Royal Caribbean Cruises Ltd.

CLIENT REPORT

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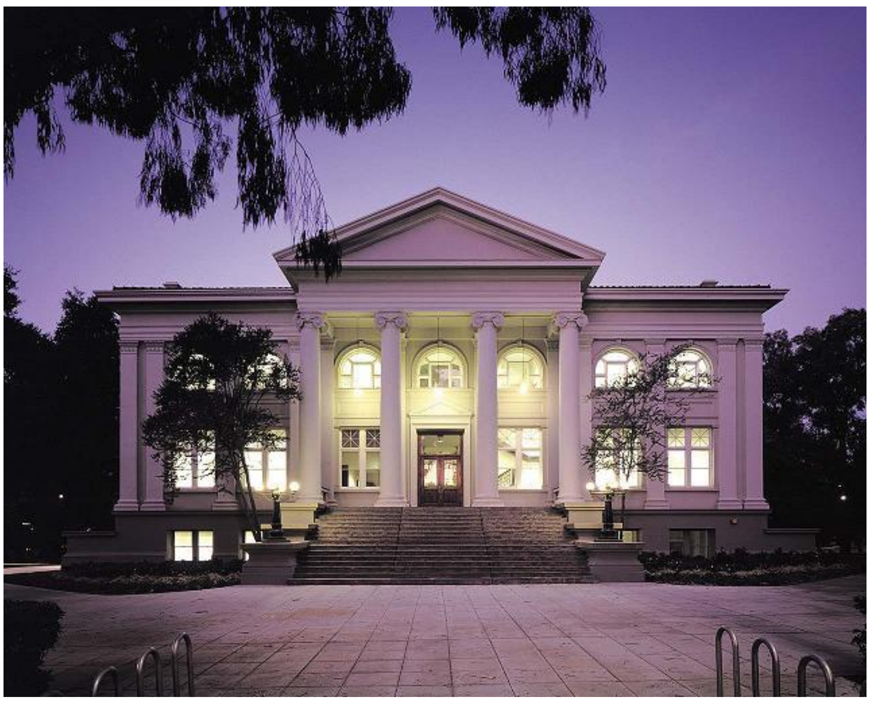

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Executive Summary

Royal Caribbean Cruises Ltd. (Royal Caribbean or RCL) is the world's second largest cruise line operator. It owns five cruise lines: Royal Caribbean International (22 ships), Celebrity Cruises (11 ships), Pullmantur Cruises (3 ships), Azamara Club Cruises (2 ships), and CDF Croisieres de France (2 ships), and a 50% stake in TUI Cruises (3 ships). Together, these six companies operate 43 ships, travel to 480 destinations on all seven continents, and have an aggregate capacity of approximately 105,750 berths[1]. Royal Caribbean is incorporated in Liberia, and headquartered in Miami, Florida. Its biggest competitor are Carnival Corporation & plc (CCL), and Norwegian Cruise Line Holdings Ltd. (Norwegian or NCLH).

Most of Royal Caribbean's ships have home ports in America or Europe, with some ships departing from Asia and Latin America. Royal Caribbean is positioned as an up-scale contemporary and premium cruise line company, with a variety of itineraries and activities. Trips last between 2-23 days, with multiple stops. Royal Caribbean takes pride in their exceptional service, innovation and quality of ships, variety of itineraries, choice of destinations, and price. They have been able to attract new and repeat guests through building state-of-the-art ships and incorporating new innovations into their itineraries. Royal Caribbean faces stiff competition from Carnival Corporation as well as land based resorts.

[1] A berth is one bed. Most cabins are double occupancy rooms with two berths.

Cruising is considered a well-established vacation sector in North America and a growing sector in Europe. It is a quickly developing sector in emerging markets (Asia, Latin America, etc.). Market penetration is still relatively low (3.5% NA, 1.2% EU) and reliant on repeat customers. Competition exists among cruise line operators and with land-based vacations, but entrants in the cruising industry have a difficult time gaining scale. Recently, buyers have new avenues to purchase tickets online instead of solely through travel agents. Suppliers in this market however are limited, as not many shipyards can build the megaships the industry is shifting to.

