Sprott Energy Fund

December 2017 Commentary

Investment Team

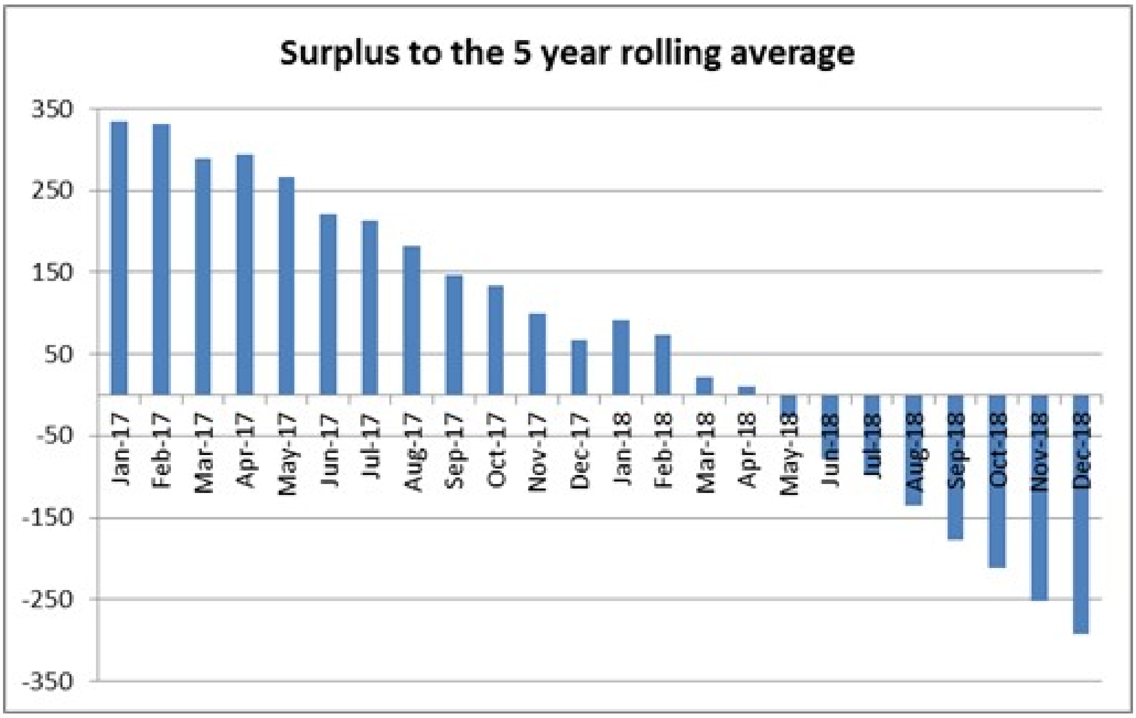
Eric Nuttall, CIM
Partner, Senior Portfolio Manager

As champagne corks popped on New Year's Eve energy fund managers around the world toasted the end of what was truly a miserable year. It is not an exaggeration to describe 2017 as the most challenging year we and others in the sector have had to navigate through as oil hit multi-year highs and yet due to an all-time high level of despondency based on myths and fiction oil equities fell with some down as much as 50%. It took a full 9 months for the market to wake up to the reality that the oil market was undersupplied (expressed in global inventories falling by the fastest pace in history) and that the 3 year long bear market had come to an end. As we enter 2018 one can feel a discernible improvement in tone (the US energy sector is off to its second best relative start in 25 years) and as I write this a major US brokerage firm is holding a conference call titled "Positioning for higher oil prices in 2018"…this would not have happened six months ago. There are 3 main points that we would like to make and expand on in what is essentially our 2018 energy outlook:

- Oil is in a multi-year bull market that will last for at least the next 4-5 years – be invested
- Energy stocks have lagged the 25% one year rise in oil creating an epic buying opportunity in which stocks could rally by 30%-40%+ even if the oil price were to stay flat – don't follow the herd
- Sentiment is starting to turn and the best opportunities are in service stocks and select US/Canadian oil stocks

