

**HEADWATER EXPLORATION INC.**  
**Interim Condensed Statements of Financial Position**  
(unaudited)

	March 31 2020	December 31 2019
<i>(thousands)</i>	\$	\$
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	111,634	60,957
Restricted cash (note 13 (b))	1,030	680
Accounts receivable (note 12 (a) (iii))	2,502	3,007
Financial derivatives receivable (note 12 (a) (i))	-	1,481
Prepays and security deposits	432	287
<b>Total current assets</b>	<b>115,598</b>	<b>66,412</b>
Exploration and evaluation assets (note 3)	-	3,816
Property, plant and equipment (note 4)	50,485	54,118
Deferred income tax asset	3,286	3,286
Right-of-use assets (note 5)	251	289
Restricted cash (note 13 (b))	-	350
<b>Total assets</b>	<b>169,620</b>	<b>128,271</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 12 (a) (iv))	1,300	1,378
Deferred share units liability (note 8 (b))	38	322
Current portion of lease liability (note 5)	60	90
<b>Total current liabilities</b>	<b>1,398</b>	<b>1,790</b>
Lease liability (note 5)	189	195
Decommissioning liability (note 6)	10,798	11,976
<b>Total liabilities</b>	<b>12,385</b>	<b>13,961</b>
<b>Shareholders' Equity</b>		
Capital stock (note 7 (b))	290,328	247,332
Warrants (note 7 (c))	7,680	-
Contributed surplus	10,425	11,366
Deficit	(151,198)	(144,388)
<b>Total shareholders' equity</b>	<b>157,235</b>	<b>114,310</b>
<b>Total liabilities and shareholders' equity</b>	<b>169,620</b>	<b>128,271</b>

Commitments (note 13)  
Subsequent events (note 14)

*See accompanying notes to the interim condensed financial statements*

Approved by the board

(signed) "Chandra Henry"  
Chandra Henry, CPA, CA  
Director

(signed) "Neil Roszell"  
Neil Roszell  
Director

**HEADWATER EXPLORATION INC.**  
**Interim Condensed Statements of Income (Loss) and Comprehensive**  
**Income (Loss)**  
(unaudited)

	Three months ended March 31	
	2020	2019
<i>(thousands, except per share data)</i>	\$	\$
<b>REVENUE</b>		
Sales (note 9)	2,308	6,009
Royalties	(57)	(159)
Revenue	2,251	5,850
Gains on financial derivatives (note 12 (a) (i))	2,456	2,420
Revenue and gains on financial derivatives	4,707	8,270
<b>EXPENSES</b>		
Production	647	746
General and administrative	683	602
Transaction costs (note 7 (b))	4,382	-
Stock-based compensation expense (recovery) (note 8)	(19)	61
Depletion, depreciation and amortization (notes 4 & 5)	2,505	2,574
Exploration and evaluation expense (note 3)	3,821	-
	12,019	3,983
Interest income and other (note 10)	(502)	(122)
Income (loss) before income taxes	(6,810)	4,409
Deferred income tax expense	-	1,449
<b>Net income (loss) and comprehensive income (loss)</b>	<b>(6,810)</b>	<b>2,960</b>
Net income (loss) per share (note 7 (d))		
Basic	(0.06)	0.03
Diluted	(0.06)	0.03

*See accompanying notes to the interim condensed financial statements*

**HEADWATER EXPLORATION INC.**  
**Interim Condensed Statements of Cash Flows**  
(unaudited)

<b>Cash flow related to the following activities:</b> <i>(thousands)</i>	Three months ended March 31	
	2020	2019
	\$	\$
<b>OPERATING</b>		
Net income (loss)	(6,810)	2,960
Items not involving cash:		
Depletion, depreciation and amortization	2,505	2,574
Exploration and evaluation expense	3,821	-
Stock-based compensation expense (recovery)	(19)	61
Unrealized gains on financial derivatives (note 12 (a) (i))	1,481	426
Deferred income tax expense	-	1,449
Accretion (note 6)	53	80
Decommissioning liabilities settled	-	4
Change in non-cash operating working capital (note 11)	151	166
Cash flows provided by operating activities	1,182	7,720
<b>FINANCING</b>		
Issue of common shares, net of costs (note 7 (b))	48,096	-
Payment of lease liability (note 5)	(37)	(29)
Proceeds from exercise of stock options (note 7 (b))	1,670	18
Cash flows provided by (used in) financing activities	49,729	(11)
<b>INVESTING</b>		
Capital expenditures – property, plant and equipment (note 4)	(65)	(17)
Capital expenditures – exploration and evaluation (note 3)	(5)	(161)
Change in non-cash investing working capital (note 11)	(164)	(524)
Cash flows used in investing activities	(234)	(702)
Change in cash and cash equivalents	50,677	7,007
Cash and cash equivalents, beginning of period	60,957	53,652
Cash and cash equivalents, end of period	111,634	60,659
Cash and cash equivalents consist of:		
Cash	95,007	10,609
Short-term investments	16,627	50,050
Cash and cash equivalents, end of period	111,634	60,659

