Tsakos Energy Navigation Preferred Shares: Despite Risks, Attractive +10% Dividend Yield, Capital Appreciation Potential

Key Takeaways:

- Stable dividends
- Long term chartering policy provides cash flow visibility
- Consistently de-leveraging the balance sheet
- Discounted price of preferred shares offers capital appreciation potential

If you are an income-focused investor, these preferred shares are worth considering. Despite the risks (such as a high debt load, a growing amount of preferred share dividend payments, significant fleet depreciation and the first decrease in oil demand since 2009), there are reasons to believe this investment opportunity is very attractive. For example, the company has historically navigated through many crisis situations, thanks in large part to its fixed-rate chartering policy. Further, the company has a diversified fleet and a consistently improving debt profile (albeit with growing preferreds). Further still, efforts to improve the common stock's price (via a reverse stock split), the expected recovery in charter rates (from an anticipated oil demand rebound in 2021) and a possible tanker supply imbalance (created by the implementation of IMO regulations), all bode well. Overall, we like the deeply discounted price on the preferred shares, especially considering the big stable dividend payments to investors.

Overview

Tsakos Energy Navigation Ltd. (TNP), a Bermuda-incorporated company having its common and preferred shares listed on the NYSE, is one of the largest independent transporters of energy in the world. The company currently operates a fleet of 65 double-hull vessels, one LNG carrier, two Suezmax tankers, and up to three Suezmax DP2 shuttle tankers under construction. The fleet is well-diversified constituting a mix of crude tankers, product tankers, and LNG carriers, exceeding 8.0 million dwt.

The company's current roster of outstanding preferred shares includes five sets of preferred shares with a total liquidation value of $435 million.

Preferred Stock	Preferred Stock Feature	Outstanding Preferred Shares	Face Value	Liquidation Value ($ million)	Coupon Rate	Current Price*	Premium / (Discount) to Face Value	Current Dividend Yield	Call Date
Series C	CRPP**	2,000,000	$25.00	50	8.875%	$25.33	1%	8.76%	10/30/2018
Series D	CRPP**	3,400,000	$25.00	85	8.750%	$21.18	-15%	10.34%	04/29/2020
Series E	Fixed-to-Floating CRPP	4,600,000	$25.00	115	9.250%	$19.85	-21%	11.64%	05/28/2027
Series F	Fixed-to-Floating CRPP	6,000,000	$25.00	150	9.500%	$19.74	-21%	12.06%	07/30/2028
							Average Dividend Yield	**10.70%**	

* As on 09/03/2020

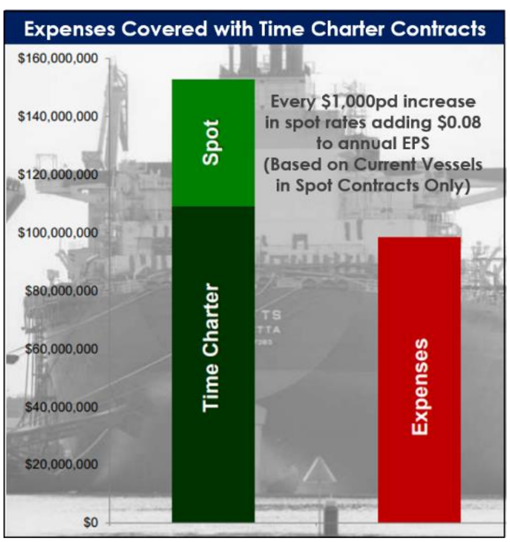
** Cumulative Redeemable Perpetual Preferred

Source: TNP Regulatory Filings, Blue Harbinger Research

In addition to the preference shares listed in the table above, TNP has $35 million of Series G redeemable convertible perpetual preferred shares outstanding, which were issued to OMP, a maritime and offshore energy institutional investor, in a private placement in September 2019. These preferred shares are convertible into common shares at any time, at the option of the holder, at a conversion price of $3.00 per share. Within Q1 of 2021, any outstanding shares will, subject to certain limitations, be mandatorily exchanged for non-convertible perpetual preferred shares with a 7.50% coupon to be issued by Shyris Shipping, a crude oil tanker owning subsidiary of TNP.

