VOSS CAPITAL

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March 2015 | RCL | Royal Caribbean | Sell Short | Current Price: $79.50

Fully Diluted Shares Out: 223.4 million | Market Cap: $17.76 billion | Price Target: $45 (43% downside)

Introduction

One way I choose to mitigate the risk of an uncertain and unpredictable world is by avoiding extreme portfolio concentrations and finding ideas that will benefit from the world's inherent volatility (despite every central bank trying to suppress it recently). If over the course of this market cycle, history does indeed rhyme once again then one idea that will benefit from the uncertainty of the world is shorting the equity of Royal Caribbean (RCL). RCL embodies many of the characteristics that I desire in a short investment: there is a cluster of insiders selling, there is no free cash flow generation, the business is destroying economic value due to low returns on capital, the shares are expensive on a relative and absolute basis, the industry is capital intensive and operates on price based competition, and the balance sheet is highly levered. The cherry on top is they have poor earnings quality and use aggressive accounting.

RCL has an unblemished 25 year history of adding capital inefficiently. The company's return on invested capital has regressed and been under their cost of capital for most of its public history. The company is once again emphasizing ROIC, but is doing so at a time when industry supply growth is about to hit a positive inflection point. I don't think anything has changed and I will show that just like all of their past emphases on future profitability, they will continue to fall short of long term targets while dumping stock to outside shareholders at record high valuations.

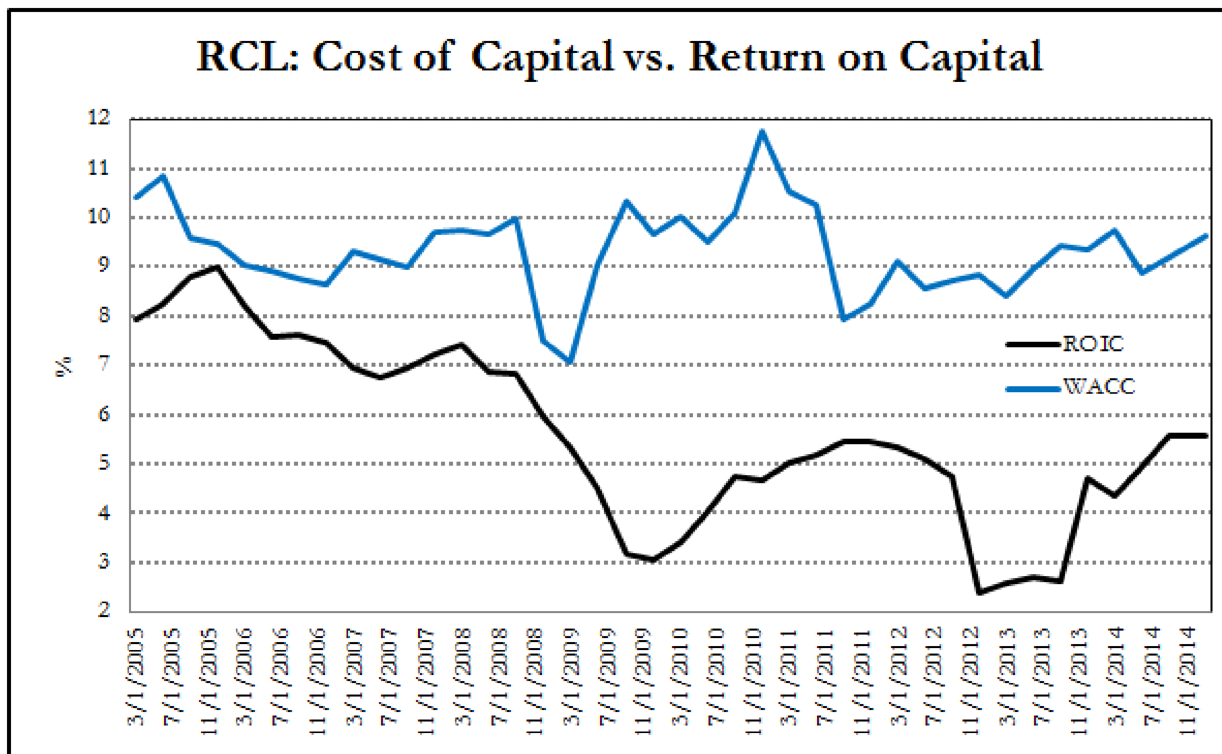
At a high level, RCL is not too unlike my short thesis shared on SumZero on Tuesday Morning (TUES). TUES is shifting its store base to stores that are 50-200% larger while keeping these in the comp base, therefore juicing positive same store sales comps and focusing attention on that metric, while never generating cash. Royal Caribbean has done the same thing on a larger scale for the entirety of its existence. Their playbook consist of continuing to lever up to build larger ships and show boosts to net yields, revenue and maybe even accounting EPS, but never generating FCF or demonstrating scale and improving ROIC.

Financial theory (and economic history) dictates that a company must achieve an ROIC in excess of its WACC for growth to contribute to the value of the business. Growing a business that consistently earns an ROIC below its

WACC increases the rate of value destruction. Furthermore, the faster a business with ROIC < WACC grows, the more value it destroys. As this happens the Enterprise Value of such capital intensive business should trend towards book value of invested capital. RCL shares, however, trade at ~2x book value.

For RCL, getting the economics of the business in shape is much more important than growth, but both the company and its investors are enamored with revenue and GAAP EPS growth, which have very little to do with value creation and there is a high likelihood when the slacktide ebbs—as it inevitably does—RCL shares will sink back below book value.

There is a good general rule of thumb in VC-land I heard once: How a company starts is how they will typically end. This makes sense to me. Uber? Profitable from the get-go. AirBnb? Profitable right away. Tesla? Capital intensive money loser—still losing money 10+ years into its existence. RCL is also fitting the mold of this generalization—despite over two decades of horribly wrong forecasts, the elusive Mr. Free Cash Flow has yet to make an appearance.

