STIFEL | GMP

Equity Research

Drone Delivery Canada Corp.[1,7,11]

BUY

FLT-TSXV

March 5, 2020

Last: **C$0.74**
Target: **C$3.00**

On track for first revenue generation in Q1/20

We spoke with management recently and gained further insight into recent press releases and existing projects underway. In summary, we believe Drone Delivery Canada ("DDC") remains on track to generate first revenue in March, which will mark a pivotal milestone for the business. Furthermore, we expect continued evolution at the corporate level, as the business transitions from a start-up structure towards a more institutional grade governance structure. We continue to see DDC as a leader in drone delivery and believe long-term investors with a tolerance for start-up risk will be well rewarded.

First revenue to start this month: DDC said that test flights are now underway at DSV's Milton distribution centre and first revenue generating flights are expected in March. Vision Extrusion continues to be delayed by municipal permitting, but is expected to start by April; while Moosonee continues to wait for federal government approvals expected in Q2. Finally, Edmonton Airport remains on track for June launch, following the opening of a new $19mm (50k sq.ft.) Air Canada Cargo ("ACC") facility at the airport.

International discussions ongoing: DDC said that discussions continue with potential international licensing partners, with continued hope that DDC can reach one new agreement this year. This includes discussions with full service airlines in the U.S. and Europe as well as cargo airlines in continental Africa and South Asia. While region and business models remain in very early days, the signing of a new agreement this year is consistent with our expectations.

Corporate structure evolution to continue: Following several Board and management changes in 2019, DDC said it plans to continue to evolve towards a more independent Board structure and broader corporate team. This includes plans for further Board changes, a full time CFO, a Tier 1 audit firm, and regular quarterly earnings calls. While details and timing are still vague, we think this reflects the transition from a start-up culture towards a more professional governance structure suitable for institutional investors.

Valuation: We made minor changes to reflect working capital adjustments and now forecast Q4/19 cash of $10.8mm vs $13.6mm prior. We remind investors that the timing and magnitude of first revenue and 2020 revenue for that matter, are less important than the achievement of this milestone. We continue to focus on near-term strategic progress and value the business based on longer-term expectations for revenue growth. Our target price is unchanged at $3.00 based on 10x 2024 EV/Sales discounted at 10%. **BUY**.

What's Changed	Old	New
Rating	BUY	n.c.
Target	C$3.00	n.c.
Revenue 2019E (mm)	$0.0	n.c.
Revenue 2020E (mm)	$5.8	n.c.
EBITDA 2019E (mm)	($11.8)	n.c.
EBITDA 2020E (mm)	($7.2)	n.c.
FCF 2019E (mm)	($12.4)	n.c.
FCF 2020E (mm)	($7.6)	n.c.

Share Data	
Share o/s (mm, basic/f.d.)	176.2 / 198.4
52-week high/low	C$1.74 / C$0.62
Market cap (mm)	$146.8
Enterprise value (mm)	$133.1
Dividend	n.a.
Dividend yield	n.a.
Projected return	313%

Financial Data

YE Dec. 31	2018	2019E	2020E
Revenue (mm)	$0.0	$0.0	$5.8
EV/Revenue	n.a.	n.a.	22.9x
EBITDA (mm)	($19.3)	($11.8)	($7.2)
EV/EBITDA	n.a.	n.a.	-18.5x
EPS f.d.	($0.11)	($0.06)	($0.03)
P/E	n.a.	n.a.	-23.8x
FCF	($10.9)	($15.2)	($4.9)
P/FCF	n.a.	n.a.	-30.2x
Net debt	($14.3)	($10.8)	($5.8)
Net debt/EBITDA	n.a.	n.a.	n.a.
Book value	$14.5	$17.3	$12.0
P/BV	10.1x	8.5x	12.3x