*See accompanying notes to the interim condensed financial statements*

**HEADWATER EXPLORATION INC.**  
**Interim Condensed Statements of Changes in Shareholders' Equity**  
(unaudited)

<i>(thousands)</i>	Notes	Capital stock \$	Warrants \$	Contributed surplus \$	Deficit \$	Total Shareholders' equity \$
<b>Balance at January 1, 2019</b>		<b>247,855</b>	-	<b>11,048</b>	<b>(147,203)</b>	<b>111,700</b>
Transfer of contributed surplus		8	-	(8)	-	-
Issued for cash on exercise of stock options		18	-	-	-	18
Stock-based compensation		-	-	90	-	90
Net income		-	-	-	2,960	2,960
<b>Balance at March 31, 2019</b>		<b>247,881</b>	-	<b>11,130</b>	<b>(144,243)</b>	<b>114,768</b>
<b>Balance at January 1, 2020</b>		<b>247,332</b>	-	<b>11,366</b>	<b>(144,388)</b>	<b>114,310</b>
Issued on Recapitalization Transaction	7 (b)	50,000	-	-	-	50,000
Allocation to warrants	7 (c)	(7,680)	7,680	-	-	-
Issue costs	7 (b)	(1,905)	-	-	-	(1,905)
Transfer of contributed surplus	7 (b)	911	-	(911)	-	-
Issued for cash on exercise of stock options	7 (b)	1,670	-	-	-	1,670
Stock-based compensation	8 (a)	-	-	(30)	-	(30)
Net loss		-	-	-	(6,810)	(6,810)
<b>Balance at March 31, 2020</b>		<b>290,328</b>	<b>7,680</b>	<b>10,425</b>	<b>(151,198)</b>	<b>157,235</b>

*See accompanying notes to the interim condensed financial statements*

# HEADWATER EXPLORATION INC.

## Notes to the Interim Condensed Financial Statements

(unaudited)

As at and for the three months ended March 31, 2020 and 2019

*(All tabular amounts in thousands, unless otherwise stated)*

### 1. NATURE OF OPERATIONS

Headwater Exploration Inc. (formerly Corridor Resources Inc.) (“Headwater” or the “Company”) is a Canadian junior resource company engaged in the exploration for and development and production of petroleum and natural gas onshore in Canada. Headwater is a public company existing under the Alberta Business Corporations Act with common shares listed on the Toronto Stock Exchange (“TSX”) under the symbol “HWX”.

On March 4, 2020, Headwater announced the completion of the Recapitalization Transaction (defined herein), pursuant to which the Company raised aggregate gross proceeds of \$50 million pursuant to two equity private placements, a new management team was appointed and the board of directors of the Company was reconstituted. Details of the Recapitalization Transaction are provided in note 7 of these interim condensed financial statements.

Headwater’s principle place of business is located at 1700, 500 – 4<sup>TH</sup> Avenue S.W., Calgary, Alberta, T2P 2V6 and its registered office is located at 2400, 525 - 8<sup>th</sup> Avenue S.W., Calgary Alberta, T2P 1G1.

### 2. BASIS OF PREPARATION

#### ***Statement of compliance***

These unaudited interim condensed financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”), and in accordance with IAS 34 – *Interim Financial Reporting*. The unaudited interim condensed financial statements do not include all information required for annual financial statements and should be read in conjunction with the Company’s audited financial statements for the year ended December 31, 2019. These unaudited interim condensed financial statements have been prepared following the same accounting policies as the Company’s audited financial statements for the year ended December 31, 2019.

These unaudited interim condensed financial statements were approved and authorized for issue by the Company’s board of directors on May 14, 2020.

#### ***Basis of measurement, functional and presentation currency***

The financial statements have been prepared on a historical cost basis except derivative financial instruments and deferred share units which are measured at fair value.

