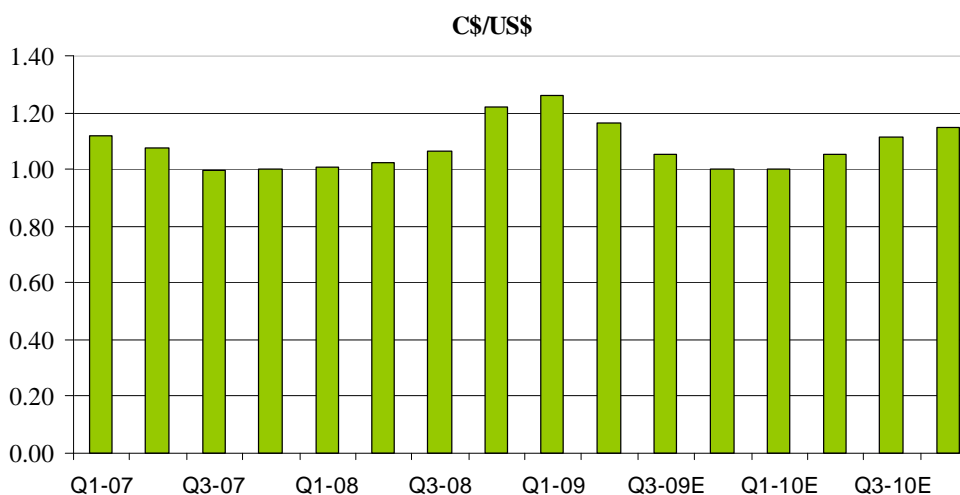
Q3 revenues dropped 11% YOY, from \$1.29 million, to \$1.15 million. We were expecting a 7% YOY decrease in revenues. Revenues dropped primarily due to a decrease in sales of water treatment units, offset by a stronger US\$ (with respect to the C\$), and an increase in sales of service and replacement parts, and water system components – which is encouraging. The table below shows YOY revenue comparisons.

	2007-Q3	2008-Q3	2009-Q3	2007 - 9 mo	2008 - 9 mo	2009 - 9 mo
Sales	\$1,042,882	\$1,292,745	\$1,146,415	\$3,206,212	\$3,003,193	\$3,686,825
Growth YOY	2.8%	24.0%	-11.3%	17.3%	-6.3%	22.8%

YOY revenue growth of 49% in the first six months of FY2009, helped the company achieve 23% YOY growth in the nine month period. (Note that revenues in the first half of 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.)

Revenue forecasts – As revenues were below expectations, we have lowered our revenue forecast for FY2009 from \$4.81 million, to \$4.67 million. We have maintained our FY2010 revenue forecast at \$4.29 million.

A strong US\$ offset some of the YOY decrease in revenues in Q3. However, IWG should not expect such favorable exchange rate fluctuations in Q4 as little YOY change in the US\$/C\$ is expected in the quarter. The US\$, however, is expected to pick up later this year (as shown in the following chart), which we believe will positively benefit IWG.



Source: TD Economics

Reduces operating costs in response to the reduced sales trend

Gross margins changed little YOY in Q3-2009 (58.2% in Q3-2009 versus 58.8% in Q3-2008). However, the company was able to reduce its operating expenses (which includes selling, research and development, and general and administrative expenses) from \$0.67 million in Q3-2008 (\$0.76 million in Q2-2009, and \$0.64 million in Q1-2009), to \$0.61 million in Q3-2009, a 9% YOY decrease. In the first six months of FY2009, costs were up by 38% YOY. Operating costs dropped as IWG slowed its product development activities, and reduced certain administration costs (including compensation, investor relations and general office expenses), in response to the reduced sales trend.

Although operating costs dropped in absolute terms, costs as a percentage of sales increased

(due to lower revenues), which resulted in lower YOY EBTDA margins in Q3. The following table shows YOY margins comparisons.