Long Term Chartering Policy Provides Cash Flow Stability

TNP has a policy of locking in medium to long term fixed-rate or profit share contracts with

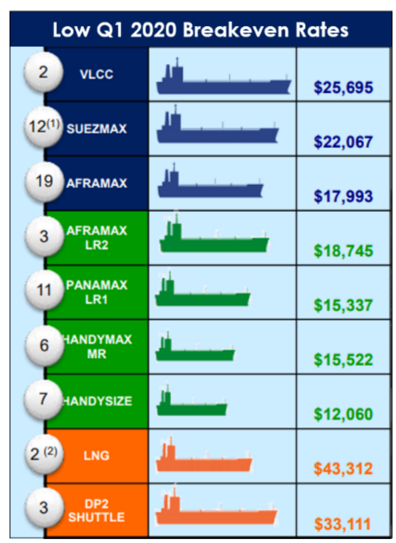


Source: [TNP Q1 2020 Earnings Presentation]

Additionally, the recently announced long-term charters for the building of up to 3 Suezmax DP2 tankers adds about $250 million in minimum time charter income, thus providing further cash flow visibility.

well-known industrial companies, while also maintaining vessels to leverage from spot rate exposure. The fixed-rate time charter contracts help the company cover its expense obligations, while having vessels on spot rate exposure helps it increase its profitability. This secures the company's revenue base to a large extent and also provides stability to future cash flows.

For example, TNP's locked-in contracts at the end of Q120 at time charter rates are sufficient to cover its expenses, and any additional contracts at spot prices will add to its profitability, which is further augmented by the low breakeven rates on its fleet. From vessels in spot contracts, for every $1,000 per day increase in spot charter rates, TNP's annual EPS increases by $0.08. This has provided the company a solid revenue base to grow its earnings, despite the unfavorable market cycle.



Consistently Improving Debt Profile

TNP has been consistently reducing its debt load and has paid back $282 million from its peak debt level of ~$1.8 billion in 2017. While the debt load at $1.5 billion is still high considering the Net Debt/LTM EBITDA ratio of around 4.5x, it is back by $2.7 billion worth of hard assets on the balance sheet. In other words, in a highly unlikely to happen hypothetical scenario of the company going bankrupt, it has a $1.2 billion cushion to service its preferred and common shareholders.