Moving forward, Sontag Solutions believes Royal Caribbean should conduct in-depth customer analytics to gain further insight into guests' decision making process. This will allow them to increase their market penetration and customer base. They need to create greater brand loyalty to ensure repeat guests. Royal Caribbean should develop additional ways to market and sell cruise tickets, decreasing the influence of traditional travel agents. They can also shift to technology based travel companies to decrease commissions. It would also be prudent to focus on developing their presence in Asia, which represents the fastest growing market. They should establish cruising as a vacation choice, rather than an alternative, early on. Expanding their fleet will allow them to service additional markets, both in Asia and internationally. Finally, maintaining strong and active public relations can keep customers happy and demand high. Focusing on these aspects will allow Royal Caribbean to continue to grow and generate profit in the future.

Company Background

Royal Caribbean Cruises Ltd. (RCL) is the second largest global cruise line operator. They have 43 ships[2], an aggregate capacity of approximately 105,750 berths, and carried 5,149,952 passenger with an occupancy rate of 105.6%[3] in 2014. They employ over 64,000 employees, and around 86% of their 58,000 shipboard employees are covered by collective bargaining agreements.

Cruising offers an “all-inclusive” package for vacationers to escape to exotic destinations while enjoying the journey there. Cruising is a great value proposition for couples and families with kids, especially compared to alternative land-based vacations. The combinations of transportation, accommodations, dining, and entertainment for an all-inclusive price is difficult to replicate.

The cruising industry has grown significantly but remains relatively small compared to the global vacation industry. Cruising is a well-established vacation sector in the North American market, a growing sector in the European market, and a developing sector in other emerging markets inducing Asia and Latin America. Approximately 20% of the U.S. population and lower percentages of the European, Asian, and Latin American populations have ever taken a cruise[4]. Penetration rates are low and indicate the whole cruising market has room to grow by capturing a greater share of consumers’ spending. Many emerging international markets are experiencing a

[2] Ships are registered in the Bahamas, Malta, or Ecuador.
[3] RCL 2014 Annual Report. Occupancy rate calculated using 2 passengers per stateroom.
[4] Carnival Corporation & plc 2014 Annual Report

rapid growth in middle-class consumers, who have greater levels of disposable income to spend on travel.

Annual Market Penetration Rate

Year	North America	Europe
2010	3.10%	1.10%
2011	3.40%	1.10%
2012	3.30%	1.20%
2011	3.40%	1.10%
2012	3.30%	1.20%

The total number of global cruise guests is estimated to be at 22 million in 2014; the aggregate global supply of berths is estimated to be 457,000 on 283 ships with an additional 98,650 berths on 33 ships coming into service between 2015 and 2019. The North American market represented 55.7% of global cruise guests in 2014 and has grown at a compound annual growth rate (CAGR) of 3.3% from 2010 to 2014. Europe represented 29.7% of the global cruise guests in 2014 and has grown at a CAGR of 4.2% from 2010 to 2014. The Asia/Pacific region represented 8.5% of the global cruise guests in 2014 and has grown at a CAGR of 16.4% from 2010 to 2014[5].

Royal Caribbean Cruises Ltd. is well situated to take advantage of these trends. Royal Caribbean Cruise Line was founding in Norway in 1968 as a partnership. Royal Caribbean Cruises Ltd. was formed when Royal Caribbean Cruise Lines and Celebrity Cruises merged in 1997[6]. The two

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[5] RCL 2014 Annual Report
[6] "Royal Caribbean Cruises Ltd." Reference for Business, Encyclopedia of Business, 2nd ed. Retrieved 4/10/15. http://www.referenceforbusiness.com/history/Ro-Sh/Royal-Caribbean-Cruises-Ltd.html

cruise brands were kept separate following the merger, and Royal Caribbean Cruise Line was rebranded Royal Caribbean International while Royal Caribbean Cruises Ltd. was established as the parent company. Royal Caribbean maintains its headquarters in Miami, Florida, but is incorporated in Liberia for strategic purposes.

Royal Caribbean later began developing additional brands and purchased Pullmantur Cruises in 2006, created Azamara Club Cruises in 2007, CDF Croisières de France 2008, and the joint venture TUI Cruises in 2009. Royal Caribbean International, Celebrity Cruises, and Azamara Club Cruises are global brands. The Pullmantur brand is targeted towards the cruise markets in Spain, Portugal, and Latin America; the CDF Croisieres de France brand is tailored to serve the French market; the 50% joint venture TUI Cruises is tailored for the German market. In 2014, Royal Caribbean acquired a 35% equity stake in Skysea Holding International Ltd., a cruise ship operator created in partnership with Chinese travel service provider Ctrip.com International Ltd.

