RCL – THE MATH BEHIND DOUBLE-DOUBLE

What about cannibalization and FX?

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CALL TO ACTION

Granted, the cruise stocks will probably not go down as long as oil is falling 3% per day. However, we believe investors are baking in 2015/2016 estimates that are too high, certainly higher than current sell-side estimates. Adverse foreign currency moves will eat into the fuel related EPS tailwind that appears to be already discounted into the stocks.

In this note, we analyze the assumptions necessary for RCL to meet its *Double-Double* target on a ship-by-ship basis. Meeting or beating that target seems to be factored into the stock and while *Double-Double* is certainly achievable, cannibalization and a stronger dollar may be significant hurdles.

SUMMARY

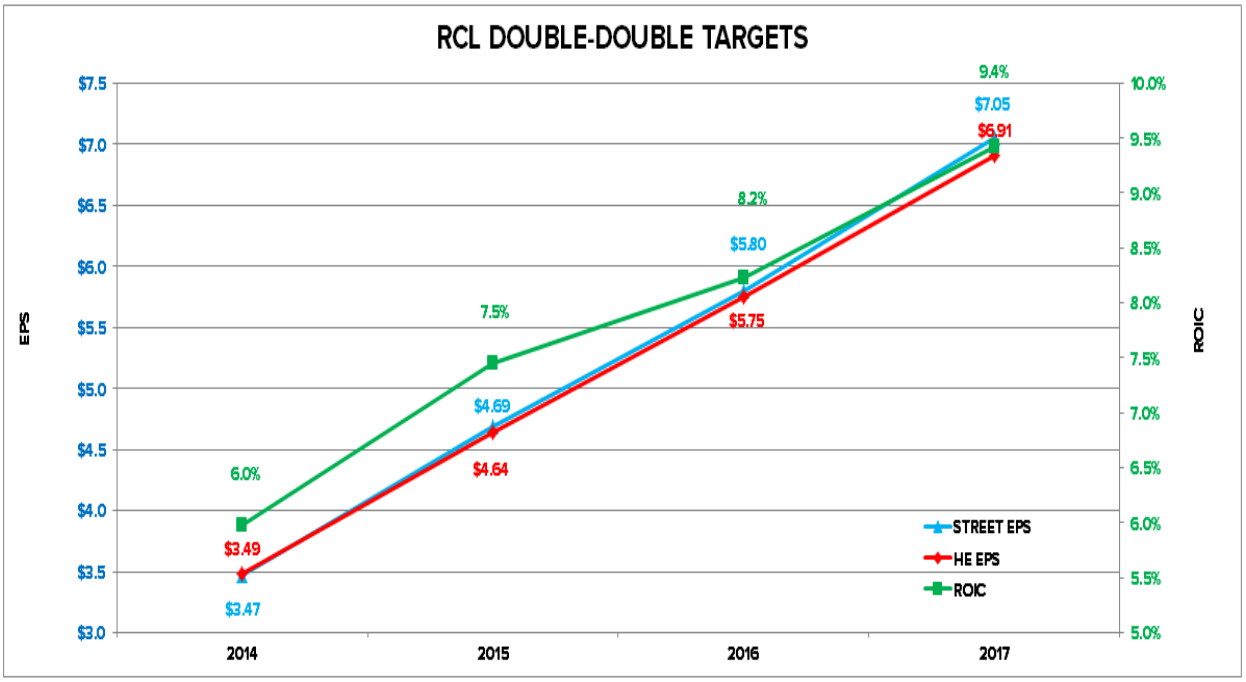
RCL management continues to tout its 3-yr Double-Double program goals. The two main tenets of *Double-Double* are to increase ROIC to double digits and double 2014 EPS. The Street and investors believe both will happen and have already revised higher their estimates to account for this aggressive growth strategy. In this rigorous study, we look at the factors that could derail the Double-Double thesis and the stock.

