Sprott Energy Strategy

February 2018 Commentary

How can one of the most lucrative investment opportunities in decades stare investors in the face and yet month after month energy stocks have continued to languish while the market's focus stubbornly remains on other areas like bitcoin, marijuana stocks, and the general tech space leading to an unintentional shunning of the energy sector? Every morning on CNBC and BNN significantly more airtime is given to discussing in-vogue names like Amazon or Canopy Growth than the $2.3 trillion oil market or the energy stocks which have dislocated from the price of oil by the greatest extent in history while oil trades at multi-year highs (see below...oil spot/strip price in CAD$ terms is up 14%/6% since the beginning of 2017 and many Canadian oil stocks are down 50%-60% over the same time frame = 65%+ relative underperformance!!!).

Investment Team

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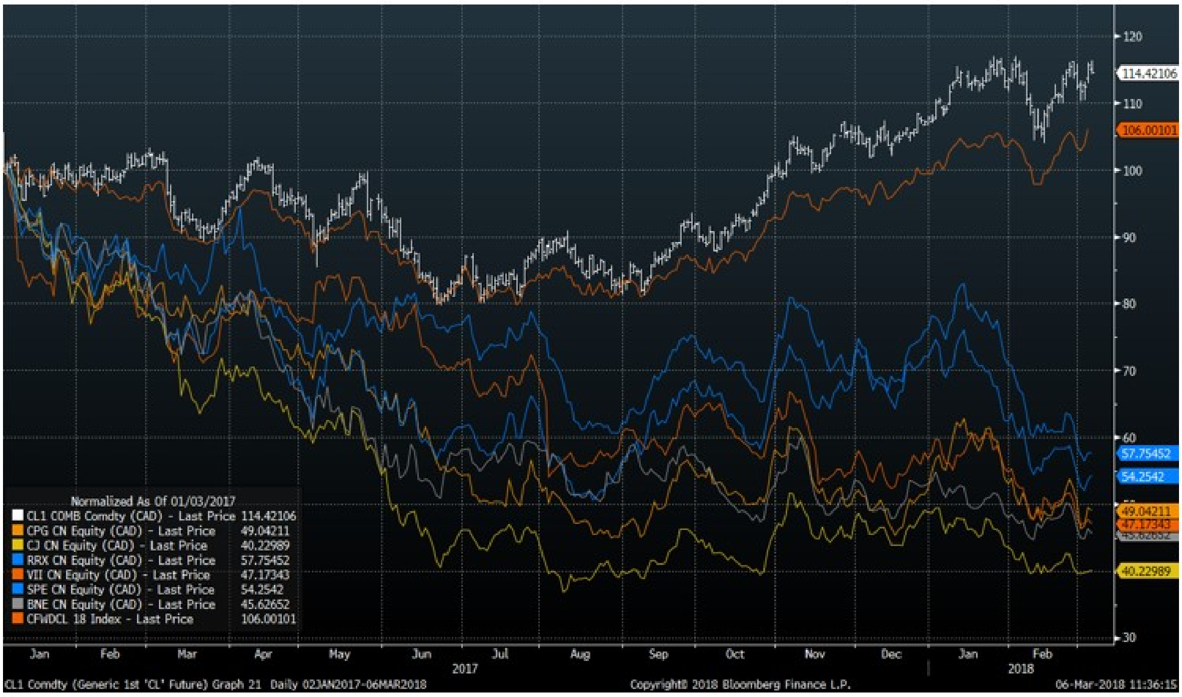


