SPROTT ENERGY FUND

NOVEMBER 2017 COMMENTARY

A common theme over the past several monthly commentaries has been the trend of the market to ignore the incontrovertible truths that have pointed to an ever tightening global oil market. We have chronicled all year how the combination of strong demand growth, tame US oil production growth, and strong compliance on the part of OPEC and Russia to their historic production cut was reducing the glut of oil and how the market was quickly approaching balanced levels. With each passing month this year the oil market has tightened and data points have continued to corroborate a bullish outlook over the next several years and yet up until recently the price of oil failed to reflect this reality. That changed in September when WTI broke above $50/bbl and Brent went into backwardation. Since then oil has gone on to make (and nearly remain at) 2 year highs yet oil equities have failed to rally. In fact there are many oil stocks that are -50% YTD while oil is up about 4% YTD. This dislocation has led to many similar conversations over the past few months with clients:

<*Client*>: So you're telling me that the oil price is at a 2 year high and yet some oil stocks are down over 50%

<*Eric*>: Yes

<*Client*>: Well, something has to be wrong. Demand growth must be slowing

<*Eric*>: No, actually demand is growing by about 1.7MM Bbl/d which is 40% stronger than the 5 year average

<*Client*>: Well, then OPEC must be cheating and the market is losing confidence in their deal

<*Eric*>: Actually, OPEC just solidified a 9 month extension of their cut to the end of 2018 and compliance has been improving from already high levels and in November (latest data point) OPEC exports fell to a seven month low

<*Client*>: Okay, but we're over $50/bbl and the market must be expecting US shale growth to ramp and offset any benefit of the OPEC cut

<*Eric*>: The data would say otherwise. US production is up about 700,000 Bbl/d as of September even though the rig count is up 40% on the year so there appears to be some evidence that average well productivity is starting to fall and inefficiencies are taking hold. At the same time since growth investors have left the sector and only value investors largely remain. Given their obvious value bent they are strongly "encouraging" US shale producers to better align spending with their cash flows and focus on improving returns which means less spending and this means that the production growth rate in 2018 (at least) will likely come in about 500,000Bbl/d lower than consensus

<*Client*>: But isn't oil a sunset industry anyways since electric cars are going to be the new norm going forward?

<*Eric*>: Well as you know we've written a lot about this. Electric car sales globally are about 850,000 per year and oil demand is growing by 1,700,000Bbl/d this year. Since every 1,000,000 electric cars that replace gasoline/diesel cars only reduces oil demand by 14,000Bbl/d (0.014%) and the existing fleet of gasoline/diesel burning cars is growing by about 20,000,000 per year it is likely going to take a few decades before we hit peak demand growth at which point US shale will have been exhausted and the cost curve will be significantly higher than today's oil price (side note: at that point oil demand will be at ~ 120,000,000Bbl/d and the annual decline rate will amount to 5,000,000Bbl/d of lost production per annum = ~ 2 Permians/year)

<*Client*>: That all makes sense but we still must be missing something. Why isn't the market seeing what you're seeing?

This is the question that we struggle to answer. How can it be that we are able to invest in service companies that are trading at 15%-20% free cash flow yields (this means they could over 5 years buy back all of their stock and pay back all of their debt from cash flow in excess of that required to maintain their fleets) that have visibility for the next 6-12 months of continued strong margins (which are in many cases at 3 to 5 year highs) while at the same time they and their peers are exercising discipline in not building excess capacity thereby extending the longevity of the cycle? How can we be able to buy oil companies that at $55/bbl oil (below the current strip) are able to pay a 9% dividend, grow by 3%, and still generate enough excess cash flow to either pay down 15% of their debt or buy back 8% of their stock? We can find far too many cases where stocks are trading at roughly half of their historical average multiples yet either their corporate netbacks (oil companies) or EBITDA margins (service companies) are the best in years. Why?