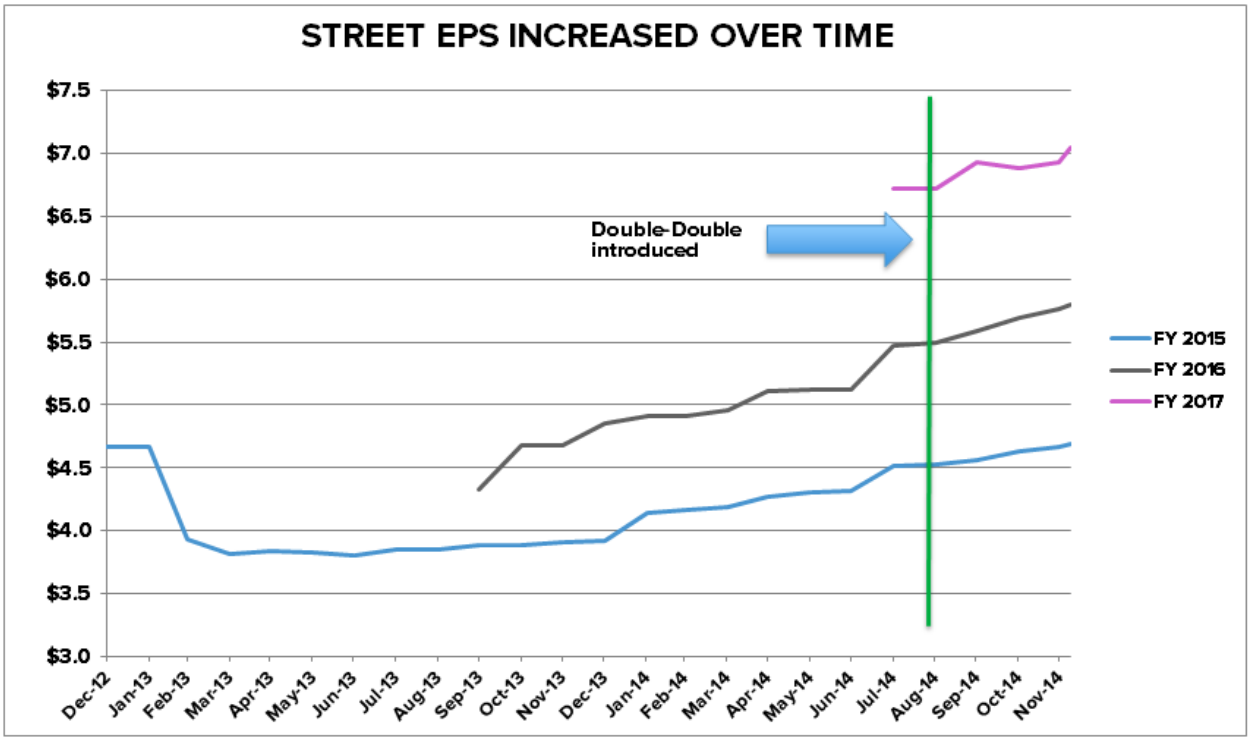
Specifically, we analyze the revenue/cost contribution for each Royal Caribbean ship needed to meet *Double-Double* targets. While there are multiple scenarios, we have identified 3 main scenarios, each highly dependent upon how the *older* fleet of the Royal Caribbean brand performs during the next 3 years. While much of the investors' interest has been on the performance of the newer ships, we believe measuring the resiliency of the older fleet is just as important, particularly the ships that are older than 2006, and will dictate how much the newer ships will need to excel.

While some of the older ships (particularly Caribbean-focused ones) may benefit from some of the Quantumizing in 2015/2016, we still believe there is risk of cannibalization which needs to be accounted for. If cannibalization occurs, the road to *Double-Double* will be more challenging and, perhaps, out of reach.

DOUBLE-DOUBLE TARGETS

RCL management believes they can double their 2014 EPS and reach double digit ROIC by 2017. The Street's 2017 EPS is already factoring in RCL **exceeding** *Double-Double* targets. We expect 2015-2017 Street estimates to go higher during the next week, particularly as more analysts jump on the "low fuel" bandwagon. We, however, remain slightly below the Street and Double-Double targets.





Source: Factset

So what is the Street missing? Before we get there, let's review what management has said about ship performance in the past.

MANAGEMENT COLOR ON SHIP PERFORMANCE

Management has mentioned that its *Oasis/Freedom* Class Royal Caribbean ships generate 25% more revenues and are 20% more cost effective than their respective pre-2006 *Royal Caribbean* brand ships. Similar outperformance can be said about the *Solstice* Class Celebrity ships. The new *Quantum* class ships perform better than the +25%/-20% revenue/cost relationship. When *Oasis 3* and *Ovation of the Seas* launch in 2016, performance metrics will be even higher than those of the *Quantum* Class. Per management, new ships will contribute 50% of the growth in the next 3 years; we think their contribution will be higher.

