

### CON-SPACE Communications Ltd. (TSX-V: CCB) – Q1 Results Disappointing; Q2 Preliminary Results More Optimistic

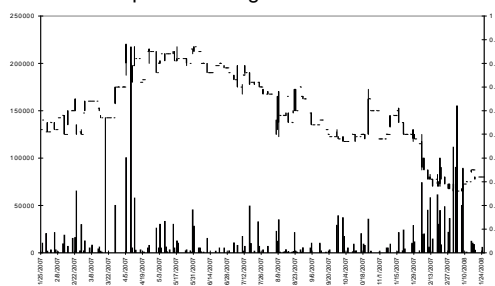
Sector/Industry: Safety Products/Communications

www.con-space.com

#### Market Data (as of January 28, 2008)

Current Price	\$0.32
Fair Value	\$0.80 ↓
Rating*	BUY
Risk*	3 – AVERAGE
52 Week Range	\$0.26 -\$0.88
Shares O/S	14.8 mm
Market Cap	\$4.7 mm
Current Yield	N/A
P/E (forward)	N/A
P/B	0.57x
YoY Return	-38.5%
YoY TSX-V	-11.9%

\*see back of report for rating and risk definitions



#### Q1 Results and Q2 Preview

- CCB announced Q1 sales results below expectations. Recently, the company pre-announced Q2 sales growth of 61%. While this is encouraging, it is still below our expectations. We believe the SSI acquisition will take more time to make a material contribution to CCB, and we have adjusted our models accordingly.
- While gross margins continue to show improvement over last year's results, all other Q1 margins were disappointing. G&A costs rose relative to sales and exceeded our forecasts. This was due to operating leverage and one-time charges.
- Sales in Canada continue to be weak, and we are expecting growth to come from outside Canada.
- Although we do not know the company's bank covenants, we are concerned that EBITDA interest coverage was less than one for the first quarter.
- We are lowering our fair value estimate to \$0.80, and maintaining our BUY rating. We note that the company is trading below book value. We believe current prices represent an excellent entry point for highly risk tolerant and patient investors.

#### Key Financial Data and Statistics

(C\$ 000's)	2005	2006A	2007A	2008E	2009E
Revenues	7,090.8	5,490.4	7,255.5	10,981.1	12,628.2
EBITDA	1,786.8	421.4	871.5	549.1	1,262.8
Net Income	1,135.6	195.0	213.5	(765.5)	(305.9)
Assets	4,785.1	4,542.7	18,728.4	17,569.4	17,180.0
Debt	87.1	-	7,436.7	7,257.2	7,066.6
Equity	3,989.3	4,272.2	8,596.8	8,070.5	7,764.7
Free Cash Flow to Equity	94.3	242.2	(6,333.4)	(272.2)	(513.1)
W/A Basic Shares O/S (000s)	10,686.0	10,724.2	14,773.4	15,100.8	15,100.8
EPS (Basic)	0.11	0.02	0.02	(0.05)	(0.02)
EPS (Fully Diluted)	0.11	0.02	0.02	(0.05)	(0.02)
EBITDA Margin	25.2%	7.7%	12.0%	5.0%	10.0%
ROE	28.5%	4.6%	2.5%	-9.5%	-3.9%

CON-SPACE Communications Ltd. ("Con-Space", "CCB" or the "Company") is a recognized worldwide leader in the design and manufacturing of specialized voice communication equipment for the purpose of providing safety and efficiency to workers in confined space work environments and the public safety market.

## Q1 Sales Disappointing

For the first quarter ended September 30, 2007, CCB reported revenues of \$1.87 million versus \$1.35 million for the same period last fiscal year. Although this translates into revenue growth of 38.8%, they are extremely disappointing and way below our expectations. For FY2008, we are expecting revenues of \$14.3 million, or 97.7% growth in sales. Q1 results are nowhere near our expectations. SSI, the company CCB acquired in April 2007, had annual revenues of about \$10 million. We did not see any revenue contribution from SSI in the Q1 results. In fact, if we annualize Q1 results, we get a figure of \$7.5 million. CCB could have achieved this entirely on their own, without acquiring SSI, and the large debt they incurred as a result.

Obviously we were curious as to where the SSI revenues were and asked management about this in a recent conference call. As in the previous quarter, we were told that the lack of SSI contribution resulted from disruptions that occurred during the acquisition. During the six month acquisition processes, a lot of SSI's resources shifted from their business to dealing with acquisition related matters. Also, from our conversations with management we got a clearer picture of SSI as a family run business that was not able to conduct business during the acquisition because: a) the family members focused more on acquisition related matters than conducting business, and/or b) key members left the business.