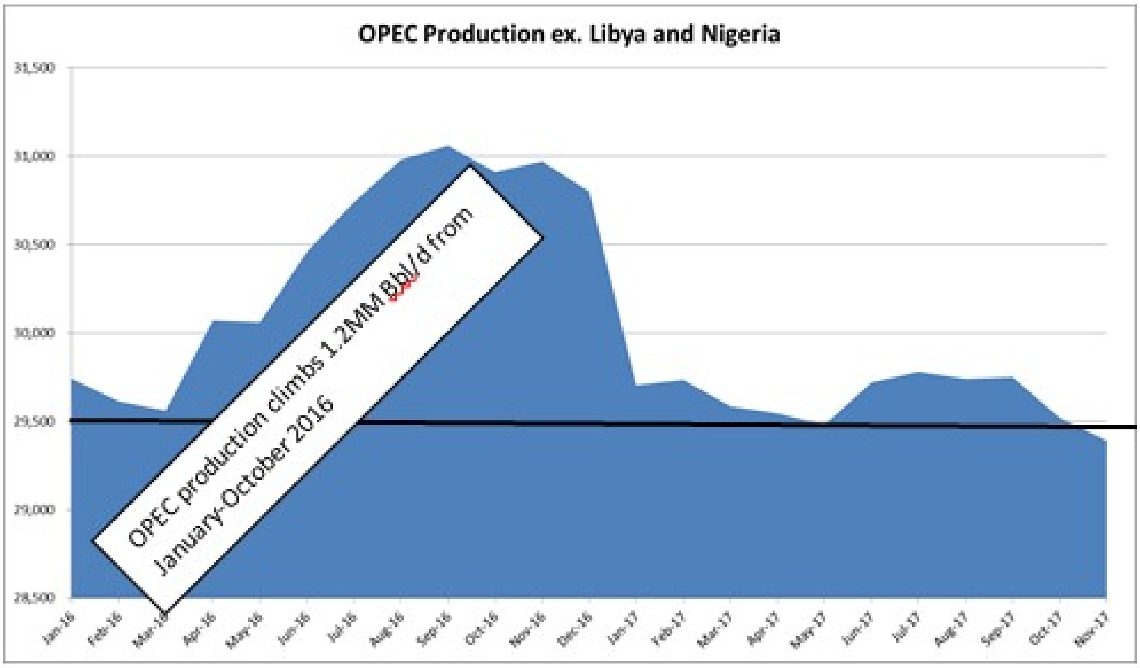
Why are we in a multi-year oil bull market?

Coming into 2017 the oil market's narrative revolved around the oil glut as inventories exceeded the often quoted 5 year average by 334MM Bbls. Everyone "knew" that OPEC and Russia would cheat and that US production would ramp and notable agencies like the IEA early in the year had forecasts for the oil glut to extend out for the next several years. We wrote several times that out of a need for self-preservation that OPEC compliance would be surprisingly high and that due to labour and equipment shortages as well as a new mantra of fiscal discipline and returns focus that US production growth would disappoint. Both forecasts were correct. These 2 factors combined with yet another year of exceedingly strong demand growth led to a massive drawdown in storage that occurred at the fastest pace in history. OECD surplus inventories fell by 232MM bbls as of the end of November and we estimate that the surplus ended the year at 70MM Bbls (a 79% reduction over the year). Given the continuation of strong demand growth around the world (the demand story isn't just about China anymore) we believe that the market will go into deficit relative to the 5 year average by May and that the deficit (assuming OPEC compliance does extend to the end of the year) will expand to ~287MM Bbls by YE'18. This only assumes an average undersupply of 0.5MM Bbl/d YOY which appears conservative to us with demand growth forecasts of 1.8MM Bbl/d, US supply growth of 1.0MM Bbl/d, essentially no growth from OPEC+Russia, and non-OPEC/Russia growth of about 0.2MM Bbl/d.



