Highlands Natural Resources plc

Highlands Natural Resources (HNR) is a diversified resources company with a broad portfolio of activities. The group's core assets are located in Colorado and include a vertically integrated cannabidiol (CBD) products business and a 7.5% carried working interest in the East Denver Project, a producing oil and gas field. These businesses represent the foundations of HNR's strategy to assemble a portfolio of projects whereby up to 80% of its assets generate sustainable revenue streams, complemented by more speculative projects which offer the potential for longer term capital appreciation.

Following a successful placing to raise gross funds of £1.56m in March 2019, HNR launched Zoetic on 1 April 2019, with the aim of establishing a vertically integrated premium producer of CBD products derived from organic hemp in Colorado.

HNR has leased a purpose built intensive indoor growing facility of 33,000 square feet which has an annual capacity of up to 40,000 plants over four 90-day growing cycles. This capacity is augmented by at least 40,000 additional plants to be cultivated from the company's outdoor growing operations, which cover an initial area of 16 acres.

In order to maximise the returns on its CBD production, HNR has established two CBD brands; 'Zoetic' and 'Chill', with their own direct-to-retail websites. Launched already in the US and soon in the UK, Zoetic is a premium CBD brand with products including tinctures, soft gel capsules and in due course, topicals whereas the Chill brand will market high quality CBD products sold as an alternative to tobacco including smokables, vapes and chew pouches.

Across other sales channels, HNR has a distribution agreement with Schrader Oil and Ox Distributing which will stock products from the Chill brand in 36 convenience stores in the US, while in the UK Zoetic is introducing CBD products online that include tinctures in a range of flavours and strengths. Zoetic also has an agreement with Chicago-based online retailer, LeafyQuick which is now stocking products from both the Chill and Zoetic ranges.

Looking ahead, HNR has aspirations to expand its outdoor growing operations up to 100 acres in 2020 and further develop Zoetic's seed genetics which will enable the company to broaden its product spectrum. The company will also direct resources into growing its online retail sales platform and promote further its international expansion beyond key markets in the UK and the US, with a particular focus on continental Europe.

On the oil and gas side of the business, HNR holds a 7.5% carried working interest in the East Denver Project oil and gas in Colorado. Currently comprising eight wells that have been in production since January 2019, East Denver provides cash flow to HNR which covers a proportion of group fixed overhead. HNR contributes its share of operating expenditure. However, the operator has assumed all capital costs for the project and in the event that the full development potential (16-24 additional wells) of the field is realised within budget, such a project could provide HNR with significant future revenue at negligible capital outlay.

HNR possesses several additional assets which represent longer term potential including its enhanced oil recovery business, DT Ultravert and a Kansas-based nitrogen-hydrogen asset which has exciting potential for agriculture. The group also possesses a Colorado based frack-water treatment business and leases in Montana which could be prospective for natural gas and helium. With activities in East Denver now stabilised following well intervention work by the operator in June and July, we believe that HNR will increasingly focus its cash resources and management time growing Zoetic as it seeks to become a leading premium CBD products business with the prospect of attractive revenue growth in the latter part of the current financial year.

Stock Data

Share Price:	6.9p
Market Cap:	9.8m
Shares in issue:	142.5m

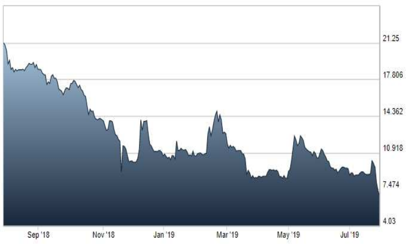
Company Profile

Sector:	Natural Resources
Ticker:	HNR
Exchange:	Standard List

Activities

Diversified natural resources company whose core assets include a 7.5% carried working interest in the East Denver Project, a producing oil and gas field in Colorado and a vertically integrated premium CBD business also located in Colorado, USA.

Share price performance chart



Source: LSE

Past performance is not an indication of future performance.