GENERAL ASSUMPTIONS

To understand the mechanics of *Double-Double*, we have decided to focus on the *Royal Caribbean* (RC) brand as the main driver of our study. That said, it is important to go over some other *Double-Double* assumptions first.

- 3-yr average net yield growth (current $): 3.2%
- 3-yr average net yield growth (constant $): 3.6%
- 3-yr average net cruise costs (ex fuel) (constant $): 2.2%
- Assume no purchases/sales of ships in 2017
- 6% decline in fuel cost per metric ton in 2015, followed by 3% increases in 2016 and 2017
- 2.7% fuel efficiency in 2015; 2.0% in 2016 and 2017
- 2015 FX negative impact: $41m
- ~$10m yearly incremental contribution from each new *Mein Schiff* ship
- $500m stock buyback in 2017
- Ship brand yield (contact us for a ship-by-ship breakdown)
    - 3-yr average *Celebrity* brand yield growth of 3.5%
        - *Solstice* Class has 25% revenue premium and 20% cost savings relative to its *Celebrity* peers
    - 3-yr average *Pullmantur* brand yield growth of 3.6%
    - 3-yr average *Croisières de France* brand yield growth of 3.0%
    - 3-yr average *Azamara* brand yield growth of 4.3%

SHIP CLASSES THROUGH 2017

ROYAL CARIBBEAN BRAND

PRE-2006
Jewel of the Seas
Mariner of the Seas
Serenade of the Seas
Navigator of the Seas
Brilliance of the Seas
Adventure of the Seas
Radiance of the Seas
Explorer of the Seas
Voyager of the Seas
Vision of the Seas
Enchantment of the Seas
Rhapsody of the Seas
Grandeur of the Seas
Splendour of the Seas
Legend of the Seas
Majesty of the Seas*

OASIS/FREEDOM CLASS
Allure of the Seas
Oasis of the Seas
Independence of the Seas
Liberty of the Seas
Freedom of the Seas

QUANTUM CLASS/ OASIS
Ovation of the Seas (Quantum 3)
Oasis 3
Anthem of the Seas
Quantum of the Seas

CELEBRITY BRAND

MILLENNIUM CLASS
Constellation
Infinity
Millennium
Summit

XPEDITION
Xpedition

SOLSTICE CLASS
Reflections
Silhouette
Eclipse
Equinox
Solstice

PULLMANTUR BRAND

Majesty of the Seas*
Monarch of the Seas
Empress
Soverign

AZAMARA BRAND

Journey
Quest

CROISIERES DE FRANCE BRAND

Horizon
Zenith

TUI (JV)

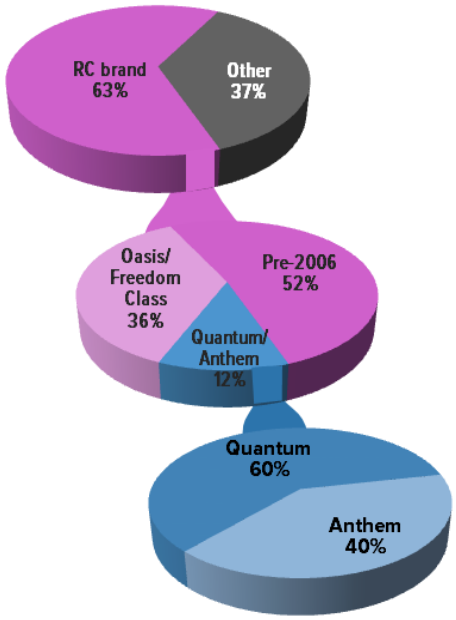
Mein Schiff 6
Mein Schiff 5
Mein Schiff 4
Mein Schiff 3
Mein Schiff 2
Mein Schiff

* Majesty of the Seas will be transferred to the Pullmantur brand beginning in May 2016.