The financial statements are presented in Canadian dollars, which is the Company’s functional currency.

### **Significant judgments and estimates**

The timely preparation of the financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amount of assets, liabilities, income and expenses. Actual results may differ materially from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Significant judgments, estimates and assumptions made by management in these financial statements are outlined in note 2 of the December 31, 2019 annual financial statements. With the exception of the Warrants issued pursuant to the non-brokered private placement and Recapitalization Transaction (as defined herein) (see note 7 (c)), there have been no significant changes in the Company's judgments and estimates applied during the interim period ended March 31, 2020, relative to those described in the most recent annual financial statements as at and for the year ended December 31, 2019.

Since December 31, 2019, the outbreak of the COVID-19 pandemic has had a significantly negative impact on economic conditions around the world. This has resulted in significant volatility of commodity prices as well as increased economic uncertainty. Estimates and judgments made by management in the preparation of the interim condensed financial statements are increasingly difficult and subject to a higher degree of measurement uncertainty during this volatile period.

### **New accounting standard**

In October 2018, the IASB issued amendments to the definition of a business in IFRS 3 "Business Combinations". The amendments are intended to assist entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition. IFRS 3 continues to adopt a market participant's perspective to determine whether an acquired set of activities and assets is a business. The amendments clarify the minimum requirements for a business; remove the assessment of whether market participants are capable of replacing any missing elements; add guidance to help entities assess whether an acquired process is substantive; narrow the definitions of a business and of outputs; and introduce an optional fair value concentration test. The concentration test is a simplified assessment that results in an asset acquisition if substantially all of the fair value of the gross assets is concentrated in a single identifiable asset or group of similar identifiable assets. If an entity chooses not to apply the concentration test, or the test is failed, then the assessment focuses on the existence of a substantive process.

The amendments to IFRS 3 are effective for annual reporting periods beginning on or after January 1, 2020 and apply prospectively.

### **3. EXPLORATION AND EVALUATION ASSETS**

Reconciliation of movements in exploration and evaluation assets ("E&E"):

	March 31, 2020	December 31, 2019
	\$	\$
Balance, beginning of period	3,816	3,451
Additions	5	391
Changes in decommissioning liabilities	-	(26)
Expensed	(3,821)	-
Balance, end of period	-	3,816

Since May 27, 2016, the McCully assets in New Brunswick have been subject to a moratorium on hydraulic fracturing. The new management team believes there is significant uncertainty regarding the ultimate realization of the value of the E&E assets as all undeveloped wells in the McCully field require hydraulic fracture stimulation to be commercially productive. The Company does not currently have any plans to pursue exploratory capital spending in the McCully Field. As such, all assets in E&E were expensed as at March 31, 2020.

#### 4. PROPERTY, PLANT AND EQUIPMENT

Reconciliation of movements in property, plant and equipment ("PP&E"):

	Oil and gas properties	Production facilities	Inventory	Office and other assets	Total
<b>Cost</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Balance at December 31, 2018	244,325	77,730	1,531	2,695	326,281
Additions	44	206	-	44	294
Transfer from (to) current assets	-	-	(32)	-	(32)
Sale of assets	(48)	(15)	-	(55)	(118)
Changes in decommissioning liabilities	707	-	-	-	707
Balance at December 31, 2019	245,028	77,921	1,499	2,684	327,132
Additions	(12)	57	-	20	65
Changes in decommissioning liabilities	(1,231)	-	-	-	(1,231)
Balance at March 31, 2020	243,785	77,978	1,499	2,704	325,966
<b>Accumulated depletion, depreciation and impairment</b>					
Balance at December 31, 2018	202,921	62,626	1,012	1,989	268,548
Depletion or depreciation expense	3,367	1,134	-	110	4,611
Impairment reversal	(226)	(96)	-	-	(322)
Transfer from current assets	-	-	57	-	57
Sale of assets	-	-	-	(31)	(31)
Write-down of assets	-	-	151	-	151
Balance at December 31, 2019	206,062	63,664	1,220	2,068	273,014
Depletion or depreciation expense	1,812	634	-	21	2,467
Balance at March 31, 2020	207,874	64,298	1,220	2,089	275,481
Net book value at December 31, 2019	38,966	14,257	279	616	54,118
Net book value at March 31, 2020	35,911	13,680	279	615	50,485

The calculation of depletion includes estimated future development costs relating to the development of proved reserves of \$2,643 thousand for the three months ended March 31, 2020 (March 31, 2019 - \$2,652 thousand).

