SPROTT
ASSET MANAGEMENT

SPROTT ENERGY FUND

May 2017 Commentary

The energy bloodbath continued in the month of May as we officially entered into unchartered territory: going back 25 years the energy sector (see below chart of monthly performance of the S&P 500 Energy Index back to 1993) has never fallen for 5 sequential months. With June in negative territory so far we are into month 6. Energy is the worst performing sector in the world and this persistent trend has led to a complete buyer's strike as money remains in winning sectors (Amazon and Google etc; OSX vs. SOX hit a 17 year low this week). At the same time the meaningfully increased impact of quant and macro funds in the space has seen them press their negative bets on oil and oil stocks leading to exaggerated capitulation on the part of many energy investors as they reached their individual puke points. As commented before this profound energy weakness has also led to the shutdown of at least 7 material energy hedge fund pods in the United States in the past 2 months which by our estimates amounted to at least a further $10BN of forced selling. Many stocks are breaching their 52 week lows and some are trading lower than when oil reached its low in February 2016 at $26.05 and have fallen by 40%-50% year-to-date. The market is stuck in a negative feedback loop as largely ignorant headlines (legitimately "fake news") about persistent US supply growth, the impotence of the OPEC production cut, and weak demand bombard investors day after day on CNBC, BNN, and other mainstream media.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Average(Monthly Change)	-.50	1.00	2.69	3.10	.23	-.19						
2017	-3.64	-2.73	-1.10	-2.93	-3.96	-.66						
2016	-3.07	-2.56	9.18	8.65	-1.17	3.19	-1.98	.64	2.95	-2.97	7.88	1.80
2015	-4.88	3.51	-2.04	6.56	-5.22	-3.55	-7.81	-4.69	-6.79	11.25	-.77	-10.00
2014	-6.33	4.57	2.28	5.11	1.05	4.93	-3.40	1.83	-7.64	-2.99	-8.85	.34
2013	7.59	.00	1.85	-.88	2.08	-2.09	5.00	-2.08	1.68	4.07	.50	3.00
2012	1.48	5.45	-3.40	-.98	-10.62	5.62	4.06	1.88	3.31	-2.04	-1.80	.52
2011	7.32	6.77	1.49	1.48	-4.61	-1.93	.64	-10.04	-12.58	16.95	1.65	-1.06
2010	-4.51	1.87	2.88	4.43	-11.81	-5.79	7.98	-4.71	9.14	5.56	5.11	8.93
2009	-3.16	-12.46	3.71	4.81	10.16	-4.68	4.30	.36	4.60	3.15	2.85	-.99
2008	-10.93	6.66	-2.67	10.87	3.16	2.23	-13.99	-.84	-12.00	-18.01	.40	-4.08
2007	-1.85	-2.30	6.08	5.21	6.82	1.72	.71	.54	8.04	1.03	-3.98	7.28
2006	13.85	-8.14	3.84	5.11	-3.18	2.04	4.96	-4.07	-2.80	4.46	8.06	-1.90
2005	2.72	18.29	-3.65	-5.32	1.36	5.77	5.72	5.10	5.99	-9.39	1.35	.48
2004	1.25	4.01	-.67	1.65	.10	5.15	3.32	-1.39	8.37	.62	5.72	-2.03
2003	-2.59	1.50	1.13	-.49	8.11	-1.11	-2.52	5.67	-2.50	.81	-.14	13.80
2002	-1.91	3.94	6.64	-5.11	.09	-.29	-12.74	-.46	-8.66	2.86	3.17	-.03
2001	-3.03	-2.25	-1.56	9.90	.14	-6.80	-1.66	-3.91	-6.78	3.16	-4.20	5.27
2000	-1.65	-6.27	10.46	-.84	9.01	-5.30	-2.29	7.20	3.13	-2.02	-2.99	5.78
1999	-7.30	-1.01	14.59	14.51	-3.00	.86	1.23	1.17	-4.06	-1.46	1.43	.24
1998	-5.46	6.56	4.20	3.48	-3.73	-1.29	-5.80	-11.64	13.70	1.18	.29	-1.08
1997	4.92	-4.61	4.93	.97	6.52	3.58	6.74	-3.26	6.58	-2.73	-2.10	-.49
1996	-.16	.17	4.74	2.60	.35	.88	-3.85	1.35	3.54	6.07	4.26	.29
1995	1.81	3.12	5.09	2.71	2.99	-3.63	3.27	-3.78	1.90	.14	3.89	6.32
1994	4.69	-3.64	-4.30	4.64	-.19	-2.59	4.79	-1.24	-2.95	8.09	-5.46	-1.20
1993	2.31	4.63	3.67	1.33	1.20	-1.07	.90	3.20	.75	-.82	-6.03	.98

