Fundamental Research Corp.
Investment Analysis for Intelligent Investors

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Canada Jetlines Ltd. (TSXV: JET) – Financing Commitments and New Routes

Sector/Industry: Airlines **www.jetlines.ca**

Market Data (as of May 9, 2019)

Current Price	**C$0.44**
Fair Value	**C$2.04**
Rating*	**BUY**
Risk*	**4**
52 Week Range	C$0.40 - C$0.90
Shares O/S	81,687,416
Market Cap	C$35.94 mm
Current Yield	N/A
P/E (forward)	N/A
P/B	8.15x
YoY Return	-49.44%
YoY TSXV	-22.07%

*see back of report for rating and risk definitions.
* All figures in C$ unless otherwise specified.

Highlights

- Canada Jetlines Ltd. ("Jetlines", "Company") has announced a number of operational developments signaling that they are in the later stage of rolling out their Ultra Low Cost Carrier ("ULCC") airline.

- **Launch Date Delayed, But Portion of Required Financing Secured:** Jetlines has delayed their anticipated launch date to December 17, 2019. However, we believe that this date is more definitive than past launch date guidance, and the company has secured equity facilities for up to $29 million, of the required $55 million of startup capital.

- **Exceptional Talent, But High Turnover:** The company's management and directorship has received an injection of airline expertise in the appointment of individuals with ULCC backgrounds. However, C level executive turnover remains high, with a newly appointed COO leaving his post after only a few months on the job.

- **Expected Route Offerings Expanded:** The expected routes offered by the company upon commercial launch have grown, with several sun destinations across Mexico and the Dominican Republic now available.

- **North American Aviation Earnings Strong and Ancillary Revenue Prospects Rosy:** Earnings performance from North American carriers have remained resilient and returns on invested capital remain positive. Furthermore, ancillary revenues, a significant portion of a ULCC's revenues, have grown 4.11x in 8 years.

- **We are revising our fair value estimate from $2.57 per share to $2.04, and maintaining our BUY rating.**

Key Financial Data (FYE - Dec 31) (C$)	2016	2017	2018
Cash	$ 91,397	$ 2,981,046	$ 1,220,555
Working Capital	$ -674,499	$ 2,698,286	$ 979,811
Debt	$ 213,536	$ -	$ -
Total Assets	$ 199,496	$ 3,564,831	$ 5,529,495
Net Income (Loss)	$ -942,925	$ -9,067,694	$ -5,686,394
EPS	$ -0.07	$ -0.16	$ -0.08

Anticipated Launch Timing Announced

On April 4, 2019, Jetlines announced that it had set a target launch date of December 17, 2019, which is considered the peak of the winter season and a high-traffic period. As a result of the adjusted launch date, Jetlines and AerCap Holdings N.V. (NYSE: AER) had agreed to terminate the leases for the two Airbus A320 aircraft that the company had previously ordered. Instead, Jetlines has entered into a Letter of Intent ("LOI") with SmartLynx Airlines SA ("SmartLynx") for the lease of two alternate Airbus A320 aircraft, for delivery in Q4-2019. These planes are envisioned to be largely identical (with regards to operating features) to the AerCap aircraft. Based on the information disclosed, we believe that the company terminated their lease with AerCap in favor of SmartLynx due to the updated launch timing – the aircraft to be delivered by AerCap were due in Q2-2019, which is now too early given a December 2019 launch.

The announcement delays the company's expected launch date past the beginning of Q3-2019, that we had previously forecasted (reflecting the company's previous guidance). The market reacted poorly, with the stock plunging 23.73% from $0.59 per share to $0.45 per share. Though the delay in launch date does come as a negative shock, we believe that the stock has been oversold and that the degree of selling was largely driven by continual launch delays. However, we have reason to believe that the new launch date guidance provided is more definitive in nature than previous launch date guidance. Firstly, the company has continuously and frequently updated investors with their activities, which have skewed towards operations-specific endeavors. Secondly, the company has now arranged a large portion of the $55 million required funding needed to initiate operations (covered in the financials section of this report).