We can come up with 3 answers:

1) The market does not believe in the sustainability of the oil rally. We have had too many head fakes in 2017 and given the extent of the oil bear market energy investors are exhausted

2) Energy fund/pod dissolvement over the past year means that fewer energy specialists remain employed to identify and take advantage of existing opportunities and the battle of passive vs. active means that any fund flow goes into the largest index constituents (SU, CNQ, ECA, and CVE = 60% of the S&P/TSX Capped Energy Index) while no money flows into sub $5BN market cap stocks

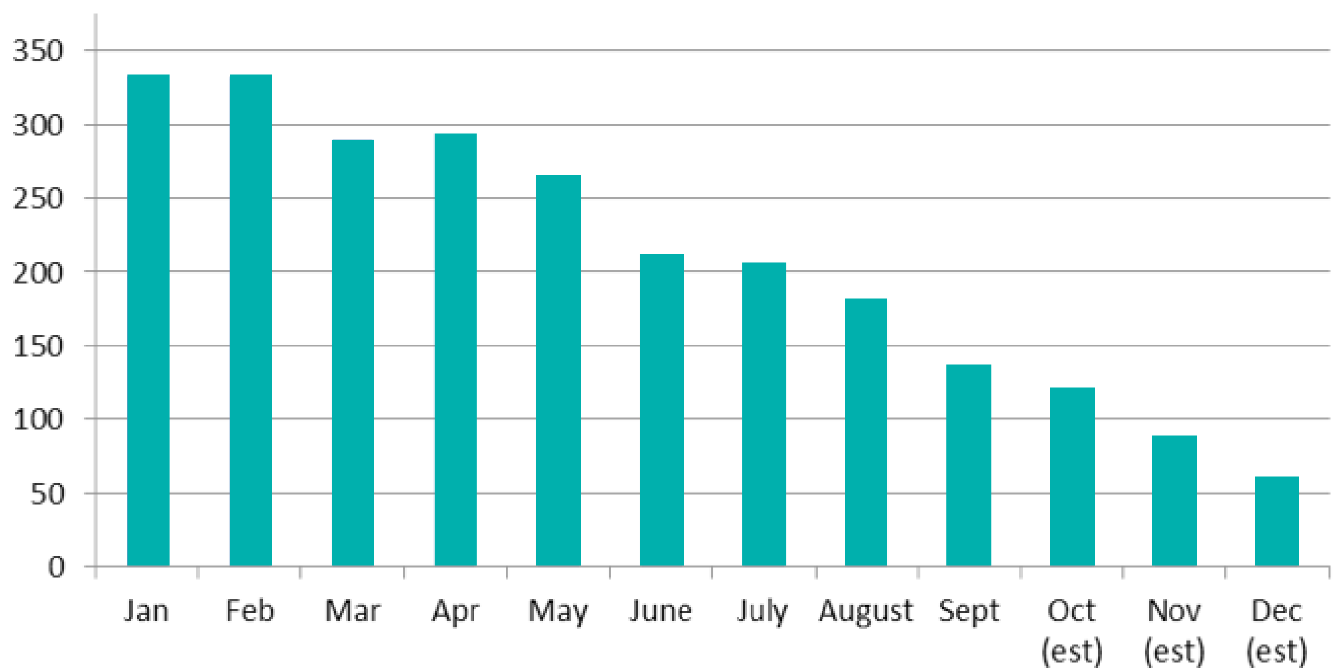
3) Generalist money is either staying in other sectors that seem to make new highs every day (tech) or is flowing into other "speculative" areas like bitcoin (up 90% in a week!), block chain (sold out conference in Toronto this week with 700 registrants), and "medical" marijuana stocks

The staying power of the oil price rally relies on three elements: continued strong demand growth, strong compliance on the part of OPEC for the extent of the deal and then a gradual tapering of shut in volumes once the deal ends, and US production growth that does not overwhelm the market.