Source: Bloomberg, June 8, 2017

Sentiment today towards energy is literally the worst I've ever seen in my career as everyone "knows" that US shale growth will swamp the market, that OPEC always cheats, and that Tesla is going to entirely displace the need for gasoline perhaps as early as 2025.The mood and stock reaction to the never ending barrage of negative headlines and seemingly negative data points to us feels very much like January/February 2016. Similar to now, in those 2 months I dealt with daily phone calls with clients deeply worried about perceived weak oil demand, the belief that shale is everywhere so why can't shale

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oil production explode all around the world, the never ending improvement in US shale well efficiencies lowering the global supply cost, and near the bottom had to defend why oil wouldn't fall to $15/bbl as one CNBC commentator said that crude oil was the new whale oil. From late 2015 to early 2016 the Sprott Energy Fund fell by just over 40% and our conviction was tested. Our belief in the short and long term direction of crude was challenged as were our beliefs in the underlying fundamentals of our investments. We did not waver when others were panicking as all that we could discover on a fundamental level suggested that our logic was sound even though stocks then (like now) seemed to fall almost every day. Was our conviction (and epic stress levels) rewarded? From the low the Sprott Energy Fund rallied by 143% over the remainder of the year.

Source: Bloomberg, June 8, 2017

At the time of writing this update to you the Sprott Energy Fund is down nearly 38% and once again we are naturally and appropriately having our beliefs in oil fundamentals and company fundamentals called into question. So let's address that head on. Oil is down almost 15% YTD when we have continued to say that oil fundamentals are generally quite good so how exactly are we seeing the world and how is that different from consensus? At the same time we have met with many of our holdings over the past few days so what are they telling us? How is business? Does what they tell us line up with having their share prices fall by 10% a few days ago?

We have long talked about oil inventories being the best real-time indicator of over/undersupply and is currently the key metric that the market is focusing on. The problem has been that the focus has been on the wrong thing: US inventories rather than global levels since oil is a global commodity. OECD inventories have been falling since July 2016 (with the