However, the launch date delay will irrefutably affect our revenue forecasts and valuation, which we have updated and cover in the valuation section.

Operational Updates Ahead of Launch

In the run up to launch, the company has undergone several key developments required to set-up operationally. The overview below outlines these developments, from the time of our last report through to the date of the current update:

- **September 13, 2018:** Jetlines announces the submission of operations manuals to Transport Canada, advancing their application for an Air Operator Certificate ("AOC"). Milestones to follow include actual hiring and training of staff ahead of launch.
- **September 18, 2018:** signs with Radixx International Inc. ("Radixx") for booking reservation services.
- **October 23, 2018:** selects CAE Inc. (TSX: CAE) to provide Airbus A320 pilot training services. Training is slated to begin in the first half of 2019, and is crucial not only to the development of Jetlines' pilots, but also to the advancement of their AOC application.
- **January 15, 2019:** reaches an agreement with Revenue Management Systems Inc. ("RMS") for their proprietary airRM airline revenue management software. RMS works with over 90 carriers worldwide, including ULCCs such as RyanAir (LSE: RYA) and AirAsia (KLSE: AIRASIA).
- **February 4, 2019:** contracts Global Aviation Services Inc. for ground handling

services.

- **February 7, 2019:** secures slots at Vancouver International Airport ("YVR") and selected YVR as their home base. YVR reported total enplaned and deplaned passengers of 25.94 million in 2018, up 7.30% YoY. Furthermore, over 2.50 million people live within a 30-minute drive of YVR.
- **February 19, 2019:** announces agreements with Booking.com (accommodation booking), Google Flights (online flight booking and search engine), Travel Fusion (travel content aggregator), and CarTrawler (ground transportation solutions).
- **February 26, 2019:** partners with Elavon Inc., a subsidiary of U.S. Bancorp (NYSE: USB), for payment processing services.
- **March 14, 2019:** reaches an agreement with AKKA Technologies (EPA: AKA) for engineer consulting services. The company also signed agreements with Flightcraft Maintenance Services ("FMS"), TRAX and SysAIO Inc.

The above developments demonstrate that the company are approaching the late stage of the airline's commercial roll-out. As the company gets closer to their expected launch date, investors should expect news flow regarding various aspects of the airlines operations to accelerate, as Jetlines evolves from a start-up into an active commercial airline.

Management Team Reinforced with Experienced Airline Professionals

In our last update, we had discussed the ascension of Lukas Johnson and Javier Suarez to the CEO and COO positions, respectively. On September 11, 2018, it was announced that Mr. Johnson would be stepping down from the CEO position due to personal reasons, though as a sign of continued belief in the company, would move ahead with a $0.70 million investment into Jetlines' subsidiary. In his place, Mr. Suarez has ascended to the CEO position, and investors may refer to our previous update for his background and biography. On November 1, 2018, Michael Bata assumed the COO position, however on March 28, 2019, Mr. Bata departed the company. Though the COO position remains vacant, Jryi Strandman, an experienced ULCC executive, has joined as the company's operations adviser.

On November 14, 2018, the company announced that it had appointed Mr. Alan Bird to Jetlines' Board of Directors. In addition, Mr. Bird would act as a special advisor to the CEO. Mr. Bird has over 25 years of airline finance experience, and most recently served as CFO for Mexico's fastest growing ULCC, VivaAerobus, where he was a colleague of current Jetlines CEO Javier Suarez. In our opinion, his track record and history with the current CEO offers potential synergies which may help Jetlines jumpstart growth upon launch.

