Seeking Alpha

Dividend Investing Ideas: Crude Oil Tankers

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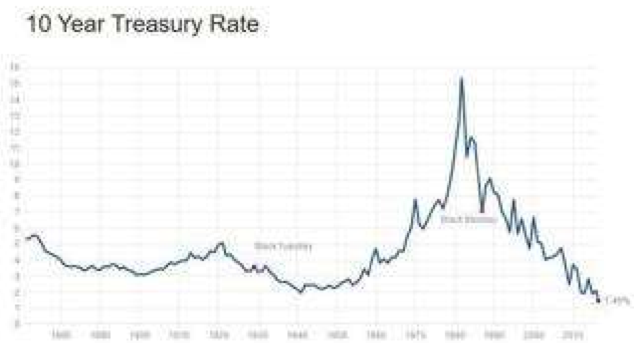
by: Kevin Quon

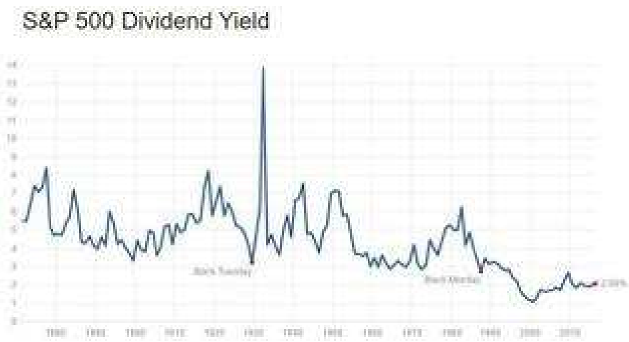
Summary

- Safe financial assets are becoming less viable long-term income plays in light of significantly decreased yields.
- Oil tankers continue to prosper from a fundamental shift in oil supply and demand.
- Constraining barriers to entry is helping to prevent an overcapacity of new tankers.

Income investors are finding it increasingly more difficult to find adequate yield from their investments. As of Friday, the 10-year treasury rate was at a low 1.46% and the dividend yield of the S&P 500 was 2.09%. A look at the charts below shows that through the years, the ability for investors to find safe income has been fleeting. By and large, it has been the case for both the debt and equity markets. This should not stir well for risk-adverse investors looking to find safety in their most conservative income components.

(Image Source #1 and #2)





In the pursuit for income, I would argue that it is becoming increasingly more dangerous to rely solely on the traditional assets of safety. Just as European and Japanese bonds have now entered into the territory of negative interest rates, overbought debt instruments have considerably suppressed yields in a way that might not provide the adequate income needed to compensate investors for the risk taken.

It might do investors well to begin balancing out such "safe" investments with those characterized by more opportunistic risk. While inherently allowing for more risk to enter into equation, underappreciated value can prove to be attractive by providing greater compensation than what is proportionate to the expected volatility.