Source: Ninepoint Partners, IEA

At some point in 2H'18 or 2019 as oil prices continue to move higher given the persistent tightening outlined above we fully expect OPEC+Russia volumes to be gradually brought back onto the market (in a measured manner). As previously examined, the amount of barrels amounts to roughly 1.2MM Bbl/d versus the advertised 1.8MM Bbl/d given the artificial ramp in OPEC+Russia production heading into the "production freeze" meeting in September 2016. This 1.2MM Bbl/d of incremental production would amount to a meagre 8 months of demand growth.

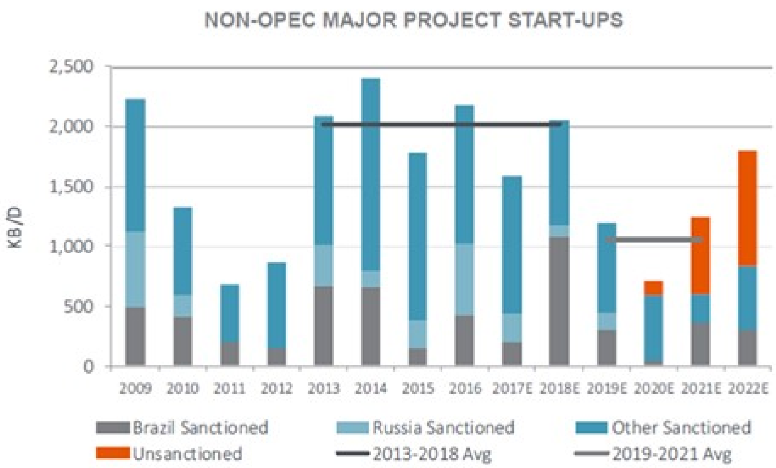


Source: Bloomberg

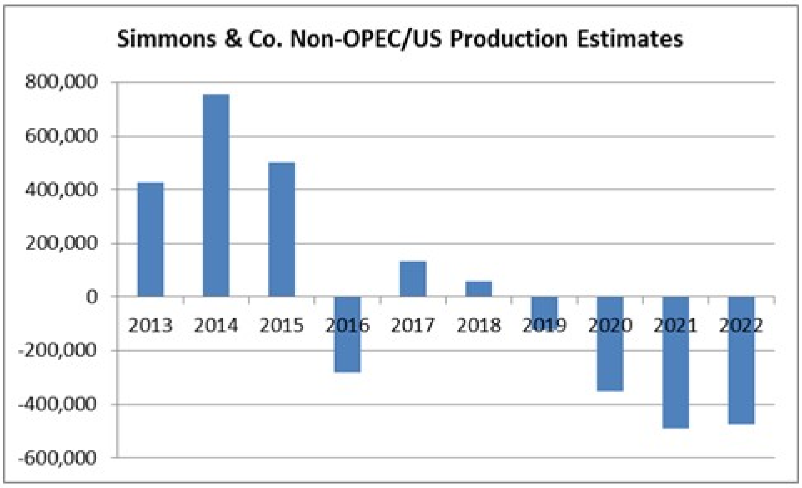
Beyond this 1.2MM Bbl/d of “flush” production we do not believe that OPEC has significant ability to grow production further: Iran is essentially back to pre-embargo levels and requires foreign investment over a several year period to grow, Saudi would be near their max operational capability before risking formation damage, Venezuela continues to suffer from a currency shortage (and other profound issues), Nigeria is once again facing rebel activity that has been disrupting production, and Iraq faces a new source of instability in Kurdistan.

We expect the United States will grow production by about 0.8-1.0MM Bbl/d in 2018, even in a $60/bbl environment. It is evident from meeting with many US companies over the past few weeks that they have widely found religion and are pursuing returns over growth (Anadarko CEO on a panel on January 9th/18: “financial discipline and returning cash to shareholders will not be a passing fad”, Apache CEO: “an E&P should live within its means”). US E&P budgets will be released next month and we believe a $50-$55/bbl price deck will be universally employed with strong and consistent messaging that incremental cash flow beyond the budgeted oil price will go towards debt repayments and share buybacks and thus the historical relationship of $1 of incremental cash flow = $1.30 in incremental spending is no longer valid (Jim Hackett of Silver Run: “the flattening of the oil curve was a big shift for management teams and the psychology today is very different than last year”). Beyond fiscal discipline two other factors will further suppress production growth potential: a shortage of labour (the jobless rate for 25+ year olds without a high school diploma is the lowest since at least 1992; Midland, TX unemployment rate is 2.8%; Pioneer CEO: “people will be the #1 issue and will hit the industry this year”) as well as a shortage in completion equipment (more on that later).

