

### Hodgins Auctioneers Inc. (TSXV: HA) – Continues to generate higher commission rates; Gross auctions sales were lower in Q3 due to fewer auctions held

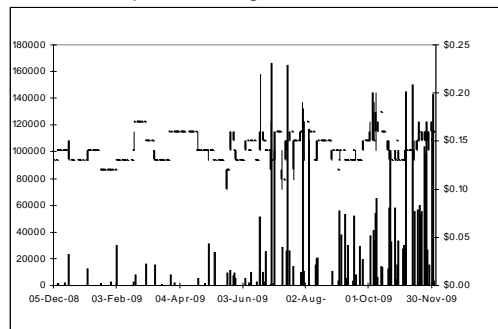
Sector/Industry: Commercial Auction Services

<http://www.hodginsauctioneers.com/>

#### Market Data (as of January 25, 2010)

Current Price	\$0.135
Fair Value	\$0.20 (↓)
Rating*	BUY
Risk*	3 (Average)
52 Week Range	\$0.10 - \$0.22
Shares O/S	8.60 mm
Market Cap	\$1.16 mm
Current Yield	N/A
P/E	N/A
P/B	1.95
YoY Return	12.5%
YoY TSX-V	83.9%

\*see back of report for rating and risk definitions



#### Q3-2009 Highlights

- Hodgins reported revenues of \$0.68 million in Q3 2009, compared to \$0.74 million in Q3 2008. For the first nine months of 2009, Hodgins reported revenues \$2.80 million, compared to \$2.98 million in the same period in 2008.
- Hodgins continued to generate higher average commission rates (commission revenues as a percentage of gross auction sales) of 11.3% in Q3 2009, an improvement from 10.1% in Q2 2009, and 8.3% in Q3 2008. For the nine month period, Hodgins earned a commission rate of 10.2% in 2009, an increase from 8.2% in 2008.
- The company's gross auction sales continued in a downward trend in the third quarter. Gross auction sales were \$5.59 million in Q3 2009, compared to \$7.32 million in Q3 2008. For the nine month period, gross auction sales were \$26.43 million in 2009, compared to \$35.17 million in 2008
- Sales were down primarily because fewer auctions were held – 59 auctions in the first nine months of 2009, versus 85 in 2008 (13 in Q3 2009 versus 15 in Q3 2008).
- In the third quarter, Hodgins introduced two additional services: online real estate auctions, and a mobile bidding platform for automobiles.
- We expect total revenues to be \$3.20 million (up from \$3.04 million) in FY2009. We have maintained our FY2010 revenue forecast at \$3.45 million.

#### Key Financial Data (FYE - Dec 31)

(Million C\$)	2004	2005	2006	2007	2008	2009E	2010E
Revenue	3.53	3.61	3.34	4.26	3.40	3.20	3.45
Net Income	0.20	0.04	(0.19)	0.49	(0.38)	(0.03)	0.13
EPS	0.04	0.00	(0.02)	0.04	(0.05)	(0.00)	0.01
Cash	0.38	0.47	0.11	0.00	0.25	0.03	0.06
Working Capital	(0.01)	0.00	(0.18)	0.22	(0.16)	(0.18)	(0.11)
Total Assets	1.08	1.42	0.96	1.33	1.42	1.43	1.57
Debts/Assets	38.4%	31.0%	41.7%	32.8%	47.1%	45.4%	31.0%

Hodgins Auctioneers, Inc. is a Melfort, Saskatchewan based auctioneer, providing auction services of agricultural, and industrial equipment and real estate. The company conducts live onsite auctions primarily in Western Canada, and also has an online only auction platform. To achieve a successful auction, Hodgins offers a range of services such as marketing campaigns, financial guarantees, outright purchases, live internet bidding, and various support services.

### **Industry Update**

Canadian farmers continued to face challenges in the third quarter of 2009, after an outstanding 2008. For the period of July to September, total farm cash receipts dropped to \$10.10 billion in 2009, from \$11.45 billion in 2008, a decrease of 11.8%. Saskatchewan was hit the worst, as receipts dropped to \$1.72 billion, from \$2.16 billion in the same period, a decrease of 20.1%. The drop in grain prices and softer exports of livestock to the U.S. were some of the main contributors to the lower income for Canadian farmers.