All figures in C$ unless otherwise noted

Current Chart | Previous Research

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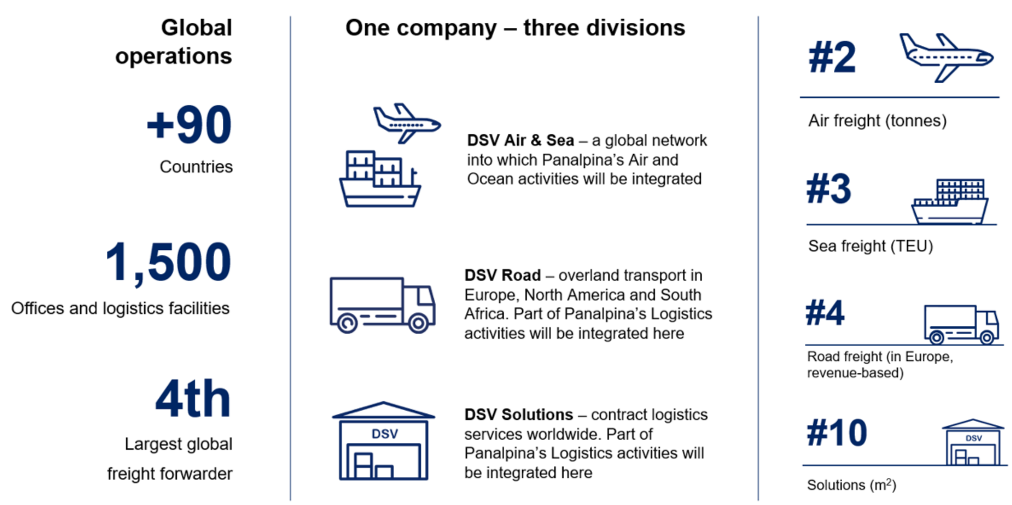
First revenue generation on track for Q1/Q20

DSV Air and Sea Inc. ("DSV")

- **First revenue to start this month:** DDC said that test flights are now underway at DSV's Milton facility and first revenue generating flights are expected in March. For reference, DSV's new Milton facility is the largest of its kind in the DSV network and the 1.1mm square feet complex will house 800+ employees. DDC will begin flights with its 10lb Sparrow drone and has said in the past that there is potential to add up to 20+ routes in Milton.
- **Background:** DSV Air & Sea Inc. is the Canadian arm of global freight forwarder DSV Panalpina A/S. DSV Panalpina A/S is a global transport and logistics company headquartered in Denmark with ~118bn DKK revenue (~ C$23bn), over 1,500 offices and logistics facilities, and operations in 90+ countries. We estimate that DSV Panalpina is the fourth largest freight forwarder globally and controls 3-4% of the total freight forwarding market.

Figure 1. Snapshot of DSV Panalpina



Source: Stifel GMP, DSV Panalpina

Vision Profile Extrusions Limited ("Vision")

- **Permitting continues to be delayed, now expected early April**: Vision Extrusion continues to be delayed by municipal permitting and now is expected to start by April 2020. This comes after its initial delay in Nov. 2019 when DDC announced as part of its Q3 financials that first revenue from Vision was delayed from its original Q4/2019 target date to Q1/2020.
- **Background:** Vision Profile Extrusions Limited is Drone Delivery's first announced customer via its Air Canada Cargo partnership. Vision is a manufacturing company based out of Vaughan, Ontario that produces extruded-plastic products such as window frames, barriers and railing, and is part of a larger family of companies under the Vision Group that manufactures steel doors, windows and outdoor patio products. It has 18 facilities across 750 acres, but not all in one place. DDC expects to have the first route running in April, and expand to four shortly thereafter.

Edmonton Regional Airports Authority ("ERAA")

- **On track for June 2020 launch**: Edmonton International Airport ("EIA") is on track for a June 2020 launch, following the opening of a new $19mm (50k sq.ft.) Air Canada Cargo ("ACC") facility at the airport. The new ACC facility at EIA will support Air Canada's ground support services and cargo teams, including maintenance and upkeep for 167 vehicles. We believe this represents significant opportunity for DDC to roll out its services for more efficient transportation within ACC's internal operations as well as for external customers, similar to its DSV opportunity in Milton. ERAA is expected to help promote and market DDC's services to new and existing customers, which we believe could accelerate the robust growth potential given EIA's existing customer relationships, in particular with partner airports and high air cargo traffic in Canada.

