

CON-SPACE Communications Ltd. (TSX-V: CCB) – Amendments in Loan Agreement Approved

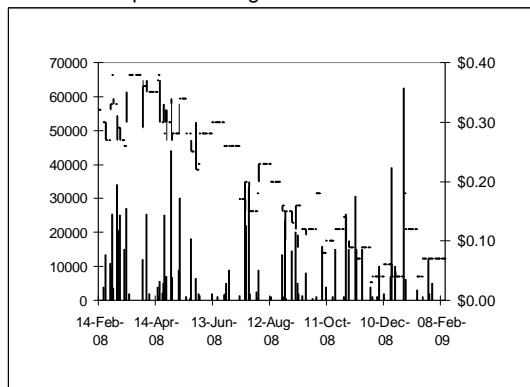
Sector/Industry: Safety Products/Communications

www.con-space.com

Market Data (as of February 13, 2009)

| | |
|---------------|------------------------|
| Current Price | \$0.07 |
| Fair Value | \$0.31 (↓) |
| Rating* | HOLD |
| Risk* | 5 (Highly Spec) |
| 52 Week Range | \$0.03 - \$0.38 |
| Shares O/S | 24.80 mm |
| Market Cap | \$1.74 million |
| Current Yield | N/A |
| P/E (2009) | N/A |
| P/B | 0.39x |
| YoY Return | -78.1% |
| YoY TSX-V | -64.2% |

*see back of report for rating and risk definitions



Q1 2009 Highlights

- In December 2008, the company received shareholder and regulatory approval of the amendment agreement on the secured loan with its creditor Turret Oy Ab, and a satisfactory written waiver agreement with both its other two secured creditors.
- Turret has subsequently converted \$1.2 million of principal, and \$0.30 million unpaid interest, to 10.03 million common shares both at a conversion rate of \$0.15 per share. This has resulted in significant dilution of the company's share as expected in our previous report.
- The company reported revenues of \$2.34 million in Q1 2009, up from \$1.87 million in Q1 2008. YTD Revenues are in line with expectations, and we have not made material revisions to our revenue outlook in FY2009.
- Q1 2009 gross and EBITDA margins improved YOY, and were 45.2% and 10.5% respectively, inline with expectations. However, due to higher amortization expenses, EBIT was below expectations at 1.6%, compared to our forecast of 3.5%. We have revised our valuation models and now expect an EBIT margin of 2.1% in FY2009.
- In Q1 2009, the company reported a net loss of \$0.33 million (EPS: -\$0.02), compared to a net loss of \$0.39 million (EPS: -\$0.03) in Q1 2008.
- We maintain our HOLD rating but lower our fair value estimate to \$0.31/share from \$0.44/share.

Key Financial Data and Statistics

| (C\$ 000's) | 2005A | 2006A | 2007A | 2008A | 2009E | 2010E |
|---------------------------|----------|----------|-----------|-----------|----------|----------|
| Revenues | 7,090.8 | 5,490.4 | 7,255.5 | 9,281.6 | 10,238.9 | 11,774.8 |
| EBITDA | 1,786.8 | 421.4 | 871.5 | (2,460.5) | 1,027.0 | 1,766.2 |
| Net Income | 1,135.6 | 195.0 | 213.5 | (4,205.4) | (579.3) | 106.3 |
| Assets | 4,785.1 | 4,542.7 | 18,728.4 | 14,214.0 | 14,068.3 | 14,253.0 |
| Debt | 87.1 | - | 7,436.7 | 8,071.2 | 7,065.7 | 7,097.5 |
| Equity | 3,989.3 | 4,272.2 | 8,596.8 | 4,402.6 | 5,323.3 | 5,429.6 |
| Free Cash Flow to Equity | 94.3 | 242.2 | (4,896.7) | - | (163.0) | (10.7) |
| Diluted Shares O/S (000s) | 10,686.0 | 10,724.2 | 14,773.4 | 14,773.4 | 24,802.0 | 24,802.0 |
| EPS (Fully Diluted) | 0.11 | 0.02 | 0.02 | (0.28) | (0.02) | 0.00 |
| EBITDA Margin | 25.2% | 7.7% | 12.0% | -26.5% | 10.0% | 15.0% |

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.