Royal Caribbean Intentional

Royal Caribbean International is the flagship brand of Royal Caribbean. They operate 22 ships with an aggregate capacity of approximately 64,150 berths and offer cruise itineraries that range from two to 18 nights. Royal Caribbean International is positioned at the upper end of the contemporary segment of the industry, which is usually characterized by cruises seven nights or shorter, and feature a casual ambiance. Its positioning also allows it to attract guests from the premium segment, where cruises are generally seven to 14 nights and appeal to the more affluent and experienced guests.

Royal Caribbean International differentiates itself by seeking innovations in onboard dining, entertainment, and other onboard activities, in addition to providing a wide variety of itineraries and cruise lengths. They are also known for operating the largest cruise ships in the industry; the Oasis-class ships are the largest, while the Quantum-class are in second, and the Freedom-class in fourth[7]. Royal Caribbean International also owns two private islands, Labadee and Coco Cay, which are used on certain itineraries.

Royal Caribbean International will by greatly increasing their fleet size over the next few years. Royal Caribbean International received the Quantum-class 4,150 berth *Quantum of the Seas* in 2014. They have placed orders for four new ships, two 4,150 berth Quantum-class and two 5,400 berth Oasis-class ships, which will increase aggregate capacity by about 19,200 over the next three years[8]. Quantum-class *Anthem of the Seas* is scheduled to be delivered in spring 2015, Oasis-class *Harmony of the Seas* is expected to be delivered in spring 2016, Quantum-class *Ovation of the Seas* is expected to be delivered in fall 2016, and the other Oasis-class ship is expected to be delivered in second quarter 2018. Since market share is almost directly correlated with capacity, these new ships will allow Royal Caribbean International to grow and capture a greater share of the market.

Celebrity Cruises

Celebrity Cruises operates 11 ships with an aggregate capacity of 24,900 berths. They offer cruise itineraries that range from two nights to 23 nights, and position themselves in the premium

[7] "List of the World's Largest Cruise Ships." Wikipedia. Retrieved 4/10/15.
[8] RCL 2014 Annual Report

segment of the cruise vacation industry. Celebrity Cruises offers luxurious accommodations, a high staff-to-guest ratio, fine dining, and spa facilities to offer an upscale experience for experienced cruisers and quality and service oriented new cruisers. Celebrity Cruises has also placed orders for two 2,900 berth Project Edge ships, which will be delivered in 2018 and 2020.

Azamara Club Cruises

Azamara Club Cruises operates two ships with an aggregate capacity of 1,400 berths. Itineraries range from four to 20 nights and are targeted towards the premium and luxury segments, characterized by longer trips and high levels of service, of North America, United Kingdom, and. They differentiate themselves by offering smaller ships, high standards of accommodation and service, and exotic destinations. They also have comprehensive tours allowing guests to explore the destination in-depth.

Pullmantur

Pullmantur operates three ships with an aggregate capacity of 6,200 berths, with itineraries ranging from two to 17 nights. The Pullmantur brand is targeted towards the contemporary segment of the Spanish, Portuguese, and Latin American cruise markets. Over the past few years, Pullmantur has been expanding their presence in the Latin American market. The fleet will expand by one ship when the 2,750 berth *Majesty of the Seas* is redeployed from Royal Caribbean International to Pullmantur in 2016.

CDF Croisieres de France

CDF Croisieres de France operates two ships with an aggregate capacity of 2,800 berths. They are targeted towards the contemporary segment of the French market and offer seasonal itineraries to the Mediterranean, Europe, and the Caribbean.

TUI Cruises

TUI cruises operates three ships with an aggregate capacity of 6,300 berths. It is a joint venture owned 50% by Royal Caribbean, and 50% by TUI AG targeted towards the contemporary and premium segments of the German market. TUI Cruises has orders for three new ships with an aggregate capacity of 7,500 berths to be delivered in the second quarter of 2015, the third quarter of 2016, and the second quarter of 2017.

SkySea Cruises

In 2014, Royal Caribbean entered a partnership with Ctrip.com International Ltd. to operate SkySea Cruises, a new brand offering custom-tailed products for Chinese cruise guests[9]. SkySea has purchased a ship from Celebrity Cruises and will begin service in the second quarter of 2015. Royal Caribbean owns 35% of the new company, Skysea Holding International Ltd.

