

# PALOS

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## Weekly Commentary

Issue No. 13 | MARCH 28, 2022

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## Headwater Exploration – Huge Potential in the Clearwater

Headwater Exploration Inc. (TSX: HWX) is a Calgary-based company that's engaged in the exploration and development of petroleum and natural gas assets in Canada. The company was created on March 4, 2020 after a Recapitalization Transaction that raised \$50 million via two private placements. The management team is led by the former management team of Raging River Exploration Inc., which was acquired by Baytex Energy Corp. (TSX: BTE) in 2018.

Headwater's primary focus is the Clearwater play located in North Central Alberta. The company also engages in natural gas production from the McCully gas field located near Sussex, New Brunswick. The McCully play is a "wintertime producer" that includes processing and transmission capacity that allows for marketing into U.S. Northeast markets where HXW benefits from premier winter season pricing.

Management's strategy is built on five objectives: build a sustainable business with no debt, grow through exploration of the land assets, add to the land base through strategic tuck-in acquisitions, pursue a program of long-term return of capital to shareholders and the utilization of EOR (Enhanced Oil Recovery) to improve production. EOR is achieved through a process called "waterflooding". This process involves injecting water into the reservoir formation which in turn creates sufficient pressure to "force" additional oil to the surface.

In December 2020, HWX acquired the Marten Hills assets owned by Cenovus Energy (TSX: CVE) for a total consideration of \$135.3 million comprised of cash (\$32.8 million), common shares (\$96.5 million), and warrants (\$6.0 million). The deal included a 100% interest in the Marten Hills heavy oil properties located in the prolific Clearwater play. The acquisition included a significant amount of undeveloped property in the area.

As we previously mentioned in our March 14 letter, the Clearwater play is widely viewed as the most promising discovery in North America in decades. Characteristics that distinguish the value potential of Clearwater play include the favorable viscosity of the heavy oil, significant potential for expansion and the relatively short amount of time for wells to turn a profit. Current production is approximately 12,400 boe/day

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consisting of 85% heavy oil. Three new wells were drilled and brought online at Marten Hills in Q4/2021 and exceeded expectations. In late 2021, drilling programs in the Marten Hills area indicated a potential new pool discovery. Headwater's board has approved an increase in capital from \$120 million to \$145 million which is destined for drilling on newly acquired properties.

The company's oil processing facility commenced operations in January and is moving roughly 12,000 boe/day. This has resulted in an immediate reduction in transportation costs of \$2.00/day. In addition, 90% of HWX production is anticipated to be pipeline connected in Q1/2022, offering an additional \$2.00/barrel reduction in transportation costs.

HWX is ideally positioned to capitalize on the incredible long-term potential of the Clearwater play. Management has a proven track record of success and has enshrined principles of positive governance in the company's culture. Worker health and safety, community and indigenous engagement, environmental stewardship and transparent communication are being embraced as essential to sustainability and success.

In our view, Headwater offers an excellent way to invest in a pure play Clearwater company. Three of our funds, the **Palos Income Fund**, the **Palos Equity Income Fund**, and the **Palos-Mitchell Alpha Fund** are currently invested in shares of Headwater.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) <sup>1</sup>	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$10.12	2.85%
Palos Equity Income Fund - RRSP	PAL101	\$7.40	2.10%
Palos Merchant Fund L.P. (Dec 31, 2021) <sup>2</sup>	PAL500	\$1.16	24.67%
Palos WP Growth Fund - RRSP	PAL213	\$18.25	-3.69%
Palos-Mitchell Alpha Fund <sup>3</sup>	PAL300	\$10.62	3.31%
S&P TSX Composite (Total Return with dividends reinvested)			4.31%
S&P 500 (Total Return with dividends reinvested)			-4.35%
S&P TSX Venture (Total Return with dividends reinvested)			-5.62%
Chart 2: Market Data <sup>1</sup>			Value
US Government 10-Year			2.47%
Canadian Government 10-Year			2.55%
Crude Oil Spot			US \$113.90
Gold Spot			US \$1,954.20
US Gov't10-Year/Moody BAA Corp. Spread			198 bps
USD/CAD Exchange Rate Spot			US \$0.8015

<sup>1</sup> Period ending March 25th, 2022. Data extracted from Bloomberg

<sup>2</sup> Fund is priced annually

<sup>3</sup> Fund is priced weekly on Tuesdays



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