Looking to 2019 (only 11 months away) it will increasingly become evident to the casual observer that the market is heading for a measurable and extended period of tightness for it is in 2019 that the first impact from the largest period of underfunding in the history of the oil and gas business will begin to be felt (Schlumberger on January 19th/18 noted that “the production base in the rest of the world [ie. non-US] is showing fatigue after three years of unprecedented underinvestment”). The level of new production capacity outside of the US will fall by 50% in 2019-2021 vs. 2014-2018 and when one considers demand growth of about 1.6-1.8MM Bbl/d per year and base declines of 4MM-6MM Bbl/d it is apparent that the US cannot alone make up the coming gap between supply and demand. Further, 50% of the projects from 2020-2022 remain unsanctioned and remain funding challenged given the steep backwardation of the oil curve.

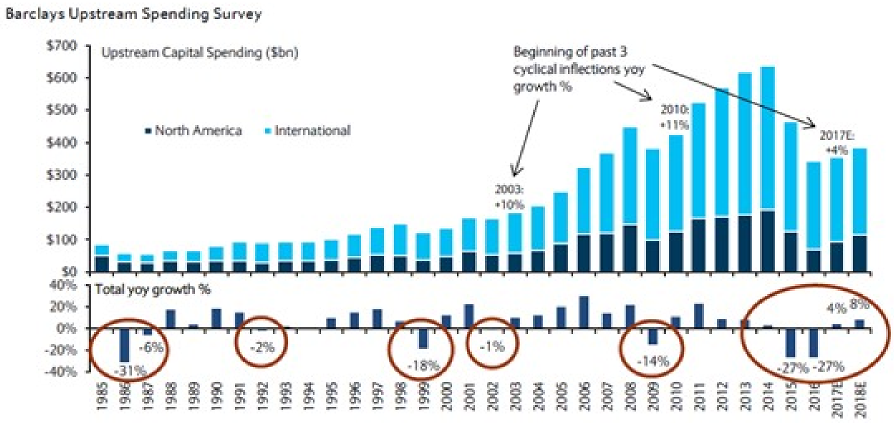


Source: Simmons & Co, December 17, 2017



Source: Simmons & Co, December 12, 2017

It is critically important to understand that this drop in new production is from large scale projects that have 4-6 year cycle times (versus 4-6 months for a US shale well). In other words, as the oil price rallies on a persistently tight/undersupplied market industry outside of the US cannot react quickly and meaningfully enough since dollars spent today will only begin to impact production in 2022-2024. This is what gives us confidence in the longevity of the oil bull market. As an aside 2017 also marked the lowest level of oil discoveries in 70 years with new reserves only equating to 70 days of demand. Unless investment increases soon the market could be facing a significant shortage in the years ahead (even with uber aggressive electric car adoption [reminder: every 1MM EV sales = 14,000 Bbl/d of demand destruction versus 100,000,000 Bbl/d of demand and annual demand growth of 1,800,000 Bbl/d]).