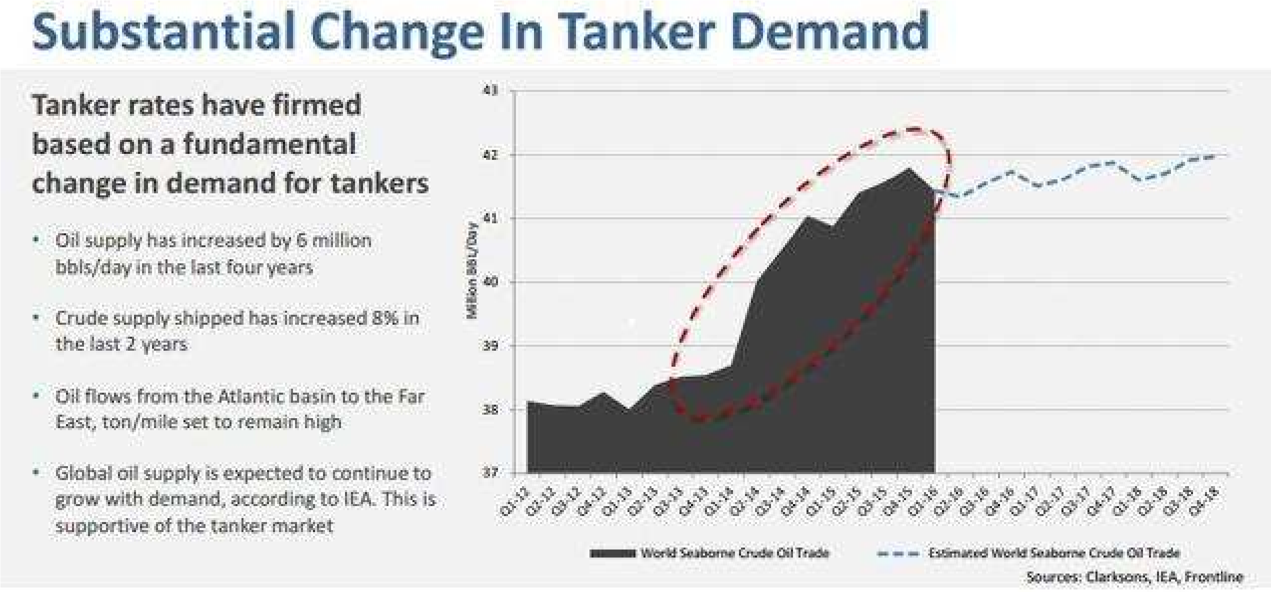
An Undervalued Market Sector

One such undervalued sector that income investors may find to be acceptable in the present is that of crude oil tankers. Historically, shipping has been an income-related industry where steady dividends are typically paid out by companies. Over the past decade, however, shipping as a whole has experienced a tremendous amount of volatility and dividends have wavered. Many segments (ex. dry bulk and container ships) within the industry continue to face difficult circumstances even today. The rapid fall of oil and commodity prices have also compounded the effect on crude oil tankers due to a prevalent fear surrounding companies with oil exposure. For some time, there has been much reason for investors to look over and avoid the supposed risk in crude oil tankers.

Yet a closer look at the market today also remains suggestive that fears over crude oil tankers may now be peaking. One significant reason for this is the changing dynamics now underway within the oil economy. The rapid rise of tight oil plays in America launched a unrestrained response by the conventional oil producers to flood the market with cheap crude oil in order to protect market share.

Seemingly overnight, the long-term prospect of keeping the global oil supply constrained and localized has greatly diminished. For the foreseeable future, an abundance of cheap oil will continue to be available because significant increases in oil prices would allow for the re-entry of more costly unconventional oil into the market. Simply put, the world is awash with an excess supply of crude oil. More importantly, barring a decline in market share there is little motivation for the current market producers to restrain themselves.

(Image Source)



This situation continues to favor tanker demand. On the one hand, lower oil prices have increased the overall volume of crude oil transportation. On the other hand, limited storage capabilities has prompted the use of some crude oil tankers as floating storage options. Farther trading routes have also increased in terms of miles needing to be traveled resulting in longer voyages. In the case of China, a need to also safely diversify its supply sources have likewise resulted in additional miles and traveling routes.

Yet along with increasingly favorable tanker demand, tanker supply continues to face increasing barriers to entry. For example, ship financing has become problematic for much of the shipping industry. Many of the tanker heavyweights remain under pressure from their other shipping segments such as dry bulk and container to speculate further into tankers. Struggles throughout the shipping industry has also prompted reforms to the shipyards that bring additional capacity online.

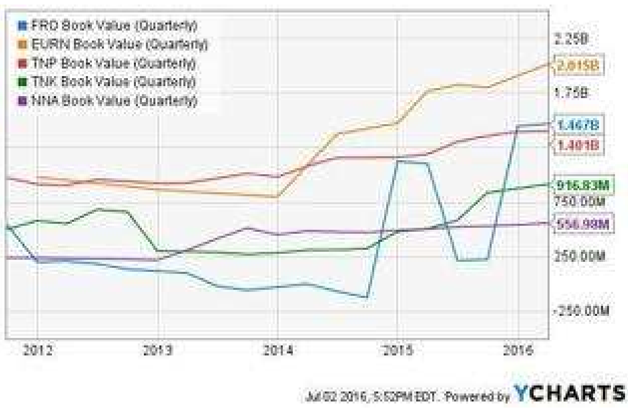
(Image Source)

While much fear exists that a rapid expansion of additional capacity will begin to adversely affect crude tanker rates, a look at the fleet age also suggests that much of the additional capacity will also be absorbed by the need to scrap aging ships. This can be seen in the graphic below, where very large crude carriers [VLCC] in particular are beginning to reach an age in which they are typically retired over the coming decade.