Approval of Amendment to Secured Lender Agreement

In December 2008, the company received shareholder and regulatory approval of the amendment agreement on the secured loan with its creditor Turret Oy Ab, and a satisfactory written waiver agreement with its other two secured creditors (the default on the secured loan also triggered a default on the company's bank operating line and possible default on its note payable). Pursuant to the amendment of the secured loan, Turret has converted \$1.2 million of principal, and \$0.30 million unpaid interest, to 10.03 million common shares both at a conversion rate of \$0.15 per share. After the conversion, Turret will own 11.53 million shares of the company or 46.5% of the outstanding shares. As discussed in our previous report, the amendment also gives Turret conversion rights for the \$4.8 million remainder of the secured loan at variable conversion rates, and the right to appoint two directors to the board, in addition to reduced earnings covenants and the interest rate.

Management Changes

In January 2009, James Swanson, Chairman, CFO and a co-founder of the company resigned from all positions. Gordon Cook, President and CEO, has been appointed acting CFO effective immediately. Mr. Swanson will provide consulting services to the company as required and assist in a smooth transition in both his operating and board activities. In addition, Rahul Kapur resigned from the board of directors and the company appointed Martin Carsky, Peter Eriksson and Paulin L. Laberge as directors. The current members of the board are Gordon Cook, Terence Ibbetson, Martin Carsky, Peter Eriksson and Paulin Laberge.

Sales inline with expectations

The company reported revenues of \$2.34 million in Q1 FY2009 (ended September 2008), up from \$1.87 million in Q1 FY2008. This is inline with our expectations. According to our discussion with management, SSI contributed about \$1.2 million in revenues in Q1 2009. At the company's annual meeting, we learned that the company has refocused attention on the technical rescue market (structural collapse, confined space, industrial rescue such as mining, etc.), and it currently represents over 95% of sales (previously, the company also focused on law enforcement, hospitals, industry and military markets). We have previously expressed concern that the sharp economic slowdown in the U.S. could delay government spending. However, the newly elected government has a large economic stimulus package planned, including hundreds of billions of dollars proposed for infrastructure spending. We believe this is positive for the company and may negate some risks of possible delays in government spending.

Geographically, the company recorded sales gains in both the U.S. and the Canadian markets, whereas sales for the U.K. market has declined YOY, which we believe is attributable to a slowing economy which constrained government spending and industrial activities.

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

| | Q1 2008 | Q1 2009 | growth |
|--------------|--------------|--------------|---------------|
| Canada | 311 | 478 | 53.67% |
| U.S. | 1,451 | 1,769 | 21.94% |
| U.K. | 112 | 94 | -15.94% |
| Total | 1,873 | 2,341 | 24.95% |

Revenue Forecasts: We have not made significant revisions to our revenue outlook, and forecasts revenues of \$10.24 million in 2009, and \$11.77 million in 2010, compared to \$10.26 million in 2009, and \$11.80 million in 2010, in our previous report.

Margins

Gross and EBITDA margins were inline with our expectations. The company's gross margins were 45.2% in Q1 2009, compared to 46.2% in Q1 2008. We have maintained our gross margins at 46% for FY2009 in our valuation models. In addition, at the Annual General Meeting, we learned that the company has saved considerable amounts in its costs of goods sold from the integration of SSI and CCB (for example, from maximizing manufacturing capabilities, and consolidate raw material purchases and material control). In light of no improvements seen in Q1 2009 gross margins, we predict improvement starting in FY2010, in which we forecasts gross margins of 50%.