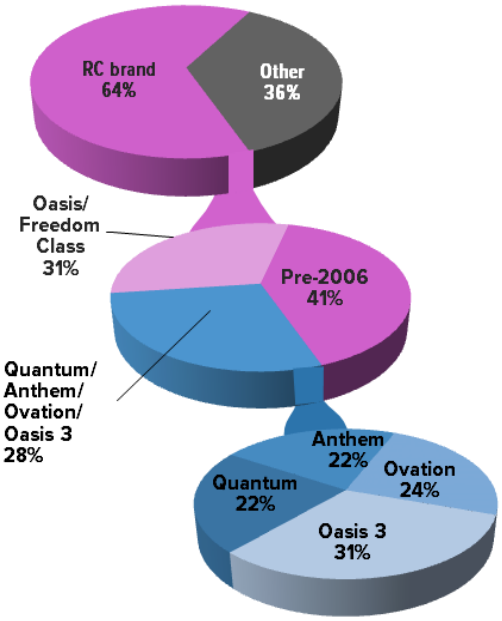
3 SCENARIOS FOR ROYAL CARIBBEAN BRAND

As mentioned, the main driver for the *Double-Double* program will be the *Royal Caribbean (RC)* brand. With the introduction of 3 new ships (plus *Mein Schiff* 4, 5, and 6) from 2015-2017, the revenue contribution from the more advanced ships will be higher. For example, under a scenario where the pre-2014 *RC* ships revenue/berth is unchanged in the next three year (i.e. Scenario 2, as described below) , the revenue contribution of the new ships will rise from 12% in 2015 to 28% in 2017.

2015 revenue contribution



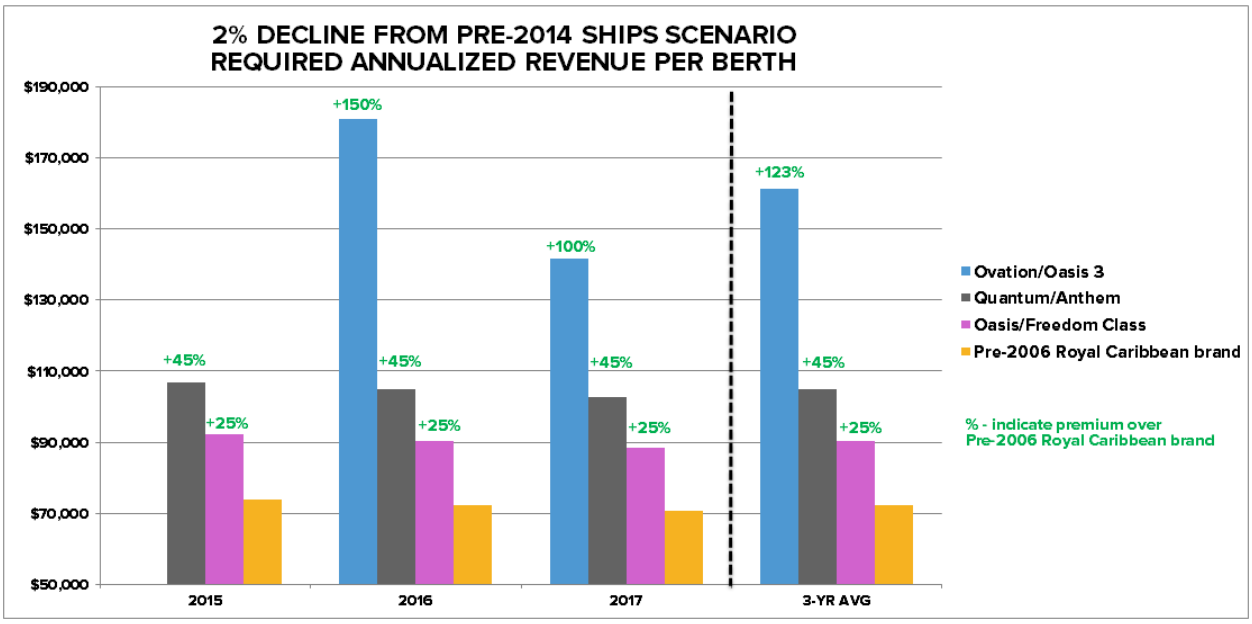
2017 revenue contribution



Nevertheless, the pre-2014 ships will still account for a large majority of RCL's revenues (72%). We forecast three *Double-Double* scenarios that could play out for the pre-2014 *RC* brand fleet over the next three years: 1) cannibalization; 2) no revenue growth; 3) modest revenue growth. Given the introduction of newer *RC* ships, we worry that the older *RC* fleet performance may suffer, despite upgrades from Quantumizing and opportunities in the emerging markets. Obviously, the cannibalization scenario is the hardest path to achieving *Double-Double* and would put tremendous pressure on the new ships to outperform by a large margin. Let's look at that one first.