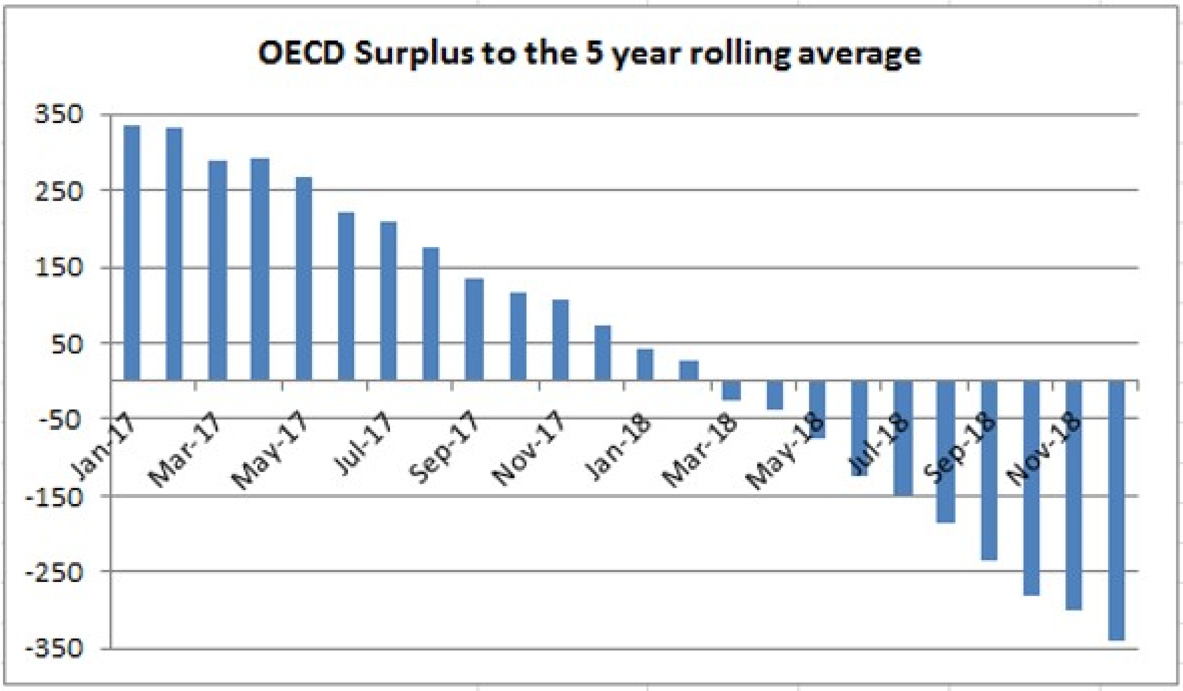
Source: Bloomberg

What makes this lack of interest (and commensurate lack of investment flow) so frustrating? It is that the current macro backdrop for oil is overwhelmingly positive in addition to our belief that oil is in a multi-year bull market with few things capable of interrupting this reality. Why can't everyone see what we see?

1. Oil is trading near a 4 year high

Source: Bloomberg

2. The “oil glut” (ie. OECD surplus oil inventories to the rolling 5 year average) has fallen from 334MM Bbls as of January 2017 to a now ~26MM Bbl deficit and this number could swell to a deficit of more than 300MM Bbls by the end of 2018.

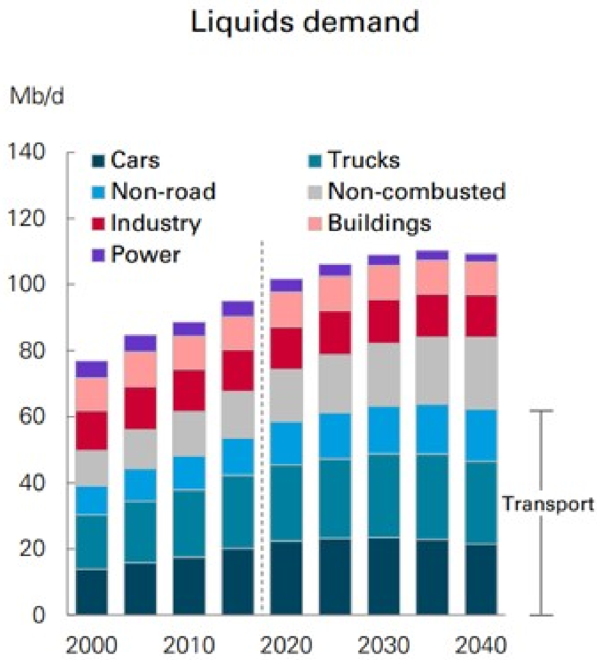


Source: Ninepoint Partners

3. OPEC + Russia have pledged that their 1.2MM Bbl/d cut will continue throughout 2018 and their compliance to the cut has been impressively strong, consistently exceeding 100%. Even if they are

lying and all of the shut-in production were to come online TODAY the market would be back to an undersupplied scenario by the end of 2018 (this is not well understood).

4. Oil demand is rocking with 2017 demand up ~1.7MM Bbl/d and 2018 looking to be an even stronger year with some firms like Goldman Sachs calling for growth to exceed 2MM Bbl/d.



Source: BP Statistical Review

5. The big boogeyman in the room, US shale, will not grow as quickly as people believe and will be limited to ~1.2MM Bbl/d. This is due to an incredibly important and yet still under appreciated shift in management mindset (and incentive plans with 60%-70% of companies adopting returns based incentive plan in 2018, up from 10% in 2015) to generating acceptable economic rates of return versus absolute production growth (aka "growth for growth's sake"). In addition, infrastructure, labour, and equipment shortages all are acting as further anchors to growth potential.

