PCP PROGRESSIVE CAPITAL PARTNERS LTD

TANKER RATES - TO THE MOON (& BACK?)

2020 COULD BE ONE OF THE WORST YEARS FOR THE WORLD ECONOMY IN A LONG TIME, YET ONE OF THE BEST YEARS FOR TANKER COMPANY PROFITS

PROJECTED DEMAND-REDUCTIONS ARE AROUND 25 MILLION BARRELS PER DAY

OIL OVERSUPPLY AND STORAGE CAPACITY

2020 IS LIKELY TURNING OUT TO BE ONE OF THE WORST YEARS FOR THE WORLD ECONOMY IN A LONG TIME. AT THE SAME TIME, IT COULD ENTER THE HISTORY BOOKS AS ONE OF THE BEST YEARS FOR TANKER COMPANY PROFITS. WHILE MOST BUSINESSES FEAR THE DEVASTATING CONSEQUENCES OF AN UNPRECEDENTED GLOBAL DEMAND SHOCK, TANKER OPERATORS AWAIT STAGGERING CASH FLOWS.

After March 6th, oil and tanker investors focused mostly on the OPEC+ production surplus strategy. As March progressed and country after country in the west went into lockdown, the focus had shifted to the expected collapse of global energy demand, which sent Brent to USD 25 a barrel and into a super-contango of USD 17 for 1-year.

The projected demand-reductions now hover around 25 to 30 million barrels per day (mbd) during the expected peak stress periods in Q2 2020; this is an extraordinary shock for a market that normally balances supply and demand at roughly 100 mbd.

The next chapter played out during the first two weeks of April and started with the Trump tweet on April 2nd orchestrating an OPEC+ production cut, which cooled the market for tanker rates for a while and pushed the contango down to USD 6.

On April 12th, OPEC+ finally announced that they had reached a deal after several days of negotiations, agreeing to a 9.7 mbd oil production cut for May and June. The agreed production trimming will be relaxed to 7.6 mbd in the second half of 2020, and further to 5.6 mbd in the first quarter of 2021. These are material cuts, but unlikely enough reduction to balance the supply versus demand over the coming months. Meanwhile, the one-year contango (Jun-2021 minus Jun-2020) has increased to USD 12 again.

We at Progressive Capital have modelled the projected over-supply for 2020 as shown in Figure 1.

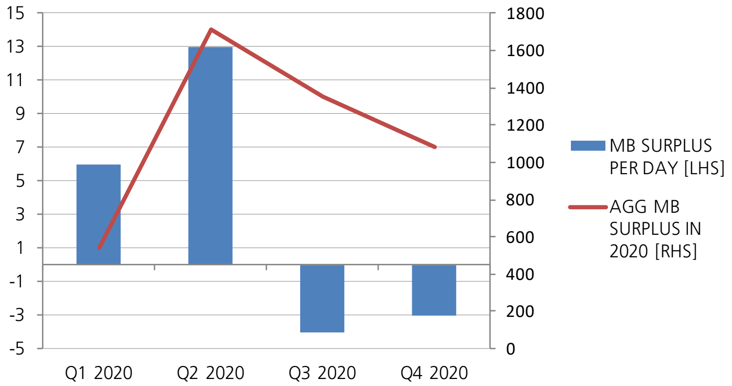

FIGURE 1 - PROJECTED OIL OVERSUPPLY IN MILLIONS OF BARRELS PER DAY; SOURCE: PROGRESSIVE CAPITAL PARTNERS

To be clear: Oil demand over the next 12 months has many unpredictable variables, and any estimate needs constant reassessment as both the oil price war and the COVID-19 situation can change rapidly.

Still, with such levels of over-supply, global oil inventories are surging at an unprecedented pace. We, therefore, estimate that from the start of January to the end of June 2020, stocks of around 1,700 million barrels (mb) will have been established (+/- 300 mb).

This excess supply will partially go into on-shore storage facilities (including strategic petroleum reserves - SPR), with the remainder being put into floating storage, i.e., tankers.

The total available land storage capacity is about 6,900 mb, roughly 70% of which, we estimate, will be filled up as of April 2020. Land storage and SPR are typically never filled up to 100%. Therefore, there is less than 2,000 mb land-based capacity available.

CONTANGO - AN OPPORTUNITY FOR PHYSICAL ARBITRAGE

As stated, the collapse in oil demand has pushed oil prices sharply downwards, and into a strong contango. On April 16th, the nearby Brent Crude contract Jun-2020 traded at USD 28, and the Dec-2020 forward contract traded at USD 37, a difference of USD 9.

This large contango offers an opportunity for physical arbitrage: A trader could buy two mb Brent Crude to fill a Very Large Crude Carrier (VLCC), at USD 28 per barrel, store it on the ship for six months, and immediately sell the oil forward six months in the futures market at USD 37. As long as the expenses for tanker charter, financing, and arrangement fees are smaller than USD 18m, the trader is set to lock in a risk-free profit.

Based on these metrics, the VLCC day-rate floor for six months charters is around USD 86,000 per day (time charters typically trade at a discount to spot rates). We believe that oversupply in the near-term is inevitable, causing a continued wave of stockpiling. On-land storage facilities are likely to reach their limits within the second quarter of 2020, underpinning the need for floating storage.