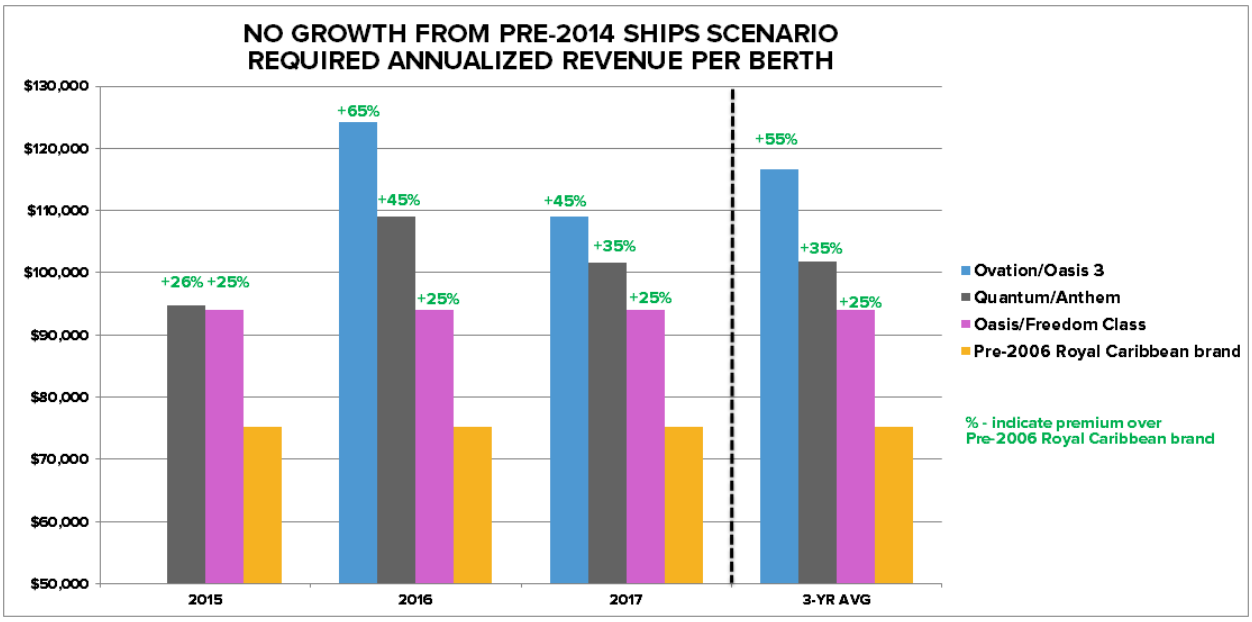
Scenario 1

In *Double-Double* Scenario 1, we assume a 2% yearly decline in revenue per berth for all of the pre-2014 *RC* ships. As the base, we estimate the older ships' (pre-2006) revenue per berth in 2014 was around $75k. The chart below shows one of the many possible revenue combinations the *RC* fleet needs to fulfill *Double-Double* targets under this scenario. Assuming *Oasis/Freedom* Class ships maintain their 25% premium over the pre-2006 *RC* ships, and *Quantum/Anthem* ships grow 45% above its pre-2006 peers, the next generation of ships (*Ovation/Oasis* 3) would need to more than double the performance of its pre-2006 peers to meet the necessary revenue growth implied under *Double-Double*. Indeed, that is a very high bar and the Scenario with which we're most concerned.