Demand over the past few years has been and remains at the very bottom of my list of worries. Oil demand has grown every year in modern history and given the improvement in the global economy over the past few years demand growth has actually accelerated (10 year average ~ 1MM Bbl/d growth, 5 year average ~ 1.2MM Bbl/d growth, 2017 ~ 1.7MM Bbl/d of growth). Despite continued paranoia about electric cars we believe oil demand will continue to grow for the next two decades. It was notable that the first major broker (Morgan Stanley) issued a note last week signaling newfound caution on the timing of electric car adoption ("we have grown more cautious on the timing of EV adoption given the amount of capital and work that needs to go into EV infrastructure"). Their work points to massive required investment in order for the fantasy of mass wide electric car adoption to become a reality ($0.8 trillion to upgrade the power grid and $0.5 trillion for increased battery production to get to 9% penetration by 2025). As noted below in order for oil growth to get to zero (assuming that cars = 100% of oil demand growth vs. ~ 30% of total global demand) electric car sales would have to increase to approximately 121,000,000 this year…up from about 850,000. Perhaps the market is being overly pessimistic on the outlook for continued demand growth? For more information on EV's refer to our previous monthly commentaries.

OPEC compliance has and remains very strong with the rate of compliance by key member countries (Saudi Arabia and Russia specifically) exceeding 100%. OPEC is acting in their own self-interest: 70% - 90% of their overall economics rely on oil revenue and major members have upcoming events that are supportive of higher oil prices (Russian presidential elections in March and Saudi Aramco IPO in late 2018). Exports from OPEC have reached multi-month lows and their strong commitment to the cut has been a key reason why global oil inventories have been normalizing at the fastest pace in history:

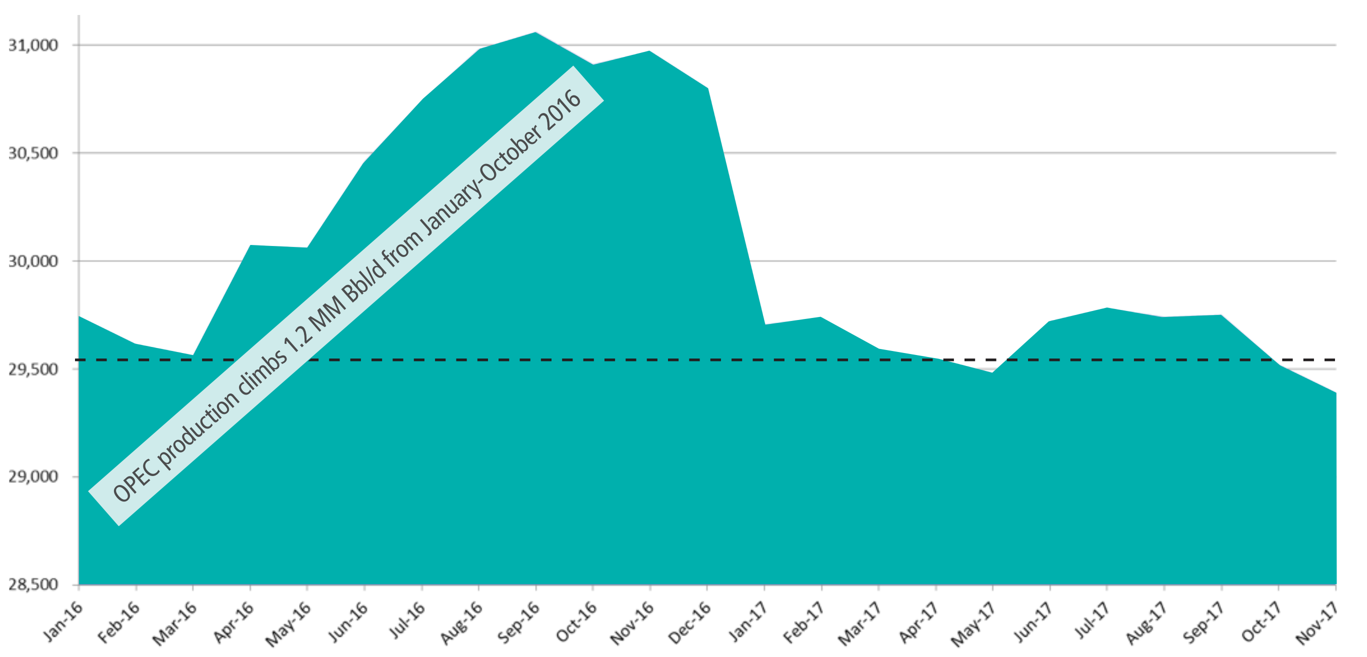
OECD TOTAL PETROLEUM SURPLUS VERSUS THE 5 YEAR AVERAGE



Source: Bloomberg

It is reasonable to question what happens to the oil market when the OPEC/Russia agreement ends. While we have Saudi Arabia on record saying that all of the barrels will not return to the market the day after the deal concludes and that it will be a gradual process the advertised number of "1.8MM Bbl/d" of incremental production is at first worrying in the face of continued (albeit more tepid) US production growth. A bit of background is required though to appreciate why the 1.8MM Bbl/d number is not real. After the disastrous outcome from the Thanksgiving 2014 OPEC meeting where Saudi basically said "over to you free market" and oil became a price discovery mechanism and eventually collapsed to below $30/bbl nearly all OPEC member countries were at that point staring into the financial abyss. Oil revenues are absolutely critical to their economies (and ability to pay for social programs which appease young populations) and a sub $50/bbl price level saw countries reduce foreign currency reserves at unprecedented rates. On November 30, 2016 OPEC announced a production cut (vs. then consensus of a freeze) of 1.34MM Bbl/d plus an additional 0.6MM Bbl/d cut from Russia as a means of propping up the oil price. However, given that during much of 2016 the ongoing conversation revolved around a production freeze and not a cut, member countries were incentivized to goose production as much as they could heading into the announcement so as to have a higher number to be measured off of. This explains the mysterious ramp in production in the months heading into the OPEC meeting:

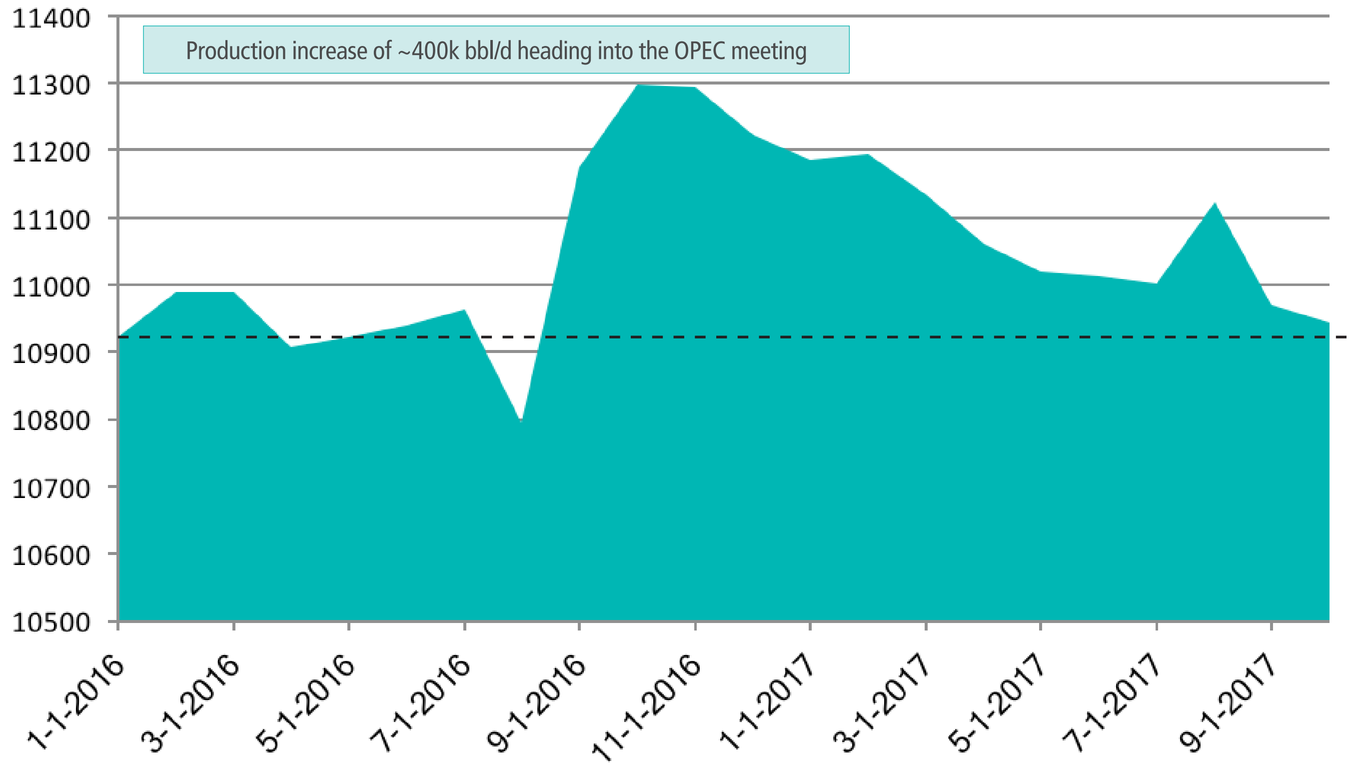
OPEC PRODUCTION EX. LIBYA AND NIGERIA



Source: Bloomberg

It is our belief that much of the production gains were from short-term production enhancements (ie. pulling on fields harder vs. increasing production through new wells/projects) which over the long run were unsustainable and likely damaging to long-term production potential. The reference date/benchmark for the cut was October 2016 however OPEC production (excluding Libya and Nigeria who were not part of the initial cut) had already risen in 2016 by 1.2MM Bbl/d by that point. It is our suspicion then that much of the reported 1.3MM Bbl/d of OPEC shut-ins will never return to the market; they were artificial in nature given that OPEC members jammed up their production by 1.2MM Bbl/d using artificial means in the first 10 months of the year and then announced a 1.3MM Bbl/d cut to essentially return back to where their more sustainable production levels already was. Russian production saw a similar pattern heading into the same announcement where it averaged 10.94MM Bbl/d for the first six months of 2016 but magically shot up to 11.3MM Bbl/d on the very same month that became the "reference month" for the production cut of 600k bbl/d. This would imply that about 50% of the Russian cut is artificial.

RUSSIA OIL PRODUCTION (K BBL/D)



Source: Bloomberg

Our conclusion would be that one of the largest remaining oil macro worries has no real basis in reality. Much of the OPEC+Russia cut is smoke and mirrors. While the production cut did partially help restore market balance (along with a stellar year of demand growth and disappointing US production growth) as noted above it never amounted to the 1.8MM Bbl/d as initially announced. The punch line: when the deal does ultimately conclude sometime in 2018 there are far fewer barrels to be absorbed than consensus believes hence the oil market will remain tighter than consensus believes = staying power for the oil price rally.