Source: Barclays, December 14, 2017

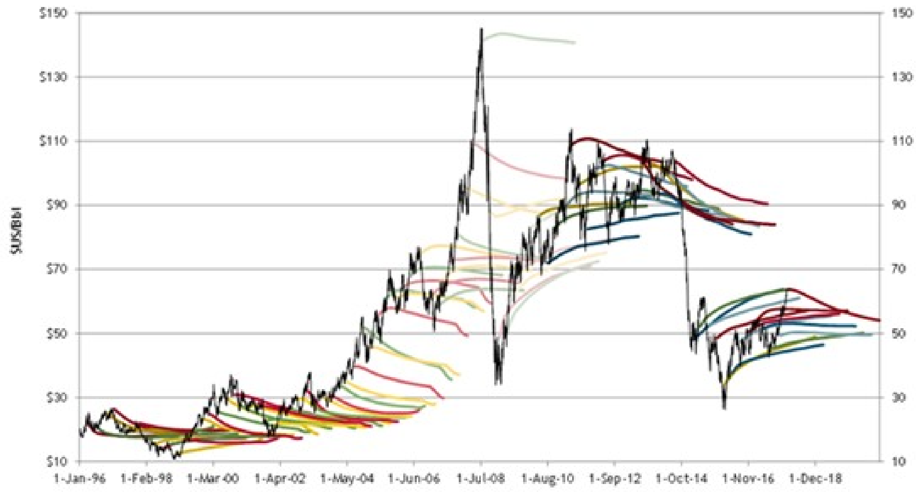
In summary, oil is and will remain in a bull market for the next several years. While the market perceives the unravelling/unwinding of the OPEC+Russia deal as a key risk oil demand will only take 8 months to absorb the incremental barrels and OPEC has stated that the returning of production will happen in a gradual manner. While the US will grow production by about 1MM Bbl/d each year for the next several years until tier 1 inventory is exhausted it is not enough to make up for demand growth and the impending non-OPEC/US supply losses beginning in 2019. The oil price will gradually move higher and break out of a $55-$65 trading range in 2019 and may in the next several years need to go high enough to balance the market by destroying demand.

Epic buying opportunity

Given this backdrop, there is what we believe to be an epic buying opportunity in oil stocks. In 2017 oil rallied by 12.5% yet energy indices were all negative on the year (XLE -4.1%, OSX -18.6%, S&P TSX Capped Energy TR Index -10.6%). Specifically in Canada as more and more "investment" dollars flowed into block chain, bitcoin, and weed stocks (RBC and BMO online trading sites have been recently failing due to a volume surge in weed stocks; CBC article on January 19th: "When taking a look at his portfolio in the past year or so, Cosentino did something that previously would have been unthinkable — he sold off all of his oil and gas investments and moved the money largely into cannabis. "Most of my oil and gas holdings were either in the red, stagnant or (had posted) very modest gains," In comparison, my cannabis sector holdings were doubling, tripling, quadrupling and so on.") the energy sector has become increasingly abandoned (buyers strike combined with selling pressure due to multi-year long frustration) and energy equity underperformance relative to WTI has been magnified. Some stocks like Crescent Point fell by 47.5% and Cardinal Energy fell by 51.9%; with oil up 4.7% in CAD$ in 2017 this represents underperformance of 52% and 56% respectively… wow. However, as noted above this profound underperformance relative to the oil price is not just a Canadian phenomenon. Why? First, it hasn't helped that while oil stocks have been stuck in mire for what feels like an eternity the S&P and Nasdaq seem to make new highs every day. This has resulted in the energy weighting of various indices reaching multiyear lows (~5.8% of the S&P500…the lowest since 2004) where energy stocks have become for the moment irrelevant to large diversified fund managers. Secondly and perhaps more meaningful is the mistake that many are making of paying too much attention to the forward oil curve. Given strong backwardation (the price today is higher than outer months and years) many investors are believing that the future weakness of the oil price will mean that either oil stocks will eventually sell off or that oil stocks are much more expensive today than they appear (WTI spot is $63.80 vs. 2019 WTI strip of $58.04 and 2020 WTI strip of

$55.21).

Historical WTI futures curves vs. actual



Source: CIBC, January 18, 2018

The critical error in using the forward strip is that it has historically been a terrible predictor of the future oil price (kind of like using the IEA for oil demand growth estimates). Jon Morrison, one of our favourite service analysts in Canada and a great oil macro thinker estimates that the historical correlation between the oil strip and the actual future price of oil is a meagre 0.17 (ie. there is no statistical significance at all). Further, in previous cycles where the market has emerged from a situation of aggressive oversupply to eventually undersupply (1998-2006) it is common for the curve to stay backwardated and for outer years to be dragged up by spot (incidentally the oil strip has risen by over $3/bbl over the past few weeks). Under our oil macro forecast the future years of the strip are trading at least $15/bbl below what will likely transpire with the passage of time.