#### **Q1 2020 Impairment Assessment**

At March 31, 2020, an indicator of impairment was determined to exist for the Company's New Brunswick CGU as a result of a decline in forward benchmark commodity prices for natural gas. As such, an impairment test was performed. No resulting impairment charge was recorded.

## 5. LEASES

### *Right-of-use assets*

The following table reconciles the right-of-use assets by class as at March 31, 2020:

	Office building	Land	Vehicles	Total
Cost	\$	\$	\$	\$
Balance at December 31, 2018	-	-	-	-
Leases recognized at January 1, 2019	170	174	10	354
Additions	-	-	79	79
Balance at December 31, 2019	170	174	89	433
Additions	-	-	-	-
Balance at March 31, 2020	170	174	89	433
<b>Accumulated depreciation</b>				
Balance at December 31, 2018	-	-	-	-
Depreciation expense	113	8	23	144
Balance at December 31, 2019	113	8	23	144
Depreciation expense	28	2	8	38
Balance at March 31, 2020	141	10	31	182
Net book value as at December 31, 2019	57	166	66	289
Net book value as at March 31, 2020	29	164	58	251

### *Lease liability*

The following table reconciles the changes in the lease liability as at March 31, 2020:

	March 31, 2020	December 31, 2019
	\$	\$
Lease liability, beginning of period	285	-
Leases recognized at January 1, 2019	-	354
Additions	-	79
Interest expense	1	15
Payment of lease liability	(37)	(163)
Lease liability, end of period	249	285
Current portion of lease liability	60	90
Non-current portion of lease liability	189	195
Total lease liability	249	285

During the three months ended March 31, 2020, the weighted average discount rate used was 3.8%.



## 6. DECOMMISSIONING LIABILITY

The change in the decommissioning liability is due to the following:

	March 31, 2020	December 31, 2019
	\$	\$
Balance, beginning of period	11,976	11,100
Change in estimate <sup>(1)</sup>	(1,231)	681
Liabilities settled	-	(24)
Accretion	53	219
<b>Balance, end of period</b>	<b>10,798</b>	<b>11,976</b>

*(1) Relates to an increase in cost estimates of \$190 thousand with remainder of change due to a decrease in both the risk-free rate and inflation rate for the three months ended March 31, 2020.*

The Company's decommissioning liabilities are based on the Company's net ownership in wells, its gas processing plant and related infrastructure.

The Company has estimated the net present value of its total decommissioning liabilities to be \$10,798 thousand at March 31, 2020 (December 31, 2019 - \$11,976 thousand). The total future undiscounted amount of estimated cash flows required to settle these obligations is \$13,936 thousand (December 31, 2019 - \$16,998 thousand). The total undiscounted uninflated amount of estimated cash flows required to settle these obligations is \$11,650 thousand (December 31, 2019 - \$11,460 thousand). Management estimates the settlement of these obligations to occur between the years 2020 and 2040. At March 31, 2020, a risk-free rate of 1.3% (December 31, 2019 - 1.8%) and an inflation rate of 0.9% (December 31, 2019 - 2.0%) were used to calculate the estimated fair value of the decommissioning liability.

## 7. CAPITAL STOCK

- a) Authorized – unlimited common shares without nominal or par value.
- b) Issued and outstanding

	March 31, 2020		December 31, 2019	
	Number of shares	Amount	Number of shares	Amount
		\$		\$
Balance, beginning of period	88,147	247,332	88,899	247,855
Recapitalization Transaction:				
Common shares issued	54,348	50,000	-	-
Allocation to warrants	-	(7,680)	-	-
Share issue costs	-	(1,905)	-	-
Exercise of stock options (note 8 (a))	1,832	2,581	25	26
Cancellations under normal course issuer bid	-	-	(777)	(549)
<b>Balance, end of period</b>	<b>144,327</b>	<b>290,328</b>	<b>88,147</b>	<b>247,332</b>

### **Recapitalization Transaction**

On March 4, 2020, the Company completed a recapitalization transaction (the "Recapitalization Transaction"). The Recapitalization Transaction involved the following:

- A non-brokered private placement of 21,739,130 units of the Company at a price of \$0.92 per unit for aggregate gross proceeds of \$20.0 million. Each unit was comprised of one common share and one common share purchase warrant ("Warrant") of the Company. Each Warrant entitles the holder to purchase one common share at a price of \$0.92 per common share for a period of 4

years from the issuance date. The Warrants vest and become exercisable as to one-third upon the 20-day volume weighted average price of the common shares equaling or exceeding \$1.30, \$1.60 and \$1.90, respectively. Pursuant to the rules of the TSX, the non-brokered private placement was approved by shareholders of the Company at a special meeting held on March 4, 2020.

