

# HIGHFIELD RESOURCES LIMITED

## INITIATION: A Stand Out Potash Opportunity

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We say

Price

Target

Strategic Target

# BUY

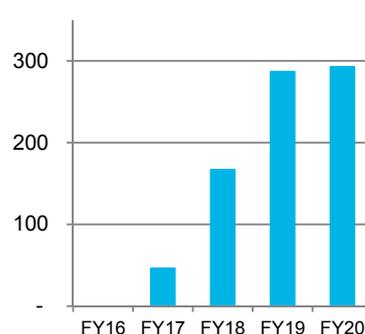
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Highfield is a potash developer in Spain and is one of our top picks in the ASX resource space for 2015. We believe Muga is one of the best greenfield potash projects globally, based on its margins and projected return on capital. We expect the DFS, due in March, to confirm a post-tax IRR north of 40% at spot potash prices, driven by lower capex than peers and a competitive advantage on freight, which drives ~55% EBITDA margins, well within the first quartile.

**HFR SHARE PRICE (A\$)**



**MUGA EBITDA (A\$M)**



Potash producers typically trade on 8-10x EV/EBITDA

**COMPANY DATA**

Enterprise value	A\$215m
Diluted market cap**	A\$245m
Diluted shares	340m
Free float*	51%
12 month price range	0.35-0.79
GICS sector	Materials
* EMR Capital ~20%, Management ~29% (FD)	
** Diluted for 100m performance shares and 39.3m options	

**IMPLIED RETURN**

Total expected return	129%
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## POTASH PRICES RELATIVELY STABLE

Unlike many other commodities, potash prices have been relatively stable for the past 12-months at ~US\$300/t FOB Vancouver. The primary end use for potash is in fertiliser and most industry experts expect modest demand growth of ~3% pa, to accommodate the need to increase crop yields in line with the ever growing global population. At full production, Muga represents <2% of global potash demand.

## COMPELLING RETURNS AND A COMPETITIVE ADVANTAGE

The Muga project has a number of advantages over other potash development projects leading to lower capex (~US\$300m), wider margins and ultimately a better return on capital. On our estimates, if the potash price fell to US\$250/t, Muga's post-tax IRR would still be above 30%.

## STRONG NEAR-TERM NEWSFLOW

2015 is set to be a big year for Highfield and Muga with a resource update due in late January, the Definitive Feasibility Study (DFS) due at the end of March and permitting approvals due by mid-year. The company is aiming to have development finance in place by the end of September with a view to commencing the 15-months construction period in October.

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## COMPANY OVERVIEW

Highfield Resources Limited (ASX:HFR) is an ASX-listed potash developer with four 100%-owned projects comprising ~400km<sup>2</sup> and located near Pamplona in Northern Spain.

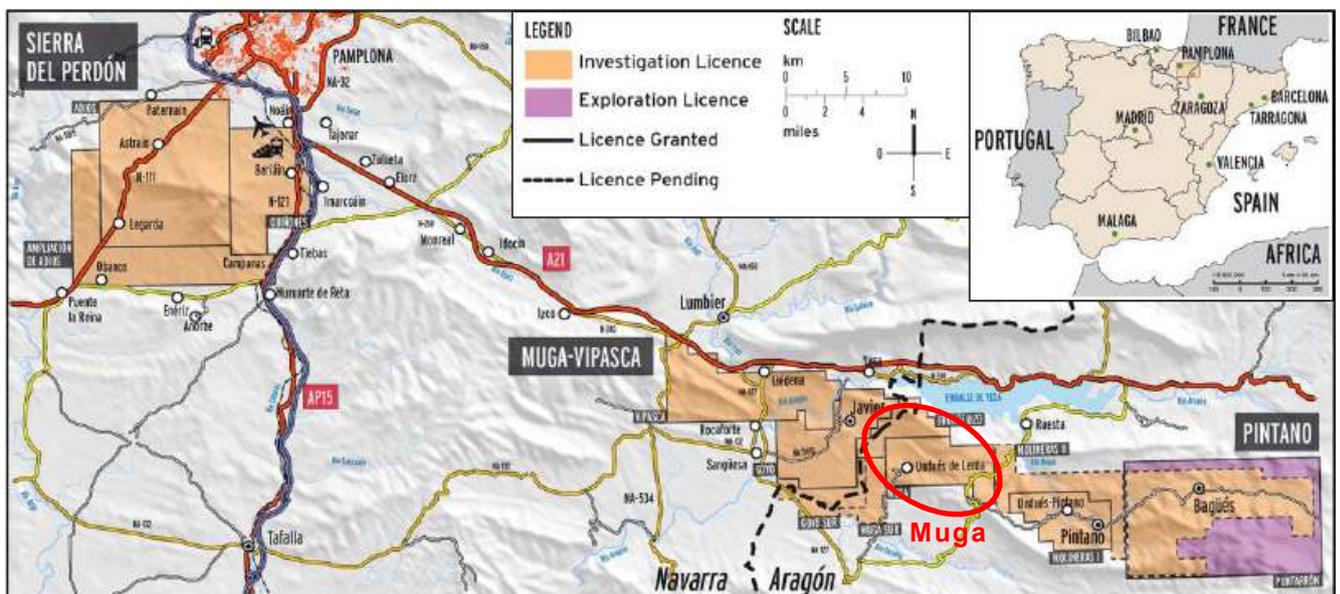
Highfield was listed on the ASX in February 2012 and acquired its assets in Spain in June 2012 from KCL Resources Limited (an unlisted Australian company) in a 100% scrip transaction valued at A\$30m.

The company's flagship asset is the Muga project (previously called Javier) where a Definitive Feasibility Study (DFS) is due by the end of March 2015 and permitting approval expected by mid-year. We expect the DFS to confirm Muga as **one of the best undeveloped potash projects globally**. We expect healthy EBITDA margins of ~55% and compelling project returns of 40-45% at spot prices.

Muga is located in the Ebro basin in Spain which has historically hosted 4 potash mines, 2 of which are still in operation (both owned by Iberpotash). The other 2 mines were located at Highfield's Sierra del Perdon project, where Highfield is developing a second project.

The company also has a further 2 pipeline projects, Vipasca and Pintano, which are less advanced, but share many of the characteristics of Muga, and which we believe could easily become compelling in their own right as they are moved up the development curve.

**At the end of September 2014, Highfield had A\$30m in cash and no debt.**



Source: Company, Blue Ocean (red circle)

In our view, two of the key risks for Highfield this year are permitting and funding for Muga.

On the permitting side, the head of Highfield's development team, Pedro Rodriguez, has direct recent experience permitting and building a number of mines in Spain, which we believe puts the company in a strong position to mitigate the risk of delays.

While the last few years have been a challenging time to fund resource projects, in our view Highfield's Muga project stands out compared to peers and has sufficiently attractive projected returns to attract the necessary funding.



## PFS

In May 2014, Highfield completed its positive Pre-Feasibility Study (PFS) for Muga which comprised a potash mine and processing facility based on:

- **Mine access:** Single decline, ore taken to surface via conveyor (as opposed to a shaft)
- **Mining method:** Conventional room and pillar (as opposed to solution mining)
- **Processing:** Conventional flotation circuit (as opposed to crystallisation processing)
- **Final product:** K60 (not K62) and a 50/50 mix of standard and granular
- **Transport:** Mix of trucking and rail to port
- **Salt by-product credits:** Likely to be de-icing salt but not included in PFS figures

The key project metrics for the PFS are summarised below:

Project Metrics	PFS	Commentary
Total Capex	€231m / US\$308m	Pre-production capex €187m / US\$250m
C1 Costs (including sustaining capex)	€108/t / US\$145/t	
Plant Throughput	600tph for 4.73mtpa	2.37mtpa initially ramping up to 4.73mtpa over 18 months
Grade	12.9% K <sub>2</sub> O / 21.5% K60	Average grade assumed life of mine, even though in practice the company will be targeting higher grade zones first
Recovery	84.6%	
Potash Production	860ktpa	
Mine Life	20 years	Based on a 60% extraction ratio applied to the 154mt high-grade resource (M+I+I), a sub-set up the 268mt total resource*.