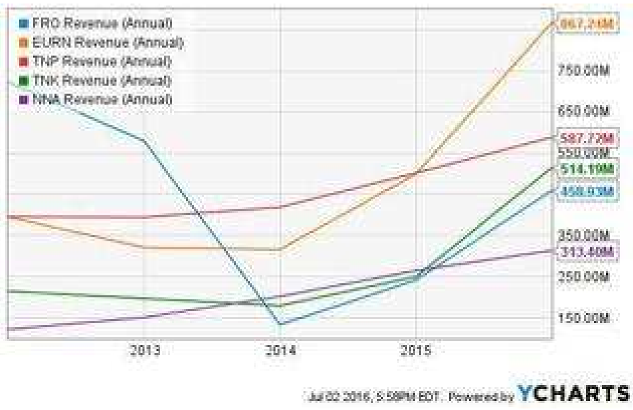
(Image Source)

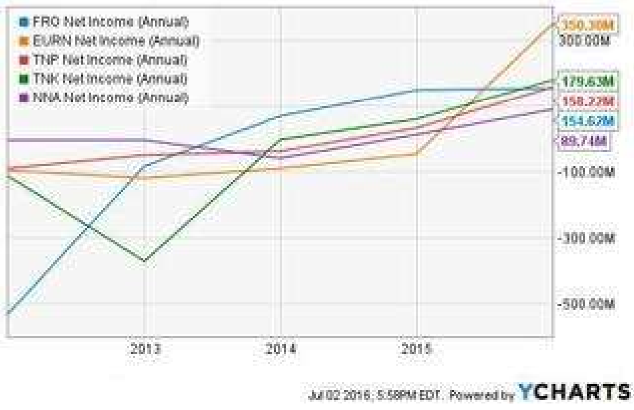
A Look At The Industry

When we look crude oil tanker companies, it is abundantly clear that most have seen their share prices fall alongside much of the shipping industry. The charts below include several of the leading public companies focused on tankers. As seen in these charts, market capitalizations on average now trade well below book values. While it may be the case that the book values themselves are inflated in light of a poor-performing market, the fact remains that the companies themselves are now highly profitable. This should continue to suggest the sector itself has become underappreciated.



As shown in the additional charts below, the same companies have seen increasing returns over the past few years and all have experienced positive net incomes. By and large, much of this transformation has occurred because of the fundamental shift in the oil economy as previously discussed. The slow turnaround time for ship creation often leads to imbalances that can prove favorable to tanker companies when major oil producers collectively agree to not restrain the supply of crude oil.





Yet most importantly for income investors is the fact that these companies have begun to share these higher profits with investors. A look at the table below shows that the dividend yields of these companies far outpaces that of the market as a whole.

Company	Last Price	Dividend Rate	Dividend Yield
Frontline Ltd. (NYSE:FRO)	$7.87	$1.60	20.33%
Euronav NV (NYSE:EURN)	$9.33	$1.64	17.58%
Tsakos Energy Navigation Limited (NYSE:TNP)	$4.93	$0.32	6.49%
Teekay Tankers Ltd. (NYSE:TNK)	$3.07	$0.36	11.72%
Navios Maritime Acquisition Corporation (NYSE:NNA)	$1.57	$0.20	12.74%

Investors would also do well to consider the leverage now utilized by these companies. While the market environment is not yet at the point for this to be a concern, extended debt-to-equity ratios can often put some companies at considerable risk should industry conditions deteriorate. As seen in the chart below, Euronav and Frontline in particular have been more balanced when it comes to this metric.