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Introduction to the company

Highlands Natural Resources' (HNR) is a diversified resources company whose core assets include a portfolio of oil producing wells located in the US state of Colorado and a vertically integrated CBD (cannabidiol) products business; Zoetic, also based in the US. In addition to these primary assets, HNR also possesses several additional businesses which include:

- Highlands Water Resources: A business with plans to address water shortages on hydrocarbon fracking sites.
- Kansas nitrogen-hydrogen discovery: Already being used in Zoetic's business but with the capability of third party sales to come.
- Enhanced oil recovery: A re-fracking and oil and gas well protection technology named 'DT Ultravert' which could have potentially positively disruptive applications in the oil and gas industry.
- Montana Project: An earlier stage business which holds acreage that could be prospective for both natural gas and helium.

Core strategy and management

HNR has formulated a strategy to build, develop and manage a diverse portfolio of projects and assets whereby up to 80% of the company's ventures generate sustainable revenue with strong visibility, complemented by more speculative projects which provide the potential for longer term yet significant capital appreciation.

The group is led by an experienced management team headed up by CEO Robert B. Price and recently appointed Finance Director, Nick Tulloch complemented by an in-house technical and analytical team comprising Eric Anderson (Senior VP) and Paul Mendell (Geologist). This is augmented by a team consisting of geologists, analysts and consultants and the expertise of an Advisory Board with a broad range of experience which HNR is able draw upon in regard to its portfolio of projects.

Zoetic - Background

In March 2019, HNR raised £1.56m through the issue of 18.3 million new shares at 8.5p per share with the purpose of establishing a vertically integrated cannabidiol (CBD) business in Colorado, USA through a new wholly owned subsidiary. Commencing operations on 1 April 2019, Zoetic has a core aim to establish the brand as a leading premium producer of CBD products derived from hemp in the US primarily and also internationally.

The establishment of Zoetic follows on from HNR's hydrogen-nitrogen gas discovery in western Kansas (see later section of this report) where the company explored the concept of utilising its gas mixture as an organic agricultural yield enhancer. In this regard, HNR reported that the hydrogen-nitrogen mixture increased cannabis plant size, height, root diameter and flower count by up to 30%.

The hydrogen-nitrogen gas mixture has been tested successfully on several agricultural products and following the passage of 2018 US Government Farm Bill, HNR elected to integrate its gas with organic industrial hemp growing operations in the state of Colorado. It should be noted that since the 2018 Farm Bill, the growing of industrial hemp and production of CBD derived from it are fully legal in the US under federal law.

Operations

To commence operations, HNR entered into an agreement to lease a large purpose built indoor growing facility from a company which had ceased earlier cannabis cultivation operations. The facility seen in the photograph below comprises approximately 33,000 square feet of indoor growing space. HNR also retained the previous management team for their expertise and knowledge and incentivised them with 5 million warrants (all subsequently exercised in June 2019) in addition to an agreement to issue the team with 12.9 million new HNR shares in March 2020.

Indoor CBD growing operations at De Beque, Colorado

Source: Company

Indoor cropping

HNR secured the initial hemp plants and seeds from local organic hemp producers in Colorado and activities are currently focused on growing up to 40,000 annual plants from the company's indoor growing operations located in De Beque, Colorado.

We understand that it takes approximately 90 days for a plant cultivated indoors to reach maturity (albeit potentially slightly longer if the plants are being cultivated for seed production). As such, we assume that annual output of 40,000 plants will be derived from up to four 90-day growing periods comprising 10,000 plants per period over the course of a full year.

Outdoor activities

HNR is also cultivating at least 40,000 plants from its outdoor growing operations covering an area of over 16 acres located in Palisade, Colorado. Although this is a less intensive operation as the company will not be able to instigate multiple annual crops as a result of outdoor seasonal conditions, it is far less capital intensive than indoor activities, where facility construction costs amounted over $5m. We note that HNR has 53 acres of available area at its De Beque operation providing a significant opportunity to increase the size of the outdoor crop over time. Additional land could be leased from local farmers as required.

According to HNR, the wholesale price of hemp seeds is high at approximately $1 per seed. As such, establishing a large growing operation from scratch is expensive. However, HNR has completed all start-up operations and ongoing cropping of mature hemp will also provide the company with a significant batch of new seeds to propagate not only the next round of planting but also for commercial sale.