\* Note: Both resources reduced by 15% for unknown geological anomalies. Source: Company, Blue Ocean

The key financial outcomes of the PFS were:

Project Financials	PFS	Commentary
Potash Price	US\$384/t FOB Vancouver	2016 potash price forecast estimated by potash industry expert Integer. The spot potash price is US\$305/t
US\$/€ FX	0.75:1	The Euro has since weakened markedly against the US\$, representing potential margin expansion for HFR
<b>Post-tax IRR</b>	<b>48.4%</b>	<b>We estimate an IRR of ~35% at the spot price of US\$305/t on PFS assumptions</b>
NPV <sub>10</sub>	€796m / US\$1,062m	
EBITDA 1 <sup>st</sup> full year	€176m / US\$234m	

Source: Company, Blue Ocean

The company completed two resource statements for the PFS:

- (1) a total resource (including seams P0, PAB, P1 and P2); and
- (2) a higher grade resource (being a subset of (1)) focused on seams PAB and P2 only which are typically 1.77-3.00m thick

These two resources are shown below:

Resources	Measured		Indicated			Inferred			TOTAL			
	mt	%	mt	mt	%	mt	mt	%	mt	mt	%	mt
Muga	17.4	11.3	2.0	140	11.3	15.8	111	11.1	12.4	268	11.2	30.1
Muga High Grade	9.2	13.0	1.2	74.2	13.4	9.9	70.7	12.4	8.8	154	12.9	19.9

\* Note:% = % K<sub>2</sub>O. Source: Company, Blue Ocean

A few other key features of the planned development are summarised below:

**Owner operator:** The company plans to be owner operator of both mining and processing but to outsource transport to port and domestic customers to a third party.

**Mining equipment:** Mining will be undertaken via conventional room and pillar mining using road headers. Mining heights are expected to range from 1.5m to 4m depending on the thickness of the sylvinitic seams.

**Tailings management:** Like most developed jurisdictions one of the key areas the regulator is likely to focus on is environmental and social impact and impact mitigation. Being an underground operation, the planned development should have a relatively modest footprint. But more importantly, the company plans to backfill much of its tailings (**predominately salt**), which should reduce the need for large tailings dams, but may also increase extraction ratios. During the first 12-months of the operation, tailings will need to be stored on the surface in an environmentally friendly manner to ensure no leaching of salt into the surrounding area.

**Contingency:** Essentially all of the capex and opex figures estimates in the PFS include 20% contingency. The PFS capital estimates were also confirmed by a peer review process.

### Virtual Image of Decline Access to Underground Operations



Source: Company

## WHAT MAKES MUGA SPECIAL?

There are a number of key factors which when added together give the Muga project a considerable advantage over other potash development projects globally, and collectively mean superior margins and a better return on capital.

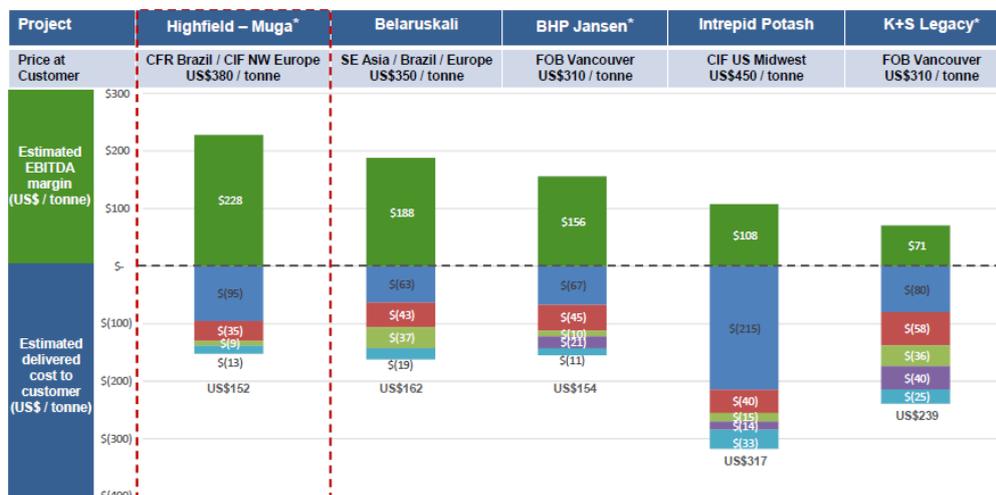
We have listed the 3 key contributing factors to each advantage below, in order of importance:

### Much lower capex:

- (1) **Close proximity to high quality infrastructure:** Which means the project does not have to carry the additional capex required to build new infrastructure (i.e. new rail, new port, dedicated power station etc). This gives Muga a significant edge over many potash projects which are in remote locations:
  - **Power:** High voltage grid power within 7km, Gas ~8km
  - **Water:** Water supply within 4km
  - **Roads/Rail:** Only 7km from major 4 line highway capable of supporting a trucking operation for 100% of Muga's product to port
  - **Port:** 150km to Port of Pasajés and 220km to the Port of Bilbao (MOU's signed with both ports)
- (2) **Absence of aquifers:** Which means lower cost and lower risk mining
- (3) **Relatively shallow mineralisation:** Which means lower cost decline access compared to many projects which need to construct deep shaft

### Superior margins:

- (1) **A major freight advantage to key customers:** This is one of *the key competitive advantages* of the Muga project, and is simply a result of the project's location, relative to the major sources of potash production globally and relative to the key sources of demand. We cover this aspect in more detail on page 23
- (2) **Relatively shallow mineralisation:** Lower cost and arguably lower risk mining as well as shorter distances to transport the ore to the plant at surface
- (3) **Lower-cost conventional mining and processing:** Usually lower cost and lower risk than solution mining and crystallisation processing



While HFR's cost to customer is competitive with Belaruskali and BHP (the bottom half of the chart)

The fact HFR is likely to receive a higher price for its product than Belaruskali and BHP means the company should enjoy **superior margins**. HFR's higher price is simply driven by the fact it is closer to the higher paying customers.

## PFS CONSULTANTS

Highfield's PFS was prepared internally but with input on each component from a number of credible specialist consultants as outlined below. We believe most of these consultants will also be used for the DFS.

<u>Component</u>	<u>Who</u>	<u>Base</u>
JORC Mineral Resource Estimate	Agapito Associates, Inc	USA
Mine Engineering	SADIM	ESP
Process Engineering	Advanced Mineral Processing	ESP
Process Engineering Peer Review	EngComp	CAN
PFS Peer Review (ex Underground)	IDOM	ESP
Metallurgical Testing	AGQ Mining	ESP
Assay Lab	ALS Global	IRE
Transport Study	IDOM	ESP
Environmental Studies	Provodit / CRN	ESP
Buildings and Facilities	Bovis Lend Lease	ESP
Potash Market Research	Integer	GBR
Socio Economic Study	IDOM	ESP

Source: Company

### Agapito Associates

- A Colorado-based mining engineering and geo-engineering consultant
- Consulting to the mining industry since 1978 (36 years)
- Has undertaken resource estimates and related technical studies for potash projects for Rio Tinto, Vale, Intrepid Potash, Potash One, Western Potash, etc

### SADIM

- A Spanish-based mine engineering consultancy, created in 1999, but history dating back to HUNOSA and coal mining
- Currently contracted on the Iberpotash expansion project
- Former Managing Director is now Head of Mining at Iberpotash

### Advanced Mineral Processing

- A Spanish-based process engineering company
- Experience in potash and designing process plants for potash projects at Iberpotash

### AGQ Mining

- A Spanish-based process engineering company
- Over 20 years experience in advanced analytical testing, agronomic consulting, specialized engineering, and environmental project management
- Clients include First Quantum (Cobre Las Cruces), Emed Tartessus, Daytal Resources

### IDOM

- A large Spanish-based engineering services firm, established in 1957
- Currently lead engineer for process, basic and detailed design for Iberpotash's expansion project in the Ebro Basin, Spain
- **Importantly, IDOM undertook a Peer Review covering most of the capex estimates in the PFS. The Peer Review estimate came in within 2% of the PFS estimates.**

## DFS – A NUMBER OF KEY CHANGES SINCE THE PFS

The DFS for the Muga project is due by the end of March 2015 and the company has flagged a number of changes since completing the PFS. Based on the company's recent releases, we expect the key changes to the DFS will be:

### Key changes to Muga project expected in DFS

	PFS	Expected DFS
Mine Access	Single decline	Dual declines
Plant Throughput	600tph for 4.7mtpa	800tph for 6.3mtpa (+33%)
Potash Production	860ktpa	1.1mtpa* (+33%)
Transport to Port	Trucks / Rail	Trucks
Export Port	Bilbao	Pasajés or Bilbao (MOU signed for both)

Source: Company, Blue Ocean. \*<2% of global demand

As a result of drilling success in the south eastern section of the Muga Project post completion of the PFS, Highfield is now considering operating two declines into the mine to take advantage of the additional mineralisation. A dual decline strategy will also create two mining fronts which should reduce mining risk, reduce production variability and also provide scope for higher production rates.