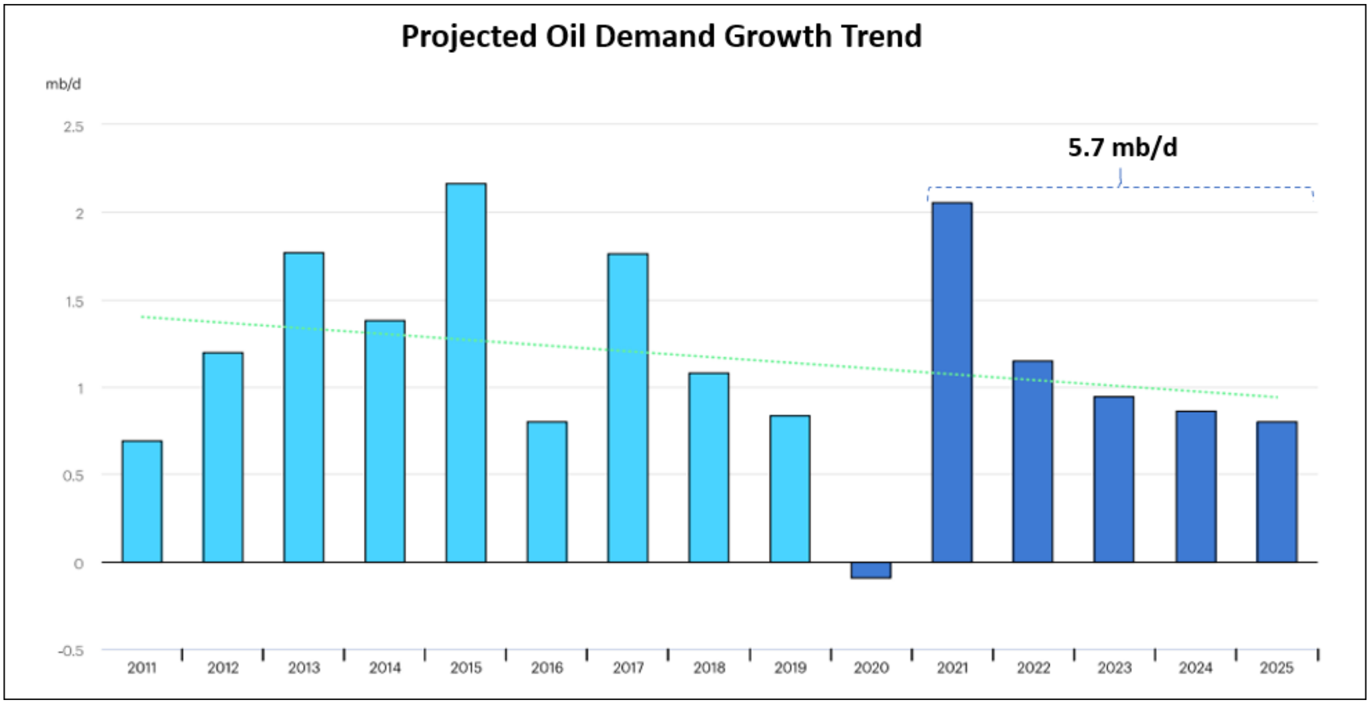
Also, the interest coverage ratio, which is around 2.6 times, provides the company with a reasonable amount of leeway to service its debt costs going forward.

Source: [TNP Q1 2020 Earnings Presentation]

Expectations of V-Shape Recovery in Oil Demand Growth in 2021

As per the [International Energy Agency] (IEA), global oil demand is expected to contract for the first time in 2020 since the global recession of 2009 due to the impact of the coronavirus pandemic. As the world steps up its fight against the pandemic, progressive recovery in oil demand is expected through the second half of 2020. Nonetheless, the large magnitude of the drop in the first half of 2020 will lead to an overall decline in global oil demand of around 90,000 barrels a day compared with 2019.

However, a sharp rebound is expected in 2021, with strong growth in oil demand coming from Asian countries, particularly China and India. As a matter of fact, China and India are expected to drive about half of the expected global oil demand growth of 5.7 million barrels per day (mb/d) through 2025.



Source: IEA

We believe TNP, with its industry-leading diversified fleet, is well-positioned to benefit from the expected rebound in oil demand, and with increased oil volumes naturally supporting the pricing for oil transportation services, profit margins are expected to improve going forward.

