BCP Research: Scorpio Tankers (STNG) Upgrading to Positive Outright

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Summary: Scorpio Tankers (STNG), one of the world's largest oil product tanker issuers, appears to be an attractive "busted" convert as a 2022 bond trading at 10.6% mid ytm. STNG currently operates 134 vessels as of 2Q20 with a leading market share in the Long-Range 2 (LR2) and Medium-Range (MR) product tankers. Product tankers are coated vessels able to transport "clean" products such as gas oil, gasoline, jet fuel and naphtha. Some coated tankers can carry edibles and liquid chemicals if they have the proper IMO certification. STNG's fleet has an average age of 4.4 years, materially better than the peer group fleet avg. of around 10 years. STNG's current focus is fuel efficient vessels, with all 134 vessels being ECO-spec and current capex plans to install scrubbers on 98 vessels. As of 2Q20, 86 vessels already had scrubbers installed enabling the vessel to use cheaper high-sulfur bunker and be compliant with the latest emission regulations. STNG expects to become the largest scrubber fitted fleet by 4Q20.

In 2019, LR2 vessel revenue was 37% of STNG's total TCE revenue, LR1 revenue 9%, MR revenue 37% and Handymax revenue 15%. For reference, LR2 vessels are too large to pass through the Panama canal, with the rest of STNG's fleet being able to do so. 2Q20 product tanker day rates spiked as covid-19 demand disruption caused E&P players to seek floating storage space given the limited land-based storage capacity. STNG's guidance for 3Q20 implies normalizing day rates, yet still being 50% higher y/y as well as potentially using the larger LR2/LR1 vessels for jet fuel storage at high day rates. We note 1Q20 rates were already at multi-year highs at US$23k/d despite the recent decline in product tanker demand from lower Saudi refining exports and covid-19 disruptions. By contrast, vessel opex have remained flat. As a result, STNG's LTM EBITDA has increased to US$590 mm reducing net leverage to 4.9x. We note the estimated BBG consensus EBITDA estimate for 2020 is US$650 mm, essentially doubling the EBITDA recorded in 2019.

We estimate STNG's fleet market value at US$4.5 bn per the reported long-term avg. sale price for five-year old second hand coated tankers. With total debt at US$3.1 bn (incl. leases and the US$204 mm convert), the implied equity value would be US$1.6 bn – 110% upside vs the current US$765 mm market cap. If tanker spot rates normalize at the expected 3Q20 day rates we estimate FCF could reach US$277 mm in 2020 – an implied 36% yield on the stock. A conservative 5.0x FCF multiple would imply 73% equity upside. Our estimated US$675 mm EBITDA for 2020 would be above current BBG consensus as well. However, with the current share price at US$12.6, neither upside case would be sufficient to reach the convert's US$39/share strike price. As a result, we see STNG 22s convert as "busted." However, as a HY bond trading at 10.6% mid-ytm at 88c with a "free" equity option, we see attractive value. Our estimated STNG fleet value would be 144% of total debt (incl. the convert). We note that bank debt and leases would be senior to the convert, as all vessels serve as collateral to the different bank lines. Current FCF prospects are sufficient to amortize debt and fund the scheduled scrubber and drydock capex. If our expectations on day rates materialize, we suspect STNG leverage could decline to ~4x with potential to become a bankable credit. As a result, we are upgrading STNG 22s converts as a Positive Outright convert.

Description	Coupon	Maturity	Amt Out (US$ MM)	Mid Price	Mid YTM	Conv. Price	STNG Price
STNG	3.00%	5/15/2022	204	87.50	11.00%	38.65	$ 12.59

**Prices sourced from BBG as of August 7th 2020*

Company Overview

- Scorpio Tankers (STNG) is the world's largest ECO product tanker company, being a pure-play product tanker and leader in MR and LR2 segments
- IMO Class I are coated tankers capable of carrying "clean" products such as gas oil, gasoline, jet fuel and naphtha
    - Depending on the IMO certification, Class II product tankers can also carry liquid chemicals and edible products