In its December quarterly report, the company also confirmed it is now looking to truck 100% of its product to port and to domestic European customers in Spain and France, which is expected to reduce transport costs.

## DEVELOPMENT TIMETABLE

The Exhibit below shows the company's planned development timetable for Muga. The company plans to complete the DFS by the end of March 2015, to have permits approved by the end of June 2015 and to begin construction in September/October 2015.

Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	
DFS	Permits	Finance	Construction (15 months)					First Production	

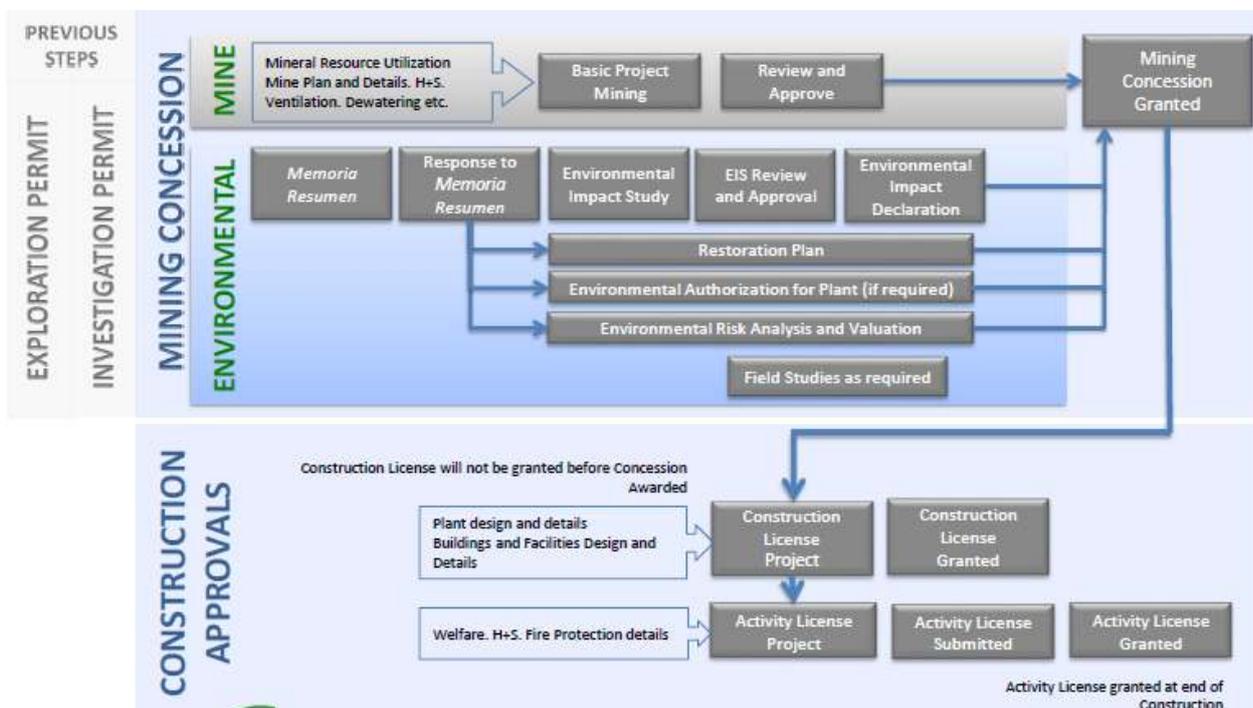
Source: Company, Blue Ocean

## PERMITTING

As is the case with most mining projects, permitting is a key area of project risk.

Importantly, Highfield’s development team is led by Pedro Rodriguez, who has direct recent experience in permitting new mines in Spain. We believe this puts the company in a strong position to have a thorough understanding of the permitting process, to understand Spanish regulator’s sensitivities and to mitigate (to the extent possible) the risk of delays.

Spain has a legislated approvals process where two principal approvals are required to construct and operate a mine. Environmental approvals are a subset of mining concession approvals. The picture below outlines the permitting process for the construction of a mine in Spain.



Source: Company

The first step to construct and operate a mine in Spain is the lodging of a Memoria Resumen, which is essentially an preliminary environmental impact assessment albeit less exhaustive. Highfield lodged its Memoria Resumen for Muga in May 2014.

After incorporating feedback from the Spanish regulator on its Memoria Resumen, the company subsequently lodged its Mining Concession Application on 10 December 2014. **There is a legislated 6-month turn around period for approvals, which means Highfield should receive approval of its Mine Concession Application by June 2015.** In the event the application is deficient in some way, the 6-month legislated turn-around period restarts.

Construction approval applications will be lodged following granting of the Mining Concession.

We believe a key area of focus for the regulator is likely to be potential environmental impacts and in particular the approach to tailings disposal. During the first year of the mine, the company will have a small above ground tailings facility, with plans to backfill the mine as mining progresses. The approach should accommodate a large portion of the tailings and the company is aiming to sell the balance as a de-icing salt.

## KEY MARKETS FOR HIGHFIELD'S PRODUCT

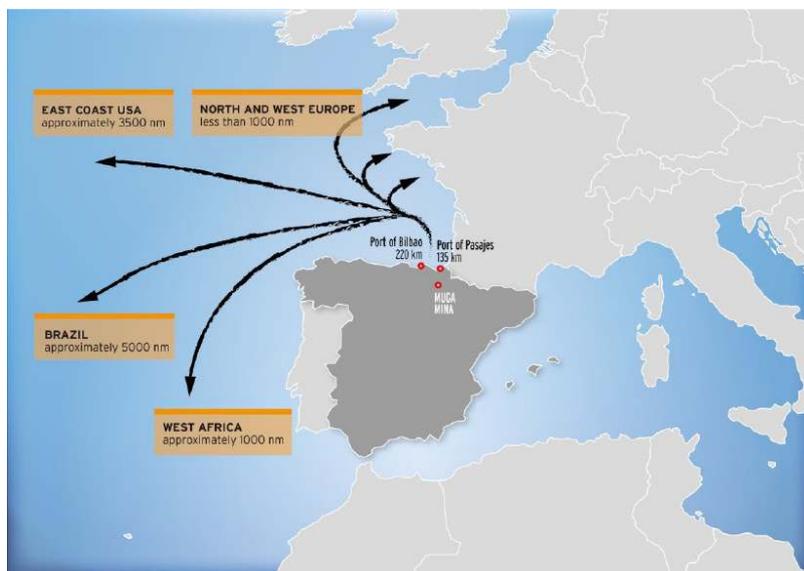
The demand for potash and fertilisers generally is seasonal and is strongest when farmers are preparing to plant new crops in early spring each year.

As such, it makes sense for potash producers to smooth out this seasonal demand, by selling half their product into the northern hemisphere and half into the southern hemisphere, which is why Highfield plans to sell its product:

- 50% into North West Europe
- 50% into Brazil

We believe it may also make sense for the company to assess the viability of selling its product into the US market since it has a significant freight advantage to most producers, and the potash price in the US market is one of the highest in the world.

### Distance to key potash markets



Source: Company

## FISCAL ENVIRONMENT IN SPAIN

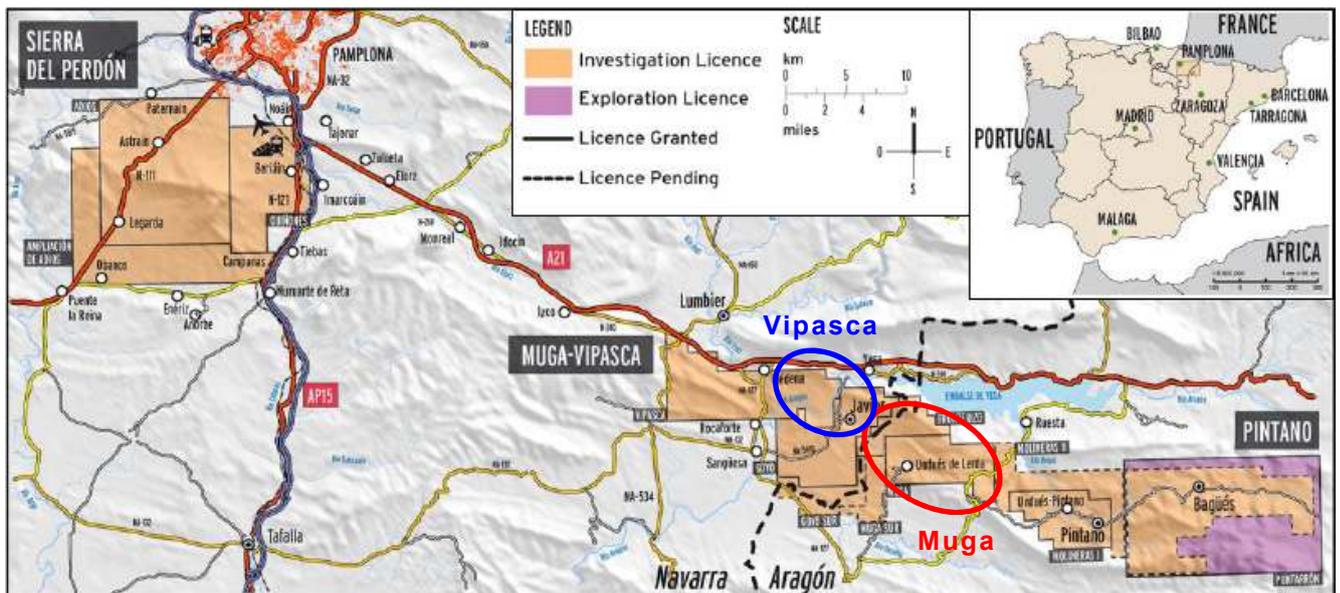
Spain has recently introduced a number of fiscal incentives to encourage investment:

- Corporate tax reduced to 25% from 1 Jan 2016 (from 30% in 2014)
- No royalties
- No mandated Govt stakes or free carried interests
- Accelerated depreciation, allowing capex to be depreciated within the first 10 years
- Reinvestment incentives including allocation of up to 15% of pre-tax revenue into a capital account for reinvestment, which allows the company to use pre-tax dollars to reinvest in its subsequent projects. This tax benefit has not been built into our HFR model and represents upside to our forecasts.

## PROJECT PIPELINE – 3 OTHER PROJECTS

Highfield has a longer-term corporate target of 2mtpa of potash production by 2020, using the cash flow from Muga to fund the development of its 3 pipeline projects, which in order are likely to be:

- Sierra del Perdón
- Vipasca; and
- Pintano



Source: Company, Blue Ocean (red and blue circles)

### SIERRA DEL PERDÓN

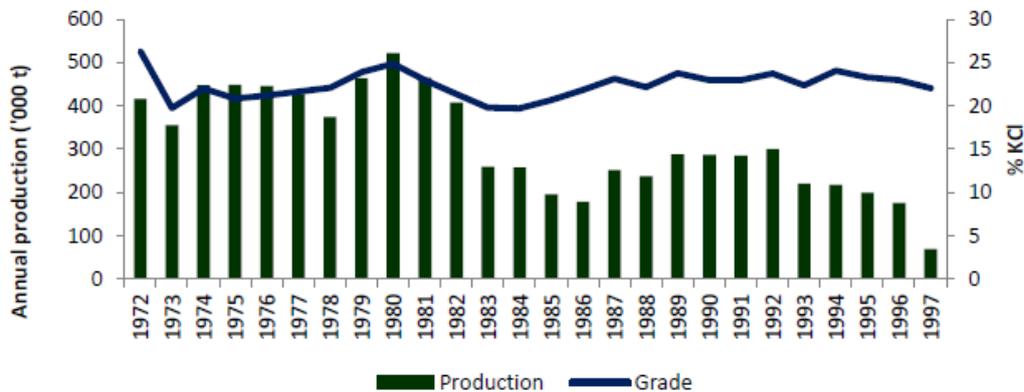
Highfield's Sierra del Perdón project covers an area of ~450km<sup>2</sup> in Northern Spain. It is located 40km northwest of Muga and hosts two former operating mines that produced over 10mt of K60 potash between 1963 and 1996. In line with the design of Muga, both mines at Sierra del Perdón were underground conventional mines with mineralisation accessed via decline using a conveyor belt to transport mineralisation to surface.

The company is working on a Scoping Study and JORC-compliance resource estimate at Sierra del Perdón. The Scoping Study is expected to be complete by late Jan / early Feb 2015 and we expect a targeted production rate in the order of 400-500ktpa. The Scoping Study is assessing 3 mining options:

- (1) Sylvinitic in previously mined areas
- (2) Sylvinitic and carnallite in previously mined areas; or
- (3) Carnallite only in previously unmined areas

Canadian process engineering consultants, Hatch is working on the carnallite options, while Spanish-based Advanced Mineral Processing will focus on the sylvinitic mineralisation given its work on the Muga PFS (Muga's focus is sylvinitic mineralisation only).

### Historic Production at Sierra del Perdón



Source: Company

While the company would need to build a new process plant at Sierra del Perdón, the fact the mine is a brownfields development with historical operating data does somewhat de-risk this project in terms of mining method and metallurgical recoveries.

### VIPASCA

The Vipasca project targets the same sylvinitic mineralisation targeted in the Muga project but to the west and at greater depths of almost 800m below surface. The Vipasca project comprises the Vipasca permit and the deeper areas of the Goyo permit.

The Company received its Investigation Permit for Vipasca on 11 December 2014, which will allow the company to drill two holes in the Vipasca permit area in the first half of 2015.

### PINTANO

Highfield's Pintano project sits adjacent to the Muga project and covers an area of 125km<sup>2</sup>. The potash mineralisation at Pintano occurs in three principal beds (A, B, and 1) starting at depths of 500m but continuing to depths as far as 2,000m.

The Company is building on substantial historical potash exploration information that includes 7 drill holes and 10 seismic profiles completed in the late 1980s.

Highfield released an Inferred Resource at Pintano on 20 November 2013 comprising 187mt at 11.2% K<sub>2</sub>O.

## INVESTMENT PROPOSITION

This section provides an in-depth look at our valuation assumptions for Highfield.

### VALUATION

Our valuation of Highfield is based on DCF-based approach, with an additional discount applied, depending on the stage of development of each project. We assume a nominal discount rate of 10% (8% real) in all our NPV estimates.

As Highfields development projects are in Spain, we model all capex and operating figures in Euros and convert back to A\$ using the A\$/€ forward curve (sourced from Bloomberg).

#### Key differences between the Muga PFS & our forecasts (based on releases since the PFS)

	PFS	BOEQ	Commentary
Throughput	600tph / 4.7mtpa	800tph / 6.3mtpa	DFS looking at twin declines and 2 400tph processing lines. <b>This represents a material 33% increase in throughput compared to the PFS.</b>
Potash production	840ktpa	1.1mtpa	Based on the increased throughput rate
C1 costs (excluding sustaining capex)	€102/t	€102/t	We apply the same unit costs calculated in the PFS, even though the larger scale could lead to some economies of scale and slightly lower costs
By-product credits	Not included	Not included	Sale of its NaCl by-product is expected to be included the DFS but this potential upside is not included in our forecasts
Mine Life (years)	20	15.5	Our forecasts do not factor in the expected resource upgrade in late Jan-15
Total capex	€231m	€261m	We add €30m to capex for the higher throughput and twin decline approach
Sustaining capex	2.5% of initial capex	3.0% of initial capex	We take a slightly more conservative position on sustaining capex
Corporate tax rate	30%	25%	Spain has its cut corporate tax rate to 25% from 1 Jan 2016. First production from Muga due in 1H 2017
Potash price US\$/t FOB Vancouver	380	305	HFR's PFS used potash prices forecast by industry expert Integer, whereas we use the spot price
<b>NPV</b>	€796m	€764m	Both NPVs based on a 10% nominal discount rate

Source: Company, Blue Ocean

Based on our input assumptions outlined in the table on the previous page, we expect to see a significant improvement in the financial outcomes of the Muga project on completion of the DFS. On these assumptions, which we believe are conservative in a number of areas, using the spot potash price of US\$305/t FOB Vancouver, we estimate the DFS for the Muga project will demonstrate:

- An unlevered post-tax IRR of 44%+
- Project payback ~2.5 years
- EBITDA of A\$292m in first full year of production (CY19)
- EBITDA margins of ~55% (or ~US\$200/t)
- In short, we expect Muga to be confirmed as an extremely robust project at current prices and one of the most compelling greenfields potash development projects globally

### Valuing Highfields Pipeline Projects

We also model Highfield's pipeline projects on a DCF-basis, but apply a heavy discount given the early stage nature of these projects. The table below summarises each of Highfields development projects, their stage of development, and the discount we apply and our resulting risk-adjusted NPV.

