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A Bull on Energy, a Bear on Nearly Everything Else

Eric Sprott, CEO, Sprott Asset Management

By ROBIN GOLDWYN BLUMENTHAL

AN INTERVIEW WITH ERIC SPROTT: Energy and natural resources are about the only thing this leading Canadian investment manager likes.

ERIC SPROTT IS A DOWN TO EARTH -- AND CONTROVERSIAL -- kind of guy. Although the 63-year-old recently became a billionaire on paper with the initial public offering of **Sprott Inc.**, the parent of his Sprott Asset Management firm, he's not above drinking soup from a cup in his 27th-floor offices in Toronto's financial district, rooms graced by a sizable collection of Canadian art, ancient money and medieval weaponry. Sprott, who started as an analyst at Merrill Lynch covering everything but commodities, has become known as a savvy natural-resources and energy investor -- and he's bearish on nearly everything else.

Sprott has been criticized for betting on high-risk penny stocks, most recently [Timminco](#), a company that claims to have an inexpensive method of producing silicon for solar panels. But it's undeniable that many of his calls on uranium and gold have been on the money. His U.S. hedge fund, **Sprott Offshore**, boasts a 32% compound annual rate of return since 2002. In Sprott's case, one might say, all that glitters includes gold. For more on one of Canada's top investment managers, read on.



You're a believer in the peak-oil thesis, which says that global oil production has topped out. How much time do we have left before the supply dries up?

We aren't going to run out of oil in the next 100 years, but it will keep getting harder and more expensive to obtain. Most people don't even realize that production is falling. In 1956, M. King Hubbert, an analyst at Shell Oil, said that production in the lower 48 states would go down by 1970. Sure enough, 14 years later, it started going down. And it's kept sliding since then. We've found over 50% of everything we are going to find here. Once you find 50%, you naturally go into a decline. And here we are, 38 years later, and, my God, think about the amount of money that's been spent trying to find more! We spend more every year and get no more net production. And the list of countries whose oil production has peaked keeps growing, including Russia, which for eight

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consecutive months has had year-over-year declines. Companies have the same problem. The latest results from Exxon showed that its production was down about 3%.

But don't all the new oil-finding and drilling technologies help?

We've made great strides in technology; it's true. Every year, there's something new. We see people get some stripper oil well to go from seven barrels a day to 15, by using sonic-resonance or water-flow technology or nitrogen injection, or whatever. But technology can simply speed up the depletion rate. A big fear is that the largest oil field in the world, Saudi Arabia's Gomar, which brings us just above 4 million barrels a day -- 5% of global oil -- is being depleted. They put 6 million to 7 million barrels of water into the formation every day. Oil floats in water, so as the water level moves up, the oil rises to the top. Someday, the water level will go above where they are producing the oil, and they'll just get water. There's not going to be a slow decline rate at Gomar. When it finally goes, there's going to be a very quick decline.

What about natural gas? Hasn't more sophisticated technology made it easier to produce more?

Yes. Fracturing techniques and horizontal drilling have caused things to pick up. But with these new discoveries, the first year's production is quite flush, but then there's a very sharp decline. In the fourth year out, production is probably 5% of the first year's or something like that. But there have been some great strikes, in the past decade and particularly the past couple of years, in places like the Haynesville Shale in Louisiana and Texas, the Utica Shale in Quebec and the Montney Shale in British Columbia.

Who's working these fields?

Different companies. In the Haynesville, there probably are 10 major U.S. companies. In the Utica, there's one U.S. company, Forest Oil and one major Toronto company, Talisman Energy. In the Montney, there is a whole bunch of companies.

What about oil demand? It's putting pressure on supply, too.

You're right. I'm not even going to discuss the demand side, but I read in a newspaper that 70 million people around the world are joining the middle class each year. That means more people using more oil.

Where is the price of petroleum going?

Long-term, up... almost forever. What it goes to, I don't know. But I can see it hitting \$200 or \$300 or \$400 a barrel. And if oil goes up, it will drag most other energy-producing products with it. Not that coal and uranium don't have their own fundamentals, but certainly costly oil will make alternative energy sources more popular.

Let's talk about coal.

The central Appalachian coal price has gone from about \$40 a ton to around \$50 in less than a year. Uranium hit a low of \$47 a pound, and it got up to \$135 and now it's around \$64. There are electricity shortages in lots of countries. So, thermal coal is going to continue to have a tremendous renaissance, which is great for some U.S. companies. The U.S. is self-sufficient in coal, and exports a lot. Many coal stocks have had huge rallies, and takeovers of coal companies will provide plenty of opportunities for

investors. For example, Alpha Natural Resources has already agreed to be acquired by Cleveland-Cliffs, but there's a rumor that ArcelorMittal, the world's top steel company, might make a bid.

What companies are attractive?

Our biggest coal holding is James River Coal, in Virginia. They just reported their results for the second quarter, which wasn't a particularly good one. They lost money. Because of contracts, the coal they are selling today, or that they sold in this last quarter, they sold for \$50 a ton. The coal they sell for next year will get \$130 a ton. They are losing money -- maybe \$3.60 this year -- but their results will get better with each quarter from here on. The shares are trading at about two times cash flow. We have calculated that the company could earn over \$10 a share next year, and the story could be even better in 2010. The stock is at 35.