EBIT margins improved to 1.6% in Q1 2009, versus -8.9% in Q1 2008 (reflecting the completed integration of SSI into CCB), however, it was still below our expectation of 3.5% due to higher amortization expenses. As a result, we have raised our amortization expenses to \$0.81 million from \$0.68 million, and revised our EBIT margin for FY2009 to 2.1%. The following table shows margins of the company with our outlook for FY2009 and FY2010.

| Margins | 2005 A | 2006A | 2007A | 2008A | 2009F | 2010F | 2009 (Q1) | 2008 (Q1) |
|---------|--------|-------|-------|--------|-------|-------|-----------|-----------|
| Gross | 57.4% | 45.8% | 46.1% | 45.8% | 46.0% | 50.0% | 45.2% | 46.2% |
| EBITDA | 25.2% | 7.7% | 12.0% | -26.5% | 10.0% | 15.0% | 10.5% | 1.4% |
| EBIT | 24.4% | 6.2% | 8.7% | -38.4% | 2.1% | 11.3% | 1.6% | -8.9% |
| EBT | 22.5% | 5.4% | 5.0% | -51.4% | -9.0% | 3.0% | -16.2% | -22.9% |
| Net | 16.0% | 3.6% | 2.9% | -45.3% | -5.7% | 1.9% | -14.3% | -20.8% |

Earnings

In Q1 2009, the company reported a net loss of \$0.33 million (EPS: -\$0.02), compared to a net loss of \$0.39 million (EPS: -\$0.03) in Q1 2008. **Given the changes discussed above, we expect a net loss of \$0.58 million (EPS: -\$0.02) in FY2009, versus our previous forecast of a net loss of \$0.49 million (EPS: -\$0.02). In FY2010, we forecast net income of \$0.11 million (EPS: \$0.00), compared to \$0.20 million (EPS: \$0.01) in our previous report.**

Capital Structure and Cash Flows

In Q1 2009, CCB spent \$0.13 million, and \$0.27 million, on operating and investing activities respectively. The company financed the cash outflows with a \$0.59 million draw on its bank operating line. Based on our capital expenditure estimate of \$0.82 million in FY2009 (including PP&E and product development costs), we believe cash flow from operations is insufficient and the company needs to raise an additional \$0.70 million from its bank operating lines. In light of the higher capital expenditures (particularly product development costs) experienced by the company since the acquisition of SSI, we have raised our capex to \$0.35 million for 2010+, compared to \$0.10 million in our previous model. We have maintained our assumptions that the remainder of the loan payable in the amount of \$4.8 million will be redeemed by the company at maturity without conversion in our valuation models.

In addition, at the end of Q1 2009 (ended September 2008), total debt to asset was about 59.1%. We expect the ratio to decrease to 50.2% at the end of FY2009, primarily due to the conversion of the \$1.2 million loan payable.

Valuation

Given the changes discussed above, our revised DCF model gave a fair value estimate on the company at \$0.31/share, compared to \$0.44/share previously.

CON-SPACE Communications - DCF Model
(C\$ 000s)

| | 2009 F | 2010 F | 2011 F | 2012 F | 2013 F | 2014 F | Terminal |
|----------------------------|-----------|-------------|---------|-----------|---------|---------|----------|
| FFO | 232.7 | 650.0 | 1,184.3 | 1,933.2 | 2,238.5 | 2,595.2 | 3,011.6 |
| -increase in w/c | (66.5) | (342.5) | (338.2) | (571.8) | (657.5) | (756.2) | (869.6) |
| =CFO | 166.2 | 307.5 | 846.1 | 1,361.4 | 1,580.9 | 1,839.1 | 2,142.0 |
| -capex | (823.7) | (350.0) | (350.0) | (350.0) | (350.0) | (350.0) | (350.0) |
| - net debt repayment | 494.5 | (18.2) | (231.7) | (5,046.0) | (202.0) | - | - |
| =FCFE | (163.0) | (60.7) | 264.4 | (4,034.5) | 1,028.9 | 1,489.1 | 1,792.0 |
| PV | (144.5) | (47.7) | 184.0 | (2,487.6) | 562.2 | 721.0 | 8,808.5 |
| Discount Rate | 13% | | | | | | |
| Terminal Growth | 3% | | | | | | |
| Diluted Shares O/S (000's) | 24,802 | | | | | | |
| Sum PV | 7,595.8 | | | | | | |
| Cash (Beg. of FY2009) | \$186 | | | | | | |
| PV Equity | 7,782 | | | | | | |
| Value Per Share | \$ | 0.31 | | | | | |

As we expect negative EPS in FY2009, we have not valued the company based on industry multiples in this report.