Margins	2007-Q3	2008-Q3	2009-Q3	2007 - 9 mo	2008 - 9 mo	2009 - 9 mo
Gross	59.18%	58.84%	58.15%	58.97%	51.51%	61.58%
EBITDA	10.37%	6.94%	4.79%	14.01%	-5.10%	6.46%
EBIT	9.01%	5.67%	3.45%	12.77%	-6.68%	5.24%
EBT	8.76%	5.45%	3.03%	12.57%	-6.97%	4.88%
Net Margin	8.76%	3.58%	1.98%	12.57%	-4.57%	3.31%
Expenses / Sales						
Selling Expenses	9.35%	8.49%	8.99%	8.11%	7.81%	9.39%
R&D	13.86%	15.84%	16.93%	11.32%	18.44%	19.00%
G & A	24.39%	27.26%	26.95%	24.70%	29.95%	26.23%
Stock Option Compensation	1.20%	0.32%	0.49%	0.82%	0.41%	0.51%
Total	48.81%	51.90%	53.36%	44.95%	56.61%	55.13%

Raised FY2009 EPS Forecasts

IWG posted net profit of \$0.02 million (EPS: \$0.00) in Q3-2009, versus \$0.05 million (EPS: \$0.00) in Q3-2008. In the nine month period, IWG posted net profit of \$0.12 million (EPS: \$0.00), versus a net loss of \$0.14 million (EPS: -\$0.00) in the comparable period in the previous year.

Lower operating costs, offset by a drop in our revenue forecasts, resulted in a net increase in our FY2009 EPS forecast from \$0.05 million (EPS: \$0.00), to \$0.11 million (EPS: \$0.00). We have maintained our FY2010 EPS forecast at \$0.11 million (EPS: \$0.00).

Improves cash position; continues to maintain a strong balance sheet

IWG generated \$0.18 million from operations (\$5,790 in Q3-2008), and spent \$3,412 on capital expenditures in Q3-2009; reflecting free cash flow of \$0.18 million in the quarter. As a result of the positive free cash flows, IWG's cash position increased QOQ from \$0.94 million, to \$1.11 million. Working capital and the current ratio at the end of Q3-2009 were \$1.92 million and 6.1x, respectively.

Liquidity Analysis	2006	2007	2008	Q3-2009
Working Capital	\$909,496	\$1,387,326	\$1,722,974	\$1,916,411
Current Ratio	3.33	4.06	4.52	6.08
Debt / Capital	9.2%	3.4%	3.4%	2.0%
Interest Coverage Ratio	8.0	44.1	(11.6)	8.1

The company continues to maintain a strong balance sheet and we do not foresee any need for external financings in the near future.

Stock Options and Warrants

At the end of Q3-2009, the company had 2.63 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 34 months. The company also had 5 million warrants (exercise price of \$0.17 per share) outstanding.

Valuation and Rating

Our revised valuation is up slightly (as we raised our near-term EPS forecasts) from our previous estimate in absolute terms, but was maintained at \$0.27 per share.

DCF Valuation Model								
	2009E(Q4)	2010E	2011E	2012E	2013E	2014E	2015E	Terminal
FFO	(\$96,617)	\$202,380	\$787,396	\$967,936	\$1,201,975	\$1,506,225	\$1,901,750	\$1,664,966
Investment in WC	(\$14,139)	(\$1,112)	\$232,129	(\$154,072)	(\$200,293)	(\$260,381)	(\$338,496)	(\$440,044)
CFO	(\$110,756)	\$201,268	\$1,019,524	\$813,865	\$1,001,682	\$1,245,844	\$1,563,254	\$1,224,921
CAPEX	(\$15,823)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)	(\$60,000)
FCF	(\$126,579)	\$141,268	\$959,524	\$753,865	\$941,682	\$1,185,844	\$1,503,254	\$1,164,921
PV	(\$123,043)	\$122,609	\$743,559	\$521,597	\$581,738	\$654,083	\$740,321	\$6,374,431
Discount Rate	12%							
Terminal Growth Rate	3%							
Total PV	\$9,615,294							
Cash - Debt	1,057,635							
Equity Value	\$10,672,929							
Shares O/S (dil)	39,340,694							
Value per share	\$0.27							

Therefore, based on the latest Q3 results, and our revised valuation, 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 have maintained our risk rating at 3 (Average).