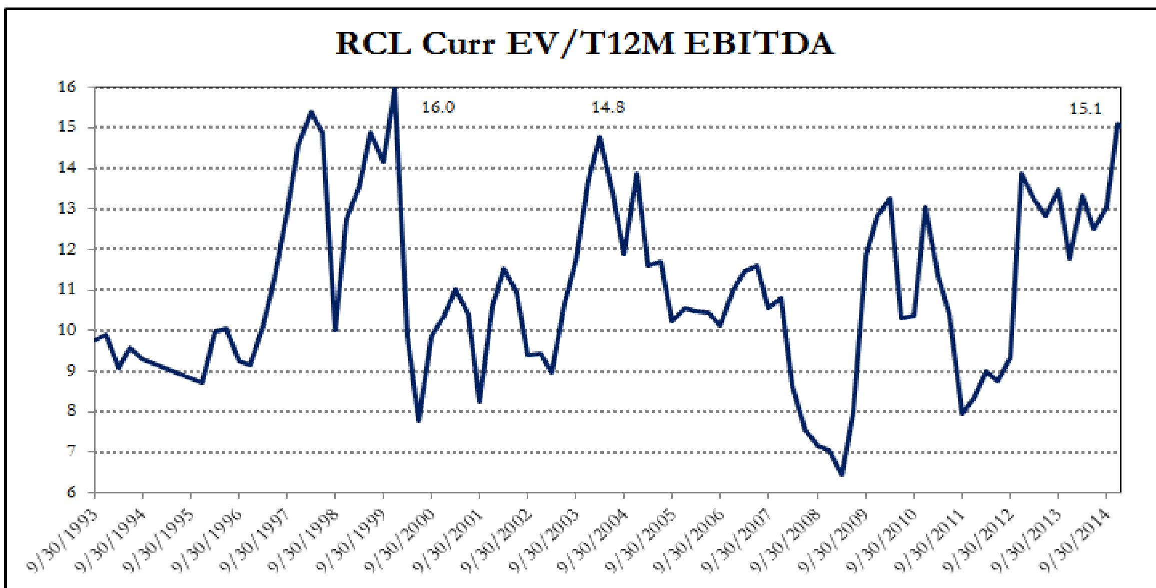


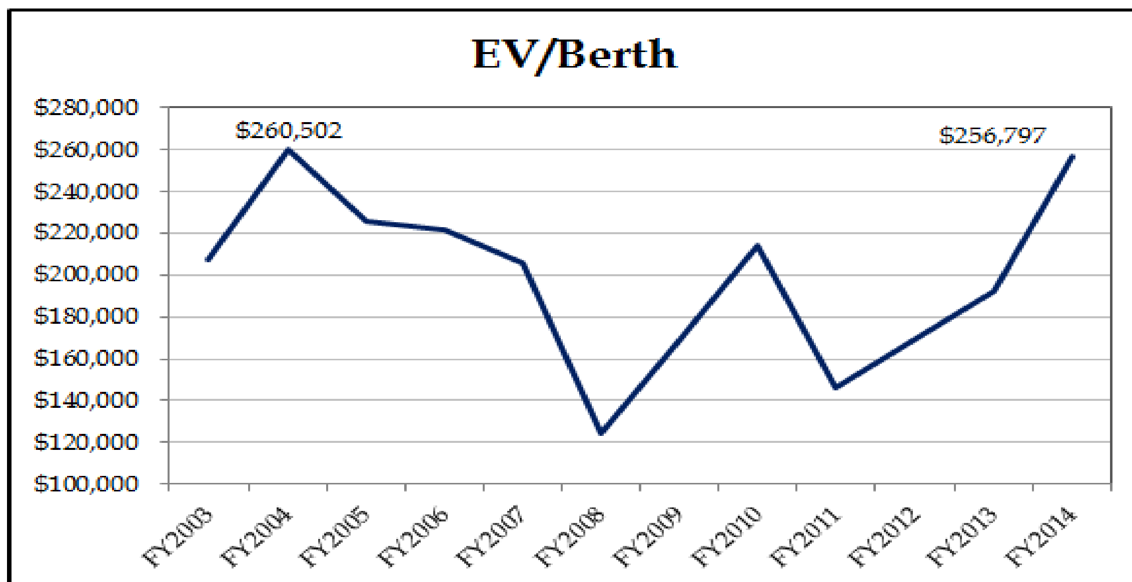
If larger, newer ships were a panacea to increase ROIC, then RCL would show a huge bump in ROIC every time they had a wave of new-builds come into the market. Scrutinizing history we can see that is simply not the case and other than management talking the same big game as the past two decades, I can't find good reasons why this cycle or renewed emphasis on ROIC will be any different. For example, they had zero ships delivered in 2005 introduced the Ultra Voyager class ships starting in 2006 with average size of 3,600 Berths which was 53% larger than the Fleet average (2,346 berths) prior to the Freedom of the Seas delivery in 2006. Did ROIC have a step-function higher when then total berths grew by 8.1% due to delivery of these larger class of ships? As you can see above, the clear answer is a resounding no. There is simply no positive correlation to larger ships/average berth size of the fleet and a higher ROIC. Despite management's hype, larger and newer ships do not equal a better outcome for shareholders.

People are simply taking the elevated and rising stock price and extrapolating that, and projecting it onto or fitting the fundamental narrative to it, without thinking critically of how this will be achieved and how the unit economics of the business have changed.

The cruise industry has had a nice lull in deliveries of new ships after the Great Recession from 2010-2014 and now will have a tidal wave of deliveries of new generation ships. There is expected to be 16.3% growth in total available berths between 2014 and 2018 in what is already characterized as a price-taking industry, e.g. commoditized and well supplied. I like an RCL short here for a plethora of reasons.

- History time and time again proves that operational outcomes for the cruise industry have an inherently negative asymmetry, with many more negative contingencies than positive ones.
- RCL is at or near all-time high valuations by a variety of metrics.
  - The stock has a history of booms and severe busts in the equity valuation due to high leverage and being at the whims of economic/industry cyclicality.
  - Other valuation peaks were followed by 50-80% drawdowns, with no failure in this pattern ever:
    - 16x EBITDA peak in 1999: followed by 78% drawdown from Q4 1999 to Q3 2001.
    - 14.8x EBITDA peak in 2004: 86% drawdown from Q4 2004 to Q1 2009.
    - 13x EBITDA peak in 2010: 59.6% decline from Q4 2010 to end of Q3 2011.
    - Current multiple is 15.1x trailing EBITDA, surpassed only briefly in 1999.
    - Current multiple on forward EBITDA estimate is 12.0x, surpassed only in 2010 at 13.07x.





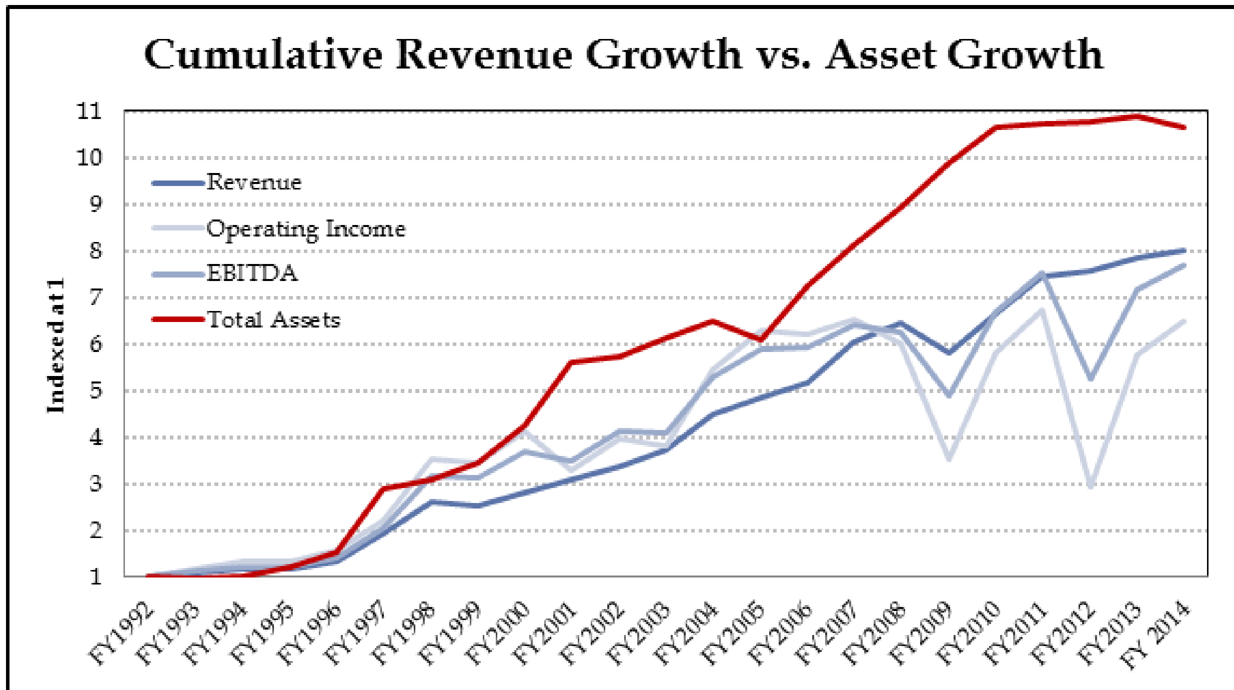
- **RCL has dug a hole of over negative $4 billion in cumulative FCF since 1991**.
  - Proceeds from ship sales has been negligible since Inception, not altering the cumulative FCF much
  - Business is funded mostly through debt issuance:
    - Since 1991 debt has gone from $1.017 billion to $8.074 billion and is anticipated to continue rising to $9.7b net.
  - Dividends paid since 1991 equal $1.792 billion.
  - Net new equity issued over this time equals $1.718 billion.

