Sprott Energy Fund

October 2017 Commentary

Investment Team

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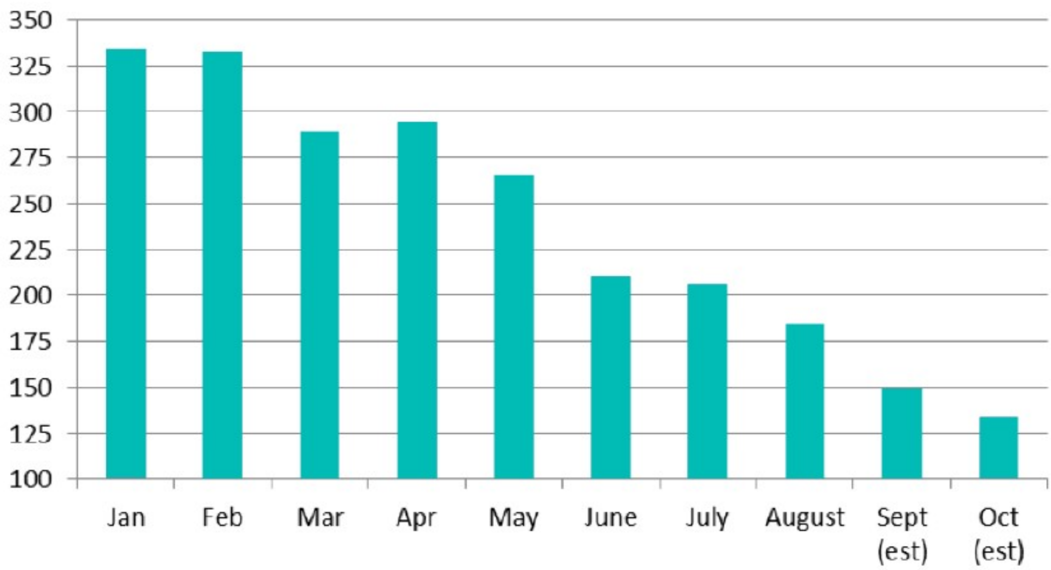
The great waiting game has finally come to an end. After many months of ever improving oil fundamentals and yet an oil price that failed to reflect that trend the oil price finally started to move higher over the past few weeks and recently reached a two year high. The change in tone in the energy sector over the past month is extremely significant and it is difficult to overstate how much things have changed (or at the very least the market's perception). It would be a critical mistake to base the oil rally solely on political developments though it is fair that we've had a few events occur over the past month that is replacing the prior "oversupply discount" with a partial political risk premium: Iraq/ Kurdistan military and sovereign tensions resulting in armed seizures of oilfields and the shutting in of production, a power consolidation within Saudi Arabia which coincided with a near missile strike launched from Yemen with an Iranian supplied missile and the following declaration from the Saudi monarchy that the act could be construed as an act of war with Iran, a near-term possible debt default by Venezuela, the Nigerian Delta Avengers announcing that they would be reinstating their "brutish, brutal, and bloody" oil terror campaign that previously involved blowing up onshore and offshore oil infrastructure, and armed conflict again in Libya resulting in the shutting in of 50,000Bbl/d. Despite all of these developments what really started the oil rally (it was over $52/bbl before the first of these incidents occurred) was the final realization by the market of a trend that we have gone out of our way to highlight all year: normalizing oil inventories.