SINCE THE BEGINNING OF MARCH, THE VLCC SPOT RATES HAVE TRADED BETWEEN USD 150,000 AND 250,000 PER DAY. THESE RATES STAND AGAINST BREAK-EVEN COST OF USD 28,000 PER DAY.

Floating storage is now being booked, and we expect the demand to remain supportive, as ship-brokers project that the equivalent of more than 200 VLCCs could leave the market for 6-12 months. To put this into context, the entire global VLCC fleet currently consists of 815 vessels.

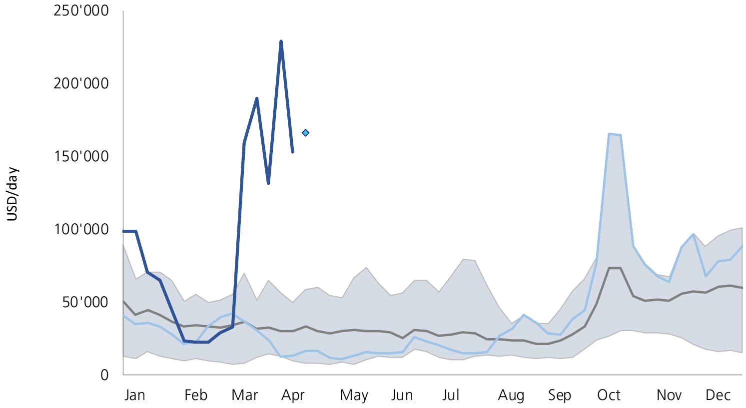

FIGURE 2 - VLCC SPOT EARNINGS (USD/DAY); SOURCE: CLARKSON PLATOU SECURITIES

So, tanker owners are the primary beneficiaries. At the moment, it looks like Q2 2020 could be one of the most profitable quarters in history for large crude carriers. Since the beginning of March, the VLCC spot rates have traded between USD 150,000 and 250,000 per day. These rates stand against break-even costs of USD 28,000 per day.

We expect strong cash-flow generation for tanker companies over the coming six to nine months, and, with it, a rapid value build, even without appreciation of the value of their fleets.

In our opinion, this development is not yet fully priced into tanker company valuations. The market realized around March 24th that these mind-blowing cash flows are about to come, and prices of tanker equities jumped between 20-30% over the following days. In the light of OPEC+ production cuts, tanker stocks have given back a large part of these recent gains and trade at attractive valuations, in our opinion. There are a lot of tanker companies that still trade at a discount to NAV and expected P/E ratios of around three times 2020 earnings.

THE RISK – FURTHER PRODUCTION CUTS

WE BELIEVE THE MARKET IS IGNORING THE FACT THAT TANKER COMPANIES ARE CURRENTLY EARNING SUBSTANTIAL AMOUNTS OF CASH AND BUILDING UP VALUE.

Seasoned market participants remain skeptical by nature and wonder how long this bonanza will last. The market consensus fears that, after the cash flow party for tankers in Q1 and Q2, a hangover will ensue in Q3 and Q4 2020, and possibly last into 2021.

At first glance, the current situation looks tough for tankers. Global oil demand is expected to be down around 25 to 30 mbd during the expected peak stress periods in Q2 2020, the new supply/demand balance is likely lower than at the start of the year, and OPEC+ producers are planning to cut production between 9.7 – 5.8 mbd until April 2021.

This combination would generally be very negative for tanker rates, if it were not for the floating storage demand and the contango. Moreover, we give the probability of further oil production cuts, and even the proper implementation of the current agreed-on deal, a low likelihood.

However, should the global producers in the coming weeks come to a more stringent oil agreement that is quickly implemented (before the storage capacity is filled up), then tanker demand will fall quickly and remain low in Q3 and Q4, and likely also in 2021, as growth in oil demand would be covered from storage. In such a scenario, charter rates are likely to drop even below the tanker companies' break-even costs.

The market fears that with lower supply and less contango, storage will be unwound and more tanker capacity will become available starting in Q3.

We do not dispute that demand for tankers will likely be lower starting in Q3. However, we believe the market is ignoring the fact that tanker companies are currently earning substantial amounts of cash, building up value, and that the fear of low charter rates is exaggerated. We expect oil demand to recover and the market to find a new equilibrium by Q4 of 2020. At that point, the 1,700 mb oil stock will gradually be absorbed back into the market.

We think there is a significant difference compared to the 2008/2009 period, the last time the market was in such a super-contango. The critical difference is that the order books for tankers today stand at a very low level of 7% of the fleet, compared to a level of 50% back then.

Moreover, we believe that many of the older tankers that now go into the floating storage market are unlikely to come back once their storage contracts are over, and the charter rates are lower again. Those tankers will likely be sold for scrap.

CONCLUSION

Despite the turbulent times, we believe that tanker companies will benefit strongly from the current extraordinary charter rates, which will help the stocks to make solid returns via dividends and price appreciation.

The attractive valuation in combination with this outsized earnings power over the coming months should more than compensate tanker owners for the period of weaker earnings, which is likely during the time when the currently accumulated storage will be unwound. This is particularly true as the medium-term outlook is bullish with the fleet supply remaining contained.

THE AUTHORS

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