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Royal Caribbean Cruises Ltd – Anchors aweigh

Investment thesis

- Royal Caribbean Cruises Ltd. is the second-largest cruise business in the world with revenue of $7.7bn recorded in FY12 and 5.5mn guests p.a.
- Overall the industry is recovering from the negative publicity spill-over due to the Costa Concordia sinking, the Carnival Triumph and Royal Caribbean's own Grandeur of the Seas fires as well as the impact of the 2008 global financial crisis (GFC).
- Because the business is cyclical the company has come under pressure from the crisis in Europe (currently the US accounts for 51% of its passengers).
- However, recently there is mounting evidence that Europe's economies have started a slow turnaround.
- Volume drivers include the global trend to leisure spend and the global economic recovery.
- Profit drivers include pricing, volume growth and increasing margins.
- Nevertheless risks remain for the industry especially relating to the pricing environment in the Caribbean, as well as regulatory risk, fuel-cost risk and the health of the global economy.
- We believe this is an efficient, well-run business with excellent cash flows (6 months in advance!) and in our view a stronger-than-expected recovery in the cruise consumer and a greater-than-expected recovery in cruise-ticket pricing will buoy the share price.

Figure 1: Royal Caribbean Cruises forecasts

Royal Caribbean Cruises				
Dec y/e	2012	2013F	2014F	2015F
EPS ($)	1.97	2.43	3.13	3.88
% growth		23%	29%	24%
DPS ($)	0.44	0.73	0.97	1.00
P/E	22.2	18.0	13.9	11.3
DY		1.7%	2.2%	2.3%
Share Price ($)	43.66			
12M Fwd P/E	14.3x			

Source: Bloomberg, Company reports, Anchor Capital estimates

Note FY12 EPS excludes $413.9mn in impairment charges

Figure 2: Royal Caribbean Cruises' metrics are:

Spot ($)	43.66
Mkt Cap $bn	9.6
12M trailing P/E	25.82
12M fwd P/E	14.3
10-year average P/E	16.1
FYE	31-Dec
P/Book ratio	1.10
12M fwd DY	1.67

Source: Bloomberg, Anchor Capital

What it does:

Royal Caribbean Cruises Ltd. is the second-largest cruise business in the world with revenue of $7.7bn recorded in FY12 and 5.5mn guests p.a. (the company welcomed its 50 millionth guest on board in August this year). The group owns six brands (Royal Caribbean International, Celebrity Cruises, Pullmantur, Azamara Club Cruises and CDF Croisières de France), as well as TUI Cruises through a 50% JV.

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Together, these brands operate a combined fleet of 41 ships (a total of 105,000 beds) around the globe with a selection of itineraries that call on approximately 460 destinations worldwide. The group also offers land-tour vacations in Alaska, Asia, Australia/New Zealand, Canada, Dubai, Europe and South America. The company has said that it will increase its fleet of ships to 47 by 2016. New ship costs are between $500mn and $1bn.

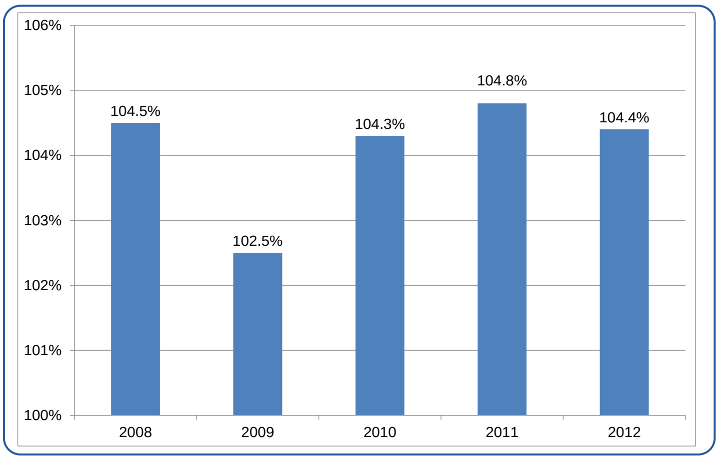
Figure 3: Royal Caribbean share price (31 December 2010 to date), $:

Source: Bloomberg, Anchor Capital

We see the profit drivers of the business as being:

- **Price:** Almost all cruises run at above 100% capacity – it is a case of how much they need to discount prices in order to fill beds and, in general, the company's capacity utilisation appears to be improving. Here it should be noted that when referring to above-100% capacity the figure includes the total number of paying passengers a ship can carry. The calculation for this number therefore includes third and fourth passengers occupying fold-away beds in an otherwise two-person cabin.

Figure 4: Occupancy rates (2008-2012):



Source: Company data, Anchor Capital

Background:

The cruise ship industry is still recovering from the negative publicity spillover from the Costa Concordia (which was operated by Costa cruises and cost 32 lives when the ship ran aground in Tuscany in January 2012) sinking and from the Carnival Triumph and Royal Caribbean's own Grandeur of the Seas fires earlier this year. The industry was also impacted by the 2008 GFC. However, with the industry estimated to be growing at c. 7% p.a. and the start of a turnaround in Europe we are positive on Royal Caribbean's potential going forward.

