SPROTT
ASSET MANAGEMENT

SPROTT ENERGY FUND

April 2017 Commentary

Earnings season is a time for Portfolio Managers and investors alike to recalibrate how they see the world with reality as told by those whom are most informed about underlying business conditions and future outlooks: the CEO's. There are times when the difference between perception and reality is large and normally in response to an earnings surprise or highly favourable future outlook a stock will re-rate to reflect the "new" information. When this happens did reality change or just the markets collective perception of it? The answer is obvious. In today's energy market it is then particularly frustrating when investors generally flat out refuse to acknowledge the significant improvement in both oil and energy company fundamentals. For every 5 positive data points that are reported the market chooses to obsess over the 1 negative. Global oil inventories falling for the past 10 months (total global product surplus peaked at ~600MM bbls in Q1/2016 and has fallen to below 400MM bbls in Q1/2017 and likely to reach flat by Q4/2017)? Sell oil because inventories are still growing in the US. Oil inventory draws finally start to draw in the US (the final area of rebalancing) with now 3 consecutive draws (the largest of the year occurring last week)? Sell oil because of a small build in gasoline inventories even though the driving season is just about to start. OPEC compliance achieves a 93% success rate in March which is probably double what the market would have expected when the initial deal got signed? Sell oil because one field in Libya was able to temporarily come back online. Oil demand growth rising by about 1.6MM Bbl/d in 2017 which is ~60% higher than the 10 year average? Sell oil because the US rig count has risen and US oil production is likely to grow by ~0.4MM Bbl/d (= only 25% of demand growth). Global E&P spending set for a third year of declines to a level that is well below what is required to offset global depletion? Sell oil because US oil production (which tight oil only representing ~5% of global supply) is now rising. You get the drift.

The same theme has been occurring on a company level. We have written previously that the Fund has built a large position in both frac sand miners and pressure pumpers. The bellwether frac sand company reported their Q1 last week and the quarter was fantastic. They beat consensus EBITDA and reported that frac sand sales volumes were up 22% sequentially and unit margins were up 67% quarter-over-quarter. In their guidance they guided for another sequential uptick in both volumes and price of 15%-20% and for another 67% sequential increase in unit margins (that would make a 180% improvement in just 2 quarters). On the conference call they used terms like "unprecedented" and "record" demand. They said that the "market is tightening pretty substantially" and that "pricing is increasing every month." On the back of the earnings release firms like RBC increased their 2017 EPS estimate by 41% and Credit Suisse increased their 2018 EBITDA estimates by 16%. So all in all not a terrible quarter. What did the stock do? It is now -4% since the earnings announcement after having already fallen by 27% heading into the earnings release. Why? The market has gotten into a tizzy around the potential for too much new supply to come onto the market. The market today for frac sand is around 75MM tons per year and identified brownfield (ie. expansion) and greenfield (ie. new sites) amount to 30-40MM tons (footnote: many constraints exist other than geological such as permitting, access to water, access to rail transportation, etc. which act as a cap on new supply adds). Given healthy margins today at around $25-$30/t the market has assumed that all new capacity will come onto the market and crush the price in the imminent future. Makes sense right? What the market is failing to do though is place as much emphasis on demand growth as it is on supply growth. Due to both a rebound in the rig count (up over 100% from the low) and more importantly the multi-year trend of using greater proppant loading (ie. more sand per well) demand for frac sand is set to increase to about 100MM tons in 2018 and potentially 130-140MM tons in 2019. Barring a total collapse in the oil price this is the reality and the math would suggest that the frac sand market will remain tight for years to come and in fact could be critically short and act as a cap on new well activity. It isn't just us thinking this as this excerpt from a Wells Fargo note on the above company echoes what we've

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consistently read in other notes: “Despite elevated concerns among investors and the growing awareness of more Permian based brown sand coming on the market the next 1-2 years, our conviction towards proppant and Company X remains firm as pricing gains become more visible and our demand outlook continues to suggest an undersupply through 2018 with a meaningful squeeze potentially coming in the next few months. In fact, as we noted above, based on the pace of pressure pumping spread reactivations, we believe the surge in completion activity could be greater than we current model, which would put more stress on the industry supply chain and raise the possibility of higher prices.” Frac sand stocks have been destroyed this year on what we believe to be totally misplaced fears on too much supply additions. Simply put total identified mine expansions and new projects total up to a maximum of 40MM tons and we believe demand will grow by over 55MM tons over the next 2 years. Just as with oil too much focus is being placed on supply growth with little attention being placed on demand growth. From their February highs these stocks have fallen by 33%-58%. We cannot identify a better situation available to us in the energy sector today where perception and reality are so starkly opposed and we continue to own these stocks with conviction that several of them could double from current levels.

