CCL/NCLH/RCL: SUMMARY FROM MANAGEMENT MEETINGS

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CALL TO ACTION

This week, we met with RCL, CCL, and NCLH managements in Miami. The tone was quite varied among the 3 companies with CCL the most cautious and NCLH the most optimistic. All operators were quite bullish on the long-term outlook for the industry. Falling fuel costs are a major tailwind in 2015 for CCL, RCL, and NCLH in that order. However, the operators, particularly CCL, corroborated our assertion that Europe pricing is under pressure in the face of a weakening economic backdrop and accelerating supply growth (+5%) in 2015.

CCL is the most exposed to European sourced customers and indeed we are most concerned with that stock as it sits at a 52 week high. Management didn't exactly bolster the long thesis that yields should outperform the industry (furthest from peak theory) as brand building costs abate (they probably won't). On the other hand, NCLH seems the best positioned for 2015.

MANAGEMENT COLOR

RCL

RCL management is generally optimistic about new ship yields and yield growth from new markets e.g. China. In the Caribbean, the promotional environment has not abated and the promotions we've seen indicate that Wave 2015 may have started earlier than usual. Fuel is obviously a big tailwind and is more than offsetting unfavorable FX. We remains concerned with the unfavorable demand/supply environment in Europe that could worsen. However, valuation looks reasonable to us at these levels and RCL does have some levers to pull should the economic conditions worsen in Europe. Not much to do with the stock long or short here, in our opinion.

- Hedgeye noted that there has been some promotional deals in the industry this December and Wave 2015 may have begun a week or two earlier than usual (we will have another note on this shortly). The promotional pressures from the Caribbean market may have driven this earlier start.
    - Management acknowledged the potential early start but opined that the promotional environment has been rational for Wave in management's opinion
- Europe:

  - Industry supply will increase 5% in 2015. With RCL, European capacity will increase 4-5%.
  - 1/3 of RCL European business is non-European sourced – RCL can increase this if the European macro deteriorates
  - TUI cruises has done well in Germany. TUI is probably the most profitable cruise brand.
  - Fly-cruise programs (popular among Canadians) will benefit from lower airfare. It's just a pass through business for RCL.
- Caribbean:
  - Industry capacity growth: -5% in 2Q, -11% in 3Q, flattish in 4Q
    - 2015 capacity for RCL: flattish
- China:
  - Confident China can become 2nd largest market for RCL
  - Goal: A new ship per year
  - Great relationship with Chinese government
  - Major ports: Shanghai, Tianjin
  - 4,5,6 night voyages
  - Retail is the 1st onboard spend category among Chinese cruisers
  - Need better facilities throughout the rest of Asia
- Australia:
  - Overcapacity is a concern for 2015. The newer ships need to dock there.
- Confluence of river and ocean cruising
  - Viking will be a formidable competitor to Azamara
  - Celebrity vacation packages (which bundle river cruises) aim to keep families together for a longer time
- Given that the dollar is up an average ~10% versus the basket of currencies (Pound, Euro, Canadian $, Brazilian real, Aussie $) in 2015 while bunker fuel is on average down 25-30% YoY in 2015, the lower fuel expenses may outgain the negative impact from the stronger dollar. However, over the long term, these two opposing factors will converge and net out to zero.
  - About 1/3 of RCL's revenues are accounted for internationally

- Cannibalization fears from new ships: A legitimate risk but fully believe they can mitigate it by conducting revitalizations across older ships
- Supply growth is rational: 3-5% (2-4%, net of dispositions)
- 2015 Fuel grade mix (77% IFO 380, 23% MGO) will be unchanged from ECA regulations
- O3B satellite integration
    - On schedule for Caribbean-destined ships.
    - Talking about lighting up Europe as well. Maybe start with 7 night, family-oriented voyages.
- RCL has gotten rid of the build, build, build mentality which haven't worked out in the past. Instead, they are now focused on reining in excessive spending.
- Cruiser demographics
    a. RCL has adjusted loyalty programs to be based on number of nights cruised. This change has led to higher onboard spend among cruisers.
    b. Younger folks taking shorter cruises
    c. Royal Caribbean International brand: more couples
    d. Mid to high income is the consumer bucket most likely to spend
    e. Quantum/Anthem: targeting millennials given their desire to be connected throughout the voyage

CCL

Management seemed less optimistic than either RCL or NCLH although they provided a positive long-term outlook for the company and the cruise industry. Europe is a worrisome market in our opinion and the meeting didn't give us any more comfort in the potentially softening demand environment in the face of 5% growth in supply in 2015. More of CCL's customers on European cruises are European sourced than RCL which makes CCL more reliant on the European consumer – a negative in our opinion. The bull thesis that CCL should outperform on yields (further from peak) as their brands regain lost luster at the same time brand rebuilding costs abate looks less viable. Yields have not outperformed (nor do we expect them too) and elevated costs are a concern. Fuel is obviously a big tailwind and bigger for CCL than RCL/NCLH for 2015. Here are some takeaways:

- Was Wave 2015 earlier than usual?

