



Sprott Energy Strategy

Market View: Feb 9/18

You would be forgiven if you're feeling either a sense of deja-vu or nausea today after seeing energy stocks suffer another sharp selloff (we're down 16% YTD after being up 5% earlier last month; energy index is -13%). Different this time is the obvious implosion in broader markets (DJIA -4.1% yesterday) which seems to have magnified the selling pressure in oil and energy stocks. What is different today when the XOP is trading only 5% away from the August lows when oil was at \$46/bbl?

Well, first oil is at \$60/bbl.

Second, inventories have been drawn down by the greatest extent in history and US surplus storage has fallen from 140MM Bbls in March to ~13MM Bbls.

Third, every US oil company is coming out with capital budgets that show capital discipline, production growth constraint, and a renewed focus on returning capital to shareholders which means that US production growth will be more tame than historical standards.

Fourth, oil demand growth is rocking with Goldman Sachs estimating growth of 2MM Bbl/d this year.

Fifth, OPEC compliance remains very strong and likely to stay that way for all of 2018.

Sixth, we are in a 4-5 year bull market for oil.

Where have valuations fallen to? We entered into "cheap territory" a long time ago. At today's levels after the 20% sell off from the highs TWO WEEKS AGO (!) our service stocks (whom I met with last Friday...business is good!) have fallen by 25% YTD (and this being February 9th). TCW now trades at an 18% free cash flow yield on 2018 and a 22% free cash flow yield on 2019 numbers. They are buying back \$100M of stock (10% of their outstanding) and I think they will buy back even more.

We had a land driller report results yesterday which slightly missed expectations (Q1 estimates got revised down 2%) and the stock sold off by 14%. This is a \$4BN market cap company that lost \$400MM of value for a \$9MM miss due to very cold weather delaying work in January and UBS this morning actually INCREASED their 2018 estimates by 1%.

Our oil producers in Canada (only a few of them) can on average buyback 15% of their outstanding stock with the free cash flow being generated today. One pays a 10% yield already that is well covered. On strip the average Canadian oil co is trading at 4.6X EV/CF when they used to trade at 7-8X. Our US producers have been equally mauled, falling by up to 18% YTD. In short there has been nowhere to hide.

Investment Team



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Given the extent of the sell off after a horrible 2017 people have clearly given up on the space. What is very odd with this is that oil a week ago was trading at a 3.5 year high and even today, after the correction, the oil strip is over \$50/bbl out past 2021. Companies are trading at their lowest valuations in memory and are starting to step up to the plate and buy back their own shares given the very significant disconnect between how their companies are doing and how their stocks are doing. We continue to encourage this action with all of our holdings.

We are in a multi-year bull market for oil. Fortunes are made when people take advantage of the disconnect between perception and reality. Admittedly, this is the absolute hardest thing to do and the lag time can take longer than one ever thinks possible (like right now). The stop gap is now corporate buybacks. If the investment public won't step up and buy shares, then the corporates will, and we are seeing this in action today.

Eric

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 January 31, 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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