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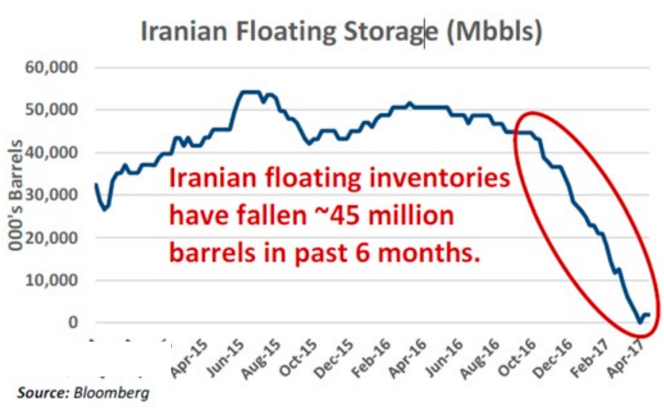
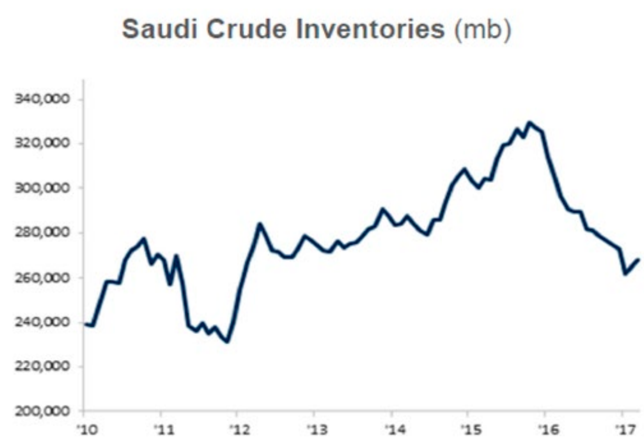
exception of this past January) and now sit around 300MM Bbls above the 5 year average. Saudi/OPEC+Russia's stated intention is to bring down global oil inventory levels back to the 5 year average through a coordinated production cut of approximately 1.6MM Bbl/d (1.2MM Bbl/d from OPEC and 0.4MM Bbl/d from non-OPEC countries though it is basically Russia). At the May 25th OPEC post-meeting press conference the Saudi Minister said "we will do whatever it takes" to balance the market. Why should we believe him? Saudi Arabia was the architect of the shift from a free market to a managed market out of a sense of self preservation. They have (and continue) to bleed from their foreign currency reserves given that oil amounts to over 90% of their national income and social expenses have escalated over the years in a post-Arab Spring world (recent wage and benefit cutbacks had to be reversed a few months ago). They have lost over $200BN since the oil meltdown began and lose approximately $8BN/month. As a means of diversifying their economy they intend to IPO a 5% position in their national oil company (~Q4/2018). To maximize the value of this asset (and hence bring in the most amount of money to spend on infrastructure/economic diversity) they are highly motivated to ensure a higher oil price until at least the end of 2018. So too in Russia is their political survival on the line as Putin faces an increasingly competitive election in March 2018 (this just so happens to be the end of the 9 month OPEC oil cut extension). Saudi Arabia and Russia are all that matter. Iraq and Iran both lack the ability to meaningfully ramp oil production and Saudi very, very importantly stated that OPEC will absorb any incremental barrels coming from improvements within Libya and Nigeria (did this ever get reported in mainstream media?). With all that said, one of the two key reasons why oil has sold off is that US (and global) inventories have not fallen as fast as the production cut would have suggested. Part of this was due to seasonality (2H oil demand significantly higher than 1H demand) and higher than normal refinery outages. The more important reason was that OPEC export cuts didn't perfectly match up with OPEC production cuts. Iran continued to export oil onto the market and their floating storage fell from 40MM Bls YE'16 to approximately zero as of last month. As well, Saudi did draw down internal inventories to a 5 year low. What we can see from recent tanker data as well as corroboration with Saudi's comments is that OPEC exports have dropped materially recently (down 1.7MM Bbl/d in early May YOY). This means that the draws from global inventories should accelerate and better match up with what the original production cut math would have suggested. As well Saudi explicitly said at the May 25th meeting that their export cuts will increasingly target the US as they are the most visible area of inventory excess.



Source: Bloomberg, June 8, 2017



Source: RBC Capital Markets, JODI

The second reason why oil sentiment did a nosedive in the first part of the year was from concerns that the growth of US shale would completely offset the production cut by OPEC and result in a persistently oversupplied market for many years to come. The US rig count has increased by 122% from the lows of May 2016 and is up 40% year-to-date at 733. To offset

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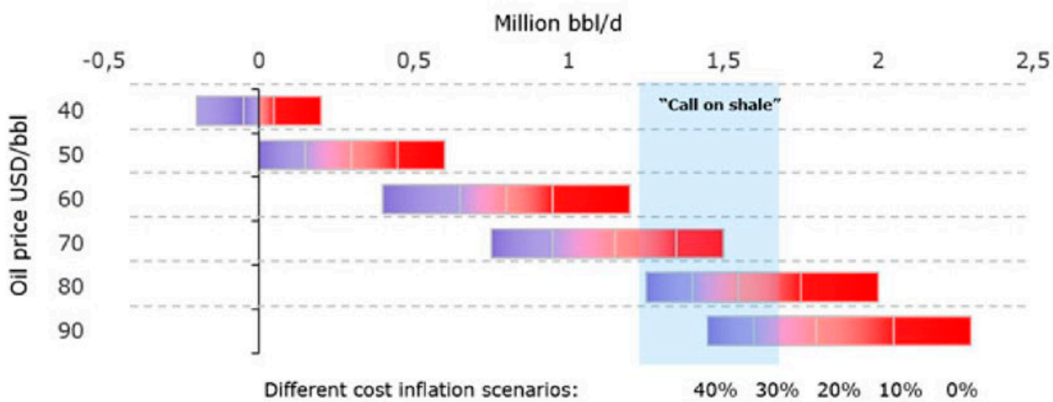
declines we believe a rig count of around 600 is required so we absolutely agree that the US is in growth mode. We take issue however that 5% of world oil production is able to satisfy global demand growth and offset global declines. While companies do indeed continue to get more efficient and well productivity in the 3 major plays continues to improve (faster drilling, staying in the sweet spot of the zone longer, more sand, more frac stages, higher pressure pumping rates) part of these gains are in real-time being lost from high service cost inflation. From the October 2016 lows the cost of renting a Tier 1 drilling rig has risen from $14,000/day to $19,000-$21,000 day. Leading edge pressure pumping prices in the US are up 70% as of last week. Raw frac sand cost is up around 75% from the lows. This all means that the "bang for the buck" of spending $1 today versus 6 months ago is much less and will have a coming impact on the pace of US production growth. Also at a conference in NY that I attended this week one interesting observation from a Permian E&P company was that they were beginning to see the impact of more green/inexperienced crews on well drilling time. All in all for every 10% increase in service cost the price of oil needs to rise by $4-5/bbl to get that same torque for every dollar of capital expenditures. Lastly our second most important takeaway from the conference was a comment from EOG (the grandfather of the oil and gas industry) that cut their internal estimate for 2017 US production growth by 30% due to a shortage in pressure pumping equipment and frac sand (this happens to be where 80% of Fund exposure is!).