    - CCL have seen some of the Wave promotions in November/December. But they may be targeted more for 1Q 2015 travel.
    - There will always be some discounting every day
- Europe
    - Pricing is now 'floundering'
    - Weeks ago, most people expected strong pricing improvement for 2015. Now pricing is looking more flattish for 2015.
    - Europe is in a little bit better shape than 2 years ago. Hopefully, cruisers can absorb all the new supply.
    - Opportunities to source more US passengers on Holland America and Princess
        - NA sourcing into Europe: 25%
    - Most of guest base is Southern European
    - Europe as a % of Carnival Corp's business: 30-35%
- Australia
    - 20% capacity increase in 2015 pressuring yields
        - Princess and Royal Caribbean are putting more ships there in addition to 2 HAL ships in November 2015
    - Would Carnival consider selling some of the old P&O Australia cruise ships?
        - Possible
        - At some point, all 3 P&O Australia ships will not be together. They will rotate in and out of Australia.
- China
    - Why put in existing ships rather than new ships?
        - Currently putting in smaller ships (2,000-3,000 passengers as opposed to 4,000 passengers in new builds)
        - All charter ships. It has been a challenge to find a charter for a 4,000 passenger ship.
        - May re-evaluate decision in 3-5 years
    - Purpose of the JV with China State Shipbuilding Corp and Fincantieri is solely to explore the possibility of building a ship in China
- 2015 Industrywide capacity growth

    - Caribbean: -1% to -2% for FY 2015
        - Up low single digits in 1Q
        - Down mid-single digits in 2Q
        - Down double digits in 3Q
        - Up a little bit in 4Q
    - Europe:
        - Up mid-single digits for FY 2015
        - Very consistent supply growth through all quarters
- New builds
    - CCL's new build order book share is less than 50%
- Spending
    - Has spent a lot of money on direct marketing
    - Costa new TV campaign
- Carnival Cruise Lines brand
    - In a tough demand environment, Carnival Cruise Lines brand is more exposed than other CCL brands while in a growing demand scenario, all CCL brands benefit at roughly similar levels
    - New CEO Christine Duffy will help rebuild the brand relationship with the travel agent community
        - The relationship was strained in the past because Carnival began to migrate to a more efficient, automated bookings system
        - Today, 75% of travel agent bookings are online for the Carnival brand
        - Online direct bookings have also been increasing for the Carnival brand
- Commissions and transportation costs
    - Lower air transportation costs in FY 2014
    - Commissions haven't moved much. They have been affected by direct bookings.
- Hybrid Satellites
    - Very small cost –basically installing an antenna on ships
    - 3rd party company needs to build towers so that the signal can reach the antenna up to 50 miles
    - Can get coverage on 75% of CCL's total berth days

    - Room for improvement in connectivity service on the other 25% of days
- 2.4% yield growth equates to 1% point improvement in ROIC

NCLH

Management seems very comfortable with demand expectations for Q4 and 2015. Caribbean is slowly recovering while the heavily-US sourced European itineraries are doing fine. Hawaii will continue to be a growth market. Fuel savings in 2015 will be less than that of CCL/RCL due to much of their 2015 fuel already hedged around a spot price in the mid-80s. However, NCLH should experience a nice lift to earnings in 2016 from lower fuel. The Prestige integration appears to be going very well and we continue to believe that the announced $25 million in synergies will prove conservative. In our opinion, NCLH is the best positioned among the cruise lines for 2015 although investors expecting a major reduction of fuel costs in 2015 may be disappointed. Fuel should provide a longer term tail benefit for NCLH versus RCL/CCL.