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[9] “Royal Caribbean’s Chinese venture named SkySea Cruises.” Travel Weekly. Retrieved 4/10/15. http://www.travelweekly.com/Cruise-Travel/RCCL-Chinese-venture-named-SkySea-Cruises/

Financial Analysis

Royal Caribbean's market cap is $17.65B and its enterprise value is $26.16B. Its stock is currently at $80.36; over the past year, its stock has greatly risen from the low 50's. They pay around $1.20 in dividends a year. It derives 73% of top line revenue from ticket sales, and most of the remaining from on ship purchases of items such as alcohol and beverages, gaming, internet service, gift shop items, shore excursions, photography, spa/salon, art auctions, and specialty restaurants. Its revenue (ttm) was 8.07B at $36.42/share giving a 2.18 price to sales ratio. Its operating margin is 11.72%, with a profit margin of 9.46%. ROA is 2.90% and ROE is 8.94%. They have $189M cash on hand and a current ratio of 0.21. They have just over 8.5B in debt. Operating cash flow is at 1.74B and levered free cash flow is -92.0M. Because Royal Caribbean is an international company, they have to take into consideration exchange rates, where the dropping Euro has hurt their profits in USD despite the use of derivatives to hedge their risk.

Direct Competitor Comparison			
	RCL	**CCL**	**NCLH**
Market Cap:	17.62B	36.80B	12.23B
Employees:	63400	94100	24900
Qtrly Rev Growth (yoy):	-0.02	-0.02	0.31
Revenue (ttm):	8.07B	15.83B	3.13B
Gross Margin (ttm):	0.35	0.36	0.38
EBITDA (ttm):	1.72B	3.25B	871.33M
Operating Margin (ttm):	0.12	0.1	0.18
Net Income (ttm):	764.15M	1.30B	338.35M
EPS (ttm):	3.43	1.68	1.62
P/E (ttm):	23.39	28.19	33.15
PEG (5 yr expected):	0.75	0.92	0.98
P/S (ttm):	2.18	2.33	3.91

Royal Caribbean and its competitors have similar financial metrics, adjusting for their relative sizes. Carnival Corporation has higher revenue per employee than other cruise lines and NCLH has greater operating margins. Compared to Carnival Corporation and Norwegian, Royal Caribbean has higher EPS, and lower P/E and P/S suggesting it may be undervalued in the market compared to its competitors.

Income Statement

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (USD $) In Thousands, except Per Share data, unless otherwise specified	12 Months Ended		
	Dec. 31, 2014	Dec. 31, 2013	Dec. 31, 2012
Income Statement [Abstract]			
Passenger ticket revenues	$5,893,847	$5,722,718	$5,594,595
Onboard and other revenues	2,180,008	2,237,176	2,093,429
Total revenues	8,073,855	7,959,894	7,688,024
Cruise operating expenses:			
Commissions, transportation and other	1,372,785	1,314,595	1,289,255
Onboard and other	582,750	568,615	529,453
Payroll and related	847,641	841,737	828,198
Food	478,130	469,653	449,649
Fuel	947,391	924,414	909,691
Other operating	1,077,584	1,186,256	1,151,188
Total cruise operating expenses	5,306,281	5,305,270	5,157,434
Marketing, selling and administrative expenses	1,048,952	1,044,819	1,011,543
Depreciation and amortization expenses	772,445	754,711	730,493
Impairment of Pullmantur related assets			385,444
Restructuring and related impairment charges	4,318	56,946	
Total operating costs	7,131,996	7,161,746	7,284,914
Operating Income	941,859	798,148	403,110
Other income (expense):			
Interest income	10,344	13,898	21,331
Interest expense, net of interest capitalized	(258,299)	(332,422)	(355,785)
Extinguishment of unsecured senior notes		(4,206)	(7,501)
Other income (expense) (including $33.5 million deferred tax benefit related to the reversal of a valuation allowance in 2014 and ($28.5) million net deferred tax expense related to impairments in 2012)	70,242	(1,726)	(42,868)