**Provincial farm cash receipts**

	January to September 2008	January to September 2009	January-September 2008 to January-September 2009	July to September 2008	July to September 2009	July-September 2008 to July-September 2009
	\$ millions	\$ millions	% change	\$ millions	\$ millions	% change
Canada	34,176	32,758	-4.2	11,446	10,099	-11.8
Newfoundland and Labrador	83	79	-4.8	27	27	0
Prince Edward Island	279	298	6.8	87	76	-12.6
Nova Scotia	350	334	-4.6	114	115	0.9
New Brunswick	346	370	6.9	113	113	0
Quebec	5,452	5,508	1.0	2,015	1,949	-3.3
Ontario	7,423	6,768	-8.8	2,664	2,270	-14.8
Manitoba	3,624	3,623	0	1,135	1,101	-3.0
Saskatchewan	7,045	6,746	-4.2	2,157	1,723	-20.1
Alberta	7,756	7,239	-6.7	2,475	2,076	-16.1
British Columbia	1,818	1,793	-1.4	658	648	-1.5

(Source: Statistic Canada)

The Government of Canada took steps to help farmers weather the financial storm. Initiatives such as the Canadian Agricultural Loans Act (CALA) and Advance Payment Program (APP) were introduced to assist the farmers. Both programs provide loans and cash advances to farmers.

As farm cash receipts decrease, we believe farmers will delay purchasing equipment, but when necessary, will move into the used-equipment market, which benefits equipment auction providers. For example, Rocky Mountain Dealership (TSX: RME), a Canadian public company that focuses on selling farming and construction equipment, saw its used equipment sales more than double in the first nine months (\$124 million in 2009 versus \$47 million in 2008) of 2009.

### **Additional Revenue Stream**

In the third quarter, Hodgins continued to expand its business beyond auctioning agriculture equipment. The company introduced two additional services – online real estate auctions and a mobile automobiles bidding platform for auto dealers– to complement its business portfolio. Management believes there are opportunities in the online real estate auction industry, with an estimated market size of \$6 billion in Canada. The mobile bidding platform is in an early testing stage. The company plans to roll out the service by the second quarter of 2010. The market size for automobiles sold by auction in the United States is about \$83 billion (Source: National Auctioneers Association).