- **Background:** ERAA operates EIA and Villeneuve Airport, and Drone Delivery expects to build out the world's first airport drone delivery hub out of EIA. For reference, EIA is the fifth busiest airport by passenger traffic and eighth busiest by air cargo traffic in Canada serving over 8.2mm passengers and 28,500 tonnes of air cargo (2% of total Canadian air cargo) in 2018.

Other developments:

- **Moosonee funding wait continues:** Moosonee continues to wait for federal government funding which is now expected to come in Q2. Deployment with the Moose Cree First Nation communities has been delayed numerous times as it was originally expected to start in the summer of 2019. To offset the unpredictability of federal funding, management said it is in talks with several charitable organizations that are interested in funding the endeavour and initial operations. While early days, management said funding discussions are currently in the range of $1mm-$15mm, with the benefit of social/charitable development and tax credits for the partner, and a bridge to federal funding for DDC.

- **International discussions ongoing:** DDC said it is still in talks with prospective international licensing partners and hopes to have an agreement by year end. This includes full service airlines in the U.S. and Europe as well as cargo airlines in continental Africa and South Asia. For the U.S. in particular, management said it is seeking a licensing partner that has aviation experience and is willing to put up at least $1mm/year in fees to start. While region and business models remain in very early days, the signing of a new agreement this year is consistent with our expectations.

Figure 2. Revenue forecasts

Revenue Model (C$mm)	FY2019E	FY2020E	FY2021E	FY2022E	FY2023E	FY2024E
Routes						
Remote Northern Communities	0	1	4	7	9	11
Int'l License Customers	0	1	2	5	11	21
Air Canada Partnership	0	10	25	50	100	300
Average Revenue per route/customer per year						
Remote Northern Communities	$0.000	$2.063	$1.656	$1.696	$1.722	$1.727
Int'l License Customers	$0.000	$2.000	$2.000	$1.700	$1.500	$1.595
Air Canada Partnership	$0.000	$0.175	$0.147	$0.140	$0.141	$0.158
Revenue						
Remote Northern Communities	$0.000	$2.063	$6.625	$11.875	$15.500	$19.000
Int'l License Customers	$0.000	$2.000	$4.000	$8.500	$16.500	$33.500
Air Canada Partnership	$0.000	$1.750	$3.675	$7.000	$14.125	$47.500
Total Revenue	**$0.000**	**$5.813**	**$14.300**	**$27.375**	**$46.125**	**$100.000**

Source: Stifel GMP

Valuation

Drone Delivery Canada has a market capitalization of $146.8mm. The stock is currently trading at C$0.74 per share, well above its initial listing price of C$0.14 and but below its most recent financing at C$1.20, its 52-week high of C$1.74 per share, and all-time high of C$2.25.

We made minor changes to our model to reflect working capital adjustments and now forecast Q4/19 cash of $10.8mm vs $13.6mm prior.

We value Drone Delivery Canada based on a future EV/Sales multiple, discounted to present value. Our target price of $3.00 is unchanged and is based on 10 times 2024 EV/Sales of $100mm and discounted to present value at a 10% discount rate. This implies a target EV of $606mm.

To further examine valuation, we looked at two comparable companies:

- **Zipline International (private)**: Zipline is a drone delivery startup based out of Half Moon Bay, California. The company specializes in medical product deliveries (blood samples, health kits, medical supplies, etc.) and has made over 14k drone flights so far, with operations in Rwanda and Ghana. Zipline raised a US$190mm Series D round at a US$1.34bn (C$1.7bn) valuation and is backed by prominent investors including Sequoia, Andreesen Horowitz, Alphabet and Goldman Sachs. Based on trade press estimates of US$4.3mm (C$6.7mm) in annual revenue, Zipline is trading at over 300x LTM sales, which is not atypical for early stage startups.
- **Cargojet Inc (CJT-TSX, not covered)**: Cargojet is one of Canada's leading providers of overnight air cargo services. CJT currently has a market cap of $1.5bn and trades at 4.1x C2020 EV/Sales and 12.2x C2020 EV/EBITDA.