Total other income (expense)	(177,713)	(324,456)	(384,823)
Net Income	764,146	473,692	18,287
Basic Earnings per Share:			
Net income (in dollars per share)	3.45	2.16	0.08
Diluted Earnings per Share:			
Net income (in dollars per share)	3.43	2.14	0.08
Comprehensive (Loss) Income			
Net income	764,146	473,692	18,287
Other comprehensive (loss) income:			
Foreign currency translation adjustments	(26,102)	1,529	(2,764)
Change in defined benefit plans	(7,213)	10,829	(4,567)
(Loss) gain on cash flow derivative hedges	(869,350)	127,829	(51,247)
Total other comprehensive (loss) income	(902,665)	140,187	(58,578)
Comprehensive (Loss) Income	($138,519)	$613,879	($40,291)

Royal Caribbean is generating sufficient revenue, but faces annual variability in profits or losses. Total revenues for 2014 increased $114 million, or 1.4%, to $8.1 billion from $8.0 billion in 2013. Passenger ticket revenues comprised 73% of Royal Caribbean's 2014 total revenues, while the remaining 27% was from onboard and other spending. Commissions, transportations, and other at $1.37 billion comprised the largest portion of Royal Caribbean's expenses, while fuel cost $947 million. In 2014, lower interest rates reduced interest expense by 22%, or $74 million, to $258 million from $332 million. Losses from cash flow derivative hedges cost Royal Caribbean $869 million in 2014. In total, Royal Caribbean lost $138 million in 2014.

Balance Sheet

CONSOLIDATED BALANCE SHEETS (USD $) In Thousands, unless otherwise specified	Dec. 31, 2014	Dec. 31, 2013
Current assets		
Cash and cash equivalents	$189,241	$204,687
Trade and other receivables, net	261,392	259,746
Inventories	123,490	151,244
Prepaid expenses and other assets	226,960	252,852
Derivative financial instruments		87,845

Total current assets	801,083	956,374
Property and equipment, net	18,235,568	17,517,752
Goodwill	420,542	439,231
Other assets	1,255,997	1,159,590
Total assets	20,713,190	20,072,947
Current liabilities		
Current portion of long-term debt	799,630	1,563,378
Accounts payable	331,505	372,226
Accrued interest	49,074	103,025
Accrued expenses and other liabilities	635,138	539,414
Derivative financial instruments	266,986	24,288
Customer deposits	1,766,914	1,664,679
Total current liabilities	3,849,247	4,267,010
Long-term debt	7,644,318	6,511,426
Other long-term liabilities	935,266	486,246
Commitments and contingencies (Note 15)		
Shareholders' equity		
Common stock ($0.01 par value; 500,000,000 shares authorized; 233,106,019 and 230,782,315 shares issued, December 31, 2014 and December 31, 2013, respectively)	2,331	2,308
Paid-in capital	3,253,552	3,159,038
Retained earnings	6,575,248	6,054,952
Accumulated other comprehensive (loss) income	(896,994)	5,671
Treasury stock (13,808,683 and 10,308,683 common shares at cost, December 31, 2014 and December 31, 2013, respectively)	(649,778)	(413,704)
Total shareholders' equity	8,284,359	8,808,265
Total liabilities and shareholders' equity	$20,713,190	$20,072,947

Royal Caribbean has a working capital deficit of $3 billion in 2013 and a current ratio of 0.21, meaning they owe five time current liabilities compared to current assets. This is normal in the cruise industry because of customer prepayments for cruises. Royal Caribbean collects cash from customers upon booking, which is then marked under liabilities. The cash from sales only becomes an asset once the customer embarks on the cruise.