Rating

Overall, we think the amendment of the company's loan agreement allows the company to focus fully on its operations going forward. However, we have yet to see the company break into profitability. We are glad to see revenues improve (despite not being as strong as expected from the acquisition of SSI) in Q1 2009. At this time, we think the key for the company is to continue to grow its revenues, and at the same time control its various expenses to become a profitable operation again.

We maintain our HOLD rating on the company with RISK 5 (Highly Speculative), and lower our fair value estimate to \$0.31 per share.

Risks

- The potential for competition, and exposure to homeland security budgets and government grants, which is likely to be mitigated by the recent economic stimulus packages.
- Although CCB has finalized its loan amendment agreement, the company may run into further credit problems.
- The company's revenues are subject to currency exposure and face significant translation risk. We have not accounted for potential foreign exchange losses in our model.
- Liquidity is also a risk for any small cap.

Appendix

CON-SPACE Communications Ltd. Income Statement

(C\$ 000s)

| | 2006A | 2007A | 2008A | 2009F | 2010F |
|-----------------------------|----------------|-----------------|------------------|----------------|----------------|
| REVENUE | \$5,490 | \$ 7,256 | \$9,282 | \$10,239 | \$11,775 |
| Cost of Goods Sold | \$2,975 | \$ 3,910 | \$5,034 | \$5,529 | \$5,887 |
| Gross Margin | \$2,515 | \$ 3,346 | \$4,248 | \$4,710 | \$5,887 |
| General & Administration | \$2,094 | \$ 2,474 | \$6,708 | \$3,683 | \$4,121 |
| EBITDA | \$421 | \$ 872 | (\$2,460) | \$1,027 | \$1,766 |
| Depreciation & Depletion | \$82 | \$ 241 | \$1,103 | \$812 | \$544 |
| Product Development Costs | - | \$ - | | | |
| EBIT | \$339 | \$ 630 | (\$3,564) | \$215 | \$1,223 |
| Interest Expense (Recovery) | \$42 | \$ 284 | \$1,205 | \$1,140 | \$1,055 |
| Other | \$0 | \$ (16) | 2.91 | (\$6) | (\$1) |
| EBT | \$297 | \$ 362 | (\$4,772) | (\$919) | \$169 |
| Current Taxes Recovery | \$35 | \$ (62) | \$88 | (\$340) | \$62 |
| Deferred Taxes | \$68 | \$ 211 | (\$655) | \$0 | \$0 |
| Total Taxes | \$103 | \$ 149 | (\$567) | (\$340) | \$62 |
| Net Income (Loss) | \$ 195 | \$ 214 | (\$4,205) | (\$579) | \$106 |

CON-SPACE Communications Ltd. Balance Sheet

(C\$ 000s)