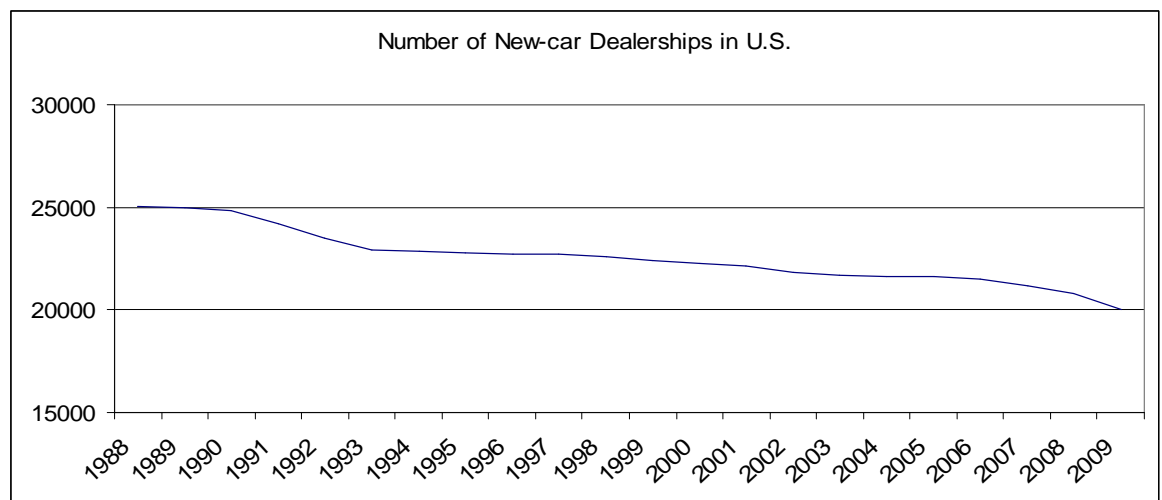
### Hodgins Auto Exchange

As previously mentioned, in December 2009, the company created a new division—Hodgins Auto Exchange—to serve licensed auto dealers with an online, mobile, bidding platform for smart phones. Management believes its platform’s main competitive advantages include: no transaction fees, commissions, or buyer premiums compared to conventional wholesale auctions; thus, this platform will lower the overall transaction cost to buyers and sellers. The pricing strategy for the mobile bidding platform is a fixed price of \$349 per user per month with unlimited units. Management believes its pricing is attractive because transaction costs in conventional wholesale auctions average \$628 per unit paid to the auctioneer, according to the National Auto Auction Association.

The company plans to roll out this service in three phases starting in the second quarter of 2010. The first phase will target dealerships in Ontario, Manitoba, and Saskatchewan; the second phase will target dealerships in Quebec, the Maritimes, Alberta and B.C.; and the final phase will target dealerships in the United States. Currently, some competitors offer similar services on-line and by mobile applications, both in Canada and in the U.S. Gaining dealers’ support will be vital to the success of the business. If successfully implemented, this platform, we believe, could have substantial impact on the company’s revenues.

### North American Auto Dealers and the Auto Auction Industry

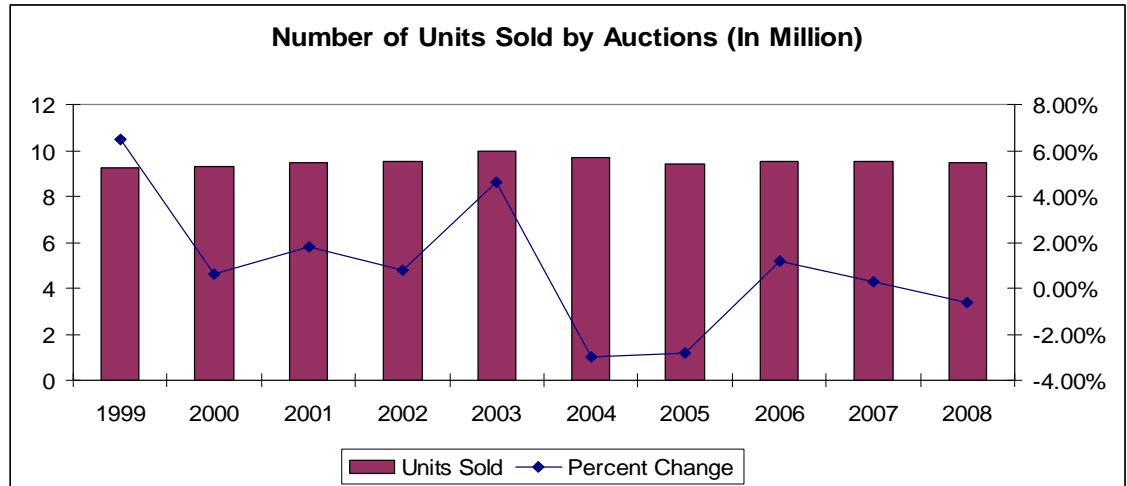
According to the most recent report published by Industry Canada, there were 3,476 new car dealerships in 2007. In the U.S., according to National Automobile Dealers Association, there are 20,010 new car dealerships. Management believes that the Canadian auto industry has about 10,000 licensed new and used car dealers and more than 70,000 licensed in North America combined.



(Source: National Automobile Dealers Association)

Consolidation in the industry has been the theme and is likely to continue in the future for both Canada and U.S. We expect the overall number of dealers to continue to decline in the long term, as more dealers consolidate to achieve economies of scale and as troubles in the auto industry persist to impact dealers.