Cash Flows

CONSOLIDATED STATEMENTS OF CASH FLOWS (USD $) In Thousands, unless otherwise specified	12 Months Ended Dec. 31, 2014	Dec. 31, 2013	Dec. 31, 2012
Operating Activities			
Net income	$764,146	$473,692	$18,287
Adjustments:			
Depreciation and amortization	772,445	754,711	730,493
Impairment charges			385,444
Asset Impairment Charges Related to Restructuring	0	33,514	0
Net deferred income tax (benefit) expense	(44,437)	(1,842)	28,939
Loss on sale of ship	17,401	0	0
Loss (gain) on derivative instruments not designated as hedges	48,637	19,287	(2,014)
Loss on extinguishment of unsecured senior notes		4,206	7,501
Changes in operating assets and liabilities:			
Decrease in trade and other receivables, net	100,095	95,401	8,026
Decrease (increase) in inventories	26,254	(4,321)	(1,645)
Decrease (increase) in prepaid expenses and other assets	41,077	(22,657)	(1,614)
(Decrease) increase in accounts payable	(40,651)	18,957	36,602
Decrease in accrued interest	(53,951)	(3,341)	(15,786)
Increase (decrease) in accrued expenses and other liabilities	70,565	(6,714)	33,060
Increase in customer deposits	14,885	37,077	103,733
Cash received on settlement of derivative financial instruments			69,684
Dividends received from unconsolidated affiliates	5,814	5,093	
Other, net	21,479	9,005	(18,976)
Net cash provided by operating activities	1,743,759	1,412,068	1,381,734
Investing Activities			
Purchases of property and equipment	(1,811,398)	(763,777)	(1,291,499)
Cash paid on settlement of derivative financial instruments	(68,098)	(17,338)	(10,886)
Investments in and loans to unconsolidated affiliates	(188,595)	(70,626)	
Cash received on loan to unconsolidated affiliate	76,167	23,372	23,512
Proceeds from sale of ships	220,000		9,811
Other, net	1,546	3,831	5,739
Net cash used in investing activities	(1,770,378)	(824,538)	(1,263,323)
Financing Activities			
Debt proceeds	4,153,958	2,449,464	2,558,474
Debt issuance costs	(72,974)	(57,622)	(75,839)
Repayments of debt	(3,724,218)	(2,856,481)	(2,561,290)
Purchase of treasury stock	(236,074)	0	0
Dividends paid	(198,952)	(143,629)	(117,707)

Proceeds from exercise of common stock options	70,879	30,125	15,146
Cash received on settlement of derivative financial instruments	22,835	0	0
Other, net	2,026	1,517	1,599
Net cash provided by (used in) financing activities	17,480	(576,626)	(179,617)
Effect of exchange rate changes on cash	(6,307)	(1,072)	(6,125)
Net (decrease) increase in cash and cash equivalents	(15,446)	9,832	(67,331)
Cash and cash equivalents at beginning of year	204,687	194,855	262,186
Cash and cash equivalents at end of year	189,241	204,687	194,855
Cash paid during the year for:			
Interest, net of amount capitalized	276,933	319,476	341,047
Non cash Investing Activities			
Purchase of property and equipment through asset trade-in	$0	$46,375	

Royal Caribbean relies on cash flow from operations to generate liquidity. Net cash provided by operating activities increased $332 million to $1.7 billion in 2014, mostly due to lower interest payments. Cash used in investing activities increased by $1 billion to $1.8 billion in 2014 in conjunction with an increase in capital expenditure for new ships. Cash from financing activities was $17 million in 2014 compared to losses of $577 million in 2013. The increase was mainly due to an increase in debt proceeds which was offset by repayments of debt. Royal Caribbean also uses drawdowns on credit facilities, incurrence of additional debt or refinancing of existing debt, and issuance of additional shares of equity to meet contractual debt obligations.

Competitive Analysis (Five Forces Framework)

Five Forces Analysis

Internal Rivalry	Moderate
Buyer Power	Moderate
Supplier Power	High
Threat of New Entrants	Low
Threat of Substitutes	High

Internal Rivalry (Moderate)

Royal Caribbean Cruises Ltd. faces competition from Carnival Corporation and Norwegian Cruise Line Holdings. However, the market is structured as an oligopoly, and cruise lines price to fill capacity, rather than compete on price alone. Rival holding company Carnival Corporation dominates the market with 48% of passengers, while Royal Caribbean is at 23.1%, and Norwegian at third with 10.4%[10]. However Carnival, Carnival Corporation's largest holding, is marketed as lower cost cruises and has 21.3% of the market but only 8.0% of total revenues. As a whole, Carnival Corporation has 42.2% of revenue – their other holdings are much better at bringing in revenue. Royal Caribbean maintains a much better ratio of % passengers to % revenue. Norwegian brings in more percent revenue than percent passengers, but is a distant third in both.

Royal Caribbean's multiple brands allows it to compete on multiple fronts. Royal Caribbean International can capture the global contemporary market, Celebrity Cruises serve the global

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[10] "2015 World Wide Market Share." Cruise Market Watch. Retrieved 4/15/15. http://www.cruisemarketwatch.com/market-share/

premium market, and other brands to complement them by targeting country specific segments. The most successful cruising companies have operated multiple lines, allowing them to target specific markets while maintaining a diversified portfolio of revenue sources. By targeting different markets with different subsidiaries, Royal Caribbean can prevent competition within its own companies. The concentration ratio in the cruise line industry is high, and significant merger and acquisition activity occur in this industry. The four largest cruise companies account for 96% of the market[11]. Companies often acquire other cruise lines to expand their service lines and take advantage of economies of scale.