		Free Cash Flow
Current TTM	$	852,779,008
FY2013	$	648,291,008
FY2012	$	90,235,000
FY2011	$	282,112,992
FY2010	$	(524,169,984)
FY2009	$	(1,632,668,032)
FY2008	$	(1,152,279,040)
FY2007	$	(48,687,000)
FY2006	$	(232,072,992)
FY2005	$	681,462,016
FY2004	$	446,320,992
FY2003	$	(171,727,056)
FY2002	$	180,478,944
FY2001	$	(1,103,781,888)
FY2000	$	(582,333,056)
FY1999	$	(389,123,040)
FY1998	$	(30,095,032)
FY1997	$	(672,092,992)
FY1996	$	(422,874,976)
FY1995	$	(202,904,992)
FY1994	$	72,073,000
FY1993	$	136,806,000
FY1992	$	(95,768,984)
FY1991	$	(318,925,984)
	$	(4,188,946,088)

Date		EBITDA-CapEx
FY2014		(614,790,000)
FY2013		789,081,984
FY2012		(157,896,000)
FY2011		460,428,000
FY2010		(740,840,000)
FY2009		(1,420,824,064)
FY2008		(871,196,992)
FY2007		67,020,000
FY2006		99,512,000
FY2005		843,736,000
FY2004		517,055,008
FY2003		(140,650,016)
FY2002		200,083,952
Cumulative EBITDA-CapEx	**$**	**(969,280,128)**

- **Cap-ex has outpaced depreciation in every single year except for one**.
  - Even in years when they have no new ships being built, RCL requires constant reinvestment into the existing fleet.
  - CapEx as a percentage of sales ranges from 7% (9.7% currently, closer to an all-time trough) to over 40% in many years and a peak of 55.2% in 2001.
  - **Accounting earnings are a flawed metric to focus on and value the company with given that CapEx has consistently exceeded depreciation expense**—and likely always will—accounting earnings have never converged with FCF. This is not a new, fast growing company. If there were going to be cash flow harvest periods, wouldn't we have seen them by now?
    - RCL is likely not conservative enough with depreciation assumptions.
      - Instead of lowering the average useful life assumption recently, RCL raised it to 35 years for 5 ships in Q1 2013, which provided a further boost to accounting EPS, causing full year EPS to "beat" estimates by 3 cents instead of missing by 2.

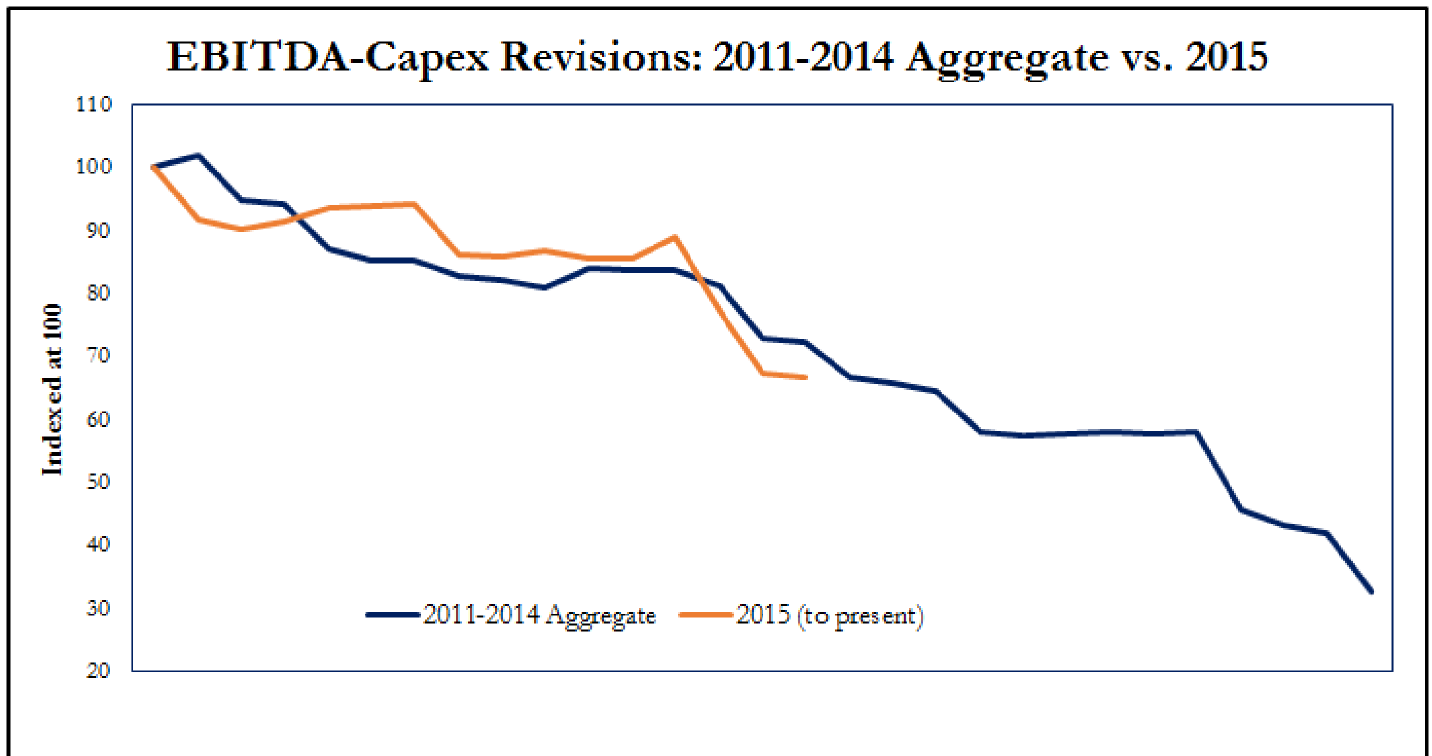
- RCL is 4.2x levered as measured by net-debt-to-EBITDA.
- Since 1998 RCL's asset growth has outpaced revenue growth.
  - There is zero operating leverage or scalability as the ships are immediately deployed and typically filled. **RCL must grow assets as quickly** (or as evidenced in the last 17 years) **or quicker than it can grow sales.**
  - Growth cannot occur without capital expansion. Not exactly a characteristic of a "good" business.



- Long term earnings targets have also been perpetually overly optimistic. For example, at the start of 2011, consensus 2014 adjusted EPS for RCL were $6.19 and the stock was at $50. Actual was $3.43 and the stock is at $84. So the multiple went from 8x FY4 forward EPS estimates, to 23x trailing EPS.