Furthermore, on January 21, 2019, Jetlines' board was further reinforced with airline expertise through the appointment of Zygimantas Surintas following a financing discussed in the financial section of this report. Mr. Surintas is the CEO of SmartLynx Airline SIA, the leading aircraft, crew, maintenance and insurance provider in the European Union on Airbus aircrafts. Mr. Surintas brings over eight years of executive experience, and he has held the position of CEO and director of SmartLynx Airlines since June 2016.

As we have noted before, Jetlines continues to attract management and directorship with significant direct value to add in the run-up to launch. Apart from having extensive backgrounds in the aviation industry, the new appointees also have significant achievements under their belts, which can be drawn upon in rolling out Jetlines. As an airline testing the ULCC concept against the entrenched duopoly of Air Canada (TSX: AC) and WestJet (TSX: WJA), strong management at the helm backed by a solid board of directors is crucial to Jetlines making it past the growth stage.

Network Planning

In addition to operational updates and management appointments, Jetlines has also announced significant developments regarding the routes that they expect to offer upon launch. Since our last update, the company has made the following announcements:

- Signed an agreement with the Quebec City Jean Lesage International Airport ("YQB") to provide ULCC air service. YQB serviced 1.77 million passengers in 2018 and has experienced air passenger CAGR of 7.20% over the past 15 years, according to self-reported statistics.
- Announced planned service out of Montreal's Saint-Hubert Longueuil Airport ("YHU") to several cities in Canada as well U.S. destinations such as Florida and New York.
- Reached agreements with Kelowna International Airport ("YLW") and Winnipeg James Armstrong Richardson International Airport ("YWG") to provide ULCC air service. YLW serviced 2.08 million passengers in 2018, whilst YWG serviced 4.31 million passengers in 2017, according to self-reported statistics.
- Reached agreements with Grupo Aeroportuario del Pacifico (NYSE: PAC) and Grupo Aeroportuario del Sureste (NYSE: ASR) to offer service to several destinations across Mexico, including Puerto Vallata, Los Cabos, and Cancun.
- Announced an agreement with Aeropuertos Dominicanos Siglo XXI to provide service to several destinations across the Dominican Republic, including Puerto Plata, Samana, and Santo Domingo.

The announced routes add a significant degree of choice to customers who are seeking both cheap air-fare and service to popular destinations. We believe that a large selection of travel routes is key to reinforce the price stimulation that forms the foundation of Jetlines value proposition to prospective flyers.

Relocating Operational Home Base to YVR

In addition to the above announced routes, the company also opted to relocate their future home base to Vancouver International Airport ("YVR") from their previously planned home base of John C. Munro Hamilton International Airport ("YHM"). By doing so, the company has chosen to fly out of a primary airport, a strategy that runs contrary to rivals Swoop Airlines of WestJet Airlines LTD (TSX: WJA), and Flair Airlines Ltd. decisions to use Abbotsford International Airport ("YXX") as a home base. The decision carries numerous benefits which we believe decidedly outweigh the higher airport taxes that will be paid by the company as a result of relocating to a primary airport.

The first and perhaps most powerful benefit from this move is that Jetlines' move their operations into closer proximity to the Vancouver metropolitan area. YVR is significantly closer and more affordable to travel to for Vancouverites, whereas traveling to YXX is decidedly more expensive and time consuming, with the commute potentially negating the cost-savings from choosing a ULCC for air-travel. As noted by management, many passengers are willing to pay extra to fly out of primary airports, and the added benefit of being the only ULCC option out of YVR could compound this into a substantial price stimulation effect. Moreover, because WestJet has been adamant about preventing Swoop cannibalizing the revenues of their legacy carrier, we do not think that WestJet will reposition Swoop to compete with Jetlines through a YVR relocation. Whilst Flair may be able to relocate, given that they do not have a legacy carrier to worry about, Flair is also a ULCC with limited resources, and as a private company, may find accessing the capital markets for funding more difficult than a public entity. As a result, a relocation may be exceedingly expensive for Flair.