Competition to attract customers is based on price, brand, itinerary, and ship amenities. However, price is largely determined by the balance of supply and demand in a certain market, and oversaturating a market can result in the same level of competition, but just at lower prices. Moreover, market share in the cruise industry is directly proportional to capacity, so growth is driven by increasing supply, while trying to expand demand. Luckily, cruise ships are a mobile good and companies can redeploy ships or even transfer them among brands to maximize profit. Royal Caribbean International is also known for its mega-cruise ships, and it has four more on the way. This should bolster their ability to compete with rivals and capture more market share.

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[11] "The Cruise Industry." The Geography of Transport Systems. Retrieved 4/10/15. http://people.hofstra.edu/geotrans/eng/ch7en/appl7en/ch7a4en.html

Bargaining Power of Buyers (Moderate)

Bargaining power of the end guest is not significant, as cruise lines ultimately set price to meet capacity and maximize profits. Although cruise companies may take customer preferences in mind, cruise lines are the final arbiters of itineraries, dates, and prices. Consumers may be able to shop for the best prices, but they don't have negotiating power with the companies. They may be able to exert some unintended influences as their purchases are often made through travel agencies.

There more interesting dynamic is between cruise lines and travel agents, who have the power to influence selection through recommendations. Cruises have been traditionally booked through travel agents, who wield moderate supplier power. Travel agents receive a commission, usually around 12%, for every sale[12]. Booking rooms can be tricky, and travel agents can help organize an entire trip including flight, pre and post-trip stays, shore excursions, and cabins. Travel agents can be influenced by the amount of commission they receive from each company, as well as the ease of booking either electronically or over the phone. However, the cruise lines negotiate commission with each travel agency directly. Because numerous travel agencies exist, cruise lines are competing as much with rival cruise companies on commission, as they are with travel agencies on bargaining power.

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[12] "Selling Cruises: Does it Still Pay?" Travel Market Report. Retrieved 4/10/15. http://www.travelmarketreport.com/articles/Selling-Cruises-Does-It-Still-Pay

Additionally, the Internet decreases the power of travel agents, and gives more power to technologically adept vacationers. It is easier to shop and compare cruises, and 10% of cruise bookings are made without speaking to an agent[13]. A larger percentage of low cost cruises, with simple cabin arrangements, are made online. Companies also have last minute discounts to fill rooms and lower fixed costs per cabin which can be advertised through email or online advertisements. The greatest barrier facing online booking is linking the separate components of the trip together. While websites exist to book a cruise, a flight, a hotel, shore excursions, and entertainment, a streamlined method of booking the disparate items together online has not arrive at the market. Until then, travel agents may be the preferred method of booking for older vacationers who would rather not deal with the hassle of navigating separate websites.

Bargaining Power of Suppliers (High)

The bargaining power of suppliers within the cruise line industry is high. Royal Caribbean and the cruise industry in general are reliant on a few shipbuilders. Not many shipyards have the ability to build mega-cruise ships; the four companies with dominate the construction market are STX Europe in the shipyard STX France, Mitsubishi Heavy Industries, Meyer Werft in their German and Finland shipyards, and Fincantieri[14]. Royal Caribbean International has placed their orders for four ships, totaling over $4 billion dollars, with Meyer Werft, and STX France. The low number of suppliers means they have significant bargaining power. Ships also take up to 2-

[13] "Why Travel Agents and Telephones Still Rule Cruise Booking." Skift. Retrieved 4/10/15. http://skift.com/2013/11/11/why-travel-agents-and-telephones-still-rule-cruise-booking/
[14] "Cruise Ships on Order 2009-2019." Austrian Marine Equipment Manufactures. Retrieved 4/10/15. http://www.amem.at/pdf/AMEM_Cruise-Ships-on-Order.pdf

years to build, meaning that commitments must be seen though over a longer time horizon. Cruise companies will also use the same shipyard for ships of the same design should they decide to increase orders at a later date. Choosing a shipyard is a significant undertaking and has lasting impacts on the ability of the cruise line to do business.