	Development Stage	Discount Applied	Risk-adjusted NPV
Muga	PFS complete. DFS due in March 2015	50%	A\$520m
Sierra del Perdón	Scoping Study due Jan 2015	80%	A\$29m
Vipasca	Extension of Muga at depth. Early stage only	90%	A\$20m
Pintano	Inferred Resource	90%	A\$12m

Source: Blue Ocean

The company has 200.5m shares on issue plus 39.3m options and a further 100m performance shares from the original purchase from KCL Resources Limited. The performance shares consist of two tranches of 50m shares:

- Tranche A vests upon HFR defining a resource of 150mt at 13% K<sub>2</sub>O; and
- Tranche B vests upon HFR receiving the construction and operating approvals for potash production of 500ktpa

We believe it is likely Tranche A will vest on the next resource update at Muga (expected in late January 2014) and we expect Tranche B to vest by mid-2015. As such, all of our per share analysis is fully diluted for all performance shares and all options.

## FUNDING ASSUMPTIONS

We assume the company develops Muga using traditional project finance with ~60% debt and ~40% equity. Our other key assumptions are presented in the tables below:

Muga Capex	€m	US\$m	A\$m
Upfront Capex	217	246	307
Ramp-up Capex	44	50	62
<b>Total Capex</b>	<b>261</b>	<b>296</b>	<b>369</b>
Working Capital	30	34	42
<b>Funding Need</b>	<b>291</b>	<b>331</b>	<b>412</b>

We have added €30m to the upfront capex in the PFS for the increase in throughput and dual decline approach.

Total capex represents ~US\$300m

Funding Mix	€m	US\$m	A\$m
Debt	170	193	241
Equity	121	137	171
	<b>291</b>	<b>331</b>	<b>412</b>

We assume €170m of debt with the balance to be raised as equity, representing ~A\$170m

Source: Blue Ocean

Highfield has a supportive major shareholder in EMR capital (a private equity firm) which holds a fully diluted stake of 20%. The company expects EMR Capital to be supportive in any major raising and to take at least its pro-rata share. EMR Capital also has 2 board seats.

## TYPICAL TRADING MULTIPLES OF COMPARABLE PEERS

As the table below illustrates, potash produces typically trade on ~8-10x forward looking EV/EBITDA.

Producers	Ticker	Last Price	Market Cap (millions)	EV (US\$m)	Net Debt (US\$m)	EV/EBITDA (x)			Price/Earnings (x)			% of EBIT from Potash
						2013	2014E	2015E	2013	2014E	2015E	
Arab Potash	APOT JR	24 JOD	US\$2,824	2,555	269	10.8x	12.4x	11.0x	25.2x	27.1x	23.5x	100%
Intrepid Potash	IPI US	US\$15.03	US\$1,144	1,259	(115)	13.0x	12.7x	9.5x	41.8x	88.4x	37.6x	100%
K+S	SDF GR	€24.10	€4,606	4,782	(176)	5.2x	6.0x	5.9x	9.9x	14.8x	14.8x	~78%*
Mosaic	MOS US	US\$47.25	US\$17,702	18,397	(695)	8.8x	8.5x	7.3x	16.2x	17.8x	13.7x	73%
PotashCorp	POT US	US\$34.84	US\$28,894	32,928	(4,034)	10.4x	11.2x	10.0x	15.7x	19.6x	16.8x	56%
SQM	SQM US	US\$27.77	US\$7,115	7,727	(612)	8.8x	10.8x	9.8x	14.5x	22.0x	17.9x	23%
Uralkali	URKA LI	US\$18.72	US\$10,971	14,880	(3,909)	11.9x	10.2x	9.6x	17.6x	17.3x	10.7x	100%
ICL	ICL IT	US\$7,60**	US\$9,476	12,131	(2,655)	8,6x	9,1x	7,7x		13,8x	10,6x	82%
<b>AVERAGE</b>						<b>9.8x</b>	<b>10.2x</b>	<b>9.0x</b>	<b>20.1x</b>	<b>29.6x</b>	<b>19.3x</b>	

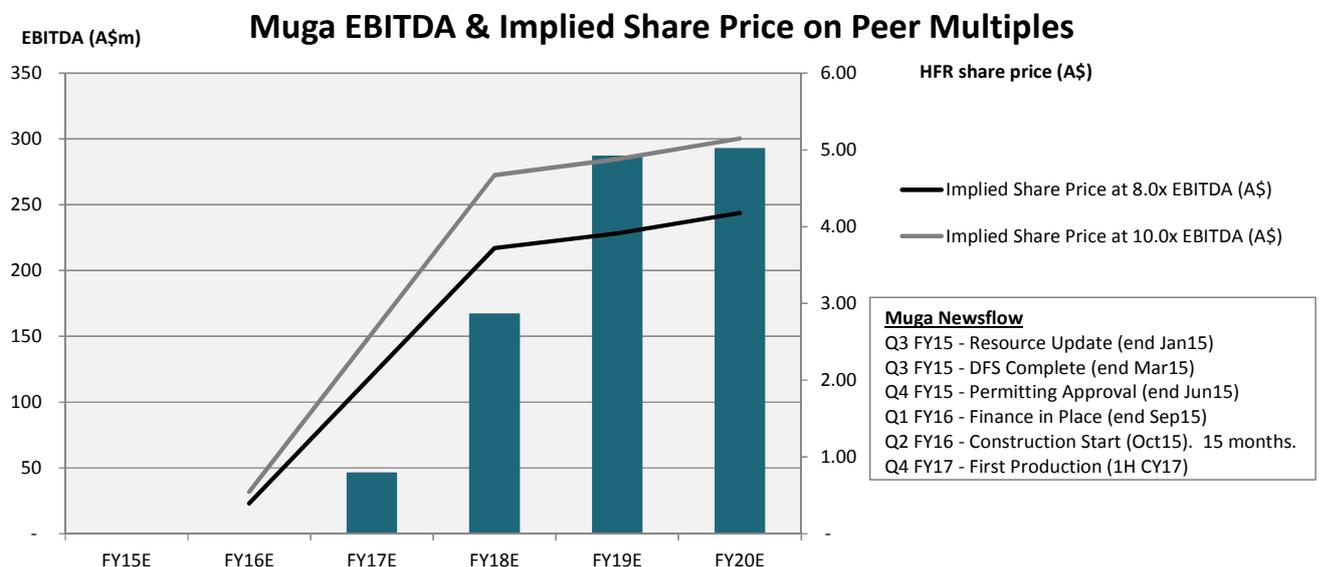
Source: Bloomberg, as at 4 September 2014

\*~78% of K+S earnings are from its Potash and Magnesium division

\*\* note share price converted to US dollars from Israeli Shekel

Source: Company

The chart below outlines our EBITDA for Muga at spot potash prices as well as the implied prices Highfield could trade at once Muga moves into production.



Implied share prices are diluted for all options, performance shares and a major raising to fund development of Muga  
We assume ~40% of the ~US\$300m development capex for Muga is equity funded and is raised at a 10% discount to the last close

Source: Blue Ocean estimates

**This analysis suggests Highfield could be a \$4-5 stock by FY19.**

## PRICE TARGET & RATING

Our \$1.65 price target represents 1.0x our risk-adjusted NAV and an implied return of 129%.

## STRATEGIC TARGET

To derive our longer-term \$5.00 Strategic Target we assume Highfield brings Muga into production, successfully ramps the project up to 1.1mtpa and achieves EBITDA of ~A\$300m.

We also assume the stock re-rates as it makes the transition to production and begins to trade in line with other potash producing peers on an EV/EBITDA multiple of ~8-10x.

## NEAR-TERM CATALYSTS

There a number of near-term catalysts for Highfield which investors should be aware of:

- (1) **Late January 2015:** Final Resource update for Muga DFS
- (2) **End March Q 2015:** DFS for Muga due
- (3) **End June 2015:** Mining Concession Approval for Muga due (legislated 6-months)
- (4) **Q3 2015:** Confirmation required project funding is in place
- (5) **Early Q4 2015:** Construction of Muga scheduled to begin

## HIGHLY LIKELY TO BE A TAKEOVER TARGET

In our view, Highfield represents a highly attractive takeover target from either a potash or fertiliser producing peer or from a major end user, given:

- The compelling economics of the Muga project
- The superior margins of the Muga project
- The very substantial discount Highfield is trading at relative to comparable potash producers what it could be worth if it can bring Muga into production

The final bullet point above is probably the most crucial given it means a potential acquirer could afford to pay **a substantial premium** for HFR and still achieve a highly accretive acquisition.

## KEY RISKS

Highfield is exposed to all the normal risks associated with developing and operating mining projects, including permitting, funding and construction risk. Once in production, the company's revenue will be predominately derived from the sale of potash, and fluctuations in the potash price as well as the Euro could impact the company's cash flow, profitability and share price.