We understand that a well-managed mature plant grown indoors can provide up to 500 seeds per plant. As such, the first crop of 10,000 plants has the potential to provide up to five million new seeds. Although it is only the feminised seeds that have a commercial value and we should conservatively half this number to generate an indicative yield, it is clear that HNR will be self-sufficient in seeds after the harvesting of the first 90-day crop. Following first planting indoors in Q2, we expect that August 2019 will deliver the first crop to HNR with revenue in the current financial year weighted towards the second half of the period.

CBD product range

Hemp produces over 100 cannabinoids from every part of the plant including the stem and leaves although the highest concentration of CBD is derived from the flower. Industrial hemp has been cultivated to produce more of the commercially valuable CBD products and less of the Tetrahydrocannabinols (THC) which is the principal psychoactive constituent of cannabis and remains illegal in many countries.

Full spectrum CBD is a brown paste and pure CBD is a white tasteless powder. Both products are commercially valuable and have been utilised in a range of commercial products. These include cosmetic skin care ranges, lotions, food including cereal and bakery products and also cigarettes which provide medicinal claims.

The company estimates that a plant grown indoors can produce up to 12 grammes of CBD per plant whilst a plant grown outdoors can yield up to 30 grammes per plant, offsetting much of the impact of a single annual yield. With estimated wholesale prices of approximately $3 per gramme according to the company, even the ground level value of CBD is attractive. However, we acknowledge that the value of CBD in HNR's own products could represent many multiples of the wholesale value and significant upside to the company.

The Zoetic brand

Zoetic has already established two CBD brands; 'Zoetic' and 'Chill' with their own direct-to-retail websites. Zoetic is a premium CBD brand available in the US and UK through the respective websites www.zoetic.com and www.zoetic.uk.com which are being launched soon. Products expected to be available soon include premium tinctures, soft gel capsules and in due course, topicals (a medication applied to a particular place on the body). In conjunction with this, Zoetic will be launching a social media campaign to build awareness of its brands in the US and UK markets.

The planned Zoetic CBD products

Source: Company

The Chill brand

The Chill brand has been positioned as a high quality CBD product used as an alternative to tobacco. As such, products will include smokables, vapes and chew pouches. The website www.thechillway.com has been launched with products expected to available in the US imminently.

In the US, under a commercial sale and distribution agreement with Schrader Oil and Ox Distributing, 36 convenience stores have also agreed to stock products from the 'Chill' brand. Chill smokables have been available in all of the stores since early July 2019 and the initial delivery of products has been invoiced by the company.

The planned chill product range

Source: Company

Other commercial activities

The company also announced in July 2019 that CBD products had already been despatched from the US operation and retail sales would commence shortly in the UK. The first product lines in the UK will be CBD tinctures available in four flavours: natural, peppermint, melon and blood orange and two strengths: 500mg and 1,000mg. Zoetic is instigating online sales and the company is in discussions with a specialist distributor with access to retail stores in the UK.

Zoetic has also reached agreement with LeafyQuick, a specialist Chicago-based online retailer of CBD products. LeafyQuick will stock products from both the Chill and Zoetic ranges. LeafyQuick sells products across the whole US. However, it has the capability to provide same day delivery in Chicago, a major US market with over 2.7 million people.

Growth opportunities

HNR is confident that the company is positioned to be a market leader in premium CBD products as its operation develops. In particular, the company intends to expand its outdoor growing operations to 100 acres by 2020 and further develop Zoetic seed genetics. This is likely to enable the company to broaden its product spectrum with additional CBD consumable products and lotions.

With regards to sales and marketing, the company will also direct resources into growing its online retail sales platform and promote further its international expansion beyond key markets in the UK and the US, with a particular focus on continental Europe.

East Denver shale

On the oil and gas side of the business, HNR possesses a 7.5% carried working interest in eight wells at the East Denver Project in Colorado. These wells, which are named Buckskin, Citadel, Grizzley, Hagar, Ouray, Thunder, Wildhorse and Powell have been in production since mid-January 2019 and provide cash flow to the company covering a proportion of its fixed group overheads. Gas sales from East Denver were established at the end of January 2019 following the completion of a gas pipeline to the field.