OECD TOTAL PETROLEUM SURPLUS VERSUS THE 5 YEAR AVERAGE



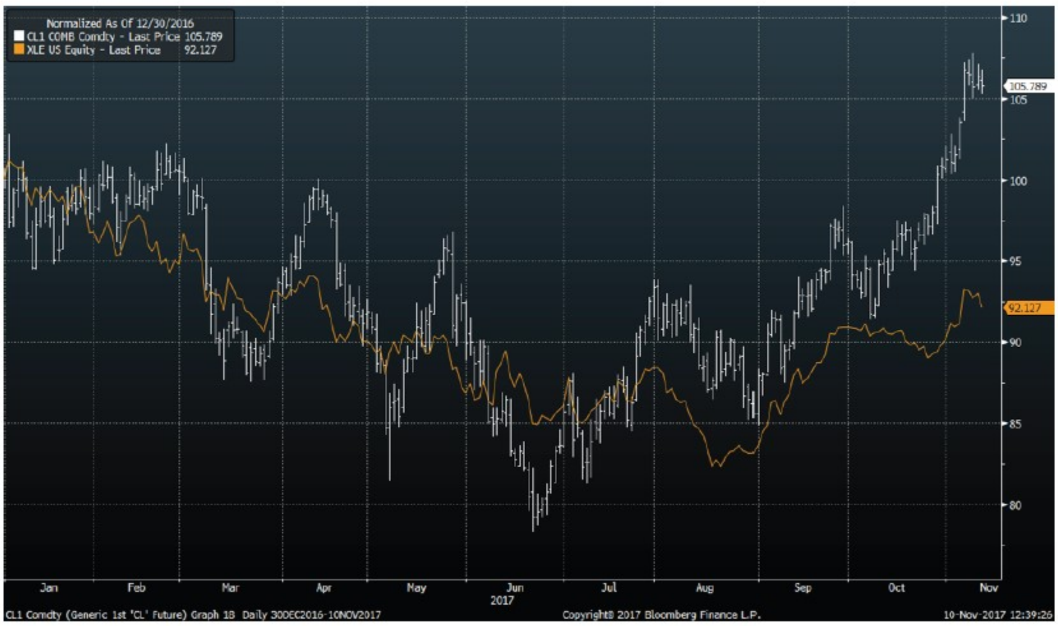
Source: Bloomberg

Due to record high oil demand (up around 1.7MM Bbl/d YOY), faltering US oil production growth (more on this later), anemic non-US/OPEC production growth, and very respectable compliance by

OPEC/Russia to their production cut (most recently 92%) inventories are falling globally at the fastest pace in history. The global “oil glut” has fallen from approximately 334MM Bbls coming into the year to an estimated 134MM Bbls as of the end of October. Floating storage in Asia has fallen by nearly 50% since June. US total product inventories have fallen by 109MM Bbls and again this pace of decline is the sharpest on record. Rarely now in the media do you hear the term “glut” and for the first time in many quarters the words “shortage” and “undersupply” are being used. Wall Street brokerage firms are increasing their oil price forecasts (Morgan Stanley last week increased their 2018 oil price forecast by 12% to average $58/bbl vs. a previous forecast of $52). Current Wall Street oil price decks are now below strip pricing setting equities up for a positive earnings revision scenario (and commensurate momentum/quantitative/algo buying). What a change a month can make!

It is mind blowing to us that despite continued improvements in oil fundamentals and now finally a price response (oil at 2 year highs…) that we had been expecting for a few quarters that the interest level in energy equities remains muted despite highly attractive valuations. Consistent feedback from energy sales specialists over the past week is that the tone of conversations between themselves and large global funds has dramatically improved (conversations have gone from which energy fund is blowing up and what is fund flow doing to asking about company valuations/ catalysts/models). Despite the tone improvement it has yet to result in actual incremental buying. As a result energy equities have greatly lagged the move in oil and we can still deploy capital into stocks that are down 40%-50% YTD despite oil now up 6% on the year (flattish in CAD$ terms).

YTD CRUDE OIL VS. ENERGY SELECT SPRD ETF



Source: Bloomberg

Despite many companies posting very good Q3 results (more on this later) with some literally posting their best EBITDA margins in five years their public equity valuations continue to remain suppressed and trade at a fraction of their historical multiples. We attribute this level of despondency to: 1) low relative weighting in major US indices (energy is a ~2% weight in the Russell 1000 Growth Index) 2) lack of sector rotation given generally positive earnings in tech land 3) concerns about deploying capital ahead of the November 30th OPEC meeting in which a production cut extension should be announced 4) continued worries about electric car adoption and the resulting imminent oil demand destruction 5) tax loss selling pressuring energy stocks given that the energy sectors' uniquely poor performance 6) uncertainty around the sustainability of the recent oil price move. Two of these factors (tax loss selling and clarity around OPEC's extension plans) will pass in the coming weeks and after that we do not believe energy equities will be able to ignore the oil price move any longer given the coming continuation of inventory drawdowns and the possibility of reaching normalized levels in early 2018.