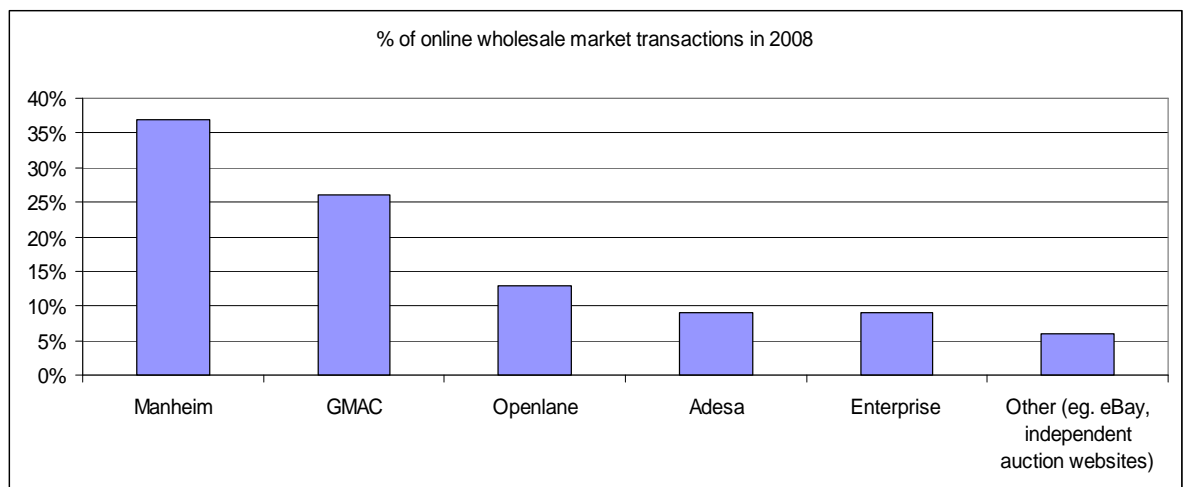
In 2008, the U.S. car auction industry sold a total of 9.48 million vehicles for gross sales of US\$83.01 billion. In 2008, 0.91 million vehicles were sold online for gross sales of US\$12.8 billion, compared to 0.62 million vehicles with gross sales of US\$9.4 billion in 2007, a growth rate of 46.7%.



(Source: National Auto Auction Association Annual Review)

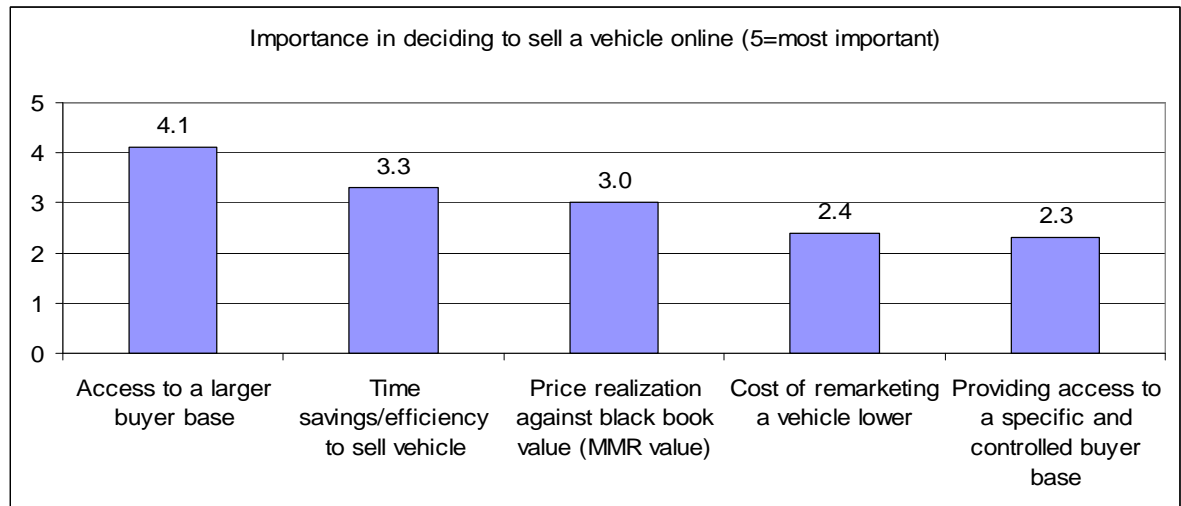
**Online Wholesale Used Vehicle Auction Industry**

The Boston Consulting Group (BCG), in association with the National Auto Auction Association, National Automobile Dealers Association, and National Independent Automobile Dealers Association, published an outlook report for online wholesale used vehicle auctions. BCG estimated that the number of online transactions would grow from 1.7 million transactions in 2008, to 3 million transactions by 2013. The top five players in the industry controls about 94% of the U.S market, and many of them also have operations in Canada. For example, Manheim, GMAC, Openlane (OTC: OPNN), and Adesa (NYSE:KAR) all have Canadian versions of their online auction sites. Openlane announced in July 2009, that they sold over 10,000 vehicles in Canada during their 2nd quarter of 2009.