How and why are we positioned?

So with all that said, we are clearly bullish on oil. Energy equities did not rally with oil last year and given our upward bias for the oil price from current levels (over time) believe that broadly stocks will do well in the months ahead. For the foreseeable future it is highly likely that we will strongly favour oil over gas, particularly Canadian natural gas names. Just as with heavy oil Canada has run out of natural gas pipeline takeaway capacity and the outlook for Canadian gas barring a LNG start up (ie. more takeaway) is bleak (AECO strip pricing is below $2/mcf out to 2022!). Despite what look like compelling valuations in some cases we cannot come up with a likely scenario where AECO can meaningfully improve, especially in the context of outperforming NYMEX.

We have maintained a very strong bias towards the service sector with a particular emphasis on pressure pumping (aka fracking). We are not alone in our enthusiasm as many Wall Street firms are calling for the oilfield service sector to do well: ISI "we continue to believe that OFS stocks are overdue for a catchup trade as the underlying stocks begin to reflect the realities of improved fundamentals and the benefits of higher oil prices"; Simmons: "2018 should be an excellent year for the OFS sector". In general we are looking for about a 35% increase in discretionary cash flow in the US and expect spending YOY to be up about 20% resulting in the first upward EPS revision cycle in almost 4 years. During the downturn pressure pumping companies stared into the abyss with several notable bankruptcies and many more just barely scraping by. As a result of working capital deficiencies equipment maintenance suffered and with the uplift in oil pricing in 2017 and by extension demand for pressure pumping companies struggled to mobilize fleets and staff up crews. This translated into meaningful price increases and companies in many cases got back to 3-5 year high margins (Wells Fargo: "profitability on a per fleet basis is inline or slightly above 2014 levels [the most recent peak]). Looking into 2018 we expect tightness to continue. In a $55/bbl+ world despite US E&P's spending restraint we estimate pressure pumping demand to exceed 20MM HHP. At the same time given 24 hour shiftwork, zipper fracs, higher density frac designs, and other factors equipment utilization and the commensurate wear and tear on equipment has meaningfully increased with attrition rates estimated at 20-25%. As a result some research firms estimate the need for new equipment at up to 8MM HHP in order to balance the market. The highest number we have seen for newbuilds comes from John Daniel, one of our favourite US service analysts, and amounts to just under 4MM HHP. While at first blush this number appears high so long as WTI continues to stay at current levels it appears that the pressure pumping market will remain tight throughout this year and will result in further price increases. As well private equity which has historically been a source of capital that has allowed industry to overbuild capacity and kill previous cycles are now sellers of pressure pumping, not buyers as a window for them to monetize long held positions opened in recent weeks (Cerberus sold a large position in pressure pumper Keane [the secondary was apparently 15X oversubscribed and was upsized 3 times coming out at a skinny1.4% discount] and Riverstone was able to IPO pressure pumper Liberty Oilfield [the deal was 20X oversubscribed with 350 different accounts in the book and the stock closed up 28%]). Last week at a major US energy conference that we attended it was common for CEO's to quote 10%-15% as their expected service cost inflation in 2018 (Simmons: "the positive pricing views would seemingly suggest a positive bias for 1H'18 upwards earnings revisions"). As the market has a bearish tilt today with regards to a pending oversupply we believe consensus estimates are too low and that there still exists meaningful upside in US pressure pumping stocks. The same narrative although slightly tempered due to very, very low natural gas prices exists in the Canadian pressure pumping space. We continue to hold Trican, STEP, and Calfrac. Trican specifically has been under severe pressure due to concerns about Canadian gas prices and while this represents about 15% of 2017 revenue we believe that given very strong condensate pricing that liquids rich gas activity will largely offset the spending cuts announced by dry natural gas producers. With TCW and STEP trading at about 4.0x and 3.0X 2018 estimates (vs. normal multiple of ~6-7x) we see very good value (and so does TCW apparently since they are buying back $100MM of stock). Despite what we believe to be modest Q4 results coming due to normal seasonal declines as well as harsh weather impact on both sides of the border the discussion around pricing increases and continued market tightness should allow the stocks to do well. Our Canadian pumpers trade at average 4.5X 2018 consensus EBITDA while our US pumpers trade at 5.2X 2018 consensus, both representing a material discount to historical multiples (especially when we think consensus is still likely too low).