Furthermore, by avoiding YXX, Jetlines opts out of the vicious competition between the two incumbent ULCCs flying out of Abbotsford. Whilst we have discussed in detail why we believe Swoop's long-term prospects as a ULCC are hamstrung by their connection to legacy carrier WestJet, in the short-term, Swoop's parent is likely happy to let Swoop's bottom line bleed out in favor of capturing the majority of air traffic out of YXX. Competing ULCCs flying out of the airport, however, do not have access to the resources that Swoop can call upon. As a result, we see the company's move to fly out of YVR as a sound strategic maneuver.

North American Aviation Benefits from Strong Profits and Growth in Ancillary Revenues

North American aviation is expected to lead global airlines in terms of profitability, with North American airlines generating the highest dollar amount of net profit as well as highest EBIT margins, both historically, and forecasted, moving forward. We suspect that the outperformance is due to the number of LCCs operating in the region, as ULCCs and LCCs both create demand via price stimulation and city-pairing, and compress costs by virtue of their leaner business models, factors that are conducive to higher earnings.

Airline Financial Results (Geographically Segmented)

System-wide global commercial airlines	EBIT margin, % revenues							Net profit, $ billion						
	2013	2014	2015	2016	2017	2018E	2019F	2013	2014	2015	2016	2017	2018E	2019F
Global	3.5%	4.6%	8.6%	8.5%	7.7%	6.8%	6.8%	10.7	13.8	36.0	34.2	37.7	32.3	35.5
Regions														
North America	6.8%	9.1%	14.4%	13.7%	11.0%	9.8%	10.0%	7.4	11.1	21.7	17.0	18.7	14.7	16.6
Europe	2.0%	3.1%	5.5%	6.1%	6.9%	6.0%	5.6%	1.0	1.9	7.1	8.5	8.2	7.5	7.4
Asia-Pacific	2.9%	2.4%	6.9%	7.4%	6.7%	6.1%	6.1%	2.3	0.5	7.5	7.4	9.9	9.6	10.4
Middle East	0.9%	3.0%	6.3%	2.2%	1.5%	1.2%	1.4%	0.3	1.1	2.1	1.3	0.7	0.6	0.8
Latin America	2.2%	5.0%	5.0%	5.6%	6.9%	5.6%	5.7%	0.2	0.1	-1.6	0.4	0.5	0.4	0.7
Africa	-0.5%	-2.7%	-2.1%	1.1%	0.8%	0.6%	0.6%	-0.5	-0.9	-0.8	-0.4	-0.3	-0.4	-0.3

Source: IATA, ICAO

Perhaps the most bullish industry trend specific to Jetlines is the growth in industry-wide ancillary revenues, which are increasing in dollar amount and as a share of total airline revenues. This growth has been constant since 2010, and the rising importance of ancillary revenues highlights the alternative revenue sources that airlines rely upon as airfares lower globally in the face of competition. For Jetlines, increasing ancillary revenues globally is a tailwind given their own expectation of significant ancillary revenues upon the initiation of operations.

CarTrawler Worldwide Estimate of Ancillary Revenue								
2018 Estimate $92.9 billion (10.7% of global revenue of $871 billion)	2017 Estimate $82.2 billion (10.6% of global revenue of $776 billion)	2016 Estimate $67.4 billion (9.1% of global revenue of $740 billion)	2015 Estimate $59.2 billion (7.8% of global revenue of $763 billion)	2014 Estimate $49.9 billion (6.7% of global revenue of $746 billion)	2013 Estimate $42.6 billion (6.0% of global revenue of $708 billion)	2012 Estimate $36.1 billion (5.4% of global revenue of $667 billion)	2011 Estimate $32.5 billion (5.6% of global revenue of $577 billion)	2010 Estimate $22.6 billion (4.8% of global revenue of $474 billion)
Source: Ancillary revenue statistics applied by IdeaWorksCompany to annual airline revenue results.								