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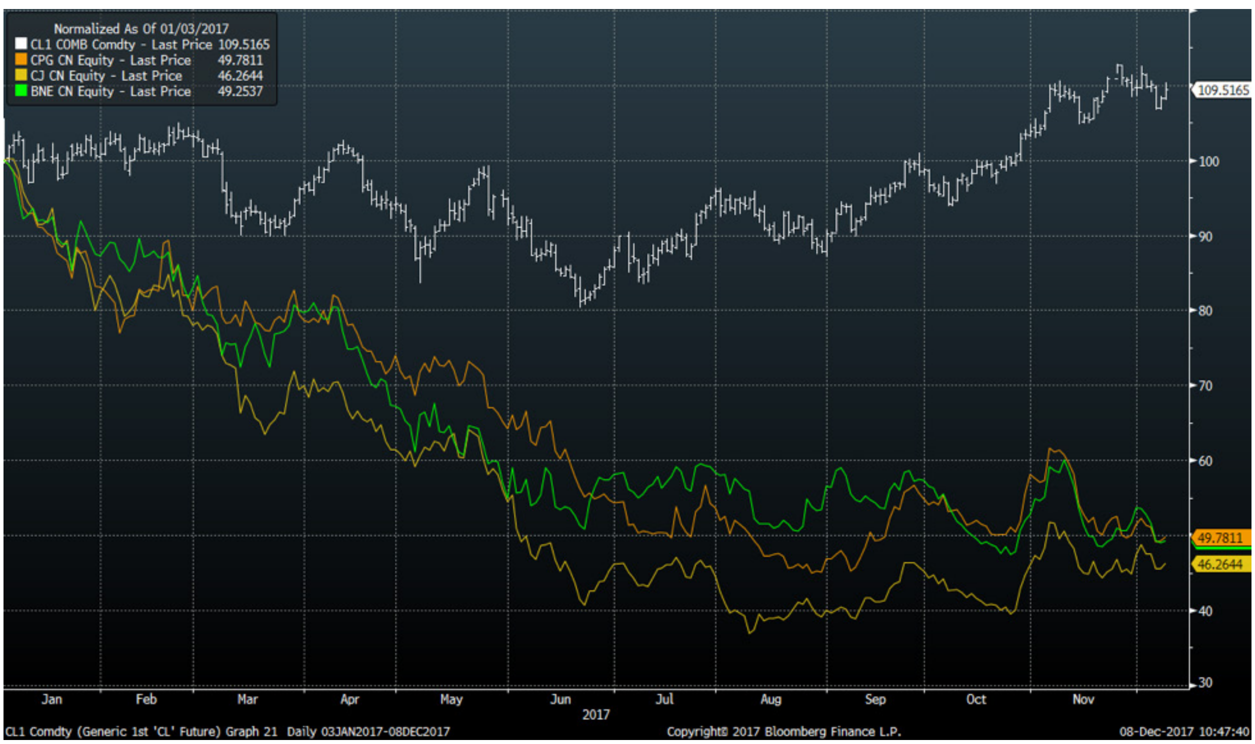
I have never in my career seen such a dislocation between a move in the oil price and such an epic failure of the price of oil equities to move along with it. Part of this can be explained by the reduction in market participants in the energy sector, both voluntarily (staying in other sectors) and involuntarily (layoffs and funds blowing up). Even in December we continue to hear of energy dedicated funds winding/shutting down and energy pods within larger hedge funds having their capital taken away from them. This has clearly led to forced liquidation throughout the year (combined with tax loss selling). At the same time given poor energy sector performance over the past several years energy weightings have shrunk in many indices to a point where their relevance is not what it once was to a generalist fund manager and given poor performance versus other sectors there has not been a pressing need to devote more capital to a sector that feels like it falls every day when other sectors make new highs every day. Finally, with passive investment products continuing to steal market share from active those energy stocks that have received buying have largely been the largest constituents of the main energy indices (SU +1% YTD and CNQ +4% YTD while many oil companies with sub $5BN market caps are down over 50% YTD!):