We believe that once the acquisition was completed, CCB basically had to replace almost all SSI staff with its own, and that integration may have been a longer process than expected. However, management informed us that it has now filled all the roles at SSI, and that things are starting to pick up. We see evidence of this in the January 15, 2008, Q2 pre-announcement reporting sales growth of 61% in Q2'08 versus Q2'07. However, this would still put year to date sales below our expectations.

Q2 revenues were reported as \$2.55 million versus \$1.59 million for the same quarter a year ago. Although this brings first half revenues to about \$4.43m, or 51% growth versus last year's first half, this still only puts annualized results at \$8.8 million, versus our estimate of \$14.3 million.

Although management has indicated to us that it still believes that SSI will contribute in the neighborhood of \$10 million per year to consolidated results, are going to reduce our revenue estimates in the near term. We believe it will take time for the company's new sales staff and administration to fully ramp up SSI's sales again. Also, weakness in Canadian segment sales is continuing as shown in the table below.

### CON-SPACE - Sales by Geographic Segment (\$000's)

	2007	Q1 2008	Q1'08 Annualized
Canada	2,200	311	1,244
U.S.	3,918	1,451	5,803
U.K.	1,138	112	447
<b>Total</b>	<b>7,256</b>	<b>1,873</b>	<b>7,494</b>

For 2008, we are reducing our SSI revenue contribution to \$3 million from our previous estimate of \$6 million. We are also going to lower our 2008 revenue growth estimate of the non-SSI portion of sales to 10% from 15%, to account for weak Canadian sales offset by growth in the U.S. After 2008, we continue to assume that SSI grows at the overall growth rate of CCB, which we have assumed to be 15%, just a bit below CCB's actual average historical revenue growth rate of 17%.

Our revised FY2008, and FY2009, revenue estimates are now \$10.98 million (from \$14.34 million), and \$12.63 million (from \$16.50 million).

### Most Margins Disappointing

The table below presents the company's margins for the first quarter and our expectations for the year.

Margins	2008F	Q1 2007	Q1 2008
Gross	55.0%	43.1%	46.2%
EBITDA	20.0%	3.0%	0.3%
EBIT	13.9%	1.6%	-8.5%
EBT	3.9%	-0.4%	-22.9%
Net	2.5%	-0.4%	-20.8%
G&A/Sales	35.0%	40.1%	45.9%

Gross margins for the first quarter, were 46.2%, a continued improvement over Q1 of FY2007. We continue to believe that SSI has higher gross margins than CCB, and as its revenues contribute more and more to CCB, we should see a continued improvement of gross margins. However, because we have assumed that SSI's full revenue contribution will be delayed, we have lowered our 2008, and 2009, gross margin expectations to 50% (from 55%).

All other margins were disappointing as a result of lower than expected sales, and higher than expected expenses relative to sales. G&A/sales were 45.9% versus 40.1% in Q1 last year, and way above our 2008 estimate of 35%. Management is attributing this to fixed costs and some one-time acquisition related issues. Therefore, we are raising our G&A/Sales estimate for 2008 to 45% (from 35%), and 2009, to 40% from 33.2%. We assume that revenue growth from SSI in 2010 on will result in more operating leverage and bring G&A/sales back down to the historical level of about 35%.

Overall, the company reported a net loss of \$389,829 or \$(0.02) EPS, for the first quarter versus a net loss of \$4,922 or \$(0.00) EPS in Q1 last year. Based on our above model revisions, for 2008, we are now expecting a net loss of \$765,000 (from net income of \$696,000) or \$(0.05) EPS (from \$0.05). For 2009, we are expecting a net loss of \$306,000 million (from net income of \$1.2 million) or \$(0.02) EPS (from \$0.08).

## Capital Structure and Cash Flow

In Q1, CCB reported negative cash from operations of \$200,834, and spent another \$576,015 on investing activities. Although the company had \$692,233 in cash on hand, it choose to finance the cash outflows with a \$453,603 draw on its bank lines (CCB has available credit of \$2.5 million). Our models indicate that CCB should not need external funding in 2008. Currently, debt to capital is about 49% and the company's EBITDA interest coverage is far below one. The second factor does cause us some concern if the company's sales continue to be below expectations.

## President Resigns

On January 23, 2008, the company announced that Michael Thirlwell, had resigned as president due to personal reasons. He will be replaced by Gordon E. Cook effective immediately. Mr. Cook has been a member of CCB's Board of Directors since July of 2004, and has held various senior level positions at companies including Versacold, Fletcher Challenge Canada Ltd, DTI Dental Technologies Inc, Tamarack Capital Advisors and William Switzer & Associates.