Highfields's shares also carry an embedded Spanish sovereign risk as the company's development projects are based in Spain.

## MODEL SUMMARY – FINANCIALS & VALUATION

### Stock Details

Recommendation:	<b>Buy</b>	Share Price	\$0.72
Target	\$1.65	52 Week High	\$0.79
NAV	\$1.65	52 Week Low	\$0.35
Implied Return	129%		

Enterprise Value	\$215m
Diluted MCap	\$245m
Diluted Shares	340m
Free Float	51%
Avg Daily Value	\$0.2m

Macro Assumptions	FY16E	FY17E	FY18E	FY19E	FY20E
Exchange Rate (€/US\$)	1.19	1.21	1.23	1.26	1.27
Potash Price FOB Van (US\$/t)	305	305	305	305	305

Profit & Loss (A\$m)	FY16E	FY17E	FY18E	FY19E	FY20E
Revenue	-	84	279	477	638
Operating Costs	-	(31)	(105)	(183)	(255)
<b>Operating Profit</b>	-	<b>53</b>	<b>174</b>	<b>294</b>	<b>383</b>
Corporate & Other	(6)	(6)	(6)	(6)	(8)
Exploration Expense	-	(1)	(1)	(1)	(2)
<b>EBITDA</b>	<b>(6)</b>	<b>46</b>	<b>167</b>	<b>287</b>	<b>373</b>
D&A	-	(5)	(16)	(28)	(48)
<b>EBIT</b>	<b>(6)</b>	<b>41</b>	<b>151</b>	<b>259</b>	<b>325</b>
Net Interest Expense	-	(10)	(16)	(11)	(6)
<b>Pre-Tax Profit</b>	<b>(6)</b>	<b>32</b>	<b>135</b>	<b>247</b>	<b>318</b>
Tax	-	(2)	(34)	(62)	(80)
Minorities	-	-	-	-	-
<b>Underlying Profit</b>	<b>(6)</b>	<b>29</b>	<b>101</b>	<b>185</b>	<b>239</b>
Significant Items (post tax)	-	-	-	-	-
Reported Profit	(6)	29	101	185	239

Cash Flow (A\$m)	FY16E	FY17E	FY18E	FY19E	FY20E
Operating Cashflow	(6)	47	168	288	374
Tax	-	-	(17)	(50)	(71)
Net Interest	-	(10)	(16)	(11)	(6)
<b>Net Operating Cash Flow</b>	<b>(6)</b>	<b>37</b>	<b>135</b>	<b>226</b>	<b>298</b>
Exploration	-	(2)	(3)	(3)	(5)
Capex	(194)	(162)	(91)	(185)	(225)
Acquisitions / Disposals	-	-	-	-	-
Other	-	-	-	-	-
<b>Net Investing Cash Flow</b>	<b>(194)</b>	<b>(164)</b>	<b>(94)</b>	<b>(188)</b>	<b>(230)</b>
Equity Issue	172	6	4	10	-
Borrowing / Repayments	51	176	(67)	(68)	(70)
Dividends	-	-	-	-	-
Other	-	-	-	-	-
<b>Net Financing Cash Flow</b>	<b>223</b>	<b>182</b>	<b>(63)</b>	<b>(58)</b>	<b>(70)</b>
Change in Cash Position	23	55	(22)	(21)	(2)
FX Adjustments	-	-	-	-	0
<b>Cash Balance</b>	<b>41</b>	<b>98</b>	<b>78</b>	<b>60</b>	<b>59</b>

Balance Sheet (A\$m)	FY16E	FY17E	FY18E	FY19E	FY20E
Cash & Cash Equivalents	41	98	78	60	59
Other Current Assets	1	1	2	2	2
PP&E	194	357	440	609	798
Exploration & Development	50	52	55	59	63
Other Non Current Assets	0	0	0	0	0
<b>Total Assets</b>	<b>286</b>	<b>508</b>	<b>575</b>	<b>729</b>	<b>921</b>
Debt	51	228	167	103	35
Other Liabilities	2	4	21	33	43
<b>Net Assets</b>	<b>234</b>	<b>276</b>	<b>387</b>	<b>593</b>	<b>843</b>

Ratio Analysis		FY16E	FY17E	FY18E	FY19E	FY20E
Diluted Shares	m	604	604	604	604	604
EPS - Diluted	Ac	(1.1)	4.9	16.7	30.9	39.5
<b>P/E</b>	<b>x</b>	<b>n.m.</b>	<b>14.8x</b>	<b>4.3x</b>	<b>2.3x</b>	<b>1.8x</b>
CFPS - Diluted	Ac	(1.1)	6.1	22.4	37.6	49.3
<b>P/CF</b>	<b>x</b>	<b>n.m.</b>	<b>11.7x</b>	<b>3.2x</b>	<b>1.9x</b>	<b>1.5x</b>
FCF - Diluted	Ac	(33.1)	(19.4)	9.5	8.1	12.2
<b>P/FCF</b>	<b>x</b>	<b>n.m.</b>	<b>n.m.</b>	<b>7.6x</b>	<b>8.9x</b>	<b>5.9x</b>
Dividends	Ac	-	-	-	-	-
Dividend Yield	%	-	-	-	-	-
Payout Ratio	%	-	-	-	-	-
Franking	%	-	-	-	-	-
Enterprise Value	A\$m	254	375	333	288	221
<b>EV/EBITDA</b>	<b>x</b>	<b>(42.7x)</b>	<b>8.1x</b>	<b>2.0x</b>	<b>1.0x</b>	<b>0.6x</b>
ROE	%	(3%)	11%	26%	31%	28%
ROA	%	(2%)	6%	18%	25%	26%
Net Debt / (Cash)	€m	9	130	88	43	(24)
Gearing (ND/(ND+E))	%	4%	32%	19%	7%	(3%)
Gearing (ND/E)	%	4%	47%	23%	7%	(3%)

	P&P Reserves		M&I Resources		Inferred		
	mt	% K <sub>2</sub> O	mt K <sub>2</sub> O	mt	% K <sub>2</sub> O	mt K <sub>2</sub> O	
Muga	-	-	-	157	11.3	18	12
Sierra del Perdon	-	-	-	-	-	-	-
Vipasca	-	-	-	-	-	-	-
Pintano	-	-	-	-	-	-	21

**M+I+I (mt K<sub>2</sub>O): 51.1**

Earnings Sensitivity			FY17E	FY18E	FY17E	FY18E
			A\$m	A\$m	%	%
Potash Price	US\$/t	+10%	5	18	19%	18%
Exchange Rate	€/US\$	-10%	4	11	12%	11%

Valuation	Discount	Stake	€m	A\$m	A\$/sh
Muga	50%	100%	368	520	1.53
Sierra del Perdon	80%	100%	21	29	0.09
Vipasca	90%	100%	14	20	0.06
Pintano	90%	100%	8	12	0.03
Exploration			15	21	0.06
Corporate & Other			(51)	(72)	(0.21)
Debt			-	-	-
Cash			21	30	0.09 P/NAV
<b>Net Asset Value</b>			<b>396</b>	<b>561</b>	<b>1.65 0.44x</b>

Source: IRESS, Company data, Blue Ocean estimates

## MODEL SUMMARY – OPERATIONAL INPUTS & FREE CASH FLOW

Operational Summary		FY16E	FY17E	FY18E	FY19E	FY20E
<b>Muga</b>						
Tonnes Processed	mt	-	1.1	3.6	6.1	6.3
Head Grade (K60)	% KCl	-	21.5%	21.5%	21.5%	21.5%
Recovery	%	-	84%	84%	84%	84%
Potash Production (K60)	kt KCl	-	199	655	1,111	1,139
All-in Sustaining Cost	€/t	-	124	118	115	115
<b>AISC Margin</b>	%	-	<b>55%</b>	<b>57%</b>	<b>57%</b>	<b>56%</b>
<b>Sierra del Perdon</b>						
Tonnes Processed	mt	-	-	-	-	2.0
Head Grade (K60)	% KCl	-	-	-	-	21.0%
Recovery	%	-	-	-	-	82%
Potash Production (K60)	kt KCl	-	-	-	-	340
All-in Sustaining Cost	€/t	-	-	-	-	133
<b>AISC Margin</b>	%	-	-	-	-	<b>50%</b>
<b>Vipasca</b>						
Tonnes Processed	mt	-	-	-	-	-
Head Grade (K60)	% KCl	-	-	-	-	-
Recovery	%	-	-	-	-	-
Potash Production (K60)	kt KCl	-	-	-	-	-
All-in Sustaining Cost	€/t	-	-	-	-	-
<b>AISC Margin</b>	%	-	-	-	-	-
<b>Pintano</b>						
Tonnes Processed	mt	-	-	-	-	-
Head Grade (K60)	% KCl	-	-	-	-	-
Recovery	%	-	-	-	-	-
Potash Production (K60)	kt KCl	-	-	-	-	-
All-in Sustaining Cost	€/t	-	-	-	-	-
<b>AISC Margin</b>	%	-	-	-	-	-
<b>Group Summary</b>		<b>FY16E</b>	<b>FY17E</b>	<b>FY18E</b>	<b>FY19E</b>	<b>FY20E</b>
<b>Potash Production (K60)</b>	<b>kt KCl</b>	<b>-</b>	<b>199</b>	<b>655</b>	<b>1,111</b>	<b>1,479</b>
All-in Sustaining Cost	€/t	-	124	118	115	119