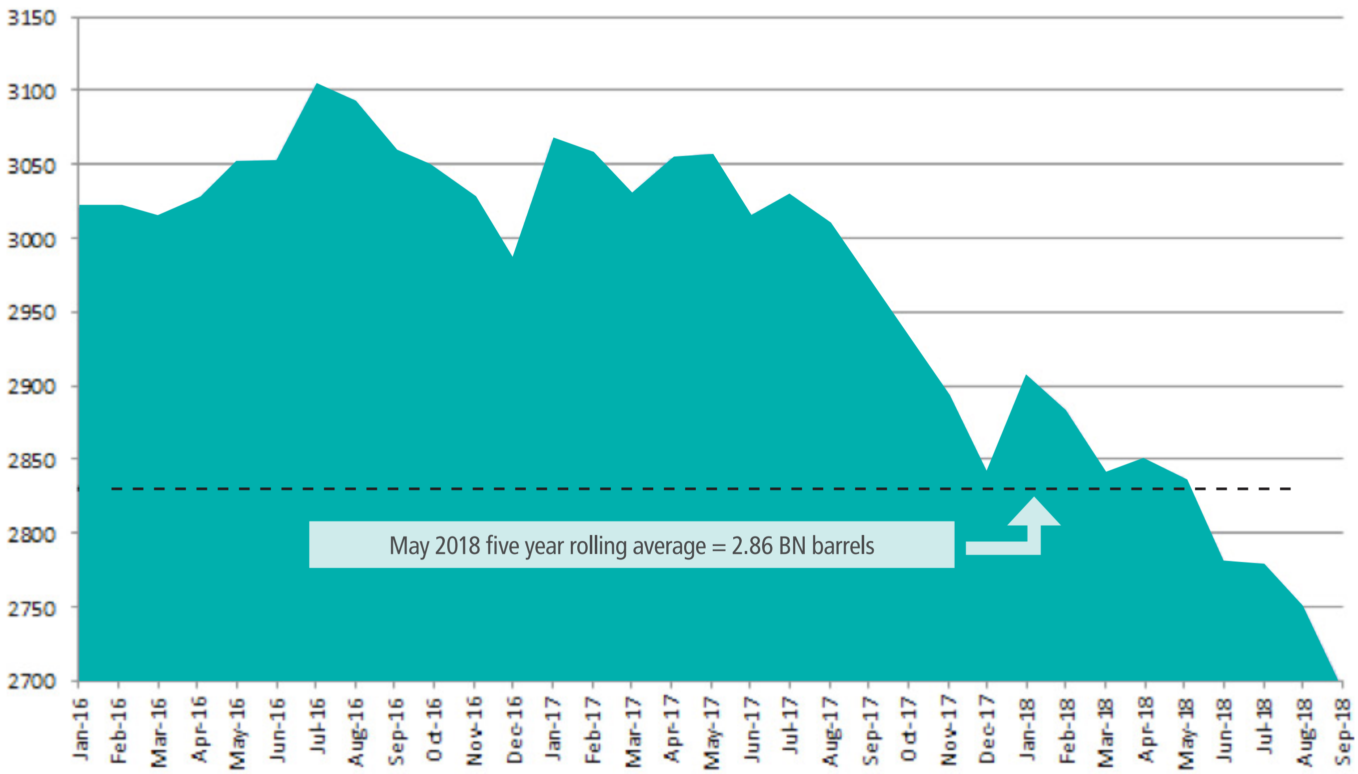
Source: Bloomberg

The result of all of these factors is that oil stocks in many cases are trading at half of their historical multiples even though the outlook for oil has materially improved and we remain in a multi-year bull market. Oil stocks are trading at FCF yields of over 8% at $55/bbl and in many cases can pay dividends in excess of 3% (some as high as 9%), grow production by 7%, and still buy back some of their shares. If the average mid cap oil stock in Canada were to go to a zero production growth mode (why bother growing at all when they can't compete with the 15%+ cash flow neutral growth rates in the Permian?) we estimate that at $55/bbl they could buy back on average 10% of their shares outstanding while keeping production flat. If the equity market continues to ignore such compelling valuations shouldn't this be the standard capital allocation strategy for 2018?