One thing that you've been criticized for is going after a lot of micro-caps.

The best opportunity is the one that is the least looked at. Do I really think that Peabody Energy isn't going to outperform James River Coal, which is a lot smaller? No, I don't. I just think that not enough people are looking at James River. Most people have never heard of James River, but they have heard of Peabody and the top 10 firms. You have to go a little bit under the surface and find things that people will recognize later as being good value. I first bought James River Coal at \$14. We love buying a small company that becomes not so small a company. We even have penny stocks, but not a huge holding.

One is Timminco, a controversial silicon processor traded in Toronto.

We first bought Timminco at 50 cents. It looked like a classic for us. First of all, it's a tech stock with a technology that has caused them to be a major source of material for the solar industry. Very early on, when we were aggressively buying it at \$1 or \$2 or \$3, we imagined this company could earn \$5 a share a couple of years out. We ended up buying 15% of the company at an average of \$6. It could earn \$5 a share. and as commodity prices go up, solar becomes a more economic source of power.

The stock, which had traded above 35 at one point during the past year, got hammered last week -- it closed around 13 -- after its earnings disappointed investors, fueling skeptics' arguments that it doesn't have a truly inexpensive way to make silicon for solar panels. What happened?

Timminco produced 291 tons in the quarter, 70 of which were compromised. We were looking for 300 tons, so it was disappointing. But these things often happen in a startup situation; the new technology doesn't always go as you anticipate. We'll have to see if they can produce it in quantity. If they can, there will be tremendous upside. In the past few months, they have had a significant extension of an existing contract, and signed a contract with Cali Solar, which would have been considered a competitor to Timminco. That in itself is a real validation of the company. Q-Cells, Timminco's biggest customer, has been vocal about the high regard its team that audits Timminco's processes has for the company. Q-Cells recently raised its revenue guidance, partially off production coming from Timminco material.

Have you cut your Timminco position?

No. I'm still by far the largest holder, with 17%. One of our portfolio managers sold some of his shares, but a very small part.

Timminco has contributed huge gains to your portfolio. Could you have gone public without it?

Our Canadian Public Equity Fund returned 27% last year, and Timminco, which we owned only for a year, was a big winner for us, but not the biggest. And it had nothing to do with our return for the first nine years.

All right, let's look at the bigger picture. What's your view of the stock market?

We're in a secular bear market, and there are lots of things that might go down for quite a long period, especially if oil starts rising again. Just imagine oil at \$200. What happens to the airline companies, car makers, mobile-home companies, destination-resort companies, casinos, retailers?

Give us some shorts, please.

Let's start with the obvious. You can't have financial institutions levered 30-to-1, which I think is the case in Europe, or 25-to-1, which I think is the case in the States, and expect nothing bad to happen. So, we have been short the banks for a long time. And the brokers. And the mortgage lenders and mortgage guarantors. We typically short stocks, not ETFs or indexes. We've been short Bank of America, JPMorgan Chase, Citigroup, Goldman Sachs, Merrill Lynch, Lehman Brothers, Morgan Stanley, SunTrust, Wachovia, Washington Mutual, Capital One. There's hardly a financial name that we aren't short.

If you're that bearish, what do you see for interest rates and the U.S. dollar?

I've always believed the dollar should be weaker; the U.S. hasn't faced up to some huge economic concerns, like Social Security, which some people think it won't have enough money to pay for once all the boomers retire. As for rates, the greatest mistake that the Federal Reserve made after the Nasdaq meltdown and 9/11 was to immediately cut them. That created this lending mania, which is finally ending with the repricing of risk. When everyone realizes that there's a lot of risk, they realize that they must charge more than 4% interest to make taking on the risk worthwhile.

What about housing?

House prices will fall further. People who I respect suggest it's got a long way to go. If my scenario, in which the banking system deleverages itself, is right, it causes an even greater problem. You won't be able to get the money to buy a house.

And gold?

Well, I believe in gold as a store of value. Gold will appreciate from here in any currency. I was just reading a piece about how, if you value the Dow in gold, from 2000 to 2008, it's done nothing. If you're a Nasdaq investor, it's been even worse. Gold has proven to be very rewarding in this climate, and I expect that to continue.

How do you play it?

We buy gold and silver bullion for about 25% of our funds. And then we have another 15% in gold and silver shares. So, that's 40%. Another 40% of our holdings is in energy, and we have probably 10% in cyclical. The rest is in other things, like fertilizer, which I don't consider a cyclical.

Which fertilizer stocks?

All little guys, like Athabasca Potash and Potash One. Another non-cyclical would be in a totally different area. It's Cal-Maine Foods, a U.S. egg producer. It has a nice dividend, and trades at six or seven times earnings, even though it's run up a lot.

We wrote favorably about that stock not long ago. But getting back to gold, where do you see its price going?

It's a little like the oil-price question. I don't know how high it will go, but I don't have a problem thinking it will hit \$2,000 an ounce. Check back with me in five years.

Maybe we will. Thanks.