  - Product tankers can switch back and forth within “clean” and “dirty” cargo – dirty cargo is often referred to crude oil, fuel oil or vacuum gas oil
  - As mentioned earlier, STNG is a pure-play product tanker
  - Cyclical business as 4Qs and 1Qs incur higher spot rates from higher heating oil demand in the winter and lower spot rates in the summer 2Qs and 3Qs
- As of 2Q20, STNG operated 134 vessels of which the issuer owns and holds under lease 127 vessels, while the remaining 7 are bareboat or time chartered
  - 42 Long-Range 2 (LR2) vessels – around 110k DWT vessels, for reference LR2 vessel dimensions are too large to pass through the Panama canal
  - 12 Long-Range 1 (LR1) vessels – 75k DWT vessels
  - 60 Medium-Range 2 (MR) vessels – around 50k DWT vessels
  - 14 Handymax vessels – 40k DWT vessels
  - The 7 bareboat and time chartered vessels are three MR and four Handymax vessels, as well as having one MR vessel under construction
- STNG’s fleet is relatively new, with an average of 4.4 years old – materially better than competitors with a 10-year old fleet
  - Main competitors are BW/Hafria, TORM, COSCO, SCF Group, Diamond S and A.P. Moller
- STNG vessels are organized into four tanker pools depending on the vessel type, which together accounted for nearly all of the TCE revenue
  - In 2019, LR2 pool revenue was 37% of TCE revenue, LR1 pool 9%, MR pool 37% and the Handymax pool was 15%
  - The pools operate in the spot market or have spot-oriented charters, with STNG responsible for the vessel opex
- In 2020, the latest IMO regulation became effective mandating a reduction in sulfur emissions and improved ballast water management systems
  - As a result, the low sulfur bunker (vessel fuel) costs have increased vs the high sulfur bunker
  - Vessels can meet the new standards by using lower sulfur fuel, install scrubbers or switch to LNG power
    - Scrubbers enable ships to use the cheaper high sulfur bunker and meet the latest IMO emissions regulation
  - STNG has plans to install scrubbers (exhaust gas cleaning systems) on 98 vessels, expecting to become the largest scrubber fitter fleet in the world by 4Q20
    - As of 2Q20, 86 of the 134 vessels had scrubbers installed, reducing capex needs for 2H20 and 2021
    - STNG mentioned scrubber-fitted vessels result in fuel savings between US$1k and US$2k per day
- Controlling shareholder is the Lolli-Ghetti Family, with around 4.87% of the common
  - We note STNG executives also serve on sister companies Scorpio Bulkers (NYSE:SALT) and Hermitagge Offshore (NYSE:PSV)

- As of 1Q20, STNG's avg. product tanker spot rate was US$23k/d, increasing to multi-year highs as the last similar rates were seen in 2015
    - Since 2015, day rates gradually declined to a bottom US$13k/d in 2017, gradually recovering since
    - Opex day rates have been steady between US$6k/d and US$7k/d during the same time period
- In 2Q20, STNG's avg. product tanker spot rate jumped to US$30k/d, generating US$252 mm in EBITDA and US$186 mm in FCF
    - Increased spot rates and tanker utilization was from vessels being used for floating storage, as well as inability to discharge until land-based inventories were used
- Recent Developments:
    - Covid-19 short-term disruptions are caused vessel re-routing and higher utilization rates as vessels are being used for floating storage
        - STNG's larger vessels (LR2s and LR1s) have been transporting mainly jet and low-sulfur fuel
        - The issuer is evaluating using them for storage at high day rates, as global travel demand is recovering slowly
    - STNG mentioned refined product floating storage peaked in May with 105 mm bbls, which had already decreased to 45 mm bbls in August
        - As a result, product tanker spot rates are returning to normalized levels, however the spot rate guidance for 3Q20 is still 50% higher y/y
    - The issuer expects healthy volumes as global refineries are finishing maintenance stoppages and increasing throughput
    - In 3Q19, STNG acquired 19 ECO-spec vessels from Trafigura and consequently adding US$670 mm in leases

STNG (US$ MM)	FY17	FY18	FY19	LTM
STNG Vessels (Owned & Leased)	**88**	**109**	**117**	**127**
Bareboat & Time Chartered Vessels	19	15	10	**7**
Avg. Total Vessels	**107**	**124**	**127**	**134**
LR2	142	189	261	-
LR1	21	47	66	-
MR	217	225	262	-
Handymax	79	83	103	-
Pool Revenue	**459**	**544**	**692**	**958**
Spot & Time Charter Revenue	54	41	12	-
Voyage Expenses	(8)	(5)	(6)	(12)
TCE Revenue	**505**	**580**	**698**	**946**
EBITDA	**174**	**212**	**364**	**590**
Interest expense	(92)	(155)	(183)	(174)
Capex	(264)	(53)	(207)	(267)
Working capital	(17)	(13)	0	(58)
Tax expense	-	-	-	-
FCF	**(199)**	**(9)**	**(26)**	**90**
Total Debt	2,767	2,910	3,122	3,124
Cash	186	594	202	251
Net Debt	2,581	2,317	2,920	2,874
Gross Leverage	15.9x	13.7x	8.6x	5.3x
Net Leverage	14.8x	10.9x	8.0x	4.9x
EBITDA Margin %	35%	37%	52%	62%