Out of the two comparables, we believe that Zipline is the more appropriate peer at present, while Cargojet may offer an indication of what valuation could look like as DDC achieves meaningful revenue, and sustained above-industry growth levels. That said, we see broader application for DDC's technology (air cargo, commercial depot-to-depot, first-nation communities) vs Zipline's medical products niche, and greater opportunity to expand globally, vs Cargojet's Canada-only operations.

We also note that Zipline is a private company, and venture-backed unicorns are becoming more commonplace. Given DDC offers a similar opportunity, but is a public stock accessible to a broader group of investors, a scarcity premium could result in our view.

We believe Drone Delivery Canada has clearly entered the commercialization phase of its development. In the past two years, the company achieved key milestones such as successfully completing the Transport Canada commercial pilot program in Moosonee/Moose Factory, receiving pilot approval from Transport Canada and NAV Canada, signing the company's first commercial agreement, and announcing a commercial partnership with a major airline, which we believe is a first in the drone industry. We continue to see DDC as a leading technology innovator in commercial drone delivery and believe long-term investors with a tolerance for start-up risk will be well rewarded.

Figure 3. Comparables valuation

Companies			2/27/2020 Price	Market Cap (M)	Enterprise Value (M)	EV/SALES LTM	EV/SALES C2019	EV/SALES C2020	EV/EBITDA LTM	EV/EBITDA C2019	EV/EBITDA C2020	PRICE/FCF LTM	PRICE/FCF C2019	PRICE/FCF C2020
Drone Delivery Canada Corp	**FLT-CA**	**CAD**	**0.74**	**146.8**	**133.1**	**n.a**	**n.a**	**22.9x**	**n.a**	**NA**	**NA**	**NA**	**NA**	**NA**
Early Stage Tech														
AppFolio Inc Class A	APPF-US	USD	120.02	4,272.4	4,318.4	16.9x	16.9x	13.5x	136.7x	122.1x	84.6x	127.7x	NA	NA
Ambarella, Inc.	AMBA-US	USD	55.18	1,837.7	1,447.6	6.3x	6.3x	6.1x	NA	179.1x	NA	37.1x	46.2x	98.0x
Coupa Software, Inc.	COUP-US	USD	153.38	9,671.7	9,599.9	27.2x	25.9x	20.0x	NA	261.2x	168.2x	225.8x	240.1x	148.2x
Alteryx, Inc. Class A	AYX-US	USD	144.76	10,007.5	9,955.0	23.8x	23.8x	17.7x	213.4x	123.4x	113.1x	440.1x	440.1x	3,549.3x
ParaZero Ltd.	PRZ-ASX	AUD	0.04	3.6	2.9	1.3x	NA	NA	NA	NA	NA	NA	NA	NA
Average						**15.1x**	**18.2x**	**14.3x**	**22.2x**	**171.4x**	**47.5x**	**165.9x**	**242.2x**	**1265.2x**
Logistics and Transportation														
Descartes Systems Group Inc.	DSG-CA	CAD	57.18	4,879.9	4,853.8	11.7x	11.2x	10.2x	34.5x	32.2x	27.9x	39.2x	39.3x	29.7x
Cargojet Inc.	CJT-CA	CAD	107.61	1,486.4	2,118.6	4.4x	4.4x	4.1x	14.1x	13.6x	12.2x	NA	NA	24.4x
Canadian Pacific Railway Limited	CP-CA	CAD	344.38	47,421.1	56,399.1	7.2x	7.2x	6.8x	14.8x	14.7x	13.3x	50.9x	38.0x	30.0x
Union Pacific Corporation	UNP-US	USD	162.17	112,691.9	138,833.9	6.4x	6.4x	6.3x	12.9x	12.9x	12.2x	44.1x	21.8x	19.5x
Canadian National Railway Company	CNR-CA	CAD	118.01	84,660.4	98,369.4	6.6x	6.6x	6.3x	13.7x	13.7x	12.8x	164.7x	42.5x	26.7x
Kansas City Southern	KSU-US	USD	158.63	15,542.6	19,099.9	6.7x	6.7x	6.3x	13.6x	13.6x	12.3x	46.7x	34.3x	25.1x
Average						**7.2x**	**7.1x**	**6.7x**	**17.3x**	**16.8x**	**15.1x**	**54.5x**	**-324.6x**	**25.9x**
FAANG Stocks														
Facebook, Inc. Class A	FB-US	USD	191.76	550,543.0	506,754.0	7.2x	7.2x	5.9x	14.6x	12.8x	11.5x	26.0x	27.0x	23.3x
Apple Inc.	AAPL-US	USD	302.74	1,348,586.8	1,358,107.8	5.1x	5.1x	4.7x	17.8x	17.4x	16.2x	27.0x	22.1x	19.3x
Amazon.com, Inc.	AMZN-US	USD	1,975.83	997,794.2	1,019,987.2	3.6x	3.6x	3.1x	27.9x	23.7x	20.4x	46.1x	37.1x	27.9x
Alphabet Inc. Class C	GOOG-US	USD	1,386.52	963,900.4	860,192.4	5.3x	5.3x	4.5x	18.2x	14.7x	12.6x	31.1x	30.9x	26.4x
Netflix, Inc.	NFLX-US	USD	383.79	173,230.1	184,584.2	9.2x	9.2x	7.6x	15.5x	59.3x	42.3x	NA	NA	NA
Alibaba Group Holding Ltd. Sponsored ADR	BABA-US	USD	211.96	566,807.5	550,753.3	7.8x	8.1x	6.2x	30.5x	26.6x	20.5x	NA	21.4x	22.6x
Microsoft Corporation	MSFT-US	USD	170.55	1,311,700.1	1,264,594.1	9.4x	9.4x	8.4x	20.7x	21.1x	18.2x	50.2x	32.9x	29.5x
Average						**6.8x**	**6.9x**	**5.8x**	**20.7x**	**25.1x**	**20.3x**	**70.0x**	**70.0x**	**70.0x**
Group Average						**9.7x**	**10.7x**	**8.9x**	**20.1x**	**71.1x**	**27.6x**	**96.8x**	**-4.1x**	**453.7x**