The astute reader may ask why both management and the sell side are so consistently wrong in their forecasts, always to the downside. Are they deceptive, delusional, or just unlucky? I believe RCL, given its heavy macro exposure, is particularly susceptible to a concept coined by Daniel Kahneman in his brilliant *Thinking, Fast and Slow*, called the Planning Fallacy. The thrust behind the Planning Fallacy is that the Base Case is often a closer representation of the Best Case, and that numerous "unknown unknowns" can by themselves be unlikely but cumulatively be rather probable (why most M&A deals destroy value). Again, this fallacy is particularly prevalent when the tail risk negatives outweigh the tail risk positives. Throughout the last 25 years, we have a rich history demonstrating there are far more negative risks than positive for RCL (in addition to common sense). In fact, every year it seems to be a new thing: propeller damage from a steel fishing net in Tokyo, oil spills in Galveston ship channel, food poisoning scares, shipwreck, delays in ship construction…the list goes on and on. On the flip side, there are very few positive surprises (one could argue currency or energy prices, but I view these as more neutral as they can work both ways).

This eternal optimism followed by a cold dose of reality is evident when looking at cash flow estimates over time (using EBITDA-CapEx as a proxy):



The chart above shows consensus EBITDA-CapEx revisions for RCL over time. The blue line is the years 2011-2014 aggregated and indexed to show the magnitude of estimate percentage declines over time (for the full data, see the table below). The first data point for each year used was one year prior to the calendar being projected, in other words, for FY2014 estimates that chart shows the estimate starting from 1/1/2013 and onwards through year end 2014. So far FY2015 is acting very much like an "average year" for RCL—one in which estimates slowly collapse over time and end up about 80% lower than when they were first made two years earlier. This also shows that unless this year is any different than most of RCL's history that 2015 estimates still have many negative revisions to come. 2016 EBITDA-Capex estimates have already come out of the gate dropping like a rock.

The only year that EBITDA-CapEx estimates did not miss by at least $200 million was 2010 and this was due to at the start of 2009 analysts across the board being too pessimistic as the market was emerging from the Great Recession. Regardless of 2009's epic pessimism, RCL still missed original EBITDA-CapEx estimates by a few million. The average revision since FY2008 has been -$593 million and the median revision was -$735 million. The fact of long term over-optimism surrounding RCL demonstrated by this chart is hard proof that so many things can go wrong while very little can cause a surprise to the upside, providing visual examples of the Planning Fallacy playing out over and over. This is important to consider when thinking about 2015 and 2016 estimates. They have "only" declined by $266.1 and $79.8 million, respectively.

EBITDA-Capex Estimates Over Time									
	12/31/2014	12/31/2013	12/31/2012	12/31/2011	12/31/2010	12/31/2009	12/31/2008	12/31/2007	12/31/2006
	3/31/2017	3/31/2016	3/31/2015	3/31/2014	3/31/2013	3/31/2012	3/31/2011	3/31/2010	3/31/2009
	2016	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**
End of Previous Year	234.6	795.2	696.0	1385.0	916.3	520.3	-692.3	-299.0	-122.0
	166.8	728.9	692.0	1353.5	940.0	599.3	-823.3	-300.6	-182.0
	161.0	717.0	560.1	1225.9	937.5	610.5	-886.8	-298.1	-152.0
	154.8	727.0	558.6	1222.9	916.4	619.3	-934.5	-307.0	-152.0
		744.0	559.0	1098.0	743.7	660.0	-921.2	-356.8	-172.0
		746.2	558.5	1098.6	684.2	656.6	-918.0	-465.5	-188.0
		750.0	558.0	1095.1	684.0	657.7	-965.0	-444.3	-188.0
		684.0	569.0	1049.1	632.6	660.3	-928.4	-474.8	-203.3
		681.5	569.0	1038.0	620.2	660.3	-928.0	-479.0	-217.7
		689.0	571.6	1047.1	566.2	660.3	-902.0	-468.5	-227.0
		679.1	567.5	1064.8	555.0	763.8	-902.0	-651.1	-240.6
		680.5	568.3	1065.1	548.0	764.2	-888.5	-666.7	-249.2
Start of Year		708.3	569.0	1071.4	536.6	764.2	-885.0	-722.5	-310.9
		614.3	485.4	1077.2	519.2	770.0	-842.8	-934.6	-317.2
		536.0	484.8	941.1	369.6	769.0	-837.0	-946.5	-351.6
		529.1	484.8	939.0	368.2	745.4	-830.8	-996.3	-364.6
			480.2	942.9	228.0	697.3	-790.5	-984.0	-426.9
			480.0	933.0	228.0	666.4	-786.8	-983.5	-439.5
			479.0	926.8	228.0	640.1	-786.0	-1010.0	-463.9
			410.0	894.6	182.2	557.4	-780.0	-1038.2	-502.9
			391.4	893.8	181.6	552.0	-779.9	-1051.5	-542.9
			392.0	891.4	184.8	556.3	-772.8	-1056.9	-542.0
			373.6	904.0	207.4	552.8	-759.0	-1057.0	-671.0
End of Year			365.9	903.7	208.2	549.8	-760.1	-1054.5	-686.5
			372.6	904.0	210.2	549.9	-758.0	-1054.7	-684.8
			0.0	844.3	210.0	548.7	-747.2	-1122.0	-732.2
			-92.0	844.3	227.8	534.1	-740.9	-1217.3	-809.5
				844.3	228.0	497.2	-740.9	-1217.3	-747.7
Final Reported Number	**$ -**		**$ (64.0)**	**$ 798.0**	**$ 117.0**	**$ 297.0**	**$ (700.0)**	**$ (1,339.0)**	**$ (857.0)**
Absolute Change	**$ (79.8)**	**$ (266.1)**	**$ (760.0)**	**$ (587.0)**	**$ (799.3)**	**$ (223.3)**	**$ (7.7)**	**$ (1,040.0)**	**$ (735.0)**

Average Decline	**$ (593.2)**
Median Decline	**$ (735.0)**

2015 Decline so far:	**$ (266.1)**
Additional Revision to match 7-year Average:	**$ (327.14)**

EPS versus FCF:

Year	EPS Surprise Vs. Estimates (%)	FCF Surprise Vs. Estimates (%)
FY '14	-2.6	-123.9
FY '13	1.3	-9.3
FY '12	1.8	-33.2
FY '11	0.9	-24.2
FY '10	17.5	-15.9
FY '09	-2.8	-13.6
FY '08	-1.1	-1.7
FY '07	-0.2	-99.1
FY '06	2.7	-303.7
FY '05	7.9	7.6

The table above again reiterates that while RCL is sometimes beating estimates on an EPS basis, it has a near perfect record of missing every year on FCF, providing further proof that investors over the long term have been overly optimistic on the FCF generation capability and have systematically underestimated maintenance CapEx needs.

All the way back to the late 90's the sell-side has been modelling in consistent positive FCF and declining debt for RCL just beyond the point of visibility, usually about two years out from the current time. Neither has ever materialized and old DCF analyses from the 90s and 2000s with their steadily growing FCF stream look quite comical.

> "Royal Caribbean is expected to turn the corner and generate economic profit starting in 2003, and we expect this momentum to accelerate through the end of the forecast period. In fact, we anticipate Royal Caribbean can continue to increase EVA each successive year through 2009, even under our conservative capacity/reinvestment estimates." – Credit Suisse First Boston Initiation, May 31st, 2000.

The cumulative FCF assumptions from 2015-2017 of $3 billion are not very good. A cumulative $3 billion over three years versus an EV of $25.6 billion, means if this number is actually manifested that the 3-year forward average "normalized" FCF yield would be 3.7%. This is actually terrible, and it will be the best FCF period for the company in history, as it is also a cherry-picked three year period with $2.3b of the $3.0 coming in 2017 due to no ship deliveries that year.