(Source: Boston Consulting Group)

According to the survey, the most important factor for sellers in choosing an online platform is the ability to access a large buyer base. Thus, we believe any growth in the industry will favour the established players because they have a significant number of buyers already available on their platform. For example, Openlane has already attracted over 25,000 dealers using its platform, and Manheim has attracted 800,000 visits per week to its website.



(Source: Boston Consulting Group)

Based on our research above, we believe that scale will be important for HA's success in the online auto auction industry. As there are already first movers in the industry, we will take a wait and see approach to this business segment and have not considered it in our valuation.

***Planned resale of shares from management***

Management filed a notice of intention, on December 29, 2009, to sell up to 2 million shares (23% of the total outstanding shares; management controls 4.54 millions shares before the sale) on the TSXV exchange. If a sale does take place, management's intention is to reinvest all or substantially all of the proceeds back in the company. Management believes that through this open market transaction, the cost of raising additional capital will be relatively lower than a private placement. Although we believe open market transactions could be cheaper than a private placement, investors should note that management does not have any obligation to reinvest the capital (from sale of shares) back into the company.

***Revenues Slightly Above Expectations***

The company reported revenues of \$0.68 million (\$0.63 million from commission revenues) in Q3 2009, compared to \$0.74 million (\$0.72 million from commission revenues) in Q3 2008. For the first nine months of 2009, Hodgins reported revenues of \$2.80 million (\$2.71 million from commission revenues), compared to \$2.98 million (\$2.89 million from commission revenues) in the same period in 2008.

Hodgins continued to generate higher average commission rates (commission revenues as a percentage of gross auction sales) of 11.3% in Q3 2009, an improvement from 10.1% in Q2 2009, and 8.3% in Q3 2008. For the nine month period, Hodgins earned a commission rate of 10.2% in 2009, an increase from 8.2% in 2008. Going forward, we believe, profit margins will depend on the level of competition in the industry.

The company's gross auction sales continued in a downward trend in the third quarter. Gross auction sales were \$5.59 million in Q3 2009, compared to \$7.32 million in Q3 2008. For the nine month period, gross auction sales were \$26.43 million in 2009, compared to \$35.17 million in 2008: a decrease of 24.45%. Sales were down primarily due to fewer auctions held – 59 auctions in the first nine months of 2009 versus 85 in 2008 (13 in Q3 2009 versus 15 in Q3 2008). The increase in commission rates is encouraging, but the company will have to generate higher gross auctions sales in the future to stay competitive in the industry.

**Overall, based on YTD performance and our industry outlook, we have adjusted our FY2009 commission revenue forecast from \$2.93 million, to \$3.07 million, and total revenues from \$3.04 million, to \$3.20 million. We maintain our 2010 revenues forecast at \$3.45 million.**

**Margins  
Within  
Expectations**

**Lower Direct Costs:** Gross margins improved to 37.0% in Q3 2009, from 29.0% in Q3 2008, and to 58.0% for the first nine months of 2009, from 52.0% in the same period in 2008. The company has offset lower revenues by adjusting its business mix and focusing on gross margin improvement. As a result, we have increased our gross margin assumption to 54% in our model.