Earnings season is a time to calibrate expectations with reality. The two largest takeaways from the past few weeks of Q3 releases are: 1) pressure pumping companies are doing great, will continue to do great, and their stocks remain undervalued and 2) the pressure being exerted on US oil companies by investors to dial back production growth in favour of focusing on returns is having an impact and will result in less production growth in 2018 than consensus believes resulting in an even tighter oil market.

The Sprott Energy Fund has had a material weight in pressure pumping stocks with a belief that the demand for pressure pumping this year would exceed supply and that this would result in material price increases and lead to very attractive profitability margins. Q3 results continued to validate this belief with all of our pressure pumping holdings (and all of their peers) reporting fantastic quarters. Industry bellwether Schlumberger reported a 42% sequential increase in hydraulic fracturing revenue. Calfrac Well Services beat consensus by 35% reporting the highest Canadian EBITDA margins (25%) since Q3 2012. Trican Well Service destroyed consensus reporting EBITDA of $98MM versus consensus of $77MM and announced a $100MM share buyback, 100% utilization through to Q2/2018, soft commitments for all of their available equipment through to 2019, and a multi-year high EBITDA margin of 26.8% (this with pricing still 15%-20% below peak). Their results were so strong that analysts scrambled to increase their forward estimates (2018 EBITDA consensus estimate was $265MM heading into the Q3 release / we were at $300MM / consensus is now $306MM with Street high BMO increasing their estimate from $240MM to $387MM(!)). ProPetro, one of our US pressure pumping holdings beat consensus by 13% and reported sequential increases in revenue of 32%, EBITDA of 56%, and net Income of 349% commenting that "our visibility for strong activity in 2018 is increasing." Another US holding, Keane, reported 48% sequential revenue growth with gross profit per fleet growing from $10.5MM/year in Q2 to $14.2MM in Q3 and heading towards $16-$18MM by year end. In general our pressure pumping companies are trading at 4.5X 2018 EBITDA versus a mid-cycle multiple of closer to 7X. The market therefore is placing more of a peak multiple on what we think are sustainable EBITDA levels due to worries about an overbuilding of capacity in 2018 which would lead to a reduction in pricing power. We do not believe this will occur. Just as US E&P's are being forced by investors to exercise greater financial discipline (next topic to be covered) service companies are feeling the same pressures from their investors (we've been part of this conversation) and have expressed little interest in making fleet expansions next year and those that have are doing so with long-term contracts in hand for their new equipment. Despite leading edge economics today that historically would have resulted in the building out of incremental capacity we believe companies will use excess cash flow to pay down debt, do share buybacks, or diversify into other business lines. As well, given greater frac intensity combined with greater sand usage the wear and tear on equipment has materially risen and these factors result in much 4 higher fleet attrition (20% per year) and a resulting reduction in overall fleet capacity as more and more horsepower needs to be parked on pads. E&P's recognize the likelihood of continued tightness and are signing up for long-term commitments in 2018 so as not to be shut-out from being able to complete wells like many were in 2017. For these reasons pressure pumping remains our largest investable theme at the moment given a massive disparity between market perceptions and what we believe to be market reality.