- Concurrently with the closing of the non-brokered private placement, the appointment of a new management team and reconstitution of the board of directors was completed.
- A brokered private placement of 32,608,696 subscription receipts ("Subscription Receipts") of the Company, which were issued at a price of \$0.92 per Subscription Receipt through a syndicate of dealers for aggregate gross proceeds of \$30.0 million, was completed on February 11, 2020. Pursuant to the terms of the Subscription Receipts, upon completion of the non-brokered private placement, reconstitution of the board of directors and appointment of the new management team on March 4, 2020, the net proceeds of the brokered private placement were released to the Company and each holder of Subscription Receipts received one common share for each Subscription Receipt held.
- Pursuant to the Recapitalization Transaction, the Company incurred \$4,382 thousand of transaction costs and \$1,905 thousand of share issue costs.

### **Stock Options**

During the three months ended March 31, 2020, 1,832 thousand stock options were exercised for cash proceeds of \$1,670 thousand. Contributed surplus related to the options exercised of \$911 thousand was transferred to capital stock.

During the three months ended March 31, 2019, 25 thousand stock options were exercised for cash proceeds of \$18 thousand. Contributed surplus related to the options exercised of \$8 thousand was transferred to capital stock.

Subsequent to March 31, 2020, 800 thousand stock options were granted and 528 thousand stock options were exercised for proceeds of \$299 thousand.

### **Normal Course Issuer Bid ("NCIB")**

On August 23, 2018, the Company implemented a NCIB pursuant to the rules of the TSX that allowed the Company to purchase, for cancellation, up to 6,803,118 common shares. The NCIB expired on August 22, 2019.

During the year ended December 31, 2019, the Company purchased and cancelled 777 thousand common shares for total consideration of \$549 thousand. The total cost paid, including commissions and fees, was recognized directly as a reduction in shareholders' equity. Under the NCIB, all common shares purchased were cancelled.

### c) Warrants

	March 31, 2020		December 31, 2019	
	Number of warrants	Amount	Number of warrants	Amount
Balance, beginning of period	-	\$ -	-	\$ -
Recapitalization Transaction:				
Warrants issued	21,739	7,680	-	-
Balance, end of period	21,739	7,680	-	-

The fair value of the Warrants is recorded in shareholders' equity. Subsequently, any consideration paid to the Company on the exercise of Warrants along with the fair value of Warrants will be credited to capital stock.

The Warrants issued in connection with the non-brokered private placement were allocated a fair value of \$7,680 thousand. The fair value was estimated using the Black-Scholes model with the following assumptions: expected life of four years; volatility of 50%; risk-free interest rate of 0.9%; and a dividend yield of 0%. The expected volatility was estimated based on a peer group historical volatility over a four-year period.

d) Per share amounts

Basic per share amounts are calculated using the weighted average number of shares outstanding. The Company uses the treasury stock method to determine the impact of dilutive securities. The reconciling items between the basic and diluted average common shares outstanding are in-the-money warrants and in-the-money stock options.

	Three months ended March 31, 2020	Three months ended March 31, 2019
Weighted average shares outstanding		
Basic	105,436	88,919
Diluted	105,436	89,213

As the Company incurred a net loss for the three months ended March 31, 2020, in computing the diluted net loss per share, the effect of stock options and Warrants were excluded as they were anti-dilutive.

## 8. STOCK-BASED COMPENSATION

a) Stock options

The Company has a stock option plan ("Existing Option Plan") under which options to purchase common shares of the Company may be granted to directors, officers, employees and consultants of the Company. The Existing Option Plan is limited to 8,262,513 common shares with no more than 5% being issued to any one officer, director or employee. The exercise price of each option is based on the market price for the common share on the close of the day prior to the date the option was granted. Options granted under the Existing Option Plan generally vest over a three-year period and expire four to five years after the grant date. Participants of the Existing Option Plan can elect to surrender any vested option in exchange for a cash payment based on the difference between the market value of the common share and the exercise price of the option. The board of directors has the sole discretion to consent or deny this election.