Notes: Averages exclude outliers. Estimates from FactSet and Bloomberg

Source: Stifel GMP, FactSet

Risks

Capital requirements: DDC is not currently generating commercial revenue. The company has raised ~$40mm of capital and has $13.7mm in cash available as of Sept. 30, 2019, versus a burn rate of ~$3mm/q. We expect partners to contribute to initial infrastructure investment and commercial revenue to begin in Q1 2020. However, timing of revenue and operating leverage are uncertain and material delays would likely require additional capital raises and potential dilution for existing shareholders.

Regulatory uncertainty: Requirements for the approval and licensing of commercial drone operations in Canada are evolving concurrent with the technology and applications. Changing regulations and government approval processes could delay licensing or increase requirements for DDC. This could impact timing of commercial operations and capital requirements near-term. Should DDC ultimately not receive a licence for commercial BVLOS operations, or approvals for key routes, this would have a material adverse effect on the business in our view.

Operational risk: As DDC moves beyond the testing and pilot phase, new operational risks will rise in importance. This includes factors such as safety, reliability, on-time efficiency and customer service. Testing and simulation help, but cannot fully mitigate these risks. We believe this will require the accumulation of real-world operating experience for DDC and its customers.

Technology risk: The pace of innovation for both drone hardware and software systems has accelerated in recent years. While this has largely benefited DDC, new advancements must be adopted and integrated quickly if DDC is to keep costs low, expand its capabilities, and maintain its leadership.

Competition: Several large technology and logistics companies have invested in drone development, including the likes of Amazon, Google, UPS and DHL, while large incumbents dominate other segments of the supply chain. While we see few direct competitors to DDC today, new entrants with access to material capital have the potential to change competitive dynamics.

Valuation risk: At this early stage, the nature of DDC's commercial agreements and revenue model remains fluid and could change. The timing of the start and ramp of commercial revenue also remains uncertain. These factors make valuation particularly challenging and uncertain for investors, irrespective of the high risks associated with early-stage technology companies.