Elsewhere in oil service land our frac sand names posted another round of solid quarters. Our largest US frac sand holding, US Silica, beat consensus by 11% and reported sequential increases in volumes sold, realized prices, and overall contribution margin of 15%, 5%, and 27% respectively. In addition they announced a $100MM share buyback (and the stock shot up 8%...financial discipline pays!). Post earnings and into the strength we decided to reduce our overall frac sand weight due to ongoing market concerns about the potential for too much new capacity being added in Texas. While we strongly believe that these worries are misplaced we see no incremental clarity on this issue for another several quarters and this will likely continue to result in ongoing multiple suppression. We have however nearly maximized our exposure to a dominant Canadian frac sand company (>60% market share) where we retain exposure to the same hyper growth trends (ie. greater proppant loading in leading edge versus average well designs resulting in improved well economics) in the US without the "in-basin supply boogeyman" haunting us. Our Canadian name due to its smaller size ($600MM market cap) and less trading liquidity is being valued at close to 3X 2019 EBITDA and at a 2018 free cash flow yield of 16%. As this name gets on more institutional radar screens we think the stock could rally by well over 50%.

The second major takeaway from Q3 reporting was the reinforcement on the part of E&P management teams that priority will be placed on maximizing economic returns and spending within their means versus maximizing production growth rates. Management teams stumbled over themselves on Q3 conference calls to talk up how they have now seen the light:

" We have listened closely to investor feedback and have continuous dialogue on the metrics that matter with our Compensation Committee, and we fully expect to integrate both the returns-based metric and a per share metric into our compensation structure. Production growth will be an outcome of our capital allocation to the highest risk-adjusted returns." – Marathon Oil

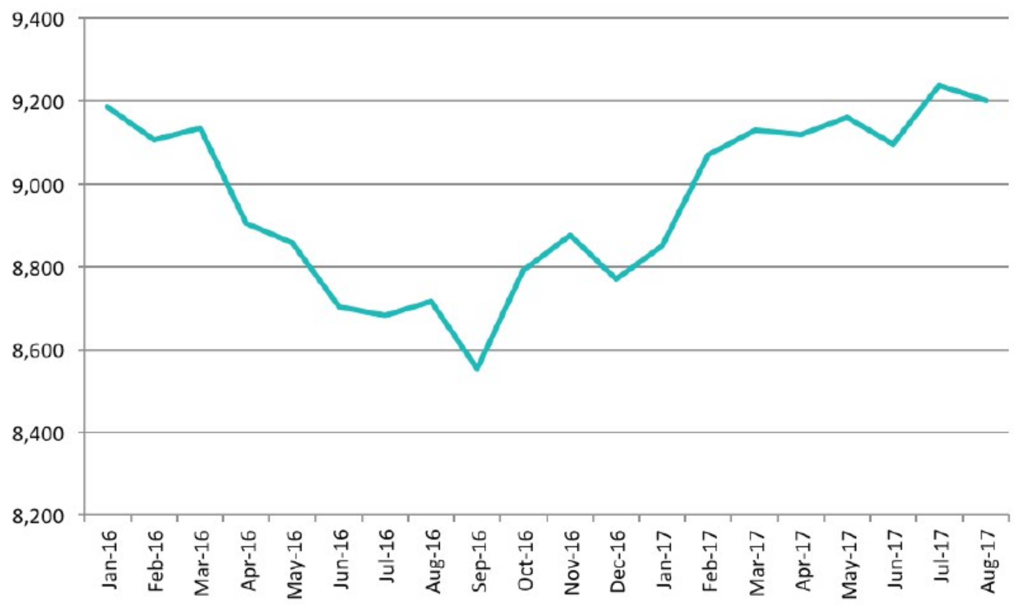
" As we sit here today, if you think about what investors are calling for today, it's somewhat different than it was a 1 1/2 to 2 years ago to some degree – maybe not totally, but to some degree. And so, I think what we'll do is we're trying to get this message out there. Our plan is to be generating free cash. And we'll look at, at what investors really are calling for." – WPX

" With the 2020 Vision, our top objective is to deliver attractive, peer-leading returns on invested capital for our shareholders. While the disciplined pursuit of returns is not new at Devon, our 2020 Vision will further refine our focus on maximizing full cycle returns at the corporate level. This balanced operating model is in contrast to the industry's historical behavior of aggressively chasing top line growth at the ultimate expense of shareholders. This is not a populist philosophy that we are paying lip service to; we are absolutely committed to doing business differently in the E&P space and we are taking the appropriate steps to become an industry leader with our disciplined approach to capital allocation." – Devon Energy