Source: IdeaWorks, CarTrawler

Financials

At the end of 2018 (ended December 31, 2018), the company had cash and working capital of $1.22 million and $0.98 million, respectively. The following table summarizes the company's liquidity position. **Note that the $7.50 million from subscription receipts recently arranged by the company (covered further below) is not reflected in the below table, nor is $3.42 million from warrants exercised subsequent to 2018.**

(in C$)	2016	2017	2018
Cash	$91,397	$2,981,046	$1,220,555
Working Capital	-$674,499	$2,698,286	$979,811
Current Ratio	0.16	6.41	1.89
LT Debt / Assets	-	-	-
Cash from Financing Activities	$561,851	$6,562,411	$6,438,245

Source: FRC

In addition, the company recorded a deposit asset of $3.22 million, comprising deposits paid with respect to previously entered aircraft leasing agreements with AerCap. Based on the wording of the company's financial statements, these deposits will not be refunded, despite the fact that the company will now be leasing their initial aircrafts from SmartLynx. Instead, the deposits may be applied to potential future aircraft lease transactions between the company and AerCap prior to April 2020.

We estimate that the company currently has 5.41 million options (weighted average exercise price of $0.41 per share) and 10.42 million warrants outstanding (weighted average exercise price of $0.40). Currently, we estimate that 3.84 million options and 9.20 million warrants are in-the-money. **If all the in-the-money options and warrants were exercised, the company could raise an additional $4.57 million.**

Financings: On December 27, 2018, Jetlines announced that it had closed a private placement with SmartLynx Airlines SIA. The company sold an aggregate of 22.73 million subscription receipts at a price of $0.33 per receipt for gross proceeds of $7.5 million. Each receipt allows SmartLynx to acquire a unit (at no additional cost) comprising one common share and a warrant exercisable at $0.45 per share. The receipts are only exercisable if the company is able to raise $40 million from subsequent financings by June 30, 2019 (which will result in proceeds of $5.25 million), and if they receive an AOC from Transport Canada (which will result in proceeds of the remaining $2.25 million). In the case that they do not meet these milestones, the company will be forced to return the raised proceeds (currently held in escrow) as well as pay unspecified interest. Furthermore, a termination fee of

US$250,000 will be owed to SmartLynx if a financing to raise the milestone of $40 million is not completed by June 30, 2019. In addition, SmartLynx has the option to acquire $7.5 million in additional subscription receipts at a later date.

In addition, the company announced on March 28, 2019, that it had entered into an LOI with a Korean special purpose fund led by InHarv Partners Ltd. ("InHarv") for a financing of up to $14 million. InHarv is a venture capital/ private equity hybrid fund based in Seoul, South Korea. A special purpose vehicle ("SPV"), a separate legal entity from the parent designed for a specific objective and to isolate financial risk, will be created to facilitate InHarv's investment into the company. The actual financing structure will consist of an initial tranche of $7 million of convertible debentures (convertible at $0.56 per share). The debentures bear an interest rate of 10% per annum, and mature 36 months from the date of issuance. The SPV has the option to increase the financing up to $14 million.

Note that the funds raised from InHarv (maximum of $14 million) will apply to the $40 million funding milestone specified by SmartLynx, as will proceeds from warrants exercised subsequent to 2018.

With the InHarv and SmartLynx investments, the company now has access to a maximum of $29 million in funding, or 52.73% of the approximately $55 million needed before the company can initiate operations. This is an important milestone for Jetlines as they establish financing facilities ahead of launch, and though the financing comes at the price of dilution and upcoming interest payments, these are necessary evils for the company. Note however, that the InHarv financing is still in early stages, and if neither InHarv nor SmartLynx exercise their options to acquire additional equity in Jetlines, the financing will be considerably smaller.

Valuation

The below outlines our updated revenue forecasts for the company. We have lowered our forecasts to account for the delay in launch, and modeled interest expenses that would arise if the InHarv financing is completed (no option exercised).