As mentioned, while there is rarely a "surprise windfall" for RCL, the market is confused and attributing one to RCL recently that we're all aware of and that is the collapse in oil prices. Over the course of its history RCL has spent on average 9.7% of sales on fuel costs. We estimate the decline in fuel cost for RCL will add about 45-50 cents of 2015 EPS, but this will be offset by a negative effect from a stronger US Dollar by ~45 cents, therefore the net effect of oil's decline for RCL's bottom line is only about +5 cents. Meanwhile the stock has gone from $53 to $79 since the mid-October oil meltdown.

Unlike other industries like Homebuilding or Oil and Gas exploration that generate no cumulative free cash flow due to reinvestment and firms trying to grow their NAV, **if RCL were to stop investing in new ships it would not all of a sudden morph into a cash cow**. There is a higher level of necessary maintenance cap-ex on the ships that is required to keep attracting passengers and keep the assets operational, as opposed to an E&P that can, in theory, collect a long tail of cash flows from its existing production or a homebuilder that simply liquidates all of its existing inventory and stops reinvesting in new lots and homes. Even **if we assume RCL all of a sudden will spend *only* 7% of sales on cap-ex as a normalized maintenance level (7.2% is the lowest in its history in 1993), then investors are still paying 23.3x multiple (or receiving a 4.3% FCF yield) in a best case bare-bones cap-ex scenario for a FCF stream that would inevitably decline from here as competition keeps chugging ahead with newer, nicer ships while RCL's fleet ages**, eroding any kind of pricing premium that RCL may be able to enjoy now.

Selling Ships: There is a famous sailor's quip that the second best day of a man's life is when he buys a yacht. What is the best day? The day he sells it. Selling ships for RCL could be a good thing if they were to aggressively slim down the size of the company, but a very recent sale provides further proof that the business value is around or below book value—as in aggregate the fleet does not generate cash and then they often sell ships below stated book value (when the stock is at >2x). In the most recent sale, they did not disclose amount received for the Splendour of the Seas (entered service in 1996), but registered a loss of $17.4mm on the sale of a ship that is included in other operating expenses for 2014. This again hints that the company is not conservative enough with estimated useful life for depreciation schedules or residual values.

Trading Comp Table:

					FCF	Cumulative			EV/FCF			EV/FCF Cumulative				
Company		P/B	ROIC (5 Yr Avg)	EV	Peak	5 Year	10 Year	15 Year	NTM	NTM	Peak	5 Year	10 Year	15 Year	FCF Hit Rate	Debt/EBITDA
Norwegian Cruise Line Holdi	NCLH	3.5	2.2%	$ 17,420	$ 172	$ (1,128)	$ -	$ -	$ 297	58.7x	101.2x	-15.5x			29%	7.8x
Carnival Corporation	CCL	1.5	5.1%	$ 44,771	$ 1,433	$ 3,508	$ 6,851	$ 6,120	$ 917	48.8x	31.2x	12.8x	6.5x	7.3x	67%	2.6x
MGM Resorts International	MGM	2.7	-1.6%	$ 26,559	$ 748	$ 2,166	$ 446	$ 2,200	$ (368)	-72.2x	35.5x	12.3x	59.5x	12.1x	71%	6.7x
Cedar Fair, L.P.	FUN	21.8	3.6%	$ 4,672	$ 204	$ 748	$ 1,248	$ 1,575	$ 178	26.2x	22.9x	6.2x	3.7x	3.0x	100%	3.8x
Las Vegas Sands Corp.	LVS	6.2	6.9%	$ 54,231	$ 3,654	$ 9,804	$ (1,132)	$ (1,329)	$ 2,884	18.8x	14.8x	5.5x	-47.9x	-40.8x	40%	1.9x
Six Flags Entertainment Corpo	SIX	19.7	12.3%	$ 6,482	$ 284	$ 975	$ 611	$ 626	$ 285	22.7x	22.8x	6.6x	10.6x	10.3x	38%	4.1x
SeaWorld Entertainment, Inc.	SEAS	2.8	2.2%	$ 3,337	$ 124	$ 325	$ -	$ -	$ 122	27.3x	27.0x	10.3x			80%	4.6x
Walt Disney Company	DIS	4.2	10.2%	$ 201,320	$ 6,656	$25,210	$43,300	$54,969	$ 7,355	27.4x	30.2x	8.0x	4.6x	3.7x	100%	1.2x
Royal Caribbean Cruises Ltd.	RCL	2.1	2.5%	$ 25,875	$ 681	$ 429	$ (1,955)	$ (3,186)	$ 413	62.7x	38.0x	60.3x	-8.1x	-8.1x	32%	4.88
	Median	3.5	3.6%	25875.2	681.5	975.2	446.0	626.3	296.9	27.3x	30.2	8.0x	4.6x	3.7x	67%	4.1x

Key Takeaways from Trading Comps Table:

- Most of these businesses are terrible: volatile operations with perpetually low ROIC and high leverage (DIS is by far the best and most consistent of the bunch)
- Direct competitor, Carnival (CCL) is at 1.5x book value (which is still expensive) despite having an identical return on invested capital (5.33% versus 5.58%), and ROIC averaging 2x higher over the last 5-years
- RCL's EV/5-year Cumulative FCF is 60x, 5x higher than CCL
- EV/Peak FCF is 38x
- EV/NTM FCF estimate is 63x
- RCL's FCF "hit rate" (FCF greater than zero in a year) is abysmal at 32%
- Leverage is almost a full turn higher than the median of the peer set

One previously stated goal of management's is to maintain market share. So my question is if competitors increase their fleet by 20%, would RCL also? In such an industry this makes no economic sense as it magnifies the boom/bust cycle. It would far better for shareholders to care about ROIC and profitability, not maintaining market share.

Bull Arguments:

RCL operates in an amicable oligopoly with low global penetration. Yawn. This has been true since inception.

Double/Double: Management's double/double initiative is to double EPS by 2017 and reach double digit ROIC by then. The pillars of the strategy laid out to achieve the double-double program are the essentially same things the company has been saying for the past two decades: **grow revenue yields, maintain cost conscious culture and grow capacity moderately** (3-5% per year). This is the same strategy the company has been articulating throughout its history. Truly nothing has changed in this regard. In the recent past (2009) such initiatives were called the "Financial Improvement Team" whose objectives were to cut costs. ROIC has been listed as a focus most years:

> "Another key measure we look at with respect to profitability is return on invested capital." Q3 2004 call
> "It's a testimony to our focus on costs…" Q1 2013

Intense Focus on Costs

- $125 Million annual savings plan with no sacrifice to guest, trade or marketing activities
  - Reduction in force of over 400 position
  - Reduction in pension contribution
  - Reduction in salary and benefits
  - Elimination of non value added activities
- Discontinued dividends driving savings of $133M
- Continuous review of cost structure and activities

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2009 slide: Intense Focus on Costs

This double/double initiative does not worry me from a shorting point of view. A focus on cost and ROIC by any other name would smell just as sweet to a short seller. Large companies miss these sorts of intermediate term forecasts all the time. Remember IBM's 2015 Roadmap in 2010? They set a three-year target to achieve at least $20 in EPS (up from $11.35) and an incremental $20 billion in revenue. Fast forward five years and their EPS is flat and revenue growth has been negative in 11 consecutive quarters so in Q4 2014 they "abandoned" the Roadmap targets. It is more of the rule than the exception that companies miss bold 3-year operational targets.