Key drivers:

The following are what we believe to be key volume drivers for Royal Caribbean:

- The global trend to leisure spend – *The World Travel and Tourism Council* expects leisure travel spending to grow by 3.2% in 2013 to $3,324.1bn, and to rise by a further 4.6% p.a. to $5,196.0bn in 2023. According to the Council, global leisure travel spending generated c. 76.0% of direct travel and tourism GDP in 2012 ($3,222.1bn) compared with 24.0% for business travel spending ($1,017.4bn).
- The global economic recovery: The recovery in the US is sure to boost US consumer spending (the US already accounts for 51% of its passengers) and the earlier-mentioned recovery of the European consumer off a very low base will also will also boost the number of European passengers. Asian travel is also increasing and going on a cruise is well suited to that region's 'group travel' mind set.

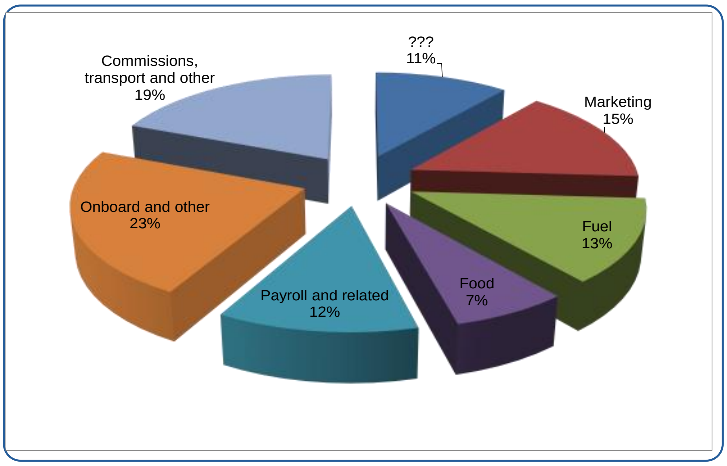
- **Volume growth:** The company has six new ships on order (21 in fleet, 41 including JVs) with the next big cruise liner arriving in November 2014. Management indicated in their 2Q13 results that ongoing discounting in the Caribbean has only modestly impacted their forecasts and that demand in the Caribbean region remains robust (see Figure 5). In Europe, operating trends continue to improve YoY, with net ticket yields expected to post increases in the mid-single digits for 2013. Both price and booked load factors were higher YoY in 2H13. The company also expects volumes to grow 5% p.a. on a four-year view, while overall the industry is expected to grow at 7% p.a.

Figure 5: Global itineraries and deployment trends:

Source: Cruise Lines International Association (CLIA)

- **Increasing margins:** Industry analysts are forecasting big margin improvements and earnings growth for the company as the global market recovers. *JPMorgan* is projecting a margin increase from 10.5% in 2013 to 14% in 2014. See major costs in Figure 6 below.
- **Carnival cruises:** Carnival is the world's biggest cruise business but recent troubles at the company including engine problems, repairs and cancelled cruises have benefitted competitors like Royal Caribbean. While Carnival tries to attract customers by offering more promotional activity and discounts, companies like Royal Caribbean's revenues and ticket prices are improving.

Figure 6: Royal Caribbean costs, FY12



Source: Company data, Anchor Capital

Risks:

Below we highlight the possible risk factors facing the company:

- Overall industry risk: This relates in a large part to the pricing environment in the Caribbean especially in the fourth quarter (a period when the industry is focused on that region).
- Investor sentiment towards consumer discretionary shares could also erode further and valuation multiples could contract.
- A more aggressive escalation in fuel costs than what the company is currently expecting could have a negative impact on profitability.
- Overcapacity in the cruise industry due to new competitive supply could negatively affect pricing if demand does not outstrip supply growth; and
- Regulatory and generic investment risks such as a weakening global economy or unfavourable legislative changes in the US and/or internationally could significantly impact the company's bottom line. For example in August a US senator introduced legislation to take away the loopholes in the US tax code which permits cruise lines to avoid US taxes on its foreign flagged cruise ships. It should be noted though that this is not law yet but has merely been put forward by the senator.

Conclusion:

We believe this is an efficient, well-run business and a great value-for-money holiday as anyone who has been on any of their cruises can attest. The company also gets paid (on average) an unprecedented six months in advance resulting in excellent cash flows underpinned by a strong NAV.

The cyclicality of the cruise-ship business which tends to move in line with economic conditions has seen the company come under pressure from the economic crisis in Europe (currently the US accounts for 51% of its passengers). However, we are encouraged by the group's comments on Europe that fundamentals have turned a corner and that it expects positive net yields from the region going forward as the European recovery boosts passenger numbers. Overall, there is thus growing evidence that Europe's economies have started to turn around. Royal Caribbean also offers investors a play not only on the European market recovery but the global market recovery as well. There also seems to be a stronger-than-expected upturn in the cruise consumer and a greater-than-expected uptick in cruise-ticket pricing while better-than-expected global economic growth should fuel increased demand for leisure travel. With all of the company's metrics improving, strong volume and profit growth is projected. On the negative side the group's RoE is currently not that impressive, but it is projected to increase from 6% in 2013 to 10% in 2014.

Royal Caribbean has a 11x fwd P/E to 2015 and an average historic P/E of c. 14x. A 14x P/E on FY15 numbers would give a share price of $60, one-to-two years forward – the share price is currently around $43/share so investors are looking at an attractive c. 40% increase. The share is also trading at a 0.9x NAV of $42/share. Given the current low RoE a big premium is not warranted, in our view, but we note that this trend should improve going forward.

Peter Armitage

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