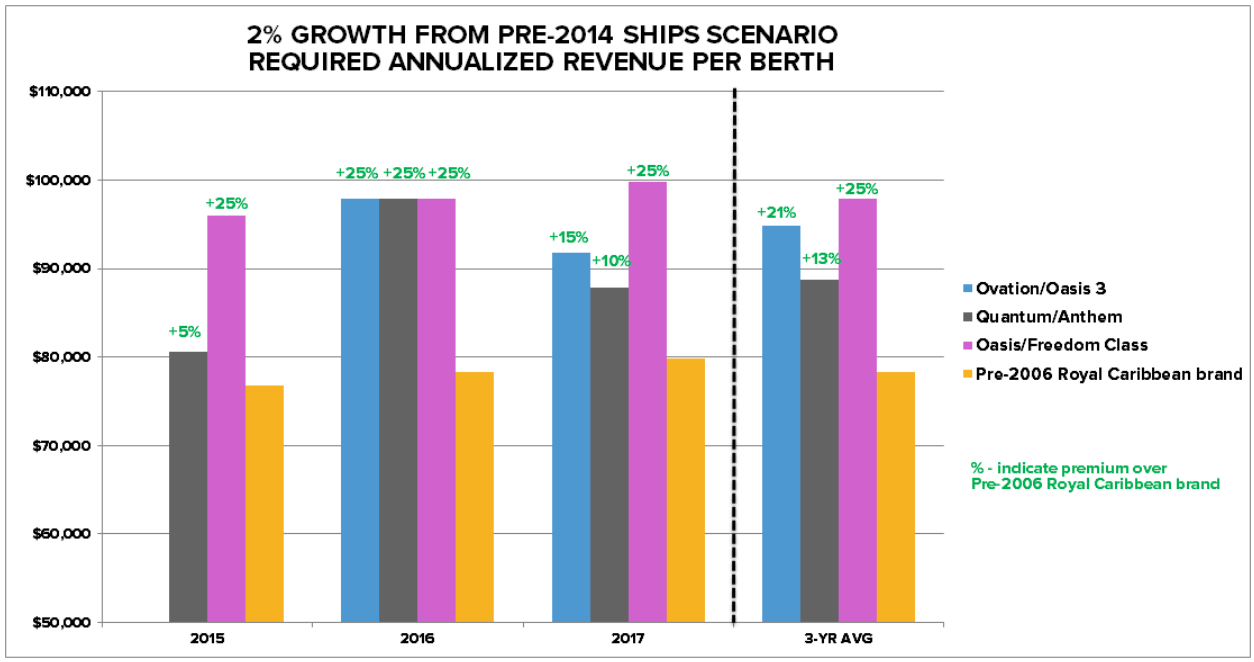
Scenario 2

Under *Double-Double* Scenario 2, we assume the pre-2014 *RC* ships maintain their 2014 revenue per berth performance level throughout 2017. This scenario is much more manageable for the newer ships with *Quantum/Anthem* needing to pull in 35% more on a revenue/berth basis than that of the pre-2006 *RC* ships and similarly, Ovation/Oasis 3's revenue/berth would have to be 55% higher.



Scenario 3

Under *Double-Double* Scenario 3, we assume pre-2014 *RC* ships' revenue per berth grow modestly or 2% each year from 2015-2017. This scenario would suggest the new ships do not need much revenue premium at all; in fact, they can *underperform* the *Oasis/Freedom* Class and still meet *Double-Double* targets.



While the RCL bulls may bet on scenario 3, we believe it is unlikely given past performance from the older fleet and heightened competition from new ships and new players.

YIELD TARGET

For the target to be met, we estimate the yearly yield growth requirement for the entire *RC* brand fleet ranges from 2.1%-2.7% from 2015-2017 depending on which scenario plays out. While 2.1% (Scenario 1) may seem like low-hanging fruit, it takes into account declining performance for almost 75% of all *RC* brand ships.

On the cost side, we believe RCL management will have to make more onboard investments in the older *RC* brand fleet to maintain their competitiveness among the contemporary cruiser community.

We use *Double-Double* Scenario 2 (no revenue growth) to show an example of the *RC* brand yield breakdown below.

Cost assumptions:

- *Oasis 3/Ovation*: 40% more cost efficient than that of pre-2006 *RC* Class ships
- *Anthem/Quantum*: 30% more cost efficient than that of pre-2006 *RC* Class ships
- *Oasis/Freedom* Class: 20% more cost efficient than that of pre-2006 *RC* Class ships

(CTOO - Commissions, transportation, onboard and other)

Required RC Yield

FY 2015

Ship	Gross revs	CTOO costs	ALBD	NET YIELD
Anthem/Quantum	$655.8	($101.7)	2.3	$243.8
Oasis/Freedom Class	$2,031.8	($362.9)	7.1	$235.1
Pre-2006	$2,885.8	($805.4)	12.6	$165.1
TOTAL RC	$5,573.4	($1,269.9)	22.0	$195.9

Required RC Yield

FY 2016

Ship	Gross revs	CTOO costs	ALBD	NET YIELD
Anthem/Quantum/Ovation/Oasis 3	$1,372.8	($181.5)	4.0	$300.6
Oasis/Freedom Class	$2,031.8	($388.8)	7.1	$231.5
Pre-2006*	$2,797.4	($836.4)	12.2	$160.5
TOTAL RC	$6,202.0	($1,406.8)	23.3	$206.0

* Majesty of the Seas will be transferred to the Pullmantur brand beginning in May 2016.