Margins	2004	2005	2006	2007	2008	2009E	2010E	Q3 2009	Q3 2008	9 mo 2009	9 mo 2008
Gross Margin	51.5%	46.5%	46.3%	53.8%	50.1%	54.8%	54.0%	36.5%	29.0%	58.0%	52.5%
EBITDA Margin	10.2%	4.7%	-0.7%	12.5%	-6.1%	6.0%	9.8%	-18.7%	-14.6%	16.7%	10.0%
EBIT Margins	8.9%	2.7%	-2.8%	10.3%	-9.0%	3.1%	6.7%	-21.8%	-17.3%	14.4%	8.1%
EBT Margin	7.1%	1.8%	-5.6%	9.3%	-11.3%	-1.1%	5.2%	-24.8%	-19.1%	10.9%	6.8%
Net Margin	5.6%	1.1%	-5.6%	11.4%	-11.3%	-1.1%	3.6%	-21.2%	-11.8%	10.9%	4.5%

**Higher G&A Expenses in Q3:** In Q3-09, the company increased its G&A expenses to \$0.37 million, compared to \$0.29 million in Q3-08. The company's G&A expenses for the nine month period ended September 30, 2009, were lower than the same period in 2008 (\$1.16 million vs. \$1.26 million). Our EBITDA margin forecast has been increased to 6% for 2009, as the company continues to improve its gross margins and reduce G&A expenses. However, we made an adjustment in our model's G&A expenses for later years which increased our G&A cost assumptions in later years.

**Raised EPS  
Forecasts**

**Given all the changes noted above, we lowered our net loss forecast in 2009 to \$0.03 million (EPS: -\$0.00), from a net loss of \$0.13 million (EPS: -\$0.02). For 2010, we forecast net income of \$0.125 million (EPS: \$0.01).**

**Cash Flows**

Based on a capital expenditure forecast of \$0.24 million in 2009 (unchanged from our previous report), our valuation model indicates that the company's current cash will not be sufficient, and it will have to raise \$0.16 million within the next few months. Management has expressed an intention to raise up to \$0.30 million through equity/debt.

**Valuation**

Based on all the changes discussed earlier in the report, our revised DCF model gave a fair value estimate of \$0.19 per share (down from \$0.32 per share). The main reason for the drop in our estimate was the revision to our G&A assumptions in later years.

Hodgins Auctioneers Inc - DCF Valuation											
(Million C\$)	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	Terminal
Net Income	(0.034)	0.125	0.219	0.238	0.256	0.270	0.283	0.296	0.311	0.326	0.341
Non Cash Charges	0.090	0.108	0.113	0.117	0.121	0.124	0.127	0.130	0.132	0.134	0.136
Funds from Operations	0.056	0.233	0.332	0.356	0.377	0.395	0.410	0.426	0.443	0.460	0.478
Investment in W/C	(0.153)	(0.033)	(0.003)	(0.003)	(0.003)	(0.004)	(0.004)	(0.004)	(0.004)	(0.004)	(0.004)
Cash From Operations	(0.097)	0.200	0.329	0.352	0.373	0.391	0.407	0.422	0.439	0.456	0.473
Capex	0.240	0.150	0.150	0.150	0.150	0.150	0.150	0.150	0.150	0.150	0.150
Free Cash Flow	(0.337)	0.050	0.179	0.202	0.223	0.241	0.257	0.272	0.289	0.306	0.323
PV	(0.337)	0.045	0.142	0.144	0.142	0.137	0.130	0.123	0.117	0.110	1.296
Discount Rate	12%										
Terminal Growth	3%										
Firm PV	2.049										
Cash (Beg. of Year)	0.247										
LT Debt (Beg. Of Year)	0.670										
PV Equity	1.627										
Shares O/S (in Millions)	8.599										
<b>DCF Value/Share</b>	<b>0.19</b>										

### **Conclusion & Rating**

**Based on our analysis, we have maintained our BUY rating, but lowered our fair value estimate from \$0.32 per share, to \$0.20 per share. We continue to rate the company a risk of 3 (Average).**

### **Risks**

- The company operates in a highly competitive industry;
- The company's expansion plan is likely to require additional capital, which is difficult to raise in current market conditions.
- The company's business is highly seasonal, and largely dependent on the Spring auction season. We note the company's business diversification and the use of online auctions may offset the seasonality of its auction business.
- The company's business is affected by other industries; for example, used equipment.