On March 25, 2020, the Company's board of directors approved a new share option plan ("New Option Plan") under which options to purchase common shares of the Company may be granted to directors, officers, employees and consultants of the Company. Under the terms of the New Option Plan, an aggregate number of options equal to 8.0% of the aggregate number of issued and outstanding common shares less the aggregate number of common shares issuable pursuant to outstanding options under the Existing Option Plan may be granted. The exercise price of each option granted under the New Option Plan is based on the closing price of the common shares on the TSX on the trading day prior to the date the option was granted and generally options will vest as to one third of the number of options granted on each of the first, second and third anniversaries of the date of grant, respectively, and expire four years from the date of grant.

No options granted under the New Option Plan will be exercisable until the Company receives approval of the New Option Plan from the shareholders of the Company in accordance with the rules of the TSX. The

shareholders of the Company will vote on the New Option Plan at the Company's annual and special meeting of shareholders to be held on June 15, 2020.

The following table summarizes the changes in the outstanding stock options:

	Three months ended March 31, 2020		Year ended December 31, 2019	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of period	3,490	\$ 0.79	3,471	\$ 0.79
Granted	5,465	\$ 1.06	225	\$ 0.70
Forfeited, cancelled or expired	(433)	\$ 0.71	(181)	\$ 0.71
Exercised <sup>(1)</sup>	(1,832)	\$ 0.91	(25)	\$ 0.72
Options outstanding, end of period	6,690	\$ 0.98	3,490	\$ 0.79
Options exercisable, end of period	642	\$ 0.56	2,466	\$ 0.82

<sup>(1)</sup> The Company's weighted average share price, at the date of exercise, for stock options exercised during the three months ended March 31, 2020 was \$1.26 per common share (year ended December 31, 2019 - \$0.76 per common share).

The fair value of options granted is estimated using the Black-Scholes option pricing model with the following assumptions:

	Three months ended March 31, 2020	Year ended December 31, 2019
Weighted average fair value of options granted	\$ 0.50	\$ 0.37
Risk-free interest rate	0.6%	1.6%
Expected forfeiture rate	9.6%	6.7%
Expected life (years)	3.9	4.5
Expected volatility <sup>(1)</sup>	50%	66%

<sup>(1)</sup> In the three months ended March 31, 2020, the expected volatility was estimated based on a peer group historical volatility.

The range of exercise prices of stock options outstanding and exercisable as at March 31, 2020 is as follows:

Exercise prices	Outstanding options			Exercisable options	
	Number of options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
\$ 0.40 - \$ 0.99	1,225	2.6	\$ 0.63	642	\$ 0.56
\$ 1.00 - \$ 1.06	5,465	4.0	\$ 1.06	-	-
Total	6,690	3.7	\$ 0.98	642	\$ 0.56

For the three months ended March 31, 2020, the Company recorded a stock-based compensation recovery of \$30 thousand with a corresponding decrease to contributed surplus with respect to stock options (three months ended March 31, 2019 - \$90 thousand stock-based compensation expense with a corresponding increase to contributed surplus).

b) Deferred share units

The Company has a deferred share unit ("DSU") plan for directors. Each vested DSU will automatically be redeemed on the third business day after the date the director ceases to be a director of Headwater. When redeemed, each vested DSU will be paid based on the weighted average trading price of the common shares over the five previous trading days.

The following table summarizes the changes in the outstanding DSUs:

	Three months ended March 31, 2020		Year ended December 31, 2019	
	Number of DSUs	Amount	Number of DSUs	Amount
		\$		\$
DSUs, beginning of period	447	322	388	311
DSUs redeemed during the period <sup>(1)</sup>	(409)	(535)	-	-
DSUs granted during the period	-	-	59	40
Fair value adjustment	-	251	-	(29)
<b>DSUs, end of period</b>	<b>38</b>	<b>38</b>	<b>447</b>	<b>322</b>

(1) DSUs were paid out pursuant to the Recapitalization Transaction and the reconstitution of the board of directors.

The DSU liability as at March 31, 2020 of \$38 thousand is based on a fair value of \$1.00 per DSU which is the Company's closing share price on March 31, 2020 (December 31, 2019 - \$0.72 per DSU).