6. The oil market in 2017 was undersupplied by 0.7MM Bbl/d (as evidenced by inventory drawdowns at the fastest pace in history). When combined with demand growth of 1.8MM Bbl/d this means that supply would have to grow by 2.5MM Bbl/d in 2018 to reach balance. With US production constrained to about 1.2MM Bbl/d, flat OPEC+Russia production, and non-OPEC/US production to be up about 0.2MM Bbl/d it should remain obvious that the market will remain undersupplied. The last time OECD inventories reached our 2018 projected levels of sub 2.6BN Bbls the price of oil (WTI) was above $70/bbl (vs. $62.50 today).

Source: Ninepoint Partners

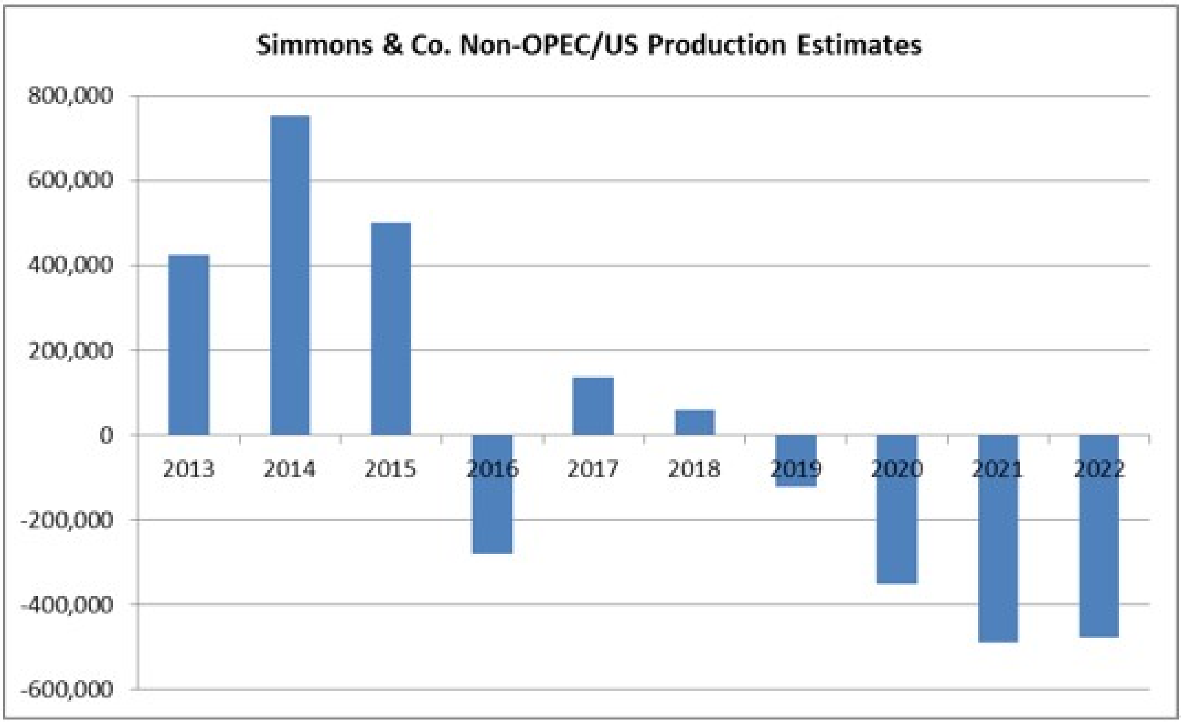
Given all of the above it should be obvious that the current backdrop for oil is universally positive. It isn't just a short term bullish call but rather one that extends over the next 4-5+ years. Why do we believe we are in a multi-year long bull market for oil? There are 4 primary reasons and they all point to a market that should remain undersupplied for the next several years (even as US shale continues to grow and OPEC volumes come back onto the market in 2019) and suggest that oil will have to rally high enough to rationalize demand growth lest inventories fall to dangerously low levels:

1. US supply growth is likely limited to ~1.2MM Bbl/d per year due to the reasons explained above.

2. OPEC supply - which once post the 1.2MM Bbl/d of shut-in volumes being returned to the market will be largely producing at near peak production levels for the next several years offering limited net aggregate growth potential.

