Sprott Energy Fund

September 2017 Commentary

Investment Team

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Many different events seemed to coalesce this month and what began as a rally in oil from $47/bbl to above $50/bbl led to a furious short covering rally in energy equities (FMSA up 59% in the month) and eventually morphed into the first signs of real, long-only money coming back into the space. What caused oil to begin its upward move? Several factors: upward revisions in demand from two closely watched agencies, Permian production issues that began to raise doubts about future consensus growth rates, sector rotation out of technology stocks, hurricane related refinery damage assessments that were better than expected, continued inventory reductions in both US and global stocks, Libyan production disruptions due to armed militants, a Kurdistan pro-independence vote which potentially threatens 550,000Bbl/d of oil exports, Venezuelan oil exports collapsing due to political upheaval, OPEC compliance improving even further, and finally Brent's backwardation steepening indicating an increasingly tight physical market.

Is this rally for real? It feels that way. The change in tone amongst energy fund manager peers, generalist investors, retail clients, energy salespeople, and even the media is palpable. For months the only dialogue institutional investors wanted to have with their energy dedicated salespeople was about macro. Today conversations mainly revolve around asking about company fundamentals/catalysts and wanting to get model updates which are signs of latent buying power that is about to be put to work. Oil and/or oil stocks actually go up now on positive headlines where only months earlier these same headlines would have served as liquidity windows. Rallies are being bought rather than sold and trading volumes are signifying the return of real money with the highest volume day of the year occurring just a few weeks ago. The result has been a powerful rally. Despite the short term upward move we would remind our clients that given the magnitude of the collapse in many stocks there remains significant (50%+) upside in many of our names in order to simply get back to where they began the year. At the same time over the past 9 months as their share prices have collapsed company fundamentals have largely gotten materially better so we could argue for valuations in excess of where stocks began 2017. Our pressure pumpers for example still trade at an average 2018 consensus EV/EBITDA multiple of 4.9X versus a historical mid-cycle multiple of 7.5X. Our frac sand names despite the strong rally in September still trade at 4.7X vs. an average multiple of ~8X. On a free cash flow basis we have several holdings trading at a greater than 10% FCF yields with one holding at a 20% FCF yield (they could buy back all of their debt and shares outstanding in 5 years). Our point is that despite the one month rally we still see very material upside in the space.

Last month we wrote about the sequential flattening of US production growth over the last 5 months; this trend has now extended into a sixth month. A few reasons were offered with one being the deterioration in average rig/completion crew efficiency given the dilution of average rig hand experience and the diminishing effect that this has on marginal production growth per marginal dollar spent. Our hypothesis was validated by Callon Petroleum recently when they issued a production warning on the quarter and stated that "the revision is related in part to heightened level of non-productive time during the completion of wells in the quarter caused by an approximate 20%

reduction in average efficiency across all vendors involved with completion operations compared to the second quarter of 2017." This trend is critically important to monitor as the single largest oil bear argument has been the supposed ability of US shale to respond quickly to any increase in the oil price and consensus up until very recently was for growth this year of 1.0-1.2MM Bbl/d (some earlier this year were calling for over 1.5MM Bbl/d of growth). The EIA released their estimate for July production a week ago and once again L48 production grew by only a modest amount (54,000Bbl/d month-over-month). This equates to an annualized growth rate of 650,000Bbl/d which is about half of what consensus was for US oil growth only a few months ago (meanwhile demand is growing at 1.8MM Bbl/d this year). Given the continued shortage in labour, infrastructure, and equipment (mainly pressure pumping) we believe consensus is still too high for 2018. As we prepare for earnings season in a few weeks we believe the theme of service tightness will pervade most company releases (we're hearing anecdotes of producers telling frac sand companies to "name their price" given desperation to obtain sand and producers warning on production due to a shortage of pressure pumping crews). Analysts have been truing up their estimates as fundamentals continue to exceed estimates and in some cases we believe that consensus forecasts for Q3 could be light by as much as 40%-50%. With the WTI strip now exceeding $50/bbl in 2018 (a critical level for US E&P spending) we've also seen 2018 estimates begin to better reflect reality. One large pressure pumping holding had one analyst last week increase their 2018 and 2019 estimates by 26% and 27% respectively. Importantly and a good example of how low 2018 estimates are in some cases their 2018 EBITDA estimate is now 25% above consensus. We've also seen this month companies demonstrate an increased focus on shareholder returns vs. historically focusing on production or capacity growth. A major pressure pumper holding initiated a NCIB allowing them to purchase 9.9% of their stock and they stated that buying back their own stock is "preferable to reinvestment of excess cash flow into additional equipment." With FCF yields exceeding 10% for many of our holdings we expect this to be a trend in 2018 and has an indirect benefit of assuaging concerns about too much capacity additions in the service sector thereby preserving pricing power and ultimately resulting in multiple expansions.

In closing, it is encouraging to see the price of oil begin to reflect the meaningful rebalancing that has occurred so far this year and perhaps even begin to include a small risk premium due to the many political unknowns at the moment (Trump de-certification of the Iranian agreement, Venezuelan bond maturity cliff, North Korea "calm before the storm", Kurdistan losing pipeline access, Nigerian rebel truce ending, increased violence in Libya, Canadian infrastructure projects getting cancelled). Energy stocks remain undervalued by any measurement and with sentiment beginning to improve we remain optimistic in our ability to recoup much of our YTD losses over the next several months.

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[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 September 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.[†] Since inception of fund Series F.

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