## Valuation

Based on the above revisions to our models, the following is our new DCF valuation of CCB.

### CON-SPACE Communications - DCF Model

(C\$ 000s)

	2008 F	2009 F	2010 F	2011 F	2012 F	2013 F	2014 F	Terminal
FFO	(96.4)	375.9	1,423.5	1,733.4	2,085.9	2,770.8	3,222.3	3,742.4
-increase in w/c	215.6	(485.9)	(362.7)	(613.2)	(705.2)	(811.0)	(932.6)	(1,072.5)
=CFO	119.2	(110.0)	1,060.7	1,120.2	1,380.8	1,959.8	2,289.7	2,669.9
-capex	(200.0)	(200.0)	(200.0)	(200.0)	(200.0)	(200.0)	(200.0)	(200.0)
- net debt repayment	(191.3)	(203.1)	(215.7)	(229.0)	(6,243.1)	-	-	-
=FCFE	(272.2)	(513.1)	645.1	691.2	(5,062.3)	1,759.8	2,089.7	2,469.9
PV	(248.6)	(415.3)	462.6	439.3	(2,850.8)	878.2	924.0	11,088.0
Discount Rate	13%							
Terminal Growth	3%							
Shares O/S (000's)	14,773							
PV Equity	11,450							

Value Per Share \$ 0.78

This is a drop from our previous estimate of \$1.46. As we expect EPS to be negative for the next two years, we do not value CCB based on P/E multiples in this report.

## Rating

CCB's Q1 results were obviously disappointing and the market has reacted accordingly. Its shares have dropped from a 52 week high of \$0.88, to the current level of \$0.32. If CCB does not deliver growth from SSI, the acquisition will of proved to be a costly mistake. At this point, we believe investors need to see growth as a result of SSI, in order to justify taking a company from no debt, to 49% debt. Also, the market will want to see an expansion in margins as evidence that the acquisition makes sense from an ROIC perspective. Although there is now more risk in the stock due to uncertainty regarding SSI's performance, poor financial results, and a weaker financial position, we believe the current stock price is a good entry opportunity for risk tolerant investors with a longer time

horizon. Therefore, based on our review of CCB's most recent results, we are maintaining our BUY rating but lowering our fair value to \$0.80 from \$1.40.

**Risks**

- The potential for competition, and exposure to homeland security budgets which is being mitigated by focusing on growth in industry sales.
- Currency exposure has increased. CCB has acquired an entity with about U\$10 million in sales and now faces significant translation risk. We have not accounted for potential foreign exchange losses in our model.
- We believe that the company's new acquisition increases CCB's risk profile as we do not have historical data on SSI. Furthermore, the company has incurred a significant amount of debt to fund the acquisition. There are also risks of integration, cost control etc. The company's EBITDA interest coverage is less than one as of the end of Q1 FY2008. We are not aware of the company's bank covenants.
- Liquidity is also a risk for any small cap.

The company's revenues are contract based and thus, may be lumpy due to timing of orders or shifts in spending. At this time, we are maintaining our risk rating of 3 (Average Risk).

## Appendix

**CON-SPACE Communications Ltd. Income Statement**

(C\$ 000s)

	<b>2006A</b>	<b>2007A</b>	<b>2008F</b>	<b>2009F</b>
<b>REVENUE</b>	\$5,490	\$7,256	\$10,981	\$12,628
Cost of Goods Sold	\$2,975	\$3,910	\$5,491	\$6,314
<b>Gross Margin</b>	<u>\$2,515</u>	<u>\$3,346</u>	<u>\$5,491</u>	<u>\$6,314</u>
General & Administration	\$2,094	\$2,474	\$4,941	\$5,051
<b>EBITDA</b>	\$421	\$872	\$549	\$1,263
Depreciation & Depletion	\$82	\$241	\$157	\$170
Product Development Costs	-	\$-	\$512	\$512
<b>EBIT</b>	\$339	\$630	(\$120)	\$581
Interest Expense	\$42	\$284	\$1,116	\$1,086
Other	\$0	\$(16)	(\$21)	(\$20)
<b>EBT</b>	\$297	\$362	(\$1,215)	(\$486)
Current Taxes	\$35	\$(62)	(\$450)	(\$180)
Deferred Taxes	\$68	\$211	\$0	\$0
<b>Total Taxes</b>	<u>\$103</u>	<u>\$149</u>	<u>(\$450)</u>	<u>(\$180)</u>
<b>Net Income</b>	<u>\$195</u>	<u>\$214</u>	<u>(\$765)</u>	<u>(\$306)</u>
Basic Shares O/S (000)	10,724	14,773	15,101	15,101
Fully Diluted Shares O/S (000)	10,724	14,773	15,101	15,101
EPS Basic	0.02	0.02	-0.05	-0.02
EPS Fully Diluted	0.02	0.02	-0.05	-0.02