3. Demand is likely to grow by at least 1.2-1.5MM Bbl/d for the next several years barring a global recession, given demand trends in both OECD and non-OECD countries.

4. Most importantly, non-OPEC/US production is set to go into a multi-year decline in 2019 given the largest decrease in spending on long-lead (4-6+ years) in history.



Source: Simmons

The summary of these 4 main factors is in the below table and shows that even with tapering oil demand growth rates, ongoing US supply growth, and OPEC bringing back online all 1.2MM Bbl/d of shut-in volumes that the oil market should remain undersupplied for at least the next several years:

	2018	2019	2020
Beginning of year undersupply	0.7	1.1	0.4
Add: Demand Growth	1.8	1.6	1.4
Total amount of required supply growth to reach balance	2.5	2.7	1.8
US Supply Growth	1.2	1.2	1.2
OPEC+Russia Supply Growth	0	1.2	0.4
Non-OPEC/US Supply Growth	0.2	-0.1	-0.4
Total estimated supply growth	1.4	2.3	1.3
End of year market balance	-1.1	-0.4	-0.6
All units are in MM Bbl/d; Source: Ninepoint Partners			

Given the fixed nature of US/OPEC growth rates and the very long-lead nature of non-OPEC/US mega-projects (4-6+ years) we believe the global oil supply chain lacks the ability to respond to the coming shortage. As a result, the price of oil beginning in 2019 and increasingly in 2020 will need to act as a demand-rationalizing mechanism which suggests that the oil price will have to increase meaningfully higher than today's price level.

Fund Positioning

What began as an encouraging start to the year in January turned into "more of the same" in February as oil names sold off along with broader markets.This has further dislocated oil stocks from the price of oil. YTD oil is up 3.4% in US$ terms and about 6% in CAD$. At the same time on both sides of the border, oil producers and service stocks have fallen (XOP -7%, SPTEN -10%, OIH -6%). It is common to find many Canadian intermediate oil companies -15% or more YTD after falling by 30%-50% last year. As a result Canadian midcap oil companies are trading at approximately 50% of their long-term average multiples, US Permian producers are trading at a ~1.5X multiple discount to their recent average trading multiples, and service stocks are trading at a 50%-75% discount to mid-cycle multiples. Such valuations would be appropriate if you believed consensus: US oil growth will swamp the market as will OPEC/Russia volumes, electric car adoption will destroy overall oil demand growth, and essentially the oil & gas sector is a sunset industry and is in blowdown mode. We do not. As consensus in the next 6 months becomes more aware of the extraordinarily bullish trends that we have highlighted above we expect sentiment to improve and a reevaluation of mid-cycle multiple vs. peak multiple expansion will occur. As a result we own some stocks in which we see 100%+ upside from current levels.

Sub-sector wise we retain our largest exposure to pressure pumpers. Despite weak-ish Q4 results due to early E&P budget exhaustion in early December and epically cold weather impacting short-term operations we believe the 2018/2019 earnings power of these companies is being underappreciated and that the cycle will last longer than consensus believes. Forward looking guidance from pressure pumpers was very strong and it is common to hear of leading edge pricing continuing to increase. Halliburton, on their Q4 conference call, said that they are "sold out as far as they can see." If we are right in that the cycle will last a further 1-2 years versus having already ended applying peak multiples (3X-4X) vs. a mid-cycle multiple (7X) is being meaningfully overly bearish.

Pressure Pumpers (mid-cycle multiple of ~7X vs. 3.6X forward multiple)

	2018 EV/EBITDA	2019 EV/EBITDA	2018 FCF Yield	2019 FCF Yield	Upside to Average Analyst Target
Trican	4.1	3.1	14.7%	20.0%	61%
Calfrac	6.2	4.8	3.1%	7.9%	22%
STEP Energy Services	2.9	2.1	9.9%	23.6%	97%
C&J Energy Services	4.0	2.5	0.5%	21.8%	43%
Keane Group	4.4	3.5	6.6%	15.4%	33%
Liberty Oilfield Services	4.2	2.6	6.2%	20.2%	58%
FTS International	4.5	2.2	13.6%	34.5%	46%
ProPetro Holding	4.6	3.6	7.4%	12.7%	32%
RPC Energy	6.6	5.4	4.2%	7.8%	17%
Superior Energy Services	6.6	5.1	3.1%	6.3%	29%
Patterson-UTI	5.7	4.6	3.2%	7.9%	28%
AVERAGE	4.9	3.6	6.6%	16.2%	42.3%
Source: Bloomberg					

The Sprott Energy Fund/Sprott Energy Opportunities Trust has modest exposure to Canadian E&P. While valuations are very attractive on an EV/CF and FCF yield basis (and even on a sustainable dividend yield…CJ at 10% which is fully supported by cash flow) we struggle to see how Canadian oil stocks will outperform their US peers when sentiment turns, given pipeline takeaway challenges. It is our belief that US E&P's will lead and that we will have the opportunity to cycle capital back into Canadian E&P stocks on the lag.