The same theme has been happening in our pressure pumping stocks with recent significant short-term weakness (-30% to -40% from their February highs. However, just as with frac sand the outlook for pressure pumping as explained by service companies on their Q1 conference calls is overwhelmingly bullish. Schlumberger (-17% from February high) said that they were seeing “significant traction on pricing.” Halliburton (-20% from February high) reported a QOQ revenue surge of 24% and said there was “great momentum on pricing.” Superior Energy Services (-30% YTD) reported a 49% QOQ increase in their pressure pumping revenue and said that “the market for US land completions has tightened significantly.” RPC Energy (-18% from February high) reported that pressure pumping pricing was up 30%-35% since December 2016. Trican Well Services (-30% from February high) in an updated slide presentation this week stated that they are “fully booked for active equipment in major service lines through to Q4” and that “Q2 programs are significantly higher than 2016.” The Q1 earnings from all service companies (especially the pressure pumpers) were all extremely good with forward guidance above street estimates and yet the stocks have fallen. Why?

We can put our finger on 2 reasons. First the level of apathy/disinterest towards the energy space is the highest we have seen in years. We have both quantitative and qualitative ways to assess this. Looking at Canadian energy stock charts is useful with many so-called “high quality” names like TOG, RRX, CJ, and SPE trading today at the same levels as in January/February 2016 when oil was at $30/bbl (!!!). More qualitatively a friend who is a bank energy salesman was marketing in Montreal and remarked that several energy clients that he met with were contemplating career changes or at the very least changing sector focus. We believe the primary aspect that is fueling this despondency has been the slower than expected reduction in US inventories (OPEC export surge + highest refining downturn season in ~4 years caused this) and the exhaustion of peoples’ patience. At the same time the rest of the stock market has been acting very well and without the generalist fund manager having an interest in one of the only sectors of the market that is down on the year energy stocks are languishing (ie. buyers strike). The second reason that explains the weakness in energy stocks has been the forced liquidation on the part of some US hedge funds. Over the past several weeks we have seen extreme selling in certain stocks on fairly benign news and were having a very tough time figuring out why. It later came to us that several high profile (and not so high profile but large) US hedge funds have either wound down or decided to decrease their exposure to the energy sector (why be invested in an area that isn’t working at the moment when you can just go buy more Amazon and Google stock?). The total selling potentially amounts to ~$8BN over the past month and given the greatly reduced trading volumes this has had a magnified impact on the sector.

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What has allowed us to maintain most of our mental sanity during the past several years and "stay the course" during the worst sell-off in the history of oil? While we do our best to prepare by trying to know company and sector fundamentals better than our peers the largest factor has been a deeply ingrained belief that fear creates opportunity. In today's market the fear of short-term underperformance (many hedge fund companies will fire a Portfolio Manager if they fall by more than 5%-10% in a single month) is leading to unbelievably short-term thinking (and this is coming from a guy with 1,000%+ annual turnover). Such short-termism can allow stocks to fall to extremely attractive levels just because the sector or theme is out of favour in the moment. It is not an exaggeration to say that sentiment towards the energy sector is as bad today as it was when oil was falling below $30/bbl and everyone "knew" that it could never go up again ("we won't see crude above $44 again in my lifetime" – Dennis Gartman, January 2016). We genuinely get excited when the sentiment pendulum swings so far one way however painful it is in the moment (and as a large investor in the Fund your pain is very much my pain). Opportunity is indeed where the (perceived) risk is.

We believe that sentiment will greatly improve once US inventory draws accelerate and that should be "any week" (yes we are getting tired of saying that). The backdrop for oil is much, much stronger than consensus believes because consensus is fixated on the wrong things (US tight oil supply growth [5% of global supply] vs. very strong demand growth + general supply growth stagnation + an implosion in new projects coming online beyond 2017/18). Given the Fund positioning we are extremely well positioned to benefit from our view that oil will see $60/bbl sometime this year (Fund beta ~ 150%). We would just ask for a bit more patience for this outcome to manifest itself as we have been right on company fundamentals (reality) but wrong so far this year on perception. The gap between these two is simply too wide to ignore for much longer and once oil starts working and money returns to the sector (post OPEC May 25th meeting?) we feel the patience expended so far this year will finally be very well rewarded.

Specifically on positioning the Sprott Energy Fund holds 14 positions. Of those 4 are Canadian service stocks and the remaining 10 are US holdings (4 E&P's, 6 US service stocks). Our average holding has fallen by 22% YTD and is down 34% from its 52 week high. The average upside per holding to consensus analysts' targets is 68% which matches closely to our average internal target upside return of 75%.

Eric Nuttall
Lead Manager
Sprott Energy Fund

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COMPOUNDED RETURNS (%) AS AT APRIL 28, 2017[1]

	1 MTH	YTD	3 MTH	6 MTH	1 YR	3 YR	5 YR	10 YR	ANNUALIZED INCEPTION (04/15/04)
SPROTT ENERGY FUND, SERIES A	-12.4	-31.1	-21.8	-22.8	-12.4	-14.2	-3.5	-4.7	3.3
S&P/TSX CAPPED ENERGY TRI	-1.8	-10.7	-2.4	-2.8	7.0	-12.2	-2.9	-2.3	3.8

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[1] All returns and fund details are a) based on Series A units; b) net of fees; c) annualized if period is greater than one year; d) as at April 28, 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 Sprott Asset Management LP based on publicly available index information.

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