Macro Assumptions		FY16E	FY17E	FY18E	FY19E	FY20E
Exchange Rate	€/US\$	1.19	1.21	1.23	1.26	1.27
Potash Price FOB Van	US\$/t	305	305	305	305	305
Net Potash Price*	US\$/t	335	335	335	335	335
Realised Potash Price	€/t	282	277	273	267	263

FCF Contribution		US\$m	FY16E	FY17E	FY18E	FY19E	FY20E
<b>Muga</b>							
Revenue		-	66	219	372	382	
Operating Costs		-	25	83	143	149	
Sustaining Capex		-	2	6	10	10	
Sustaining Exploration		-	1	2	3	3	
Corp Overheads		5	5	5	5	5	
<b>All-in Sustaining Margin</b>		<b>(5)</b>	<b>34</b>	<b>124</b>	<b>212</b>	<b>216</b>	
Growth Capex		155	126	32	-	-	
<b>Sierra del Perdon</b>							
Revenue		-	-	-	-	114	
Operating Costs		-	-	-	-	50	
Sustaining Capex		-	-	-	-	5	
Sustaining Exploration		-	-	-	-	1	
Corp Overheads		-	-	-	-	1	
<b>All-in Sustaining Margin</b>		<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>56</b>	
Growth Capex		-	-	33	135	-	
<b>Vipasca</b>							
Revenue		-	-	-	-	-	
Operating Costs		-	-	-	-	-	
Sustaining Capex		-	-	-	-	-	
Sustaining Exploration		-	-	-	-	-	
Corp Overheads		-	-	-	-	-	
<b>All-in Sustaining Margin</b>		<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	
Growth Capex		-	-	-	-	160	
<b>Pintano</b>							
Revenue		-	-	-	-	-	
Operating Costs		-	-	-	-	-	
Sustaining Capex		-	-	-	-	-	
Sustaining Exploration		-	-	-	-	-	
Corp Overheads		-	-	-	-	-	
<b>All-in Sustaining Margin</b>		<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	
Growth Capex		-	-	-	-	-	
<b>Group Production</b>		<b>US\$m</b>	<b>FY16E</b>	<b>FY17E</b>	<b>FY18E</b>	<b>FY19E</b>	<b>FY20E</b>
Revenue		-	66	219	372	496	
All-in Sustaining Cost		5	32	95	160	224	
<b>All-in Sustaining Margin</b>		<b>(5)</b>	<b>34</b>	<b>124</b>	<b>212</b>	<b>272</b>	
Growth Capex		155	126	66	135	160	
Growth Exploration		-	-	-	-	-	
<b>All-in Margin</b>		<b>(160)</b>	<b>(92)</b>	<b>58</b>	<b>77</b>	<b>112</b>	
<b>Corporate</b>		<b>US\$m</b>	<b>FY16E</b>	<b>FY17E</b>	<b>FY18E</b>	<b>FY19E</b>	<b>FY20E</b>
Cash Tax		-	-	13	39	55	
Other Items		-	-	-	-	-	
<b>FCF pre Debt Service</b>		<b>(160)</b>	<b>(92)</b>	<b>45</b>	<b>38</b>	<b>57</b>	
Net Interest on Debt		-	8	13	9	5	
Debt Drawdown / (Repayment)		40	139	(52)	(53)	(54)	
<b>FCF post Debt Service</b>		<b>(119)</b>	<b>39</b>	<b>(20)</b>	<b>(24)</b>	<b>(2)</b>	
<b>New Equity/Dividends</b>		<b>US\$m</b>	<b>FY16E</b>	<b>FY17E</b>	<b>FY18E</b>	<b>FY19E</b>	<b>FY20E</b>
Proceeds from Shares/Options		138	5	3	8	-	
Dividends Paid		-	-	-	-	-	
<b>Change in Cash</b>		<b>19</b>	<b>44</b>	<b>(17)</b>	<b>(16)</b>	<b>(2)</b>	
Cash Balance		33	77	62	46	46	

\*Add premium for granulated product plus freight differential from Vancouver to HFR's target markets, less 5% sales commission, less Brazil freight (50% of product)

Source: Company data, Blue Ocean estimates

## A BRIEF INTRODUCTION TO POTASH

In this section we provide a very brief introduction to potash, including geology, end uses, market structure as well as some of the key supply/demand dynamics.

### WHAT IS POTASH?

Potash is a term used to describe a set of potassium bearing salts, with the most common form of potash being potassium chloride (KCl). KCl is also referred to as Muriate of Potash or MOP.

Pure KCl contains 63.17%  $K_2O$  by weight, however 90% of global potash production comprises two slightly lower purity products, being K60 and K62 (containing 60% and 62%  $K_2O$  respectively).

### GEOLOGY

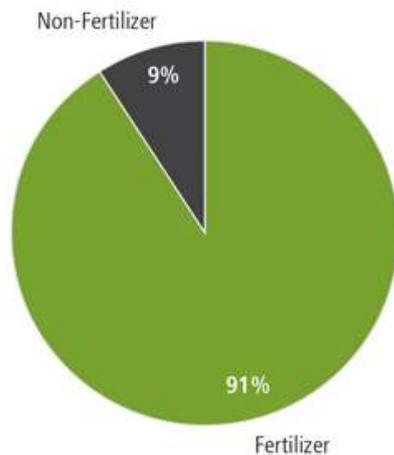
Commercial potash deposits are typically found in beds of evaporite minerals which are sedimentary sequences comprising soluble mineral salts that form through the evaporation and concentration of salt water, and are usually a remnant of inland seas and marine environments. We have defined some of the key geological terms associated with potash mineralisation below.

**Sylvinite:** An evaporate mineral comprising a mixture of sylvite (KCl) and halite (NaCl). This is the potassium-bearing ore Highfield is targeting at Muga.

**Carnallite:** An evaporite mineral comprising  $KMgCl_3 \cdot 6(H_2O)$ . While carnallite is also a source of potassium it is typically lower grade it involves a more complex production process and is thus less economically attractive than sylvite.

### END USES

Over 90% of global potash production is used as a fertilizer along with nitrogen and phosphorous.



Source: PotashCorp, August 2014

The primary role of potash in plants is to support and improve:

- Plant growth;
- Water retention;
- Nutrient value;
- Enzyme activation;
- Yield;
- Taste; and
- Disease resistance.

## SUPPLY & DEMAND

The global demand for potash is currently around **58mtpa** and is driven by:

- The growing global population, estimated at ~80m people per annum (PotashCorp)
- The trend of migration to urban areas, which tends to drive a shift in food consumption towards more balanced diets including more meat, fruit and vegetables
- Which in turn drives the need for increased crop yields and the demand for fertilisers

As the charts on the next page show, in terms of supply:

- Over 80% of the world's potash reserves are located in Canada & Russia
- Around half the world's production comes from Canada and the Former Soviet Union (FSU)

But in terms of demand:

- Asia is by far the largest source of demand
- Followed by Latin America, the US and Europe

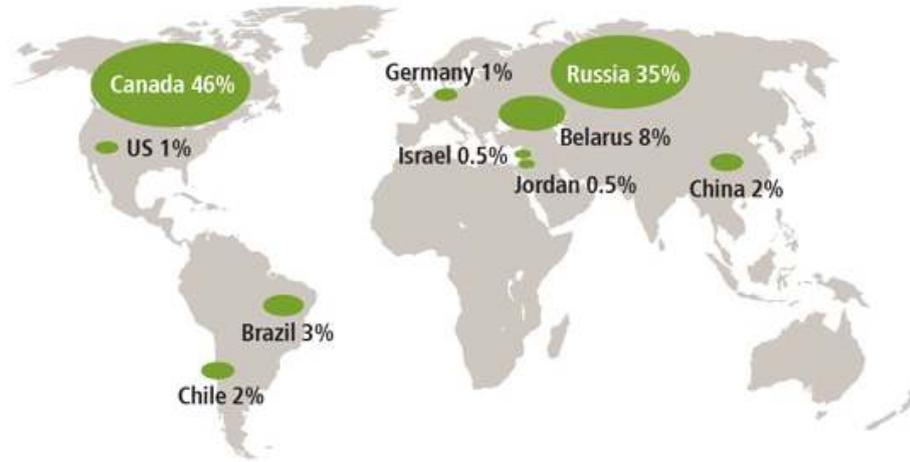
The fertiliser market generally is known to have high barriers to entry for new market participants, with potash considered to have the highest barrier to entry compared to nitrogen and phosphorous based fertilisers (Source: IFA Fertilisers Global Supply 2014).