| | 2006A | 2007A | 2008A | 2009F | 2010F |
|-------------------------------------|----------------|---------------|---------------|---------------|---------------|
| Assets | | | | | |
| Cash | \$1,457 | 692 | 186 | 23 | 12 |
| Accounts Receivable | \$950 | 1,760 | 1,100 | 1638.2 | 1,884 |
| Inventory | \$1,308 | 2,861 | 2,744 | 2,212 | 2,355 |
| Other | \$128 | 462 | 462 | 462 | 462 |
| Total Current Assets | \$3,844 | 5,776 | 4,492 | 4,335 | 4,713 |
| Fixed Assets | \$365 | 526 | 632 | 606 | 620 |
| Demonstration Inventory | \$148 | 235 | 140 | 140 | 140 |
| Product Development Costs | | 2,558 | 1,935 | 1,972 | 1,764 |
| Other | \$186 | 1,504 | 1,184 | 1,184 | 1,184 |
| Goodwill | - | 8,128 | 5,832 | 5,832 | 5,832 |
| Total Assets | \$4,543 | 18,728 | 14,214 | 14,068 | 14,253 |
| Liabilities | | | | | |
| Bank Indebtedness | \$0 | | 668 | 1,368 | 1,618 |
| Accts Payable & Accrued Charges | \$270 | 1,167 | 780 | 719 | 765 |
| Income Taxes Payable & Other | \$0.0 | 420 | 120 | 120 | 120 |
| Current LT Debt | \$0 | 191 | 7,403 | 218 | 232 |
| Total Current Liabilities | \$270 | 1,778 | 8,971 | 2,424 | 2,735 |
| Long Term Debt | \$0 | 7,245 | - | 5,480 | 5,248 |
| Capital Lease Obligations | \$0 | - | - | - | - |
| Deferred Income Taxes | \$0 | 1,108 | 841 | 841 | 841 |
| Other | \$0 | - | - | - | - |
| Total Liabilities | \$270 | 10,132 | 9,811 | 8,745 | 8,823 |
| Shareholders' Equity | | | | | |
| Capital Stock | \$3,457 | 7,631 | 7,390 | 8,890 | 8,890 |
| Retained Earnings | \$753 | 966 | (3,239) | (3,819) | (3,712) |
| Other | \$63 | - | 252 | 252 | 252 |
| Total Equity | \$4,272 | 8,597 | 4,403 | 5,323 | 5,430 |
| Total Liabilities and Equity | \$4,543 | 18,728 | 14,214 | 14,068 | 14,253 |

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

| | 2006A | 2007A | 2008A | 2009F | 2010F |
|---|--------------|-----------------|--------------|--------------|--------------|
| OPERATING ACTIVITIES | | | | | |
| Net Income from Continuous Operations | 195 | 214 | (4,205) | (579) | 106 |
| Depreciation & Amortization | 82 | 285 | 1,103 | 812 | 544 |
| Product Development Costs | - | - | - | - | - |
| Increase in Deferred Income Taxes | 68 | 211 | (655) | - | - |
| Other | - | (142) | 3,231 | - | - |
| Funds From Operations | 345 | 567 | (526) | 233 | 650 |
| Change in non-cash working capital | 176 | (9) | 464 | (67) | (342) |
| Cash and Equivalents from Operations | 521 | 558 | (63) | 166 | 307 |
| INVESTING ACTIVITIES | | | | | |
| Additions to PP&E | (104) | (277) | (264) | (178) | (150) |
| Disposal of Fixed Assets | | | | - | - |
| Acquisition of Business | | (8,682) | | - | - |
| Demonstration Inventory | 13 | (115) | (19) | | |
| Other (incl. Expenditures on Product Development) | (547) | (1,372) | (646) | (646) | (200) |
| Cash and Equivalents Applied to Investing | (638) | (10,445) | (930) | (824) | (350) |
| FINANCING ACTIVITIES | | | | | |
| Issuance (Repayment) of Long Term Debt | (87) | 7,437 | (182) | -206 | (218) |
| Issue (Repurchase) of Common Shares | 88 | 3,933 | | - | |
| Issue (Repurchase) of Preferred Shares | | | | | |
| Increase (Repayment) of Capital Lease Obligations | | | | | |
| Cash (used for) Discontinued Operations | | | | | |
| Other (Derivatives) | | | | | |
| Debt | | (411) | | | |
| Bank Debt | | | 668 | 700 | 250 |
| Cash Flow from Financing | 1 | 9,522 | 486 | 494 | 32 |
| Increase (Decrease) In Cash During the Period | (116) | (365) | (506) | (163) | (11) |
| Cash BOP | 1,173 | 1,057 | 692 | 186 | 23 |
| Cash EOP | 1,057 | 692 | 186 | 23 | 12 |

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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The distribution of FRC's ratings are as follows: BUY (72%), HOLD (11%), SELL (3%), SUSPEND (14%).

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