## Appendix

### Hodgins Auctioneers Inc - Income Statements (in Million C\$)

	2004	2005	2006	2007	2008	2009E	2010E
<b>Revenues</b>							
Auction revenues	3.38	3.50	3.23	4.12	3.29	3.07	3.32
Rental income	0.10	0.10	0.08	0.11	0.06	0.09	0.09
Other income	0.05	0.01	0.03	0.02	0.05	0.04	0.04
	<b>3.53</b>	<b>3.61</b>	<b>3.34</b>	<b>4.26</b>	<b>3.40</b>	<b>3.20</b>	<b>3.45</b>
<b>Direct Costs</b>							
	1.71	1.93	1.79	1.97	1.70	1.45	1.59
<b>Gross Margin</b>	<b>1.82</b>	<b>1.68</b>	<b>1.55</b>	<b>2.29</b>	<b>1.70</b>	<b>1.76</b>	<b>1.87</b>
<b>G&amp;A</b>							
	1.38	1.50	1.57	1.76	1.87	1.57	1.53
Stock Based Compen:	0.08	0.01	0.00	-	0.05		
<b>EBITDA</b>	<b>0.36</b>	<b>0.17</b>	<b>(0.02)</b>	<b>0.53</b>	<b>(0.21)</b>	<b>0.19</b>	<b>0.34</b>
<b>Amortization</b>							
	0.05	0.07	0.07	0.09	0.10	0.09	0.11
<b>EBIT</b>	<b>0.31</b>	<b>0.10</b>	<b>(0.10)</b>	<b>0.44</b>	<b>(0.31)</b>	<b>0.10</b>	<b>0.23</b>
<b>Interest</b>							
	0.06	0.03	0.09	0.04	0.08	0.13	0.05
<b>EBT</b>	<b>0.25</b>	<b>0.07</b>	<b>(0.19)</b>	<b>0.40</b>	<b>(0.38)</b>	<b>(0.03)</b>	<b>0.18</b>
<b>Tax</b>							
	0.05	0.03	-	(0.09)	-	-	0.05
<b>Net Income</b>	<b>0.198</b>	<b>0.040</b>	<b>(0.186)</b>	<b>0.487</b>	<b>(0.384)</b>	<b>(0.03)</b>	<b>0.125</b>
<b>EPS</b>							
	0.04	0.00	(0.02)	0.04	(0.05)	(0.00)	0.01

**Hodgins Auctioneers Inc - Balance Sheets**  
 (in Million C\$)

	2003	2004	2005	2006	2007	2008	2009E	2010E
<b>ASSETS</b>								
Cash And Equivalents	0.256	0.379	0.469	0.107	0.001	0.247	0.026	0.062
Accounts Receivable	0.152	0.037	0.233	0.128	0.326	0.108	0.13	0.175
Inventory	0.03	0.038	0.031	0.033	0.196	0.086	0.153	0.165
Prepaid Exp.	-	-	0.028	0.048	0.049	0.034	0.036	0.039
<b>Total Current Assets</b>	<b>0.438</b>	<b>0.454</b>	<b>0.761</b>	<b>0.316</b>	<b>0.572</b>	<b>0.476</b>	<b>0.344</b>	<b>0.44</b>
Long-Term Note Receivable						0.173	0.161	0.161
Net Property, Plant & Equipment	0.476	0.628	0.656	0.646	0.755	0.773	0.923	0.965
<b>Total Assets</b>	<b>0.913</b>	<b>1.082</b>	<b>1.416</b>	<b>0.962</b>	<b>1.328</b>	<b>1.422</b>	<b>1.428</b>	<b>1.566</b>
<b>LIABILITIES</b>								
Bank Indebtedness				0.106		0.090	0.090	0.090
Accounts Payable	0.32	0.29	0.524	0.159	0.223	0.337	0.274	0.3
Due to Shareholders	0.042	0.042	0.042	0.042	0.042	0.04	-	-
Curr. Port. of LT Debt	0.766	0.075	0.112	0.08	0.092	0.176	0.164	0.162
Curr. Income Taxes Payable	-	0.054	0.08	0.114	-	-	-	-
<b>Total Current Liabilities</b>	<b>1.129</b>	<b>0.462</b>	<b>0.759</b>	<b>0.501</b>	<b>0.356</b>	<b>0.639</b>	<b>0.528</b>	<b>0.552</b>
Long-Term Debt	-	0.341	0.327	0.321	0.344	0.494	0.48	0.323
<b>Total Liabilities</b>	<b>1.129</b>	<b>0.802</b>	<b>1.085</b>	<b>0.822</b>	<b>0.701</b>	<b>1.133</b>	<b>1.012</b>	<b>0.875</b>
Common Stock	0.0	0.215	0.234	0.234	0.234	0.234	0.394	0.544
Additional Paid In Capital	-	0.081	0.074	0.07	0.07	0.116	0.116	0.116
Retained Earnings	(0.215)	(0.017)	0.023	(0.163)	0.324	(0.06)	(0.094)	0.031
Total Shareholder's Equity	(0.215)	0.279	0.331	0.14	0.627	0.29	0.416	0.691
<b>Total Liability and Equity</b>	<b>0.913</b>	<b>1.082</b>	<b>1.416</b>	<b>0.962</b>	<b>1.328</b>	<b>1.422</b>	<b>1.428</b>	<b>1.566</b>