Opportunity from Possible Tanker Supply Shock due to IMO Bunker Rules 2020

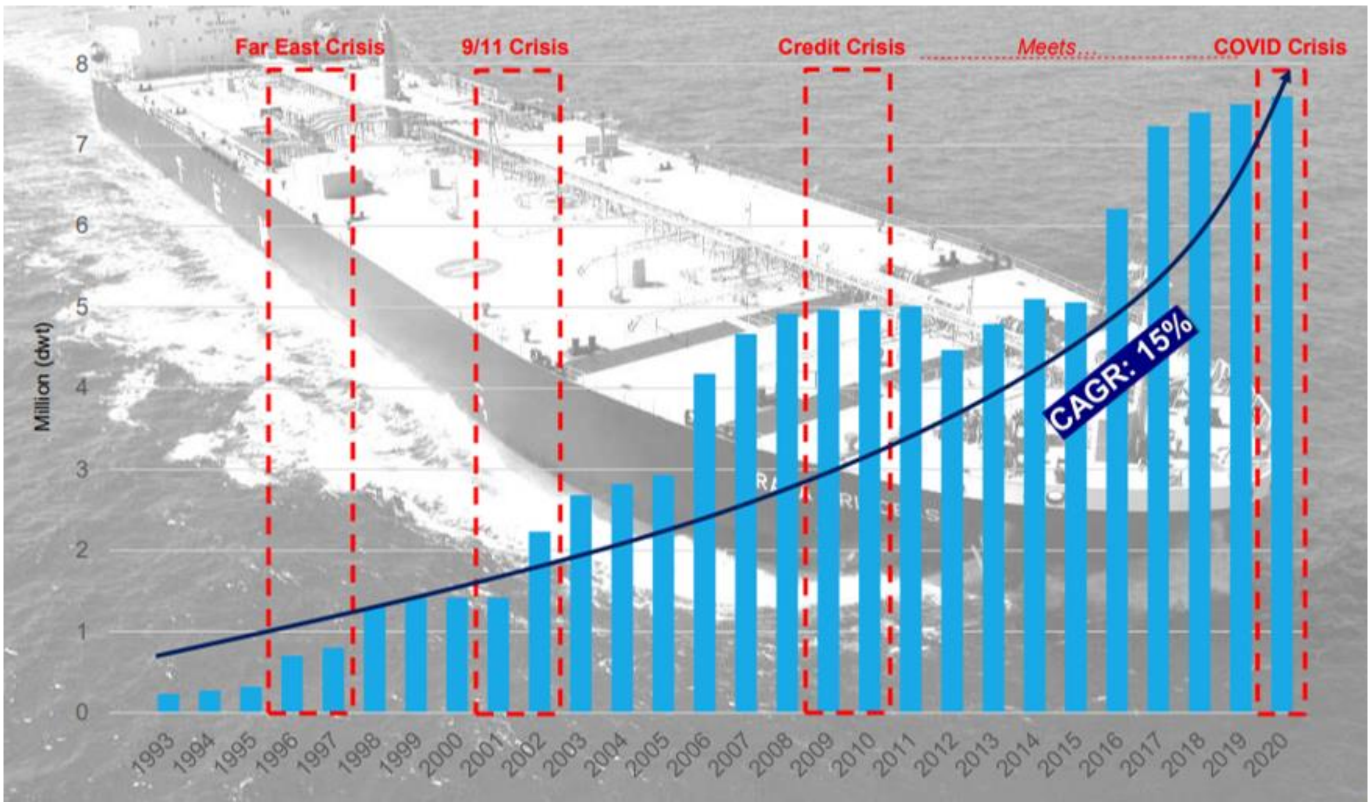
According to the International Maritime Organisation (IMO) bunker rules implemented at the beginning of 2020, the marine sector will have to reduce sulphur emissions by over 80% by switching to lower sulphur fuels. The lower sulphur fuel costs more than the currently available marine fuel, and fitting scrubbers that help ships reduce sulphur content on tankers can be expensive – the estimated cost of retrofitting scrubbers is $4.0-4.5 million per ship.

This will lead to increased scrappage as investing such amounts in old ships will not be financially viable for many companies. Although the current scrappage activity is at a standstill due to the pandemic, we expect scrappage activity to rebound in the near term to possibly lead to a tanker supply-demand imbalance. Well capitalized companies such as TNP that have the balance sheet to invest in complying with new regulations will be at the forefront of fulfilling the vacuum created by such a supply imbalance. Additionally, the possible tanker supply imbalance will result in higher charter rates, which will further boost TNP's cash flows.

On the downside, the operating margins could be suppressed over a longer period of time in the future due to the higher marine fuel costs and due to the investments in retrofitting scrubbers in tankers.