Final Thoughts

While the sector is clearly not without its risks, the crude tanker market appears to be one that is continuing to prosper from an external but fundamental shift in worldwide oil supply and demand. Many investors continue to view these companies to be unsafe and subject to large booms and busts. Yet another argument can also be made that the proper valuations of these companies have not yet emerged out of the last cycle. Oil tankers continue to now prosper and market valuations still continue to reflect a strong discount to their fair book values.

At the same time, a more risk-adverse supply market for the shipping industry has begun to emerge. Diversified shipping companies have been unable to take more speculative positions that they might have otherwise done to lead to a new tanker bubble. Financing restraints at the banks have also contributed to additional caution from an overcapacity build. In the same fashion, fundamental reforms at the shipyards have also decreased the ability for an oversupply in capacity to occur.

Overall, companies that specialize in crude oil tankers now find themselves in an operating environment that appears to be manageable for the foreseeable future. They also continue to pay very strong dividends that more than compensate for their inherent risks. With market values that are almost half of book value, investors are also provided with a significant discount to cushion investors should market prices begin to drop.

As finding a safe yield becomes an ever riskier prospect in light of rapidly falling interest rates, I would argue that investors could do well in considering some speculative risk found in opportunistic income plays. While clearly every individual should consider their own risk profile in making these decisions, such wagered opportunities could prove to be beneficial in sustaining meaningful incomes in an environment where stable income-based investments are becoming more difficult to be relied upon as a way to beat future inflation.

Disclosure: I am/we are long EURN, FRO, NNA, TNK.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Comments (5)

william l

How about setting out current VLCC, and Suezmax rates , over the last year and currently, to explain the share movement in share price.

03 Jul 2016, 03:30 AM

Dividend Hung(a)ry

Interesting article, good analysis. Thanks.

Constraints in VLCC capacity are very clear from the article. However,I do not see equally clearly the oil supply abundance. Even though "the long-term prospect of keeping the global oil supply constrained and localized has greatly diminished. For the foreseeable future, an abundance of cheap oil will continue to be available because significant increases in oil prices would allow for the re-entry of more costly unconventional oil into the market", however, is such a response guaranteeing demand for VLCCs? Im my words, cheap oil flows mainly from the Arab Gulf, but more expensive oil flows from many more places (currently, mainly from North America). As the oil price rises, the geographic mix of oil supply is going to change significantly, potentially changing the weight of existing shipping routes. How would that impact demand for VLCCs?

"The slow turnaround time for ship creation often leads to imbalances that can prove favorable to tanker companies when major oil producers collectively agree to not restrain the supply of crude oil."
As I interpret news, major oil suppliers (mainly OPEC) sooner or later may agree to restrain supply. How would that change the picture.

While interedted in the answers, EURN and FRO are worth further due diligence.

03 Jul 2016, 04:55 AM

Dividend Hung(a)ry

I checked the dividend history on nasdaq.com and split history on stocksplithistory.com of EURN and FRO. EURN only began paying dividend last year and pays in May and Sep. I consider this short history as THE BEGINNING at best. FRO had a reverse split early this year and only recommenced paying dividends last December after a 4-year pause preceded by decline/fluctuation of dividends. So,, they may be turning the corner.

03 Jul 2016, 05:20 AM

andysbling

DHT should be on the list...the GOOD list....

03 Jul 2016, 06:54 AM

Amalfi

Agree. DHT: Dividend yield: 17.83 %. No reason why it could not have been mentioned also.

As a general rule, it is more rewarding to focus on the supply side than on the demand side in shipping. 90 % of energy is used trying to predict demand: Will China boom or bust, will EU boom or bust, will electric cars make themselves felt the next two-to-three years, etc.

In reality, supply is easier and more predictable. Amazingly, only 10 % of energy is used on the supply side.

And on the supply side is where it gets interesting: Big banks are refusing to fund more ships. Private equity - Oaktree anyone? - has been burned badly and will not be back for a while.

This is makes oil tankers a rather "safeish" bet and with rock bottom share price, you get 6 - 20 % yield just for the waiting.

I' ll take that bet.

03 Jul 2016, 11:00 AM