Canadian midcap E&P's (EV/CF multiples of ~ 4.0X vs. "old" historical multiples of 8.0X)

	Spartan	Torc	Whitecap	Cardinal	Raging River	Crescent Point	Bonterra	Obsidian	Surge	Seven Generations
FCF Yield	12.2%	14.8%	9.6%	18.6%	12.3%	10.7%	16.8%	15.9%	14.4%	0.5%
Dividend Yield		3.9%	3.9%	10.1%		3.9%	9.0%		4.6%	
EV/CF - 2018 strip	3.9	4.7	5.5	4.6	4.1	4.1	5.4	4.0	4.0	4.7
2017 PDP RLI	5.1	5.3	8.0	5.9	3.6	5.2	8.3	0.0	5.6	2.2
2017 Proved RLI	8.3	8.6	12.6	6.4	8.6	8.3	15.8	0.0	10.4	11.0
2017 Proved +Probable RLI	12.8	13.2	17.5	8.7	11.2	14.8	4.3	0.0	16.2	20.5
Debt / CF - 2018 strip	0.5	0.8	1.5	1.5	0.7	1.8	2.4	1.5	1.4	1.4
Source: Bloomberg										
Note: FCF as defined as operating cash flow less maintenance capex (capital required to keep production flat)										
Strip at time of publishing was $61/bbl WTI, 1.29 USD/CAD forex, and $1.37/mcf AECO										

US Permian Producers (typical forward multiple ~ 8-9X vs. 5.7X)

	2017/2016 production growth	2018/2017 production growth	2019/2018 production growth	2018 EV/EBITDA	2019 EV/EBITDA	Average Target	Upside
Jagged Peak	209%	98%	40%	6.8	4.9	$18.00	51.6%
Centennial Resources	292%	88%	39%	9.0	5.8	$26.82	37.6%
Parsley Energy	78%	51%	37%	7.6	5.5	$37.57	40.3%
Callon	48%	39%	31%	7.8	5.7	$15.95	34.8%
RSP Permian	91%	36%	31%	8.7	6.6	$52.69	27.2%
Diamondback	88%	43%	30%	9.6	7.0	$153.57	19.7%
WPX Energy	30%	16%	28%	7.3	5.5	$19.77	34.5%
Energen	31%	33%	27%	6.6	5.3	$71.04	26.8%
Matador	39%	20%	21%	8.4	6.9	$36.28	21.5%
Cimarex	18%	15%	19%	6.6	5.7	$143.22	50.8%
EnCana	-11%	20%	18%	6.2	4.9	$15.66	42.9%
QEP	-5%	-3%	9%	5.5	4.7	$14.39	54.3%
AVERAGE	76%	38%	27%	7.5	5.7		36.8%
Source: Bloomberg							

In summary, oil is trading near a 4 year high and is in a multi-year long bull market which cannot be interrupted barring a global depression and the 65% dislocation in performance between the price of oil and oil stocks over the past year is the largest that anyone has ever seen in their careers. Still, the logical question to ask is what has to happen for this dislocation to end? We believe it will be a combination of several things: 1) US E&P's continuing to embrace their new focus on returns vs. growth which results in less capital being directed into the ground (ie. lower than historical growth rates despite high oil prices) and a better experience for shareholders as they are finally rewarded with dividends and buybacks. 2) Service stocks proving their very positive forward looking guidance in printed actual results (ie. Q1 reporting) 3) further implementation of share buybacks by both E&P's (over $4BN announced in February) and service companies (FRAC announced a $100MM buyback; stock was up 8% on the news). [As a side note we continue to urge all Canadian oil companies trading near their PDP RLI's versus EV/CF using strip pricing to stop drilling and just buyback their own stock…same result = per share growth while supporting one's share price]. While the exact timing of the inevitable inflection in sentiment is impossible to predict compensating investors for this uncertainty is highly meaningful upside: we hold several stocks in which we see more than 100% upside.

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Sprott Energy Fund / Sprott Energy Opportunities Trust

[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 February 28, 2018; 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.

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