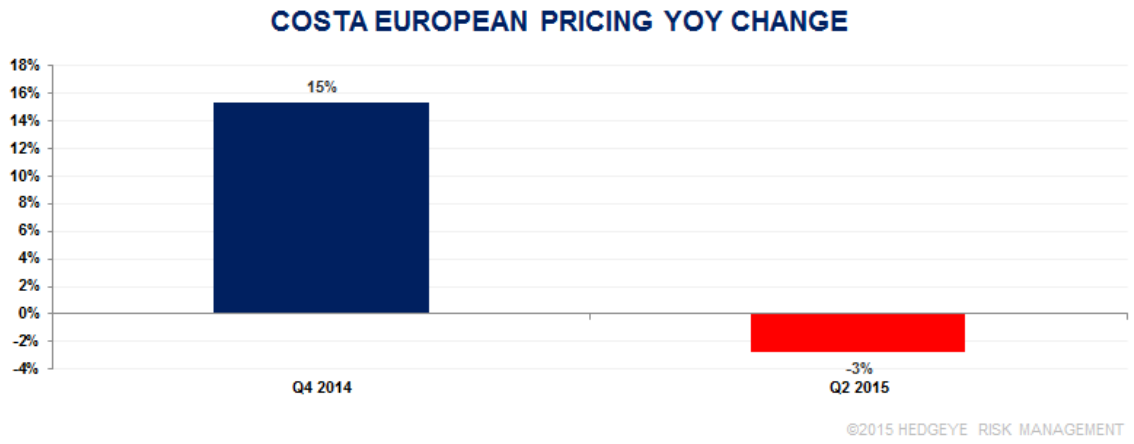
- NCL Wave 2015 campaign
    - Focus on onboard promos, similar to Celebrity's 1-2-3 GO program
    - Industry had a soft roll out of Wave in early December but mgmt says this is not unusual
- Oceania Insignia fire impact
    - Not a systemic issue and not all maintenance related
    - Insignia was coming out of an extensive dry dock in May/June 2014
    - No additional capex or additional dry dock days as a result of this incident
    - No impact on Oceania's other brands
- Fuel
    - Most of 2015 fuel was hedged at end of 3Q 2014 at a price in the mid-80s
    - Will have a much smaller fuel expense improvement in 2015 than CCL or RCL due to hedges
        - CCL estimated fuel expenses to be, net of derivatives, $475m ($650m gross) lower in 2015
    - Fuel proxy for forecasting: US Gulf Coast 3%
- Prestige

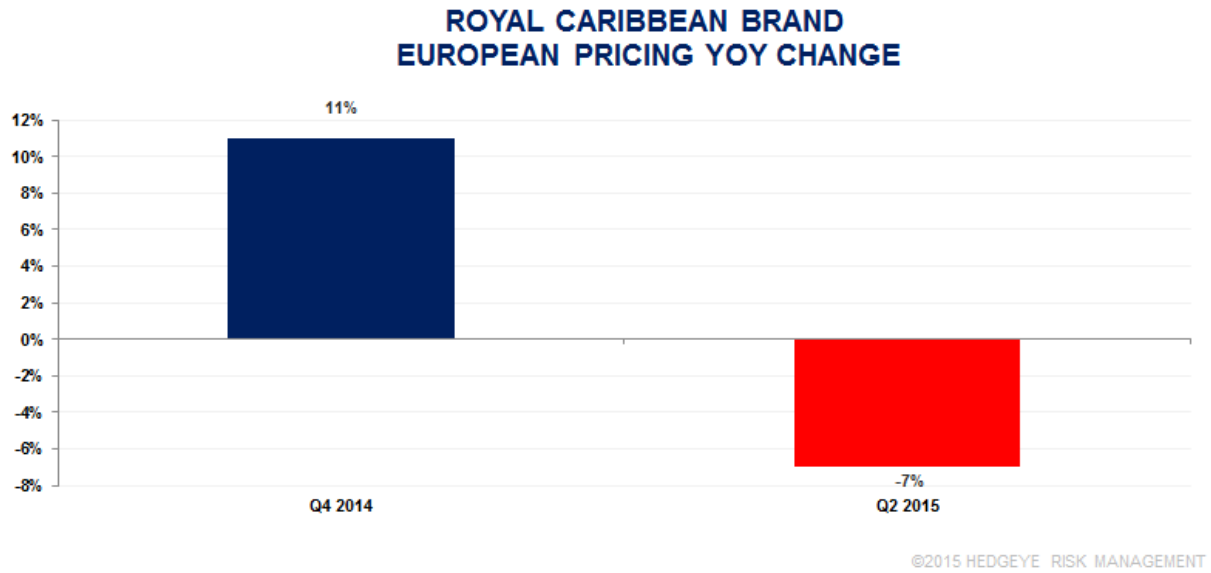
  - Market to fill strategy has worked well due to sticky loyalty from luxury cruisers
  - Hotel operations are all outsourced
  - Sees opportunity to grow their onboard revenues which has been a small part of their overall revenues
  - Highest yielding ship has been the oldest ship (Regent Navigator) due to its unique itinerary
  - 100% travel agent bookings
  - Why are commission costs so much higher as a % of revenues, relative to that of contemporary brands?
    - Prestige has a lot more bundled packages which include airfare and shore excursions costs that grossly inflate the commission line
  - Main competitors: Crystal, Seabourn, SilverSea
  - Main demographic: older baby boomers
  - Before Apollo bought Prestige, a competitor of NCL expressed interest
- Ocean Princess purchase
  - Immediately accretive
  - Cheap financing: unsecured debt at 2%s
  - New Oceania ship will be based in a "new and exciting destination"
- Europe
  - 21% of capacity in 2015 (16% Med, 3% Baltic, 2% Canary/other)—a little down YoY
  - Med has been strong but Baltic has felt some pressure due to Russian situation
  - 85% sourced from North America
- Asia
  - Pre-Quantum, NCL thought about moving an old ship to Asia
    - Was surprised that Quantum decided to base its home port in China. Profitability will be a key challenge for Quantum as yields are certainly higher but costs are higher too.
  - When NCL is ready to move into China, the natural starting point to do business is with Genting HK who is a major shareholder of NCL
  - Genting HK is building two small China-centric ships (similar to Breakaway but with less berths), expected for delivery in early 2016 and 2018, respectively