What is needed to *actually* achieve reaching a 10% ROIC? They need to take NOPAT from just shy of $1 billion in 2014 to $1.95 billion while invested capital is forecasted to grow by $3 billion over the same period from $$16.54 billion to $19.5+ billion. When you are growing invested capital so quickly it is tough to achieve an accelerating ROIC. The 2017 target is far enough off to keep investors hanging on like Rose while they can continue to miss financial targets in the nearer term.

It isn't hard to fathom and imagine the plethora of excuses the management team will recycle or could come up with when they miss their long term earnings and ROIC targets.

"The Assets Are Portable" – this is such a great soundbite and theory, but it hasn't mattered in the past and I'm not convinced it will matter now. Every competitor has the same advantage, so when Net Yields are rising in one region, everyone will react and move more ships to that area, capping the growth and repeating the cycle.

China hitting some kind of tipping point: "China game –changing shift" Please point to any public company that has successfully and profitably, seamlessly expanded in China. Any investor base that points to growth in China as a bull case will typically make me more excited about exploring a short thesis.

With an affinity for investing in large infrastructure projects and subsidizing shipyards and other industries with overcapacity that consume large amounts of commodities, I would be worried about a quick flood of capacity brought into China should decent returns make an appearance.

Main bull point: New-builds garner ticket price premiums upwards of 25% and cost 20% less to operate. Large new ships garner a 25% yield premium, therefore with 8-9% capacity growth from two new Oasis class ships alone can bump net yield growth by 2%. This will not increase FCF. This is akin to Tuesday Morning (see my short write-up on SumZero) showing highly positive same store sales by moving into stores that are at least 50% larger yet showing no improvement in operating income. Larger stores and ships are not a panacea for poor profitability but keep the investors happy and distracted.

<u>Investors have been getting excited about "new hardware" throughout the company's entire history.</u> Each new generation of ship has been more efficient and garnered ticket price premiums, though still nothing fundamentally changes for the company as a whole. Nicer, newer ships will only continue to cannibalize sales and pricing on older ships, or increase the need for renovation cap-ex on the older fleet.

To wit, here is a screenshot from a Dean Witter sell side report in May 1995:

New ships are more efficient. These new ships provide economies of scale on both an individual ship and fleet basis. New ships are the most appealing to passengers and generate higher per diems and better margins. Projected cash flow increases geometrically rather than proportionately with ship size.

Berths	Cash Flow	Construction Cost
small	$20 million	$150-200 million
large	$70-80	$275-300
mega	$90-100	$300-325

Buckingham Research – sell-side report from February 1998:

Greater Efficiency

Large new ships are significantly more efficient, spreading operating costs over a larger passenger load. Rising revenue also absorbs overhead and shore-based costs; as a result, operating margins should continue to improve.

Paine Webber report, April 2000:

Royal Caribbean has an estimated ten ships currently on order through 2004, which can result in improved operational efficiencies should yields continue to be managed effectively. We believe such yield management can position Royal Carribean to produce consistent 15-20% cash flow growth through the early part of the new millennium, and abate concerns regarding management's ability to deal with expanding capacity.

The stock fell by another 50% over the next 17 months from the time Paine Webber was hyping 15-20% cash flow growth from larger ships. Downside and multiple compression were not even contemplated and still to this day are rarely given attention. The risk section of excerpted Pain Webber report above is limited to one sentence: "Primary risks relate to the company's ability to effectively manage through a significant growth phase, in addition to concerns relating to a severe downturn in the consumer economy and industry-wide overcapacity."

for delivery within the next 2 years. New high-end ships projected to enter the fleet (such as Voyager of the Seas) will command pricing premiums, as these new ships will garner a significantly larger proportion of higher yielding balcony cabins, adding luster to Royal

Competitive Advantage from Vision Ships

The new Project Vision ships will confer important competitive advantages on RCL, in our opinion. The Project Vision ships offer more to the customers. They are large ships with a wide range of on-board activities and entertainment, including an 18-hole pitch & putt golf course, casino, show lounge, disco, cabaret, children's centers for three age groups, shopping, top-notch workout room, saunas, steamrooms, massage, facials and beauty center, running track, aerobics area, two swimming pools (one with a retractable glass roof) and a stargazing observatory. *Legend*, which is essentially booked through December, is achieving prices per diem on its Alaska itineraries about 20% higher than the ship serving these routings last year.

Above is screen shot excerpt from NatWest Securities report in May 1995.

Additional beds require additional fuel, additional crew, food, etc. History has proven there is simply no operating leverage or benefits of scale despite ongoing fuel efficiency improvements, more cabins with balconies, etc.

Quick note on Sentiment: RCL is listed as a top 2015 pick of Barron's, the top pick for UBS sell-side, the top Leisure pick for 2015 for Barclays, and probably a few others I have missed. The average target price is $85.62. The stock is unanimously loved. As a gauge of Buyside sentiment—short interest is only 3.6% and the shares are easily borrowable at GC rate. Checks of my thesis with buysiders that are long the stock provide plenty of push back saying that I am missing the potential because I am not giving management much credit. I agree, I am not taking them at face value nor giving them credit for long term guidance given the business' poor history…and *that* is the main point of my short thesis.

Capacity Additions/Near Term Outlook: The industry will do ~4.6% CAGR in total capacity from now through 2017. RCL is slated to take delivery of four new ships between now and the end of 2016. Double digit capacity additions in the Caribbean are causing earnings weakness and the sell-side thinks this is limited to a Q1 2015 phenomenon. Despite knowing a huge 13% capacity increase was coming in the Caribbean in 2014, management kept 2014 net yield guidance for Caribbean the same as 2013:

> "We acknowledge there is heightened interest in the fact that our capacity growth in the Caribbean and that of the overall industry will be approximately 13% in 2014 versus approximately 2% growth in 2013 over 2012. Interestingly, our Caribbean yield change this year over last year and our preliminary Caribbean yield change outlook for 2014 are roughly equal. This supports our view that while the capacity growth percentage is a relevant factor in the overall equation, it's just one of many factors that will determine sector performance." Q3 2013 Earnings Call

Later, they flip-flop and unsurprisingly this capacity increase is blamed for the weakness:

> "Looking again at 2015, it remains a tale of two periods. The first period is the first quarter which, as we have said before, continues to struggle. This is the tail-end of a period with large capacity additions in the Caribbean and also has the fallout from 2014's Caribbean malaise. But the last nine months of the year are a very different story." – Q4 2014 Earnings Call on January 29th, 2015.

Estimates are already turning lower—sell-side is looking through a weak guide for Q1 and assuming a quick snapback with yield increases of 2.5-4.5% for full year 2015. Net yield guidance for Q1 2015 was -1.5-2.0% in constant currency terms versus consensus of +1.1% prior to the Q4 call, so the near-term outlook turned decidedly worse in the last few months. Occupancy rates 60 days prior to sail date are coming in ~ -2% YoY, this will be reflected in lower ticket prices in order to fill the ships.

European net yields were up double digits in 2014 as capacity growth was -7%. Capacity growth in Europe will revert to massively positive, hindering the sustainability of this net yield growth, but assumptions are for mid-single digit increases for all of 2015. This issue of regional weakness following supply increase is a bit like whack-a-mole for the company—there is always something popping up causing problems.

Just when reporting Q3 2014 earnings, RCL was still guiding for full year Net Revenue Yield growth of 1.5-2.0% as reported. After Q4 the actual number for the full year was +1.4% as reported. Q2 2014 updated full year guidance was for 2-3% As-Reported Net Revenue Yield growth. I point this out not to fault management, but rather to give the read a sense of how often they miss their own forecast even just three months out due to wild swings in currencies and expenses.