As part of an ongoing agreement, HNR's partner, True Oil LLC operates the East Denver Project and has assumed all capital costs and operational responsibilities. HNR does contribute its share of operating expenditure and lease costs in accordance with its 7.5% interest in the project.

Full development potential

HNR's carried working interest applies to the next two drilling units within an Area of Mutual Interest that covers 32,000 acres. As such, the East Denver Project possesses a full development potential of an additional 16-24 wells, which if progressed by the operator, would be developed at no capital cost to Highlands, (subject to the cost of each well not exceeding $7.0m in which case HNR would contribute 5.5% of the excess). Such a project would provide HNR with significant future revenue upside at a modest or potentially negligible capital outlay.

Drilling operations and facilities at the East Denver Project

Source: Company

Recent activities

The company notes that during the month of July 2019 to date, gross production at East Denver averaged approximately 1,700 Bopd and 5,500 Mcfpd (128 bopd and 412.5 mcfpd net to HNR's carried interest). The oil component of production in particular was below the IP levels attained in February 2019 of 4,053 bopd given that during June, two of the wells were taken offline for workover activity where a gas lift was applied to assist production. This was completed successfully and both wells are now back on production as of July 2019.

Workover activity is an ongoing operation in regard to projects consisting of multiple producing wells and the company acknowledges that June production was temporarily below expectations. The company also notes that the operator is currently expected to install artificial lifting on the remaining four wells during July through the installation of rod pumps and these are likely to incur additional disruption to production whilst these procedures are carried out.

Although this hiatus is not expected to be significant, HNR notes that operating costs over recent months at the site have been higher than initially forecast as the workover programme and activities to establish a gas pipeline have been expedited. Although HNR is carried on capital expenditure across the East Denver Project, it is obliged to meet its 7.5% share of operating expenditure which has been temporarily higher as a function of recent activities. In mitigation of these circumstances, the company has received confirmation from the operator that future monthly costs will be considerably reduced.

Although the company is confident that East Denver will be a source of valuable income over the medium term, HNR acknowledges that its long term objective of covering its group fixed overheads from East Denver's cash flow has not been realised. Additionally, the nature of hydrocarbon production from shale is that the production from wells will decline substantially over time and we believe that the East Denver asset will become a less important part of the group's portfolio as Zoetic grows its revenue base over the next twelve months.

Other activities

Enhanced oil recovery – DT Ultravert

HNR has developed the DT Ultravert proprietary technology as a solution to the problem of 'well bashing' that is becoming increasingly common across many US shale plays. This problem can occur as these plays become more intensively drilled, with reduced acreage spacing between infill wells, and new wells ('child wells') are drilled in close proximity to already producing wells ('parent wells').

While an existing producing parent well is already experiencing a natural reduction in reservoir pressure, a nearby child well is fracked resulting in a reduced performance from both wells as fracking fluid from the new well migrates naturally towards the low-pressurised parent well as the fractures from the new wells connect with the old ones. This can damage wells beyond repair and impair production from both parent and child wells.

A potential solution to well-bashing

DT Ultravert uses proprietary techniques to inject gas (usually nitrogen) into the parent wells, maintaining pressure prior to and during the fracking of a new child well (effectively shielding the parent well from the impact of new fractures) in order to maximise productivity from both wells and mitigating the impact of well bashing on older parent wells.

Despite this escalating problem of well bashing in the US shale plays, HNR argues that solutions offered by oil services companies have not been particularly effective to date. In response to this HNR deployed DT Ultravert in the Permian Basin in February 2018 where it was demonstrated to be effective in preventing well-bashing in horizontal wells which represent the majority of new wells drilled into shale formations. During this pilot test, HNR noted that reservoir pressure in the parent well was boosted by up to 400% and the elevated pressures were also maintained above pre-treatment levels throughout the child well frack operation. When the parent well resumed production, the company demonstrated that the effects of well bashing had been minimised relative to neighbouring bashed parent wells.

HNR has presented its findings to the oil and gas industry through the North American Prospect Expo (NAPE) conference in Houston in February 2018 and the company has also instigated discussions with several oil and gas companies who have expressed interest in DT Ultravert. As yet, the company has yet to convert significant degrees of initial interest into orders and this arm of the business is not currently revenue generating.