History of Successfully Navigating through Crisis Situations

TNP has successfully navigated through many crisis situations in its operating history and even grown its fleet dwt annually by an impressive 15% through these periods (see chart below). This increases our conviction that the company will successfully navigate through the current COVID pandemic as well.

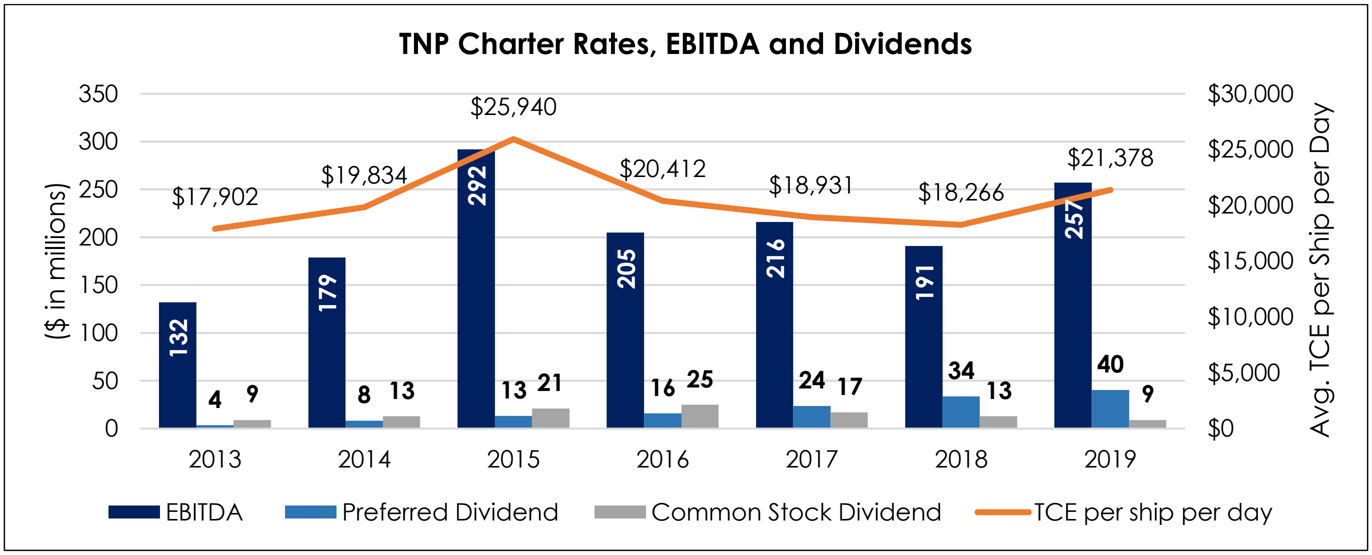


Source: [TNP Q1 2020 Earnings Presentation]

Dividend Safety

Preferred shareholders have priority over common shareholders when it comes to cash flows for dividend payments. And considering all of TNP's traded preferred shares are cumulative, even if the company withholds part of, or all, of the preferred dividends, they are considered to be in arrears and must be paid before any other dividends.

Historically, despite unfavorable market cycles and highly volatile charter rates, TNP has regularly paid dividends to both the preferred shareholders as well as common stockholders. In fact, during the current pandemic, in June of this year, TNP increased its previously announced common dividend of 5 cents by 50% to 7.5 cents via a special dividend. This was possible because the company generates far more EBITDA than what it pays out in dividends.



Source: TNP Earnings Presentations

Going forward, we strongly believe that the company will support its strong dividend track record, given its superior EBITDA generation capability, which is augmented by its policy of locking in medium to long term fixed rate or profit share contracts with well-known industrial companies and low breakeven rates on its vessels.