In mid-2000, the 2001 EPS estimates were rising due to strong "WAVE season" (the period when most people want to book a cruise, January – March) booking period and analyst extrapolated, expecting EPS to be >$3.00. They

subsequently came in at $1.32. Earnings estimates have historically been too high for the company, but are especially aggressive at the top or inflection of a cycle often missing by more than 50% for up to 2-years. Guidance is volatile and has a history of missing targets widely that were just set months prior. One Law of Hype is to always backend load guidance:

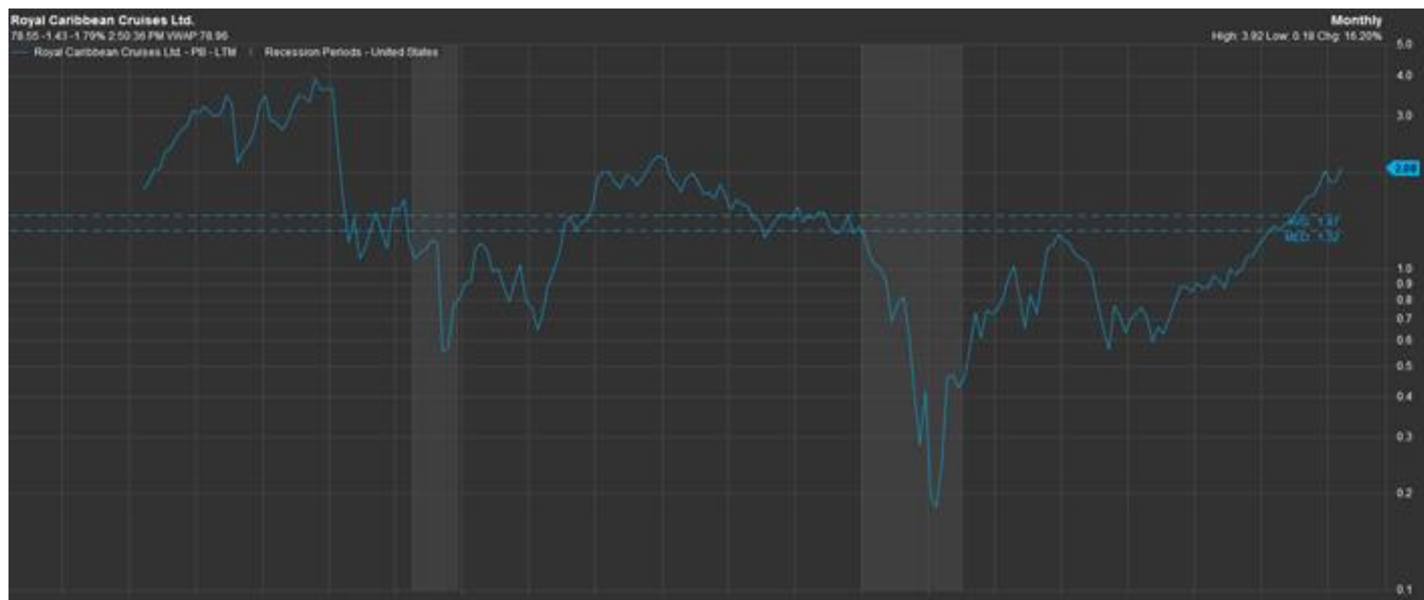
Despite this poor history of forecasting the business, late in a cycle management garners more credibility in their extrapolations and the sell side gets more confident than ever in their outlook.

Price Target:

Shares have typically tracked NTM earnings estimates but frequently take a dip below book value. Reported GAAP EPS provides a false positive impression of the nature of true business economics. As shown due to ROIC continually falling short of WACC, an earnings-based valuation approach to RCL shares is fundamentally flawed and shares should be closer to invested capital since they have never generated FCF after 25 years of operating history. Additionally, consensus estimates are often above company guidance with actual results coming in below guidance so forward EPS cannot be relied upon.

RCL's WACC is 9.2%, thus a reversion to 10% ROIC is simply a stopping of destroying shareholder value—so even if they achieve a double digit ROIC, at that point the shares should trade roughly at book value. ROIC would need to exceed WACC by a much wider margin for RCL to actually create value for shareholders and be priced at a premium to book value. At a multiple of >2x tangible book value the shares already more than incorporate the assumed increase in profitability. The implied duration of this increase in profitability and earnings growth is so far off from RCL's own history and what economic theory tells us will happen within this competitive, capital intensive cruise industry.

To derive a rough estimate of the downside I give them credit for book value per share growth from $37 to $41 and apply a 1.1x P/B multiple for a conservative share price target of $45.10 within the next 18 months. This equates to 43% downside from the current market price. Risk/returns can be tailored with bearish oriented options positions. **The shares have spent 32.3% of all months it has been public under 1.1x book value**. A reversion to such a valuation is not a rare occurrence. For the long period that shares didn't dip below 1.1x book (from July 2003 to February 2008) the P/B multiple still only averaged 1.63x versus the current 2.1x, which would put the shares at $60 versus the current $79.50.



The average P/B multiple since inception is 1.47x and the median is 1.32x (source: Factset). Shares hit a low of 0.57x book value in the 2001 recessionary period and 0.18x book in the 2008 recession. A recession or economic collapse is not necessary for the shares to revert to the long term average at some point, providing a solid return from the short side.

Conclusion

Management has grown adept at hyping the latest class of new builds while always citing a new scapegoat for poor operating performance and missing earnings estimates—be it the timing of maintenance expenditures, one-time restructuring costs, negative industry publicity, tough comparables, inflationary pressures, Ebola, SARS, the weather, or something entirely new. They are equally as eager to pat themselves on the back for positives or attribute them to "brand strength." After going through every kind of operating condition possible—periods of rising net yields per available berth, falling net yields per available berth, rising oil prices, falling oil prices, etc., one would think that 25 years of history is enough for the market to figure out this is a terribly capital intensive business model that is incapable of generating free cash flow over a cycle.

RCL must continue levering up in order to grow. They cannot internally finance debt pay down, nor growth capital expenditures. The discretionary nature of the cruise industry demand and the periodic imbalances caused when capacity sails into the market in large increments leave RCL especially susceptible to the whims of the economic volatility of the real world.

After a thorough review of the projected, the current and the historical data, I am confident there has been no paradigm shifting change now that will create a permanent inflection point in ROIC or future free cash flow prospects for RCL causing it to deserve all time high valuations. Rather what has happened is that in this momentum market, a rising tide of blind capital has simply floated RCL's boat to all time high valuations, on both a forward and trailing basis (**being in 146 different ETFs and being added to the S&P 500 in 2014 certainly helps!**).

With ongoing poor returns on capital that are consistently below the cost of capital, the shares should trade at or below invested capital of around $40 per share. Management can achieve the double/double initiative and shares should still trade closer to book value. When the euphoria inducing fog that is clouding people's judgment eventually evaporates I expect RCL shares to take on water and sink back towards book value, which is over 50% lower from here. Don't expect the captain(s) to go down with the ship-**in the last six months insiders have cashed out over $500 million worth of their stock.** Buckle your life preserver or abandon ship--the insiders are quickly rowing away to avoid the suction vortex caused by such a large mass going down.