Thoughts on STNG Convert

- Per the FY19 20-F, the long-term avg. sale price for 5-yr old coated product tanker vessels depend on its DWT
    - Our estimated market value for STNG's 127 owned and leased vessels would be US$4.5 bn
- As of 2Q20, total debt (incl. leases and the convert) was US$3.1 bn – an implied **144% coverage**
    - STNG equity would be US$1.6 bn should all vessels be sold at market, an implied 110% upside to the current US$765 mm market cap
    - Despite the stock upside to $27.44 per share, it would not be high enough to reach the US$38.65 conversion ratio
- The book value of the vessels as of 2Q20 was US$4.9 bn – an implied **155% coverage** on STNG's total debt (incl. leases and the convert)
- Short-term STNG prospects:
    - Market demand is expected to outgrow fleet growth, as new build order book is currently at 7% of the total world tanker fleet
        - This would be the lower % on record, with the 10-yr average at 17% and the 5-yr average at 14%
        - Vessel values could continue to increase
    - Though 2Q20 had extraordinary high spot rates, spot rates were already at multi-year highs in 1Q20 increasing STNG's EBITDA and FCF generation
    - Assuming the issuer's day rate guidance for 3Q20, with spot rate increasing by 25% in 4Q20 (conservative given 4Q rates being historically around 50% higher vs 3Q)
        - We see EBITDA reaching US$675 mm for 2020, an implied 85% y/y growth and above the US$650 mm BBG consensus estimate
        - FCF would be US$277 mm, sufficient to cover the scheduled scrubber and drydock capex
        - FCF would increase to US$343 mm in 2021 – assuming day rates stabilize at a mid-point 2H20
    - Our estimated US$277 mm in FCF would imply a 36% FCF yield on the current stock price
        - Assuming a conservative 5.0x FCF multiple, the market cap would increase to US$1.4 bn
        - An implied 73% upside vs the current US$765 mm market cap
        - Yet, US$22.52 per share upside would not be high enough to reach the US$38.65 conversion ratio
    - As a result, the 2022 convert would remain "busted" in our view as the common would remain out of the money
- Per the above, we see the convert attractive as a short bond option trading at 10.6% mid-ytm, including the "free" equity option
    - STNG's vessel values are sufficient to cover in full the US$3.2 bn total debt (incl. the US$204 mm convert) – with STNG already repurchasing bonds in August 2020
    - Current TCE spot rates turn the issuer FCF positive, sufficient to cover the scheduled scrubber and drydock capex in 2020 and 2021
    - EBITDA leverage metrics would improve to 4.1x

STNG (US$ MM)	2Q20	Vessel Size	Avg. Sale Price (5-yr old Coated Vessel)	Est. Vessel Value
LR2	42	95k DWT	44	US$1,840
LR1	12	75k DWT	36	433
MR	60	45k DWT	31	1,848
Handymax	14	37k DWT	26	363
Total Vessels	**128**			**US$4,484**
Credit & Lease Financing	US$2,893			
Bonds	28			
Convert	204			
Total Debt	**3,124**			
Cash	251			
Current Market Cap.	**765**			
Current EV	**US$3,639**			
EV / LTM EBITDA	**6.2x**			
Est. Vessel Value / Total Debt	**144%**			
Est. Equity Value if Vessels Sold	**US$1,610**			
Est. Equity Upside	**110%**			
Vessel Book Value + Leased Assets	**US$4,855**			
Vessel Book Value / Total Debt	**155%**			

STNG (US$ MM)	FY17	FY18	FY19	1Q20	2Q20	3Q20 Est.	4Q20 Est.	FY20 Est.	FY21 Est.
LR2	142	189	261	99	180	86	108	473	388
LR1	21	47	66	22	39	24	30	116	108
MR	217	225	262	116	122	87	108	432	390
Handymax	79	83	103	43	34	19	24	121	88
Other Revenue & Voyage Expenses	46	36	6	-	-	-	-	-	-
TCE Revenue	**505**	**580**	**698**	**281**	**375**	**216**	**270**	**1,142**	**974**
EBITDA	**174**	**212**	**364**	**159**	**252**	**107**	**157**	**675**	**528**
Interest expense	(92)	(155)	(183)	(45)	(39)	(43)	(42)	(169)	(162)
Capex	(264)	(53)	(207)	(63)	(56)	(38)	(15)	(173)	(41)
Working capital	(17)	(13)	0	(75)	30	(7)	(4)	(56)	18
Tax expense	-	-	-	-	-	-	-	-	-
FCF	**(199)**	**(9)**	**(26)**	**(25)**	**186**	**20**	**96**	**277**	**343**
Debt Raised (Amortized)						(50)	(50)	(100)	(200)
Bank Facilities & Leases	2,307	2,451	2,865	2,917	2,893	2,843	2,793	2,793	2,593
Bonds	111	111	54	54	28	28	28	28	28
Convertible Bonds	349	349	204	204	204	204	204	204	204
Total Debt	**2,767**	**2,910**	**3,122**	**3,174**	**3,124**	**3,074**	**3,025**	**3,025**	**2,825**
Cash	186	594	202	120	251	220	266	266	409
Net Debt	**2,581**	**2,317**	**2,920**	**3,055**	**2,874**	**2,854**	**2,758**	**2,758**	**2,415**
Gross Leverage	15.9x	13.7x	8.6x	20.0x	12.4x	28.6x	19.3x	4.5x	5.3x
Net Leverage	14.8x	10.9x	8.0x	19.2x	11.4x	26.6x	17.6x	4.1x	4.6x
Interest Coverage	1.9x	1.4x	2.0x	3.5x	6.4x	2.5x	3.7x	4.0x	3.3x
EBITDA Margin %	35%	37%	52%	57%	67%	50%	58%	59%	54%

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