Required RC Yield

FY 2017

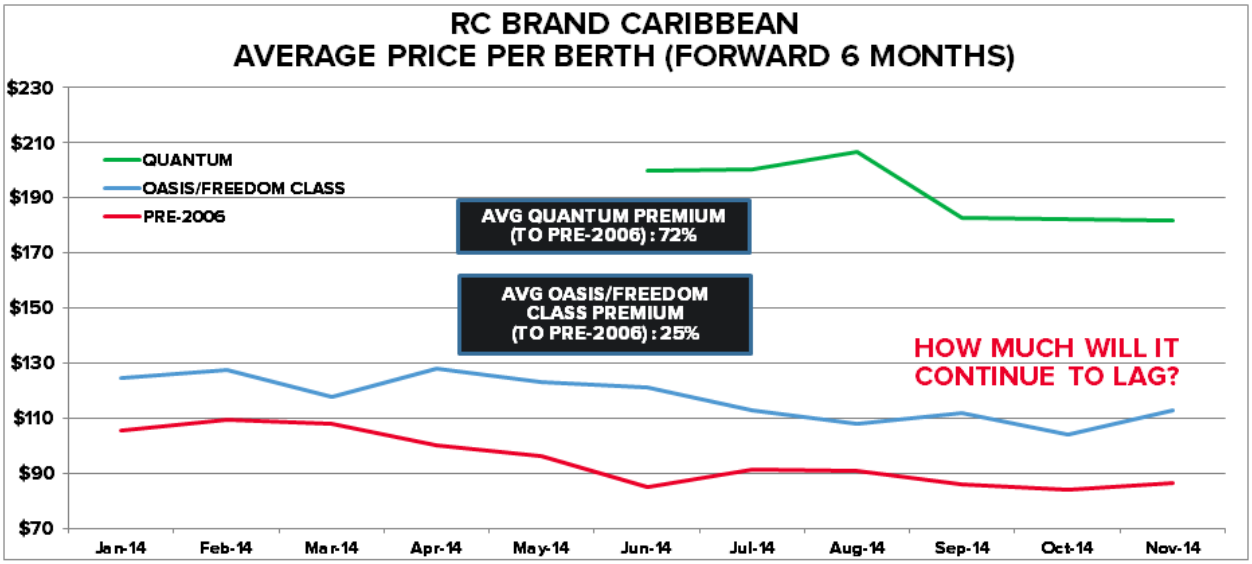
Ship	Gross revs	CTOO costs	ALBD	NET YIELD
Anthem/Quantum/Ovation/Oasis 3	$1,890.7	($228.5)	5.9	$280.2
Oasis/Freedom Class	$2,031.8	($397.4)	7.2	$228.3
Pre-2006	$2,709.0	($828.0)	11.9	$157.7
TOTAL RC	$6,631.4	($1,453.9)	25.0	$206.9

WHAT'S THE RISK OF CANNIBALIZATION?