## 9. SALES

Headwater sells its natural gas production daily from the McCully Field in New Brunswick pursuant to a long-term agreement with Repsol Oil & Gas Canada Inc. ("Repsol"). The sales price is based on the daily commodity price adjusted for the delivery location and other seasonal factors based on the terms of the agreement. The fees associated with marketing and transportation services provided by Repsol are deducted from the sales price while transportation services procured by Headwater are recognized in transportation expenses. Headwater's natural gas revenues do not contain significant financing components and payments are typically due within 25 days following the month-end.

The following table presents the Company's sales disaggregated by revenue source:

	Three months ended March 31,	
	2020	2019
	\$	\$
Natural gas sales	2,009	5,670
Gathering, processing and transportation revenue	262	272
Natural gas liquids sales	37	67
	<b>2,308</b>	<b>6,009</b>

## 10. INTEREST INCOME AND OTHER

Interest income and other consist of the following:

	Three months ended March 31,	
	2020	2019
	\$	\$
Interest income	358	264
Foreign exchange gains (losses)	198	(60)
Accretion	(53)	(80)
Interest on lease liability	(1)	(2)
	<b>502</b>	<b>122</b>

## 11. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended March 31,	
	2020	2019
	\$	\$
Change in non-cash operating working capital:		
Accounts receivable	505	808
Prepays and security deposits	(145)	(169)
Accounts payable and accrued liabilities	86	(473)
Deferred share units liability	(295)	-
	151	166
Change in non-cash investing working capital:		
Accounts receivable	-	506
Accounts payable and accrued liabilities	(164)	(1,030)
	(164)	(524)

## 12. RISK MANAGEMENT

a) The Company is exposed to the following risks:

i) Commodity price risk

Headwater enters into financial derivative contracts and physical delivery contracts to manage the risks associated with fluctuations in natural gas prices. The Company does not use derivative financial instruments for speculative purposes. There are no outstanding financial derivative contracts as at March 31, 2020.

### **Financial derivatives**

The following financial derivatives gains (losses) are reflected in the Statements of Income (Loss):

	Three months ended March 31,	
	2020	2019
	\$	\$
Gains (losses) on financial derivatives:		
- realized gains	3,937	2,846
- unrealized losses	(1,481)	(426)
Gains on financial derivatives	2,456	2,420

### **Physical delivery contracts**

The Company periodically enters into physical commodity contracts to manage commodity risk. These contracts are considered normal sales contracts and are not recorded at fair value in these interim condensed financial statements.

The Company has the following physical commodity sales contract in place as at March 31, 2020:

Type	Period	Quantity	Contract Price
Fixed price – Natural Gas	April 2020	5,000 mmbtu/d	USD \$2.40/mmbtu

### **Fair value measurements**

The Company classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The Company maximizes the use of observable inputs when preparing calculations of fair value, where possible. The fair value hierarchy has the following levels:

- Level 1 - Values are based on unadjusted quoted prices available in active markets for identical assets or liabilities as of the reporting date.
- Level 2 - Values are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace. Prices in Level 2 are either directly or indirectly observable as of the reporting date.
- Level 3 - Values are based on prices or valuation techniques that are not based on observable market data.

Assessment of the significance of an input to the fair value measurement requires judgment and may affect the placement within the fair value hierarchy. The fair value of cash and cash equivalents, restricted cash, accounts receivable, prepaids and security deposits and accounts payable and accrued liabilities approximate their carrying value due to the short term to maturity of these instruments.

#### ii) Foreign currency risk

The Company is exposed to fluctuations in the exchange rate between the Canadian dollar and the U.S. dollar. Natural gas prices, condensate prices and transportation expenses are based upon reference prices denominated in U.S. dollars, while the Company's remaining expenses are denominated in Canadian dollars. The Company does not have any derivative financial instruments in place to manage this risk.

The Company had the following financial instruments denominated in U.S. dollars:

<i>(thousands of U.S. dollars)</i>	Three months ended March 31	
	2020	2019
Cash	\$ 33	\$ 83
Accounts receivable	1,262	2,059
Financial instruments in U.S. dollars	1,295	2,142

At March 31, 2020, a 5% decrease in the CAD\$/USD\$ exchange rate would have resulted in an increase of approximately \$92 thousand to the Company's net loss (March 31, 2019 – \$100 thousand decrease in net income). Conversely, a 5% increase in the CAD\$/USD\$ exchange rate would have resulted in a decrease of approximately \$92 thousand in the Company's net loss (March 31, 2019 – \$100 thousand increase in net income).