Figure 3: Y/Y growth in shale output for oil price levels and cost increase scenarios vs. 2016 cost base.



Source: Rystad Energy UCube

Source: Rystad Energy UCube

We believe that OPEC is largely out of spare capacity on a pre-cut basis and that non-US/OPEC growth is challenged in the years ahead given the largest drop in spending on long-lead projects in the history of the oil and gas business. Our thesis that we are heading towards a meaningfully tight market in 2019 and beyond has not changed. 2018 will act as a transition year with OPEC slowly bringing back barrels in a non-disruptive way, US production growing by about 1-1.2MM Bbl/d, non-OPEC/US production largely flat lining, and demand absorbing most of the production additions. So in summary while US production growth is important it is not big enough to solve the world's needs and the price of oil will have to rise higher than US marginal supply costs ($55/bbl with normalized service costs) to avoid a chronically undersupplied market.

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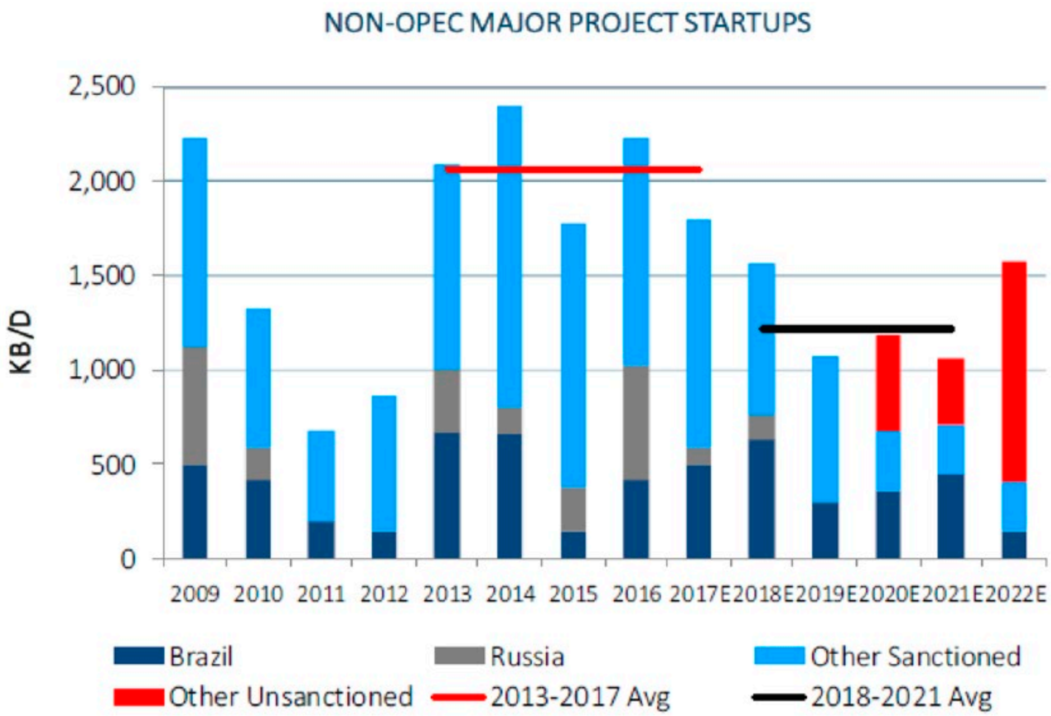