" Our overarching goal is to transition our company to one that delivers sustainable production growth within our funds from operations. It will be important that investors reward companies focused on these new metrics and not revert to past behaviors, which overwhelmingly favored production growth over capital discipline and improved returns." – Newfield Exploration

This trend has a very significant bullish impact on US production growth rates with Schlumberger noting that “the more tempered activity outlook for U.S. land, combined with the short cycle nature of the business, has an immediate impact on the outlook for production growth which for 2017 and 2018 has been revised down by 100,000 and 500,000 barrels per day respectively.” Not only has production growth this year risen by only about half of what expectations were beginning the year due to equipment shortages, service cost inflation, labour shortages, overall inefficiency creep, and a reduction in overall average well productivity but the forward outlook is even further tempered by the realignment of industry spending within cashflow. Given the oil market is already undersupplied this new theme will much more easily allow demand growth in 2018 to absorb OPEC’s shut-in barrels. This development is hugely positive and is the killshot to the bear thesis of “sub $50/bbl forever” due to unconstrained shale oil growth.

US MONTHLY OIL PRODUCTION FLATTENING SINCE FEBRUARY



Source: DOE

Earlier we mentioned that one factor causing the record high level of ambivalence towards the energy sector is the concern about oil demand destruction due to electric car adoption. This highly ignorant concern pervades every meeting I have with clients across the country and is suppressing the multiples investors around the world are willing to put on energy companies. At times it is difficult to fight fiction with facts however a simple review of some numbers should quell any worries about future demand growth. The demand for oil next year will at one point exceed 100,000,000 barrels per day and demand growth has been increasing by about 1,200,000 barrels per day per year over the past 5 years. About 70% of oil demand is for transportation and 20% of that is for light passenger vehicles (ie. Tesla’s target market). The remainder (ie. the majority) relates to industrial use and ground transportation via rail and truck hauling, neither of which have a practical “plug in” solution at the moment given energy intensity requirements. I have reviewed analysis by at least 5 different reputable firms and the conclusion from all of them is the same: even under the most extreme EV mass adoption scenario the demand for oil will continue to grow for at least the next 20 years. For every 1,000,000 electric cars that replace internal combustion engine cars (2016 EV sales globally were 850,000) oil demand would fall by 14,000Bbl/d. In a 100,000,000 barrel per day market one can see how pitifully small the near-term demand destruction could possibly amount to.

Secondly, given the install base of 1,200,000,000 internal combustion engines globally and the relationship between fleet growth to GDP growth this install base will grow by 140,000,000 gasoline/diesel burning cars/light passenger trucks over the next decade alone (=164 years of current run rate of EV sales). Thirdly, EV sales have to this point been aided by very generous government subsidies. In the Republican tabled draft tax bill the $7,500 electric vehicle tax credit is to be eliminated and if the experience in the US is similar to other countries the rate of sales growth dramatically declines when subsidies are ended.

In summary, the oil market has measurably appreciated in terms of both fundamentals and sentiment. The "oil glut" that no longer gets referenced in the media has fallen by 60% in the first 10 months of the year and this trend will continue given strong demand growth, high OPEC compliance to its production cut, anemic non-US/OPEC supply growth, and a moderation in US production growth rates. We still believe that the oil market can reach normal levels by early 2018. The oil price has made a 2 year high given this backdrop and our earlier prediction of oil rallying into the mid $50's by year end has come to pass. Given this, we never would have imagined having to still report that our Fund is down by approximately 35% YTD. There is a massive, giant, epically humungous divergence between the price of oil and the price of oil stocks due to the various reasons explained above. With valuations in some cases at roughly half of historical levels we see extremely attractive upside in energy stocks. Perhaps it will just take getting past tax loss selling season and the November 30th OPEC meeting for investors to return to the space. In the meantime, our holdings continue to experience record profitability levels, announce massive share buybacks, and reduce overall leverage due to high levels of free cash flow. We remain in a multi-year bull market for oil… patience will eventually pay off.

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Ninepoint Partners

[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 October 31, 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.

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