The potash market also has a much more concentrated source of supply, and historically two key marketing companies held a duopoly position, and spoke for over 70% of global potash exports:

- **Canpotex** (a JV between **PotashCorp**, **Mosaic** and **Agrium**); and
- The **Belarusian Potash Company (BPC)** (a JV between **Belaruskali** and **Uralkali**)

But on 30 July 2013, Uralkali announced its decision to leave BPC, which immediately led to ~20% hit to the share prices of many potash producers on concerns of lower potash prices. The potash price at the time was ~US\$400/t and while it did lose ~US\$100/t over the following 6-months, prices have been relatively steady since then, at ~US\$300/t for the last 12-months.

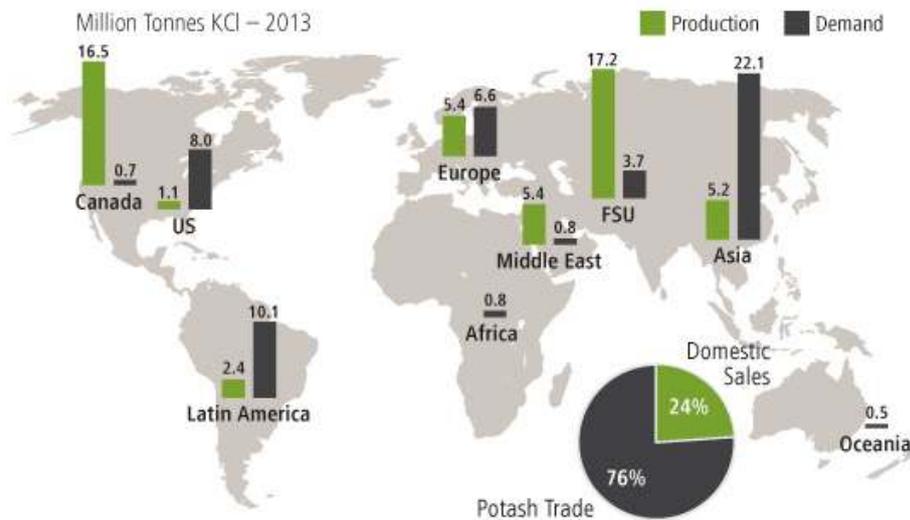
## World Potash Reserves



Over 80% of the world's Potash reserves are in Canada and Russia

Source: US Geological Service, PotashCorp, August 2014

## World Potash Production and Demand

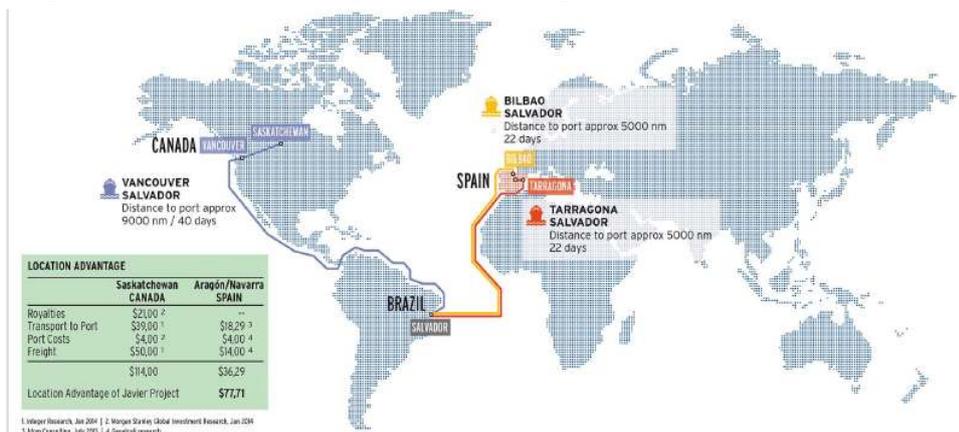


The largest potash producing regions are also Canada and the Former Soviet Union (shown in green)

The largest import demand comes from Asia, Latin America and the US (shown in black)

Source: Fertecon, IFA, PotashCorp, August 2014

## Highfield has a Freight Advantage to Latin America (and Europe)



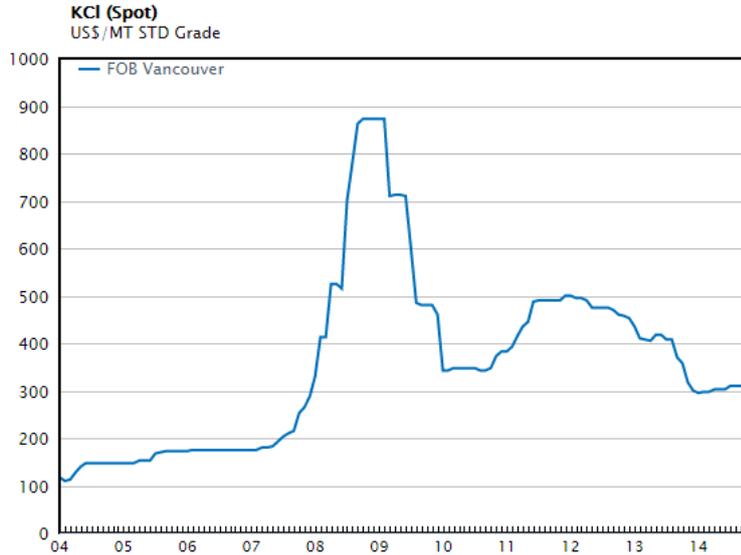
Highfield has a significant freight advantage into Brazil compared to potash produced in Saskatchewan, Canada.

Including royalties, this advantage is worth ~US\$78/t.

Source: Company, May 2014

## POTASH PRICES

Given Canada provides a large proportion of the global potash supply it stands to reason one of the dominant global benchmark prices for potash is US\$ FOB Vancouver:



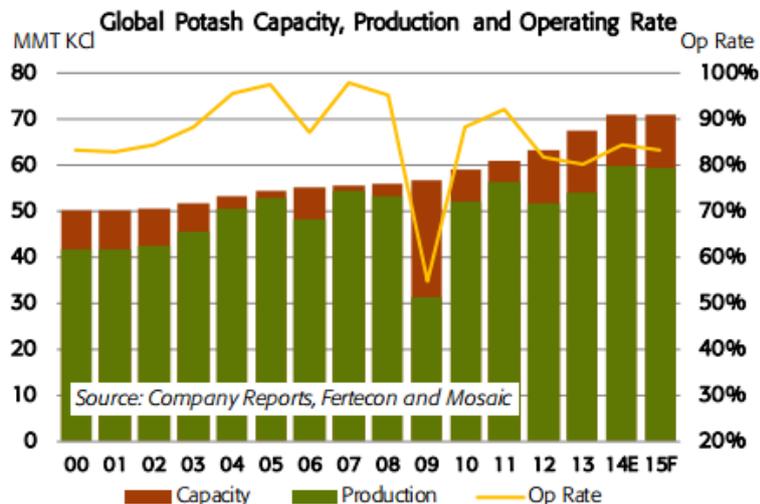
Source: Fertecon, Green Markets, PotashCorp, Jan 2015

## SIGNIFICANT UNDERUTILISED CAPACITY

Historically, global potash producers have operated at around 80% capacity in what is referred to in the industry as a ‘disciplined’ approach to production growth. In reality, this approach only works in a market where participants are acting in concert to prevent oversupply.

Thus, Uralkali’s decision to leave BPC in June 2013, generated significant concern among some investors that it could lead to Uralkali pursuing a volume over price strategy, similar that that pursued by BHP and Rio Tinto in the iron ore market.

While we expect global potash producers to maintain their historically ‘disciplined’ approach, and not to break ranks and create a more competitive potash market (and lower potash prices), this remains a key risk for the potash industry in our view.



Source: Company reports, Fertecon, Mosaic Jan 2015

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