I'll leave you with this short excerpt from the opening of chapter 8 of Howard Marks' book *The Most Important Thing*—as looking back in a few quarters from now I am confident this will apply to a short in RCL:

> "In investing, as in life, there are very few sure things. Values can evaporate, estimates can be wrong, circumstances can change and "sure things" can fail. However, there are two concepts we can hold to with confidence:
>
> - ***Rule #1*: most things will prove to be cyclical.**
> - ***Rule #2*: some of the greatest opportunities for gain and loss come when other people forget rule number one.**
>
> Very few things move in a straight line. There's progress and then there's deterioration. Things go well for a while and then poorly. Progress may be swift and then slow down. Deterioration may

> creep up gradually and then turn climactic. But the underlying principle is that things will wax and wane, grow and decline. The same is true for economies, markets and companies: they rise and fall."

Thank you kindly for your attention in reading this lengthy write-up.

Appendix: A Look back at History

Net Revenue Yield is calculated as: Passenger Ticket Sales + Onboard and Other Sales – Commissions, transportation & Other – Onboard and Other Expenses divided by Available Passenger Cruise Days. It is a quick way to gauge net revenue per cruiser per day. This is akin to same store sales comps for retailers, or RevPAR for hotels, or Revenue Per Available Seat Miles for an airline operator.

1990: Monarch of the Seas catches fire while under construction in France. RCL takes $7.5mm charge.

1991: Soft pricing environment—weak economy, Persian Gulf War. Viking Serenade goes out of service for six months. Net yields decline by 3%, total occupancy decreased from 98.6% in 1990 to 97.5%.

1992: RCL takes delivery of delayed Monarch of the Seas and Viking Serenade gets a full year of service. EPS on the year come in $1.17 versus $1.15 in 1990. Several cancelations for the Nordic Prince due to Hurricane Andrew. With 33% increase in revenues y-o-y due to Viking/Monarch, bottom line comes in the same as it was two years prior.

1993: +4.4% net yield increase. RCL goes public.

1994: No capacity increase in 1994. +5% net yield increase. RCL extends useful life assumption for ships from 25 years to 30 years, causing lower depreciation and $0.16 EPS boost.

Negatives: Legionnaires' disease outbreak, "intestinal illnesses" resulting in voyage cancellations, electrical fires, ship ran aground. A $5.7mm non-recurring charge.

Achille Lauro sinks in December 1994 off the coast of Somalia (not owned by RCL). This same ship was hijacked in 1985. **Comments on Q4 call emphasize initiatives in improving long term ROI and focusing more on the expense side during 2005. Sound familiar?**

"Given the continued solid demand that we have been experiencing, I don't see any reason that the pricing won't continue to be stable…"- Bullish comments from CEO at the end of 2004. 2005 results were abysmal. No foresight into the business one-year out.

"What a difference a year makes. Everyone recalls second quarter of last year was the quarter where we were most effected by the war in Iraq. Our yields were down 3.9% and earnings per share was down 18%."

"The strength that we've been describing for some time has really sustained itself."

"Another key measure that we look to in respect to profitability is return on invested capital. ROIC on a quarter-over-quarter basis improved by ~2.6% and is in line with **our goals for ROIC improvement.**"

No absolute number for ROIC goal was given, and there was no more mention of it other than that sequential improvement. This is but one instance of management having been talking about ROIC throughout the company's public history and said it is a focus. What is truly different this time? Nada.

1995: Soft demand—net yields decline 1%. Economic weakness and delayed tax refunds blamed for poor results. Mild winter weather blamed. Rising oil prices blamed. 2004 commentary was solidly bullish.

"These unfortunate circumstances that occurred in the cruising industry in the last year are not expected to recur as frequently in the future." – sell side report, Robinson Humphrey – November 28th, 1995.

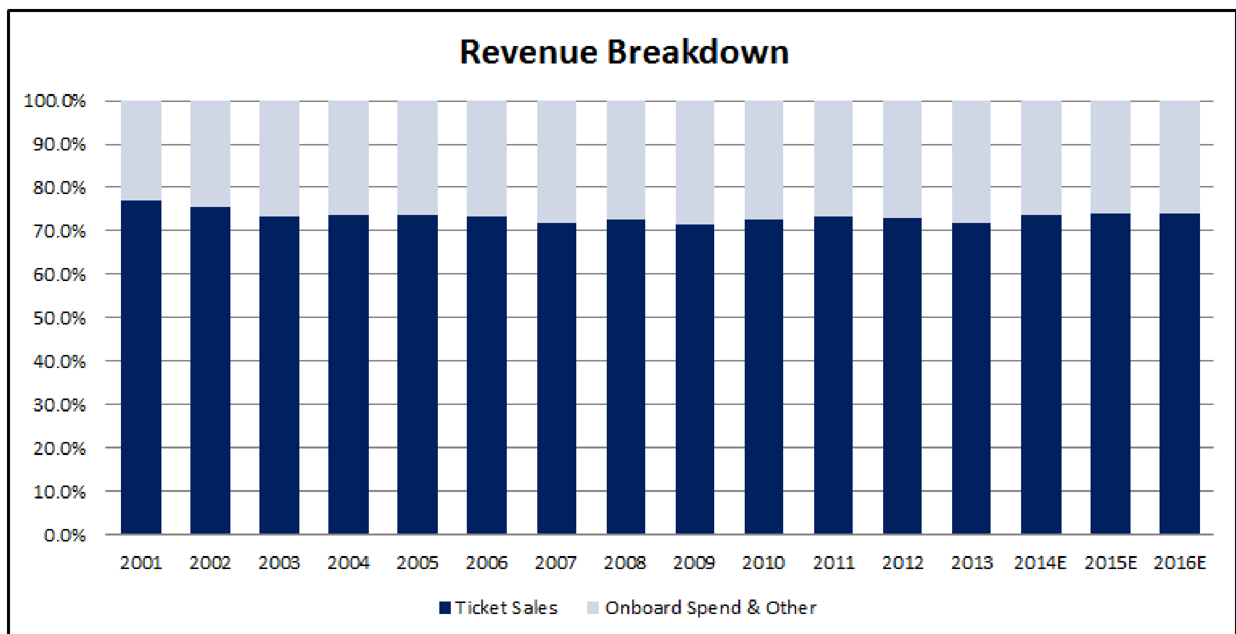
1997: $7.6mm charge for early retirement of debt. Acquired Celebrity Cruises, ROIC has declined to 9% from 13% in 1995 by now.

1998: $9mm non-recurring charge—settlement of litigation. $32mm write-down of Viking Serenade (built 1982, stretched in 1991, adjustment in 1998 below previously stated book value).

1999: Beat Q2 EPS estimates by 6 cents due to undisclosed non-operating source of income that added 7 cents to EPS. $14mm one-time legal settlement with DoJ (dumping oil contaminated bilge water then trying to conceal this from Coast Guard).

Remembering what it was like at the peak: Among a slew of other fawning upgrades, RCL coverage was initiated on December 15th, 1999 by PaineWebber. Their $65 PT out of the gate was based on 26x forward EPS estimates citing their aggressive shipbuilding program and the untapped European market (similar comments surrounding China now). With the benefit of hindsight we now know that the stock had already peaked a full two months earlier at $53.06 and was down over 60% within four months of the initiation, ultimately bottoming at $11 and not re-attaining previous $53 peak for at least another five years (and never reaching their original PT until recently in Q4 of 2014!).

2010: Q1 EPS beat comes from non-recurring legal settlement (win).



Ticket sales have averaged 73.3% of revenue since 2001, while onboard spend has averaged 26.7%. This is right in line with the 2014 period of 73.0% and 27.0%, ***again proving nothing has changed in the make-up of the business over time.*** Stress testing to the 2009 period we see that Passenger Ticket Revenues declined by 11.1% and Onboard sales were -6.6% YoY.

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