**CON-SPACE Communications Ltd. Balance Sheet**

(C\$ 000s)

	2006A	2007A	2008F	2009F
<b>Assets</b>				
Cash	\$1,457	\$692	659	146.1
Accounts Receivable	\$950	\$1,760	1,757	2020.5
Inventory	\$1,308	\$2,861	2,196	2,525.6
Other	\$128	\$462	\$462	\$462
<b>Total Current Assets</b>	<b>\$3,844</b>	<b>\$5,776</b>	<b>5,075</b>	<b>\$5,154.8</b>
Fixed Assets	\$365	\$526	569	599.0
Demonstration Inventory	\$148	\$235	235	\$235
Other	\$186	\$4,063	3,563	3,064
Goodwill	-	8,128	8,128	8,128
<b>Total Assets</b>	<b>\$4,543</b>	<b>\$18,728</b>	<b>\$17,569</b>	<b>\$17,180</b>
<b>Liabilities</b>				
Bank Indebtedness	\$0		-	-
Accts Payable & Accrued Charges	\$270	\$1,167	714	821
Income Taxes Payable & Other	\$0.0	\$419.9	\$420	\$420
Current LT Debt	\$0	\$191	203	216
<b>Total Current Liabilities</b>	<b>\$270</b>	<b>\$1,778</b>	<b>1,337</b>	<b>1,456</b>
Long Term Debt	\$0	\$7,245	7,054	6,851
Capital Lease Obligations	\$0	\$0	-	-
Deferred Income Taxes	\$0	\$1,108	1,108	1,108
Other	\$0	\$0	-	-
<b>Total Liabilities</b>	<b>\$270</b>	<b>\$10,132</b>	<b>9,499</b>	<b>9,415</b>
<b>Shareholders' Equity</b>				
Capital Stock	\$3,457	\$7,631	7,870	7,870
Retained Earnings	\$753	\$966	201	(105)
Other	\$63	\$0		-
<b>Total Equity</b>	<b>\$4,272</b>	<b>\$8,597</b>	<b>8,071</b>	<b>7,765</b>
<b>Total Liabilities and Equity</b>	<b>\$4,543</b>	<b>\$18,728</b>	<b>17,569</b>	<b>17,180</b>

**CON-SPACE Communications Ltd. Cash Flow**  
(C\$ 000s)

	2006A	2007A	2008F	2009F
<b>OPERATING ACTIVITIES</b>				
Net Income from Continuous Operations	195	214	(765)	(306)
Depreciation & Amortization	82	285	157	170
Product Development Costs	-	-	512	512
Increase in Deferred Income Taxes	68	211	-	-
Other	-	(142)	-	-
<b>Funds From Operations</b>	345	567	(96)	376
Change in non-cash working capital	176	(9)	216	(486)
<b>Cash and Equivalents from Operations</b>	521	558	119	(110)
<b>INVESTING ACTIVITIES</b>				
Additions to PP&E	(104)	(277)	(200)	(200)
Disposal of Fixed Assets			-	-
Acquisition of Business		(8,682)	-	-
Demonstration Inventory	13	(115)		
Other	(547)	(1,372)		
<b>Cash and Equivalents Applied to Investing</b>	(638)	(10,445)	(200)	(200)
<b>FINANCING ACTIVITIES</b>				
Issuance (Repayment) of Long Term Debt	(87)	6,000	(191)	(203)
Issue (Repurchase) of Common Shares	88	3,933	239	
Issue (Repurchase) of Preferred Shares				
Increase (Repayment) of Capital Lease Obligations				
Cash (used for) Discontinued Operations				
Other (Derivatives)				
Debt		(411)		
Bank Debt			-	-
<b>Cash Flow from Financing</b>	1	9,522	48	(203)
Increase (Decrease) In Cash During the Period	(116)	(365)	(33.0)	(513.1)
Cash BOP	1,173	1,057	692.2	659.3
Cash EOP	1,057	692	659.3	146.1

**Fundamental Research Corp. Equity Rating Scale:**

**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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