Appendix

STATEMENTS OF OPERATIONS

(in C\$)	2006	2007	2008	2009E	2010E
Sales	3,662,460	4,484,903	4,156,469	4,667,110	4,290,151
COGS	1,467,763	2,022,031	1,922,205	1,866,844	1,758,962
Gross Profit	2,194,697	2,462,872	2,234,264	2,800,266	2,531,189
Expenses					
Selling Expenses	373,683	369,189	328,773	434,305	399,226
Research&Development	425,338	500,718	772,194	884,796	706,078
General & Administration	864,836	1,069,852	1,186,442	1,260,651	1,216,771
Stock Option Compensation	29,745	80,709	18,408	24,345	32,176
EBITDA	501,095	442,404	(71,553)	196,169	176,938
Amortization	39,078	52,414	64,758	64,863	65,186
EBIT	462,017	389,990	(136,311)	131,306	111,752
Interest & Bank Charges	57,472	8,843	11,733	18,138	6,734
Earnings from operations, before undernoted	404,545	381,147	(148,044)	113,168	105,018
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)	113,168	105,018
Taxes/(Income Tax Recovery)	-	(427,000)	(51,000)	-	-
Net Earnings for the eperiod	404,545	808,147	(97,044)	113,168	105,018
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	976,262	1,094,460
Accounts receivable	755,321	721,278	710,770	696,360	692,016
Inventory	388,844	642,232	496,335	567,387	534,599
Prepaid Expenses	21,664	37,969	65,407	34,629	32,627
Current Assets	1,299,358	1,840,411	2,212,814	2,274,637	2,353,703
Equipment & Furniture	205,946	219,290	250,607	230,744	225,558
Deferred Dev Costs and foreign exchange loss					
Future income tax assets		427,000	478,000	478,000	478,000
Total Assets	1,505,304	2,486,701	2,941,421	2,983,382	3,057,261
Liabilities & Shareholders' Equity					
Accounts Payables & Accrued Liabilities	354,383	425,072	449,247	392,037	351,792
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	415,107	362,008
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	190,148	222,324
Deficit	(6,578,733)	(5,770,586)	(5,867,630)	(5,754,462)	(5,649,444)
Total Liabilities & Shareholders' Equity	1,505,304	2,486,701	2,941,421	2,983,382	3,057,261

STATEMENTS OF CASH FLOWS

(in C\$)	2006	2007	2008	2009E	2010E
Operating Activities					
Net earnings for the period	404,545	808,147	(97,044)	113,168	105,018
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	24,345	32,176
Write-downs					
Interest accrued (on NP, on shareholder loan)					
Amortization and equipment write-down	39,078	52,414	64,758	64,863	65,186
	473,368	514,270	(71,378)	202,376	202,380
Changes in non-cash operating working capital					
Accounts receivable	(246,545)	34,043	17,008	14,410	4,343
Inventory	(105,922)	(253,388)	145,897	(71,052)	32,788
Prepaid expenses	10,264	(16,305)	(27,438)	30,778	2,001
Accounts payable and accrued liabilities	128,363	70,689	24,175	(57,210)	(40,245)
Customer Deposits		-	-	-	-
	(213,840)	(164,961)	159,642	(83,073)	(1,112)
Cash from from (used in) operations	259,528	349,309	88,264	119,303	201,268
Investing activities					
Purchase of furniture and equipment	(107,791)	(65,758)	(47,173)	(45,000)	(60,000)
Proceeds on sale of commercial division					
Deferred Development Costs					
Purchase of equipment and leaseholds	(107,791)	(65,758)	(47,173)	(45,000)	(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	35,960	118,198
Cash beginning of period	354,804	133,529	438,932	940,302	976,262
Cash end of period	133,529	438,932	940,302	976,262	1,094,460

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:

1 (Low Risk) - The company operates in an industry where it has a strong position (for example a monopoly, high market share etc.) or operates in a regulated industry. The future outlook is stable or positive for the industry. The company generates positive free cash flow and has a history of profitability. The capital structure is conservative with little or no debt.

2 (Below Average Risk) - The company operates in an industry where the fundamentals and outlook are positive. The industry and company are relatively less sensitive to systematic risk than companies with a Risk Rating of 3. The company has a history of profitability and has demonstrated its ability to generate positive free cash flows (though current free cash flow may be negative due to capital investment). The company's capital structure is conservative with little to modest use of debt.

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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