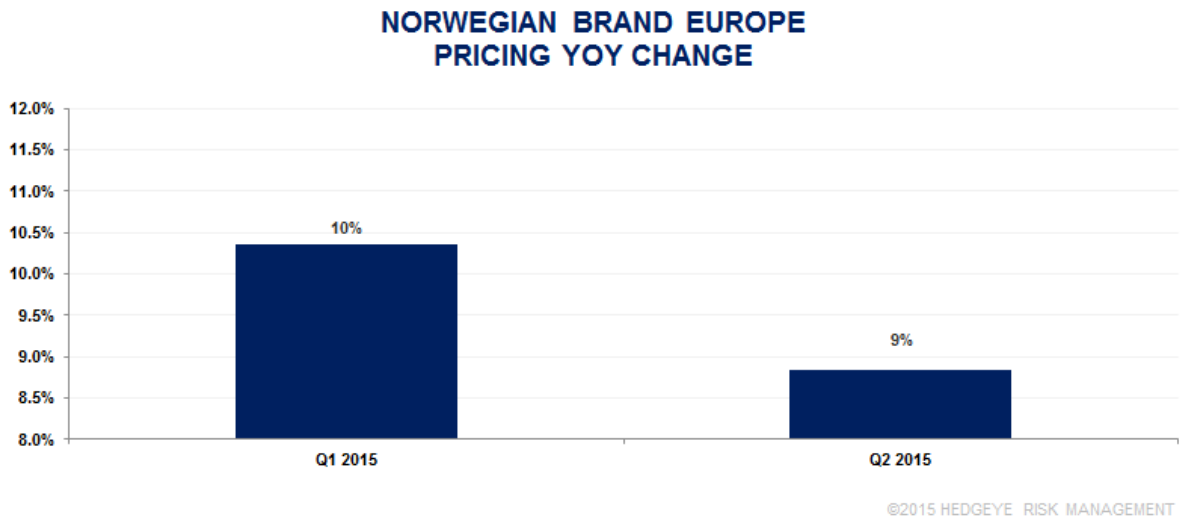
- Hawaii
    - Pride of America is highest yielding ship in Norwegian's fleet
    - Could convert to an Oceania brand in the future
    - The Jones Act protects NCL's monopoly in Hawaii
- New Markets
    - Excited about putting in a ship in South America
    - Returning to Baja, Mexico market (Carnival had a past incident there)
- International exposure
    - 15% of business is international
        - 10% euro-based, remaining split equally between Canadian $ and pound
- Ebola scare
    - Some Prestige customers did not want to travel internationally, particularly affected Asian itineraries
- Getaway/Breakaway
    - In hindsight, NCL debuted both ships too close to one another
- Dynamic Dining
    - Believes RCL copied them on Quantum
    - Believe it would be too costly to retrofit Dynamic Dining from traditional dining
- Dry dock
    - Committed to 3 dry docks/yr for Norwegian brand
- Cuba
    - Can fit in smaller ships once passage is allowed
- New ship return
    - Cash-on-cash return on new ships: 20%

THE HEADWIND: EUROPEAN PRICING

From our proprietary pricing survey as of mid-December 2014, we saw pricing deterioration in Costa and Royal Caribbean *(ex Anthem)* for FY 2015. Norwegian's European itineraries, on the other hand, has shown remarkable price resilience for FY 2015 so far.







CONCLUSION

2015 may shape up differently for CCL, RCL and NCLH. We remain cautious on the slowdown in European demand in 2015 amid growing capacity and difficult comps and CCL looks most at risk.

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