# RCL - EUROPE A THORN FOR THIS WALL STREET DARLING

## An in-depth analysis of Q1 and outlook

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Legend of the Seas at Dubrovnik, Gruž harbour

# CALL TO ACTION

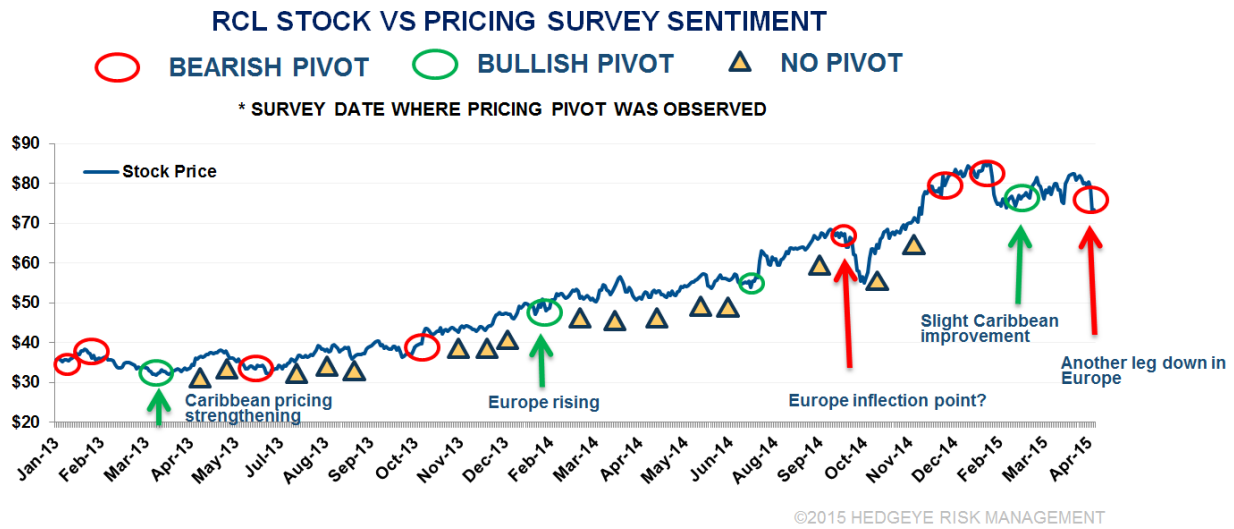
RCL was the darling in 2014, up 74% in share price. 2015 is a different story as the stock has lagged CCL and NCLH, -11% YTD versus +3% and +11%, respectively. While the stock clearly got ahead of itself, we also think RCL is facing some fundamental headwinds, particularly in Europe. For the last several months, we've been highlighting emerging weakness in Europe and it appears that RCL's Q1 and forward guidance corroborates our monthly pricing surveys.

Moving forward, 2015 estimates are no slam dunk as European uncertainty remains. Given our current estimates, we think there's a chance they miss Double Double targets in 2017. RCL's still elevated valuation leaves little room for error so we'll stay negative.

# THE EUROPEAN RISK

RCL stressed two factors that contributed to lower yield growth guidance – Eastern Mediterranean and weak onboard spend from non-US customers. However, we think the European issues are broader.

We've been highlighting that the biggest risk to RCL's growth was a slowing Europe from a macro and local consumer perspective. See our past pricing surveys and our notes, CRUISE CALL TAKEAWAYS (1/30/15) and "RCL: THE MATH BEHIND DOUBLE DOUBLE (12/10/14).




Amazingly, no one from the sell-side asked a question on yesterday's conference call regarding the slowdown stemming from the Eastern Mediterranean or European business in general.

Contrary to what some may think, at best, European pricing in 2015 has been choppy. While we do analyze Eastern Mediterranean pricing in our survey (please contact us for details), the focus should be on the bigger picture of Europe by brand. Historically, the Royal Caribbean brand and Celebrity brands account for 70-85% of total European ALBD for RCL.

To better understand pricing power or momentum, we are working on a weekly dataset that will be fully unveiled in the coming weeks. On a preliminary basis, the new dataset suggests that the Celebrity brand in Europe may have lost pricing power over the past several weeks at an accelerating rate, particularly in Q2. The same metric for the Royal Caribbean brand is more mixed for 2015 but by no means positive. The picture could be a lot worse if *Allure* wasn't stationed in Europe this summer season. European underperformance is the real risk for RCL.

RCL reiterated on the conference call that its forecast for net yield growth in Europe for 2015 remains 'mid-single digits' on a constant currency basis. Based on our datasets and accounting for a modest improvement in bookings YoY, the mid-single digit target may be difficult to achieve.