Source: Piper Jaffray

So what about company fundamentals? Does any change in the business outlook match up with the 15-20% pullback over the past month and explain why many stocks have fallen by 40%-50% so far this year? The short answer is no. We strongly believe that stocks have been in freefall due not to eroding fundamentals but due to peoples' collective patience running out. Energy has been a tough and volatile place to be over the past few years (see the first table) and when the Dow and Nasdaq make new highs every day it is difficult to justify putting new money to work in a sector that seems to go down every day. This dynamic along with a shift from active to passive + quant/algos means that there are simply fewer market participants to recognize when selling becomes overdone on a fundamental level. We've found better opportunities that we'll expand on in a minute but in Canada it is possible to buy oil stocks where if you believe in a $55/bbl long-term price deck you are getting part of a company's existing cash flow stream for free in addition to their remaining proved, probable, possible, and unbooked reserves in addition to residual infrastructure value. However for many buyers now unless a positive momentum or earnings revision indicator is flashing green they will not buy, no matter how inexpensive or brutalized a stock becomes. This dynamic is something that has changed in recent years and is something to be aware of going forward as it creates a greater herd mentality effect (and opportunity for active money?).

As explained in previous monthly writeups we have taken large stakes in frac sand and pressure pumping companies. We have chosen these 2 areas not because they happen to be 2 of the highest beta areas/ways to play an increasing oil price (not awesome over the past few months in an epically challenging oil market) but because these two subsectors have the best ability to raise prices and regain lost margins in a $50/bbl+ world. We met with 40% of our Fund earlier this week at an industry conference so consider ourselves to be fairly up to speed on leading edge pricing and outlooks. What was amazing was if you weren't staring at a quote screen and just focused on what the companies were telling you in terms of how business is and what their outlooks are you would have walked away from the meetings feeling extremely bullish.

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I left one meeting with a large frac sand holding in which I was told that they were experiencing record demand, that pricing continues to rise by 10%+ quarter-over-quarter, that sold volumes is rising over 10% quarter-over-quarter, that their product was likely to remain in deficit for at least the next 2 years, that future price increases were virtually assured, that underlying demand growth trends continued to remain strong and in fact my 2018 expectation for demand growth increased by 20%, and that their product is in such medium-term supply deficit that large service companies/producers are approaching them willing to fully fund future mine expansions with guaranteed margins under long-term take-or-pay contracts (wow!). I left the company feeling pretty excited and made the mistake of looking at my iPhone to get an update on the market: the stock was down 10% on the day (and is now down 38% on the year) and now trades at 4.7X a too low 2018 consensus EBITDA estimate when it used to trade at 9X. This is the market that we are currently in.

In closing, I would like to express how appreciative I am for both your continued confidence and patience. While most of my energy peers have been in net redemption mode this year we have enjoyed the benefit of having positive inflows YTD (including throughout the most recent carnage). Due to the industry wide redemptions in energy my peers are more likely managing career risk than they are managing to maximize their ability to make money for their clients. We are thankfully not in that position.

As the largest individual investor in the Fund, be assured that the pain that you have been feeling year-to-date is also my pain. In recent weeks I've bought more of the Fund and am being guided by a 2016 playbook that worked out very well for us. The market is panicking and sentiment is the worst I've seen in my 14+ year career. At the same time underlying fundamentals for both oil and energy stocks are much better than you would believe from looking at stock quotes or watching CNBC. Eventually perception and reality will converge. Our average upside per holding is now 84% and is the highest it has been since January 2016. The Fund beta is approximately 135% so we are ideally positioned to benefit from the imminent improvement in market sentiment. We are highly confident in our ability to make our unit holders back their losses (and then some) and to do so we only need generalist investors to be given a reason to come back to the sector. This will most likely come from the rebalancing of the oil market becoming more obvious through an acceleration in the magnitude of US inventory drawdowns.

Eric Nuttall
Portfolio Manager
Sprott Energy Fund

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SPROTT ENERGY FUND

May 2017 Commentary

COMPOUNDED RETURNS (%) AS AT MAY 31, 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	-4.5	-34.2	-21.2	-30.7	-20.9	-16.6	-2.4	-5.8	2.9
S&P/TSX CAPPED ENERGY TRI	-5.6	-15.7	-5.6	-15.2	-0.5	-13.6	-1.9	-3.6	3.3

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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 May 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 Sprott Asset Management LP based on publicly available index information.

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