	2019E	2020E	2021E	2022E	2023E	2024E	2025E
No. of Aircraft (year-end)	2	2	6	10	14	18	22
Average in the year	0	2	4	8	12	16	20
Passenger capacity per aircraft	180	180	180	180	180	180	180
Occupancy rate	80%	80%	80%	80%	80%	80%	80%
Avg no. of passengers per flight (a)	144	144	144	144	144	144	144
Aircraft utilization (block hours per day)	12	12	12	12	12	12	12
No. of flights per day per aircraft	4	4	4	4	4	4	4
Total no. of flights per year per aircraft	730	1,460	1,460	1,460	1,460	1,460	1,460
Total passengers per year	-	210,240	840,960	1,681,920	2,522,880	3,363,840	4,204,800
Average fare (base)	$115	$115	$115	$115	$115	$115	$115
Average fare (ancillery)	$34	$34	$34	$34	$34	$34	$34
Average total fare	$149	$149	$149	$149	$149	$149	$149
Total Revenues		$31,337,954	$125,351,816	$250,703,631	$376,055,447	$501,407,263	$626,759,078
Operating Costs (all-in)	$0	$27,264,020	$107,802,561	$213,098,087	$315,886,576	$416,168,028	$513,942,444
OPEX / Revenue (all-in)	88%	87%	86%	85%	84%	83%	82%
EBIT	$0	$4,073,934	$17,549,254	$37,605,545	$60,168,872	$85,239,235	$112,816,634
EBIT Margin		13.0%	14.0%	15.0%	16.0%	17.0%	18.0%
Interest Expense	$ 350,000	$ 700,000	$ 700,000	$ 350,000	$ -	$ -	$ -
Tax	27.0%	27.0%	27.0%	27.0%	27.0%	27.0%	27.0%
Net Income	-$ 350,000	$ 2,273,972	$ 12,110,956	$ 27,102,048	$ 43,923,276	$ 62,224,641	$ 82,356,143
Net Margin		7.3%	9.7%	10.8%	11.7%	12.4%	13.1%

Source: FRC

The below table outlines the various fair values of Jetlines' shares given different debt-equity financing mixes. Investors may refer to our initiating and update reports, where we outline our valuation methodology. Note that the below has been adjusted for the SmartLynx and InHarv financings outlined above. We assume that both financings will be completed, but neither SmartLynx or InHarv will exercise their options to invest additional capital.

	New Shares Issued	Total Shares	Fair Value
100% equity at $0.50 per share	78,073,029	185,145,286	$1.56
50% equity at $0.50 per share	39,036,515	146,108,771	$1.85
100% equity at $1.00 per share	39,036,515	146,108,771	$1.98
50% equity at $1.00 per share	19,518,257	126,590,514	$2.14
100% equity at $1.50 per share	26,024,343	133,096,599	$2.12
50% equity at $1.50 per share	13,012,172	120,084,428	$2.25
100% debt	-	107,072,256	$2.35
Average			**$2.04**

Source: FRC

We are revising our fair value estimate on Jetlines' shares from $2.57 per share to $2.04 per share and maintaining our BUY rating on the company.

Risks

We believe the company is exposed to the following risks (list is non-exhaustive):

- Our valuation is dependent on a December 2019 launch. Delays or other changes to the operational timeline could significantly impact our valuation.
- High barriers to entry due to existing duopoly, as well as large initial operating cash requirement.
- External surcharges that are beyond the company's control could affect their ability to charge sufficiently low prices and stimulate new demand. These charges include taxes, airport fees, etc.
- The company is in early stages and has yet to commence operations.
- The existing Air Canada (TSX: AC)/ WestJet duopoly dominates the Canadian aviation market.
- WestJet has launched their own ULCC fleet, Swoop. Though we speculate Swoop is not a true ULCC, Swoop still benefits from WestJet's existing resources.
- Access to capital and share dilution.

We are maintaining our risk rating at 4.

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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