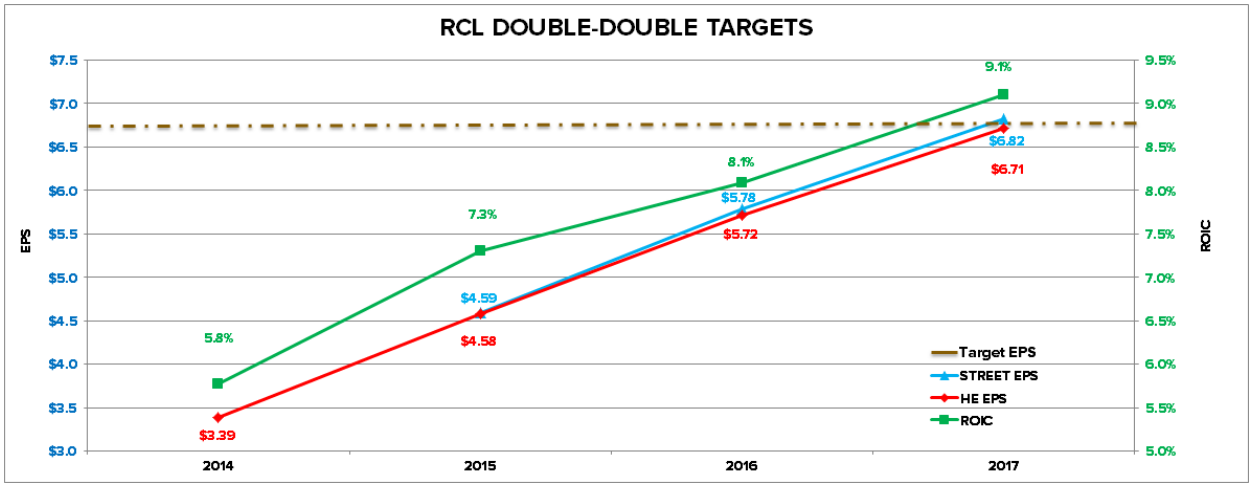
**Non-US onboard spend risk**

As we stated, we think the European pressure is more widespread than just disappointing onboard spending from Europeans. Blaming it all on Europeans is somewhat of an incomplete assertion. Offsetting Europeans, US customers have stronger purchasing power. Overall onboard and other spend actually beat our estimate in 1Q and continues to widely outperform ticket yield change. European cruisers generally spend less than US cruisers so they have less influence on overall onboard spend. Finally, CCL did not appear to have issues with European onboard spend despite a greater presence in Europe. Could this be a brand issue for RCL?

# DOUBLE DOUBLE SCENARIO REVISITED

Through the Double Double program, RCL management believes they can double their 2014 EPS and reach double digit ROIC by 2017. The ROIC goal will be much more difficult to achieve but even the EPS goal is at risk. On our current estimates, we calculate RCL will miss its goals.

One of our key concerns is whether the huge success of the new ships would cannibalize the older fleet, prompting substantial discounting to stay attractive to potential cruisers. While management has downplayed the risk of cannibalization, we believe it is already happening. New ship premiums (e.g. *Quantum*) are hitting records but that is mostly due to depressed pricing from the pre-2006 fleet.




Given the general modeling assumptions for revenue per berth that we laid out in "RCL: THE MATH BEHIND DOUBLE DOUBLE" and the new 2015 guidance, we believe the pre-2006 ships are significantly lagging behind. On the revenue side, we're assuming 50% revenue per berth premium (relative to its pre-2006 peers) for *Quantum* and 35% revenue per berth premium (relative to its pre-2006 peers) for *Allure* – given its outperformance in Europe this summer. This implies the pre-2006 ships' revenue per berth is generating **8% lower** revenue per berth this year versus last year. Even accounting for FX headwinds, this is a troubling statistic.

For 2016, we're assuming **zero** revenue per berth growth for the pre-2006 ships and an **incremental 10% (relative to 2015)** revenue per berth premium (relative to its pre-2006 peers) for *Quantum, Anthem, Allure,* and the *Oasis/Freedom Class* ships. In addition, we're modeling a whopping 90% revenue per berth premium for Oasis 3 and *Ovation.*

For 2017, we're assuming **-5%** revenue per berth growth for the pre-2006 ships and **unchanged (relative to 2016)** revenue per berth premiums (relative to its pre-2006 peers) for *Quantum, Anthem, Allure, Oasis 3, Ovation* and *Oasis/Freedom Class* ships. The competitive space will be very crowded with many new ships by the time 2017 comes. We think it will be a difficult environment to extend pricing power for the newer ships.

Given what we have seen in 2015, these revenue assumptions are not conservative for the pre-2006 ships and not aggressive for the brand new ships. As for the cost side, we lowered cost per berth slightly for 2015-2017 but it did not move the needle much for yield calculations. Hence, without new positive catalysts, Double Double targets could be in trouble.

## ASIA: A ONE-SIDED GROWTH STORY FOR NOW

Pricing is lagging bookings. As we mentioned in our note, CHART OF THE DAY: RCL: HOT ASIA BOOKINGS (4/13/15), above average bookings pace has driven the excitement in Asia but pricing is lagging behind expectations particularly in Singapore and Hong Kong. Could it be supply pressure?

*Quantum* premiums have been excellent but pricing power for its much older peers (*Mariner, Legend, Voyager*) have been mixed at best this year.

## 2015 ESTIMATES

Before the print yesterday, we were already below the Street's and company guidance for FY 2015 due to higher fuel prices and FX impact. The 2 cent increase in our FY 2015 EPS estimate is mainly due to better cost controls on opex and fuel consumption. However, we are moderating our FY 2015 yield forecast by 0.6% points to reflect the weaker demand.

| RCL ESTIMATES | FY 2015 HEDEGEYE (NEW) | FY 2015 HEDGEYE (PREVIOUS) |
|---|---|---|
| NET YIELDS (CONSTANT CURRENCY) | 3.7% | 4.3% |
| NCC EX FUEL (CONSTANT CURRENCY) | -0.7% | 0.3% |
| FUEL CONSUMPTION | 1379K | 1397K |
| FUEL EXPENSES | $833MM | $840MM |
| D&A | $830MM | $833MM |
| NET INTEREST EXPENSE | $269MM | $262MM |
| EPS | $4.58 | $4.56 |

## CONCLUSION

The Street continues to love RCL as evidenced by almost universal Buy ratings from the bigger US brokerage houses. We see a slowing growth story with continued demand risks in Europe. With sentiment and estimates still potentially too high, our negative bias remains intact.

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