Valuation

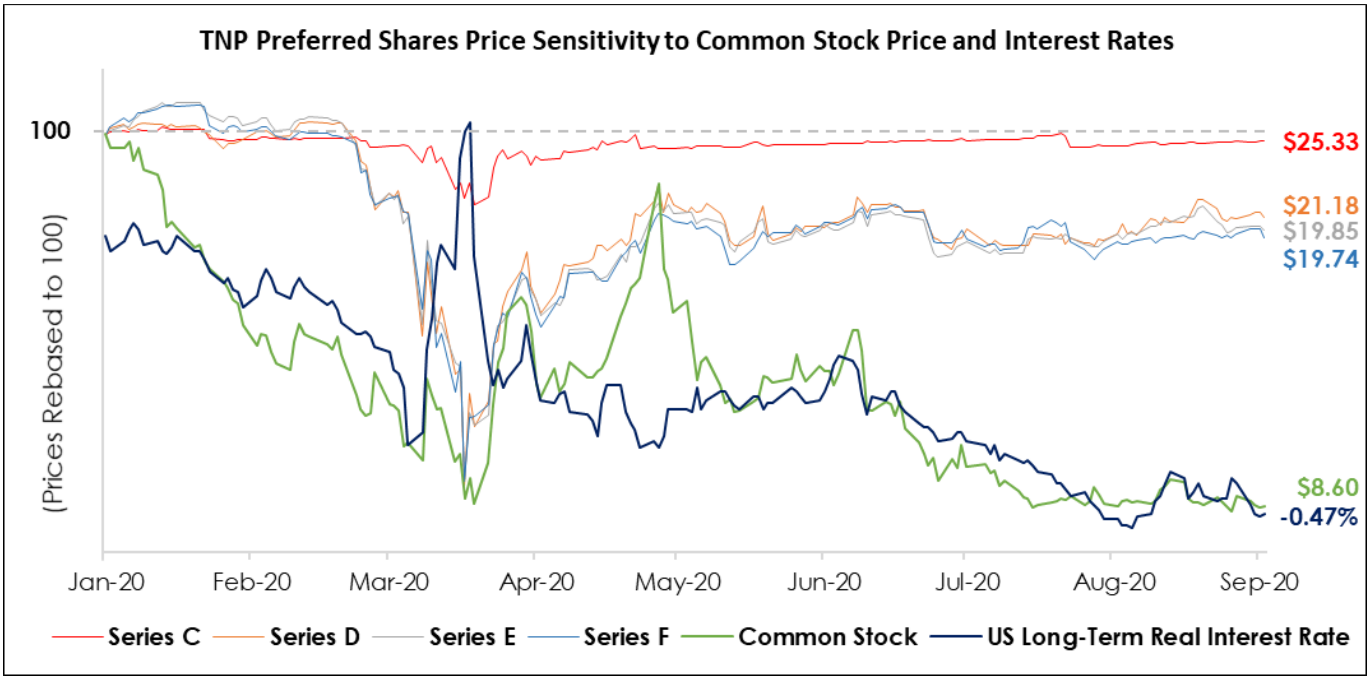
Preferred shares have a negative correlation to the prevailing market-wide interest rates, meaning their prices increase when interest rates decrease. However, interest rates are not the only factor determining the price movement. The perceived risk level of the company as well as the capitalization value the market assigns to the common shares also affect the price of preferred shares.

TNP's common stock has taken an immense beating since the start of 2020, which is primarily due to the depressed shipping market and volatile charter rates. This has also affected the price of TNP's preference shares.

The company's Series C preferred shares, which became callable in 2018, are intended to be repaid at par in the third quarter of 2020, and understandably the market is assigning a slight premium to the face value of these preferred shares.

Although Series D shares have also become callable, they are not expected to be redeemed in the near future. They are currently yielding 10.34% and trading at a 15% discount to their face value.

Series E and Series F preferred shares are not callable until 2027-28, and also become floating interest rate preferred shares post their call dates. They are currently trading at ~21% discount to their face value and are yielding ~12%.