DT Ultravert in operation

Source: Company

Kansas nitrogen

We note that DT Ultravert utilises large volumes of nitrogen during its operation given that the process pumps significant quantities of both liquefied and gaseous nitrogen into wellbores. HNR possesses over 3,500 acres of leases in Kansas where it has discovered substantial volumes of high quality nitrogen gas. If these resources can be developed, HNR believes that access to propriety nitrogen resources could reduce significantly one of the major components of DT Ultravert deployments and make the operation more cost effective and therefore more appealing to potential customers.

By way of illustration, in initial deployments of DT Ultravert, over 20,000 mcf of nitrogen was purchased at a significant premium to the wholesale price of natural gas in the US. However, on the company's Kansas lease, the Barrat 1-14B well flowed nitrogen (purity levels of 99.59%) at 2,581 mcfpd at a fraction of the cost of purchasing nitrogen indicating that there is significant potential for HNR to produce this resource in the future and reduce the input costs of its DT Ultravert technology solution.

We note that this is likely to incur a substantial capital requirement for the company for which it is currently unfunded. As such, we consider DT Ultravert a non-core activity while the management concentrates its focus on the Zoetic business.

Potential for Zoetic CBD business

At the time of the acquisition of the Kansas lease in May 2018, the company's primary focus was to secure nitrogen supplies for DT Ultravert. However, HNR also note that high purity nitrogen is used as a preserving agent by food and beverage producers, implying that the output from Kansas could be immediately used in this industry. In addition, given the potential volumes of gas available, the company has also examined the possibility of supplying nitrogen to third parties in the agricultural sector in the vicinity of the company's acreage in Kansas.

Analysis of the gas has demonstrated traces of both helium and argon and the installation of a gas concentration has evidenced hydrogen at concentrations around 8,000 parts per million. The significance of this is that scientific studies show that treatment of soil with hydrogen improves the growth performance of many crops by 15% - 48% and hydrogen is a key promoter of growth of certain nitrogen fixing micro-organisms which convert hydrogen and nitrogen into ammonia which plants take up and utilise for growth.

HNR's Kansas gas mixture exhibits the very rare characteristic of being entirely free of complex hydrocarbons which typically contaminate hydrogen discovered in oil and gas wells. As such, the company posits that this makes it potentially suitable as a fertiliser for organic crops in particular.

As outlined earlier, towards the end of 2018, HNR entered into a pilot project for the treatment of around 50 cannabis plants during the normal 90 days growing cycle and the results demonstrated that the application of the nitrogen/hydrogen gas mixture increased plant size, height, root diameter and flower count by up to 30%.

HNR is continuing to explore the potential for third party sales of nitrogen in Kansas in conjunction with a local partner and the company is in an attractive position to offer attractive prices to potential purchasers whilst still achieving a high margin should any sales agreements be completed in the medium term.

Highlands Water Resources

Wholly owned subsidiary Highlands Water Resources was formed in October 2018 whereby HNR is partnered with Pennsylvania based Epiphany Water Solutions to develop solutions for the treatment of waste water used in fracking operations.

Hydraulic fracturing operations usually require huge volumes of clean water which is subsequently recovered alongside the hydrocarbons produced as a result of a successful frack. At this point, operators are often left with considerable volumes of water to dispose of which usually contains various chemical impurities. As this water must be disposed of safely usually by being pumped into a separately drilled disposal well or transported to a suitable location, the logistics of the disposal of waste water add considerable costs to fracking operations.

Although the costs of acquiring and disposing of water varies by region, HNR estimates that the average cost of acquiring and transportation of the fresh water for fracking operations is \$2.00 - \$3.00 per barrel in the Denver Julesburg Basin. Additional to this is the subsequent cost for the disposal of a barrel of water in the basin which the company estimates is a further \$2.00 - \$3.00. In total, the handling and treatment of water during fracking operations adds a significant operating cost to oil and gas production operations particularly in times of subdued commodity prices.

Colorado operations

In a pilot test in Colorado, HNR's partner, Epiphany has trialled two of its E10X modular water treatment solutions in the East Denver Project to treat produced water from the operation and verify the technical and economic merits of the technology for wider operations in the Denver Julesburg Basin. During the trial, the modular treatment solutions processed up to 500 barrels of water per day, receiving $3.50 per barrel in payment.