Our other exposure in the service sector is in frac sand. While we divested our US sand names due to what felt like a chronic overhang due to concerns about too much capacity being built out in Texas we added to our position in Source Energy. Source controls roughly 60% of the Canadian frac sand market and Canada has the benefit over the US in that Canadian E&P's are earlier on in the process of using greater amounts of frac sand on a per well basis. Despite weak natural gas prices and related dry gas activity we believe the outlook for greater frac sand use in Canada is very good (this week in Calgary EnCana told us they are in the Montney experimenting with Eagle Ford style fracs [ie. much more tonnage per well historically; their experience is you get a 20%-25% better well for a 9% increase in overall well cost due to greater sand usage]; Vesta and Raging River are having improving success in the emerging East Shale Basin Duvernay play which would be very sand intensive). Ian Gillies, service analyst at First Energy whom we closely follow estimates that frac sand will grow from 2.6MM tonnes in 2016 to 6.1MM tonnes in 2017 to 7.9MM tonnes in 2018 (up 30%) to 10.3MM tonnes in 2019 (up 30%). Source trades at 4.0X our 2018 EBITDA estimate of $173MM versus US frac sand stocks at 5.2X despite better growth prospects, less in-basin supply risk, greater barriers to entry, and a stronger balance sheet.

For E&P exposure our preference remains to be invested in the United States. While do have a few Canadian positions the ongoing lack of oil and now natural gas pipeline takeaway capacity will continue to act as an overhang on multiples of Canadian producers and likely mean that they will underperform their US peers when sentiment truly does shift and money comes back into the sector. In the US we believe consolidation in the Permian could be a theme as the land grab is largely over and industry's focus on returns versus growth increase the requirement for scale as a means of grinding down costs through greater efficiencies. We should note that for the first time in years the consensus WTI estimate is meaningfully below strip/current oil price ($62.31 vs. $55.66) meaning that there is likely to be a series of EBITDA upwards revisions with Q1 reporting which should result in greater quant buying.

Summary

In closing we believe that the oil market is in a multi-year long bull market and that for the first time in years it feels like sentiment is slowly starting to swing back in our favour. The lack of response of oil stocks to oil making a 3 year high has been perplexing and yet offers the ability for stocks to rerate by 30%-40%+ without the price of oil having to move any higher (which we believe it will in the coming years). 2017 was an especially aggravating year in which our oil macro call largely played out (we called for oil to end the year at $55-$60/bbl in January 2017) yet we were unable to make our unit holders money from it (quite the contrary). We very much felt this frustration every day (the first six months of sequential declines in the energy index was the longest in history). We recognize that there is an opportunity cost of having money invested in the sector when the rest of the market seems to make new highs or weed stocks seem to double every 2 months and our belief is that 2018 will finally compensate unit holders for their patience throughout 2017.

Eric Nuttall

Senior Portfolio Manager

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at December 29, 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.[†] Since inception of fund Series F.

The Fund is generally exposed to the following risks. See the prospectus of the Fund for a description of these risks: concentration risk; credit risk; currency risk; cybersecurity risk; derivatives risk; exchange traded funds risk; foreign investment risk; inflation risk; interest rate risk; liquidity risk; market risk; regulatory risk; securities lending, repurchase and reverse repurchase transactions risk; series risk; short selling risk; small capitalization natural resource company risk; specific issuer risk; tax risk.

Ninepoint Partners LP: Toll Free: 1.866.299.9906. DEALER SERVICES: CIBC Mellon GSSC Record Keeping Services: Toll Free: 1.877.358.0540