Source: Yahoo Finance, US Department of Treasury, Blue Harbinger Research

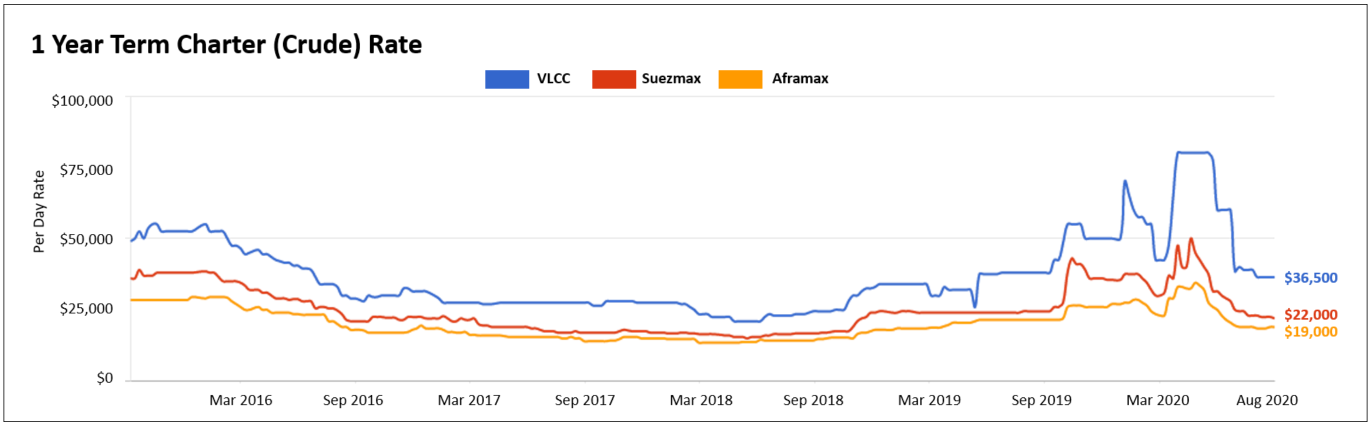
We believe these hefty trading discounts on the preferred shares of TNP are unwarranted and will eventually narrow as overall market sentiment improves, thereby offering ~20%+ capital appreciation potential versus current prices.

Risks

Slump in Oil Demand: The coronavirus pandemic has rattled the global oil market that was already facing challenges of weak oil demand growth amid high production capacities and tightening product specifications, augmented by the new vehicle efficiency measures that reduced demand for transport fuels. A further slump in the demand for oil could have a significant adverse effect on oil shipping companies such as TNP.

Higher Marine Fuel Costs: The IMO bunker rules implemented at the beginning of 2020 can potentially be highly disruptive to the pricing and availability of compliant fuels leading to increased marine fuel cost, which will put pressure on operating margins.

Volatility in Charter Rates: Given the cyclical nature of the tanker industry, tanker charter rates tend to be highly volatile, and can adversely reflect on the earnings power of companies operating in this industry.



Source: Fearnleys

The company's policy of locking in medium to long term fixed rate or profit share contracts mitigates the charter rate volatility risk to a great extent. As of 10 June 2020, TNP had 30 tankers under fixed time charter contracts and 16 under profit share contracts.

We currently own the Series E preferred shares, and believe Series, D, E and F are worth considering for a spot in your income-focused portfolio.

Conclusion

TNP's preferred shares (especially Series D, E, and F) are trading at deep discounts and offer attractive opportunity for capital appreciation. And that is in addition to big steady dividend payments.

We also like the preferred shares because the company has a consistent track record of managing through volatility (in charter rates), and because of the expected V-shaped rebound in oil demand in 2021 (as the economy re-opens). Further, the opportunities arising from a possible tanker supply shock (due to IMO regulations) could bring significant recovery in new charter rates, and bolster TNP's already stable and sustainable cash flows.