Figure 4. Financial model summary

Drone Delivery Canada
Year ended December 31
Income Statement (C$M)

	FY2019E	FY2020E	FY2021E	FY2022E	FY2023E	FY2024E
Total Northern Canada Revenue	0.00	2.063	6.625	11.875	15.500	19.000
Total Int'l Revenue	0.00	2.000	4.000	8.500	16.500	33.500
Total Air Canada Revenue	0.00	1.750	3.675	7.000	14.125	47.500
Total Revenue	**0.00**	**5.813**	**14.300**	**27.375**	**46.125**	**100.000**
Cost of Sales						
Operating and maintainance costs	0.00	2.616	5.291	10.129	17.066	37.000
Total Cost of Sales	**0.00**	**2.616**	**5.291**	**10.129**	**17.066**	**37.000**
Gross Profit	0.00	3.197	9.009	17.246	29.059	63.000
Gross Margin %	**n.a.**	**55.0%**	**63.0%**	**63.0%**	**63.0%**	**63.0%**
Total Expenses	**12.125**	**10.737**	**10.860**	**10.960**	**11.042**	**11.108**
Income from Ops.	**(12.125)**	**(7.541)**	**(1.851)**	**6.286**	**18.017**	**51.892**
Earnings before Tax	**(12.482)**	**(7.541)**	**(1.851)**	**6.286**	**18.017**	**51.892**
Net Income/(loss)	**(11.941)**	**(6.169)**	**(1.535)**	**5.044**	**14.398**	**41.867**
EBITDA	(11.837)	(7.203)	(1.391)	6.846	18.659	52.600
EBITDA %	n.a.	*-124%*	*-10%*	*25%*	*40%*	*53%*
EPS	(0.07)	(0.04)	(0.01)	0.03	0.08	0.24
EPS F.D.	(0.06)	(0.03)	(0.01)	0.03	0.07	0.21
Weighted Avg. Basic Shares	172.50	176.19	176.19	176.19	176.19	176.19
Weighted Avg. Diluted Shares	193.51	198.42	198.42	198.42	198.42	198.42
Margins %						
Gross margin	*n.a.*	*55%*	*63%*	*63%*	*63%*	*63%*
Operating margin	*n.a.*	*-130%*	*-13%*	*23%*	*39%*	*52%*
Net margin	*n.a.*	*-106%*	*-11%*	*18%*	*31%*	*42%*
SG&A	*n.a.*	*21%*	*8%*	*4%*	*3%*	*1%*
Growth YoY %						
Total Revenue	*n.a.*	*n.a.*	*146%*	*91%*	*68%*	*117%*
Expenses, excl dep + amortization	*64%*	*89%*	*102%*	*102%*	*101%*	*101%*
Operating Income	*-37%*	*-38%*	*-75%*	*-440%*	*187%*	*188%*
EBITDA	*-39%*	*-39%*	*-81%*	*-592%*	*173%*	*182%*
Cash used in operating activities	**(13.334)**	**(2.861)**	**0.398**	**5.583**	**11.470**	**37.724**
Cash from Investing	**(3.119)**	**(2.000)**	**(1.000)**	**(1.000)**	**(1.000)**	**(2.000)**
Cash from Financing	**12.989**	**(0.172)**	**(0.172)**	**(0.172)**	**(0.172)**	**(0.172)**
Cash at the end of period	**10.844**	**5.811**	**5.037**	**9.448**	**19.745**	**55.298**
Free Cash Flow						
Cash from Ops.	(13.334)	(2.861)	0.398	5.583	11.470	37.724
Capital Expenditure (Acquisition of PPE)	(1.876)	(2.000)	(1.000)	(1.000)	(1.000)	(2.000)
Free Cash Flow	**(15.211)**	**(4.861)**	**(0.602)**	**4.583**	**10.470**	**35.724**
YoY % change	39.84%	-68.04%	-87.61%	-861.18%	128.45%	241.22%
FCF as a % of revenue	n.a.	-84%	-4%	17%	23%	36%
FCF as a % of EBITDA	128%	67%	43%	67%	56%	68%

Source: Stifel GMP

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