The Sprott Energy Fund (soon to be renamed Ninepoint Energy Fund) maintains large exposure to both service stocks (pressure pumping and to a lesser extent frac sand) and oil stocks. Given oil strip pricing of $56.24/bbl in 2018 ($71.42/bbl in CAD$) and despite moderating natural gas price outlooks (AECO strip ~ $1.60/mcf) we expect E&P spending to be up 10%-15% in the US (basically covering off service cost inflation) and roughly flat in Canada. We expect pressure pumping companies both in Canada and in the US to experience continued tightness and further price increases in 2018. Private pressure pumpers in the US as two weeks ago were reporting success in passing through a 10% price increase (Q1'18/Q4'17) and spoke to their ability to ultimately raise prices by 10%-20% in Q1. This would further lift EBITDA margins above their 3 to 5 year highs of 27%-30%. Given the dislocation between perception and reality (margins are at multi-year highs with evidence of this trend continuing yet stocks are down as much as 30% YTD) we maintain our bullish bias towards this area. Recently Evercore ISI pointed out the dislocation of service stocks in general from oil with oil up 7% YTD and yet the OSX -27% YTD. They wrote: "we are now pounding the table on the OFS (oilfield services) group as numerous factors such as sentiment, relative valuation, and anemic consensus earnings estimates have all created a once in a decade buying opportunity. Further: "this is the time for the big investors to get involved – next quarter the door to enter will be smaller, the stocks will be up, and while returns will be strong the easy money will have been made. The market is a risk/reward proposition and never has the reward been so far in the favour of OFS." We couldn't agree more. Given the obvious impact of tax loss selling we have also focused on a select number of Canadian oil stocks where we are able to pay below proved developed producing RLI relative to their EV/CF multiples using $55/bbl oil where there is no balance sheet risk and companies have upcoming catalysts to potentially get the shares rerated. As a result our US exposure has fallen to approximately 43% from 70%.

In summary, we continue to believe that the complete and utter level of despondency towards the sector is creating an epic opportunity. While we have no visibility on when the "sentiment turn" will occur we are at least no longer having to wait for the "fundamental turn" to happen. All it will take for energy stocks to get materially rerated is a collective realization of the current reality. We continue to believe that the oil market could rebalance by ~May 2018. The focus on the pending inventory builds in Q1'18 are known and understood…the mistake that is being made is that the oil price will move NOT on the absolute rising level of inventories due to seasonality but rather on the inventory balance differential vs. last year and the 5 year average.

OECD TOTAL PETROLEUM INVENTORIES (MM BBLS)



Source: Bloomberg

Thank you for your continued investment and support. Patience and foresight will at some point be rewarded.

Eric Nuttall
Senior Portfolio Manager
Sprott Energy Fund

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COMPOUNDED RETURNS (%) AS AT NOVEMBER 30, 2017*

	1 MTH	YTD	3 MTH	6 MTH	1 YR	3 YR	5 YR	10 YR	ANNUALIZED INCEPTION (04/15/04)
Sprott Energy Fund, Series A	1.25	-37.79	20.65	-5.42	-34.48	-9.22	-4.16	-5.49	2.37
S&P/TSX Capped Energy TR	-1.43	-12.11	12.28	4.24	-11.66	-3.45	-2.45	-2.44	3.49

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* All returns and fund details are a) based on Series A units; b) net of fees; c) annualized if period is greater than one year; d) as at November 30, 2017; e) 2004 annual returns are from 04/15/04 to 12/31/04. The index is 100% S&P/TSX Capped Energy TRI and is computed by Ninepoint Partners LP based on publicly available index information.

The Fund is generally exposed to the following risks. See the prospectus of the Fund for a description of these risks: capital depletion risk; concentration risk; credit risk; currency risk; derivatives risk; exchange traded funds risk; foreign investment risk; income trust risk; inflation risk; interest rate risk; liquidity risk; market risk; regulatory risk; series risk; short selling risk; small company risk; specific issuer risk; tax risk.

Ninepoint Partners LP: Toll Free: 1.866.299.9906. DEALER SERVICES: RBC Investor & Treasury Services: Tel: 416.955.5885; Toll Free: 1.877.874.0899

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