HNR is a distribution partner for Epiphany's technology across several US states and as an authorised distributor; HNR could receive a sales commission on the machine. However, the company believes that a more likely income stream would be based on a per barrel fee based on the water that is treated.

Montana

HNR holds leases of over 109,694 acres in south-eastern Montana in an area that it considers to be prospective for natural gas and helium which is estimated to be present in concentrations of 0.31% to 0.33%. In 2018, flow testing of the Eagle formation at the existing Helios Two well resulted in natural gas production rates which peaked at 216 mcfpd according to the company's RNS in October 2018. However, this production rate was not sustainable.

The company believes that there is a sizable resource base within the Eagle formation. However, the technical challenges implicit it stimulating the existing wells on the acreage and establishing commercial flow rates are significant.

The company has identified that the dewatering operations in Montana have identified a substantial water resource suitable for third party oil and gas operations. However, like the potential for gas development, this remains a longer term project which is unlikely to garner the company's financial resources or management time for the foreseeable future.

Financial summary

Income statement

In the year ended 31 March 2019, HNR reported a decline in revenue which was a function of the company's reduced interest in the East Denver Project for which HNR received a capital sum from the operator during the period. Additionally, in the second half of calendar year 2018, two producing wells at East Denver were taken off production for most of that period to allow for the drilling and completion of six additional wells from the same drilling pad. These wells were all brought back on production during December 2018 and January 2019 recommencing revenue generation for the company in its Q4 period to the end of March 2019.

Group expenditure is not directly comparable between 2018 and 2019 as a function of the changed nature of HNR's ownership of East Denver Project although overall costs in the US have reduced by approximately $2m during the period. The full impact of this cost reduction has been mitigated to an extent by a weakening of Sterling against the US dollar, particularly while the company is in a period of growth, with most costs incurred denominated in US dollars.

Four year financial summary

Year ended March Item	FY 2016 GBP	FY 2017 GBP	FY 2018 GBP	FY 2019 GBP
Revenue	0	0	2,900,785	1,016,399
Operating loss	-1,818,049	-3,369,749	-3,977,270	-4,495,019
Profit before tax	-1,816,671	-3,369,272	-3,976,237	-5,770,724
Total assets	1,447,273	7,331,008	12,081,210	7,631,498
Total liabilities	53,348	322,336	2,713,549	1,314,370
Cash	717,427	1,934,486	602,814	1,508,649
Bank debt and finance leases	0	0	0	0

Source: Company RNS 6434G

Cash flow and balance sheet

The company offset operating losses in the year to March 2019 with considerably lower capital expenditure and the $5.4m (£4.2m) received from the divestment of 49.5% of its original 57% working interest in East Denver in April 2018 (leaving the company with the current 7.5% carried working interest). This investing surplus was augmented by a placing to raise gross proceeds of £1.56m near the year end which was primarily used to finance the establishment of Zoetic as outlined previously. This cash position at the year-end is reflected in the table above although we acknowledge that this was used primarily to finance start-up costs for Zoetic.

Since the beginning of the current financial year, HNR raised further gross proceeds of £525,000 in June 2019. This comprised primarily of £425,000 through the exercise of 5.0 million warrants at 8.5p which were awarded to the management of Zoetic at the time of the establishment of the business. In addition, the Schrader family, which operates the convenience stores through which Zoetic will stock its products, also subscribed for 1.0 million new shares at 10p per share to raise a further £100,000.

Following the recent fund raisings in March and June 2019, HNR has approximately 142.5 million shares in issue.

Future revenue growth

For the current year, we note that the CBD business is likely to absorb cash while the company produces early crops and establishes sales from its initial product ranges. However, we expect to see revenue generation accelerate in the second half of the year as products from the first CBD crop feeds into the sales pipeline and the retail sales develop.

We also expect this to be augmented by production from the East Denver Project given that although the field is on natural decline curve, remediation work on existing wells was completed in June. This implies a reduction of operating costs attributable to HNR going forward and a steadying of the income stream from oil and gas sales over the remainder of the current year.

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