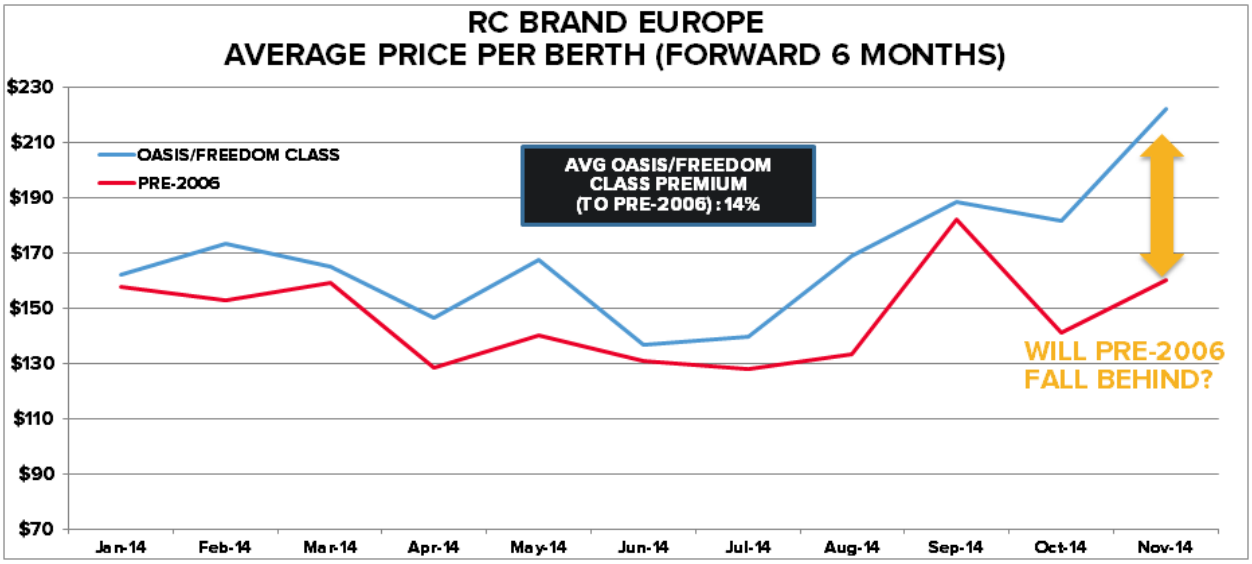
Our main concern as it relates to the *Double-Double* target is cannibalization. We saw in 2014 what oversupply and suffocating competition can do to business performance in the Caribbean. Discounting was prevalent and ships sailed without full capacity. While it won't be any more crowded in the Caribbean in 2015 past 1st quarter, there are great expectations of better performance among all the Caribbean- destined brands. But will the rising tide lift all boats? It's too early to tell.

In the chart below, we analyze average pricing per berth for the RC brand ships on a forward 6 month basis for the Caribbean. For example, for the May 2014 period, we analyze average pricing for all the June-November 2014 itineraries. The chart suggests that the Caribbean pricing decline has been relatively uniform among all the RC brand ships (excluding Quantum) this year, which could certainly indicate cannibalization for the older ships. However, it is difficult to clearly make that conclusion in a deteriorating pricing environment. The question going forward is how much the pre-*RC* 2014 ships will continue to lag the newer ships in the Caribbean.

The good news is that pricing premiums haven't been an issue. *Oasis/Freedom* Class ships have averaged a 25% pricing/berth premium (std dev of 9%) over the pre-2006 *RC* ships, which is exactly what RCL management has guided in terms of relative performance for the *Oasis/Freedom* Class ships. Meanwhile, Quantum has outperformed tremendously (averaging 72% pricing/berth premium, std dev of 11%) and has had a strong start for 2015.



While the Caribbean is the main hub for the *RC* brand, we also present European pricing trends for the *RC* brand below. Note the data set is much smaller and subject to greater volatility. In some cases, there are only a handful of available sailings for a particular period. Cannibalization shouldn't be disregarded in Europe, either. Supply pressure will be higher in 2015 and we look to see if pricing momentum will slow among the older *RC* fleet. As the chart below shows, most of the European gains in the last month has been from the strong pricing from the *Oasis/Freedom* Class ships, specifically *Allure of the Seas's* special European trip in summer 2015.



DON'T FORGET FX

While cannibalization is our chief concern, we must also not forget the stronger dollar and its ramifications. A stronger dollar, while emphasized by management as a headwind, hasn't been discussed much among the sell-side and consequently, is not entirely reflected in their upward revised EPS numbers. Management has said that the impact from lower fuel prices and a stronger dollar net net is close to zero. Based on current FX rates, we estimate a $41m adverse impact from a stronger dollar in 2015, almost erasing an estimated $42m gain from lower fuel prices. With European economies continue to lag the US and QE being discussed as an option for the Eurozone in 1Q 2015, the dollar looks to remain strong against the traded basket (Euro, Pound, Canadian Dollar, Brazilian Real, and Aussie Dollar) and drag down RCL results.

CONCLUSION

With bunker fuel prices ~10% lower since RCL last gave guidance on Oct 23, investors seem to have priced in the *Double-Double* targets easily being met. However, the targets may not be as much of a slam dunk as anticipated given cannibalization and the foreign currency headwinds.

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