#### iii) Credit risk

Headwater sells all its natural gas production to one large credit-worthy purchaser under normal industry payment terms. Headwater's receivables from joint venture partners are also subject to normal credit risks in the natural gas industry. At March 31, 2020, the majority of the Company's accounts receivables were outstanding for less than 30 days. The average expected credit loss on the Company's accounts receivable was 0% as at March 31, 2020. Trade receivables generally have a 30-day term and the majority have been collected subsequent to period-end. As at March 31, 2020, the Company's receivables consisted of \$1,794 thousand (December 31, 2019 - \$2,632 thousand) of trade receivables primarily from a natural gas purchaser and hedging counterparty, \$379 thousand (December 31, 2019 - \$276 thousand) from joint venture partners, \$232 thousand (December 31, 2019 - \$99 thousand) from interest receivables and \$97 thousand (December 31, 2019 - nil) from sales tax receivables.

The cash equivalents consist mainly of guaranteed investment certificates held with banks with high credit-ratings assigned by international credit-rating agencies. Management believes the risk of loss is low.

iv) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due.

The following table details the contractual maturities of the Company's liabilities as at March 31, 2020:

	Within 1 year	1 to 4 years	Beyond 4 years
	\$	\$	\$
Accounts payable and accrued liabilities	1,300	-	-
Lease liability	60	48	141
Operating leases	116	373	182
<b>Total</b>	<b>1,476</b>	<b>421</b>	<b>323</b>

At March 31, 2020, the Company was holding cash and cash equivalents of \$111,634 thousand. Given the Company's available liquid resources and the Company's 2020 budget, management expects to have sufficient available funds to meet current and foreseeable financial liabilities.

b) Management of capital

Management's objectives when managing capital are to provide an adequate return to its shareholders and to safeguard the Company's ability to obtain financing and have access to capital. In the management of capital, the Company includes shareholders' equity and cash and cash equivalents. To facilitate the management of its capital structure, the Company prepares annual expenditure and operating budgets that are updated as necessary depending on success factors, industry conditions and cash flow provided by operations. These annual and updated budgets are approved by the board of directors. Headwater has the ability to adjust its capital structure by making modifications to its capital expenditure program.

The Company has not paid or declared any dividends.

### 13. COMMITMENTS

a) Gas sales

The Company has a long-term agreement to sell, at market rates, all of its natural gas produced from the McCully Field and surrounding areas in southern New Brunswick to Repsol for resale to natural gas markets in Maritimes Canada and the Northeast United States. The contract terminates on April 1, 2024.

b) Letters of credit

At March 31, 2020, the Company had the following irrevocable standby letters of credit issued by a Canadian chartered bank:

	Amount
	\$
Letters of credit expiring June 3, 2020 <sup>(1)</sup>	300
Letter of credit expiring July 15, 2020	380
Letter of credit expiring June 27, 2020	350
	<b>1,030</b>

*(1) Letter of credit for \$150 thousand was cancelled effective May 11, 2020.*



The Company has pledged \$1,030 thousand of short-term investments as security. These investments are recorded as restricted cash in current assets.

c) Commitments

The maturities of the Company's commitments as of March 31, 2020 are as follows:

	Total	2020	2021	2022	2023	Thereafter
Operating leases <sup>(1) (2)</sup>	\$ 671	\$ 116	\$ 97	\$ 92	\$ 92	\$ 274

(1) Payments under operating leases include leases related to the exploration of natural gas and oil resources and office rent. For the three months ended March 31, 2020, the expense under these leases was \$69 thousand (March 31, 2019 - \$29 thousand).

(2) Excludes leases accounted for under IFRS 16. Refer to note 5.

#### 14. SUBSEQUENT EVENTS

Subsequent to March 31, 2020, the Company entered into the following financial derivative contracts:

Commodity	Type	Term	Volume	Price	Index
Natural Gas	Fixed	Dec 2020 – Mar 2021	1,000 mmbtu/d	Cdn\$4.05/mmbtu	NYMEX
Natural Gas	Fixed	Dec 2020 – Mar 2021	1,000 mmbtu/d	Cdn\$4.08/mmbtu	NYMEX
Natural Gas	Fixed	Dec 2020 – Mar 2021	1,000 mmbtu/d	Cdn\$3.99/mmbtu	NYMEX
Natural Gas	Fixed	Dec 2020 – Mar 2021	1,000 mmbtu/d	Cdn\$4.06/mmbtu	NYMEX