**Hodgins Auctioneers Inc - Cash Flow Statements**  
 (in Million C\$)

	2003	2004	2005	2006	2007	2008	2009E	2010E
Net Income	(0.006)	0.198	0.0398	(0.186)	0.487	(0.384)	(0.034)	0.125
Depreciation & Amort.	0.037	0.048	0.073	0.071	0.091	0.097	0.09	0.108
(Gain) Loss From Sale Of Assets	-	(0.013)	(0.006)	-	-	-	-	-
Stock-Based Compensation	-	0.081	0.009	0.002	-	0.05	-	-
	0.032	0.314	0.116	(0.112)	0.578	(0.24)	0.056	0.233
Change in Acc. Receivable	(0.058)	0.137	(0.196)	0.105	(0.197)	0.217	(0.021)	(0.045)
Change In Inventories	0.0195	(0.007)	0.007	(0.002)	(0.164)	0.11	(0.067)	(0.012)
Change in Acc. Payable	(0.431)	(0.066)	0.254	(0.365)	0.063	0.114	(0.063)	0.027
Change in Inc. Taxes	-	0.054	0.026	0.034	(0.114)	-	-	-
Change in Other Net Operating Assets	-	-	(0.028)	(0.02)	(0.001)	0.015	(0.002)	(0.003)
<b>Cash from Operations</b>	<b>(0.437)</b>	<b>0.433</b>	<b>0.179</b>	<b>(0.36)</b>	<b>0.165</b>	<b>0.216</b>	<b>(0.097)</b>	<b>0.200</b>
Capital Expenditure	(0.006)	(0.21)	(0.121)	(0.062)	(0.21)	(0.168)	(0.24)	(0.15)
Property, Plant, and Equipment	-	0.023	0.026	-	0.01	0.052	-	-
Increase in Note Receivable	-	-	-	-	-	(0.173)	0.012	-
<b>Cash from Investing</b>	<b>(0.006)</b>	<b>(0.187)</b>	<b>(0.095)</b>	<b>(0.062)</b>	<b>(0.2)</b>	<b>(0.289)</b>	<b>(0.228)</b>	<b>(0.15)</b>
Debt Issued	0.8	-	0.084	0.031	0.123	0.386	0.18	-
Debt Repaid	(0.49)	(0.351)	(0.061)	(0.069)	(0.088)	(0.152)	(0.201)	(0.164)
Bank Indebtness	-	-	-	-	-	-	-	-
Issuance of Common Stock	-	0.229	-	-	-	-	0.16	0.15
Repurchase of Common Stock	-	-	(0.017)	(0.007)	-	-	-	-
Other	-	-	-	-	-	(0.005)	(0.036)	-
<b>Cash from Financing</b>	<b>0.31</b>	<b>(0.122)</b>	<b>0.006</b>	<b>(0.045)</b>	<b>0.035</b>	<b>0.228</b>	<b>0.103</b>	<b>(0.01)</b>
<b>Change in Cash</b>	<b>(0.133)</b>	<b>0.124</b>	<b>0.089</b>	<b>(0.467)</b>	<b>0.0</b>	<b>0.156</b>	<b>(0.222)</b>	<b>0.036</b>
Cash BOP	-	-	-	-	-	0.00	0.25	0.03
Cash EOP	-	-	-	-	-	0.16	0.03	0.06

**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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