Maintenance of ships is also done by a few companies with large dry docks, this limits the market space for contractors. Royal Caribbean maintains 40% equity ownership of the Grand Bahama Shipyard Ltd., which they use for ship repairs and maintenance in conjunction with other facilities. Carnival Corporation has a 40% non-controlling interest in this property as well[15]. Docks not being used to repair Royal Caribbean or Carnival Corporation ships are used to service other cruise and cargo ships, or oil and gas tankers.

Suppliers of a cruise ship’s common goods, like fuel, food and beverage services, hotel and restaurant products and supplies, and technology have less power compared to ship construction and maintenance. Purchases are made on an open, competitive market and the treat of supplier power is low for these interchangeable goods. Royal Caribbean would be able to quickly switch suppliers if prices increased or quality decreased.

Another component to consider is the crew; ships require hundreds to thousands of crewmembers to run. Officers command the ship while entertainers and waitstaff have regular guest interaction. However, the majority of the crew is made up of behind-the-scenes workers

[15] CCL 2014 Annual Report

from developing countries. They are currently paid low wages, and could pose an issue if they strike in the middle of a cruise. Currently, 86% of shipboard employees are covered by collective bargaining agreements, and they can put pressure on Royal Caribbean is their conditions deteriorate. The crew are often paid monthly salaries of $500-$1000 and survive on tips[16]. Working conditions and accommodations are cramped as well. Royal Caribbean partially mitigates this issue by flagging its ships in the Bahamas, where they do not have to comply with US labor laws.

Threat of New Entrants (Low)

The threat of new entrants is low for the cruise ship industry. While it is not difficult to purchase and retrofit a cruise ship, it is unlikely that entrants will be able to significantly challenge incumbent positions in a short period of time. The high capital costs of building or buying ships reduce the likelihood of entrants. Entry into the high-end market is difficult as mega-cruise ships cost over $1 billion[17]. Since market size and power is directly related to the number of ships and passengers, and it would be difficult for entrants to capture market share without a long lead time. There are also legal and regulatory issues that new cruise lines would have to figure out. Companies would need to make agreements with ports to house ships, and also decide where to register their ships. Brand recognition is also important in the cruise industry, as the service is similar across cruise lines. Marketing would be a major expense to build up brand confidence.

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[16] "Cruise Crew Salaries Exposed." TravelTruth.com. Retrieved 4/10/15. http://www.traveltruth.com/2012/10/14/cruise-crew-salaries-exposed/

[17] "Cruise Ships on Order 2009-2019." Austrian Marine Equipment Manufactures. Retrieved 4/10/15. http://www.amem.at/pdf/AMEM_Cruise-Ships-on-Order.pdf

The exception to this might be within emerging markets like Asia and Latin America. The market is still being defined in these countries, and cruise lines are only beginning to commit significant resources. Native companies may have a cultural advantage, while large cruise line holding companies have significant advantages in capital and operations. New entrants in these markets may be able to grow on pace with incumbent operators if no significant difference in operations or strategy exists.

Threat of Substitutes (High)

Cruising for most customers is a vacation and has many possible substitutes. The closest direct substitute to cruises may be all-inclusive resorts like Disney World or Sandals. These resorts may be similar in price and present a land based vacation and possible greater entertainment operations. Cruises offer the ability to travel to multiple locations, but land-based resorts do not have to be located next to ports.

The cruise industry faces many competitors with positive cross elasticity of demand. Direct flights or driving to destinations may be viable for vacationers desiring to visit places inland. Such itineraries would allow consumers to spend a majority of their time at their desired destination, rather than on a ship traveling to the destination. In the global cruise industry, there are about 250,000 cabins, which is less than two percent of the number of hotel rooms[18]. Cruise lines face significant competition from vacation alternatives. Thus, cruises have to market

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[18] CCL 2014 Annual Report

themselves to be as much about the journey as the ports they visit. Royal Caribbean needs to focus on emphasizing the unique experiences provided by a cruise in order to capture potential customers.

SWOT Analysis

Strengths

Strong Brand Positioning

As the 2nd largest cruise ship operator, Royal Caribbean has significant power in the marketplace. It also maintains many subsidiaries out of and specifically targeted for Europe. Their new joint venture with Ctrip.com, SkySea Cruises, will allow them to have a brand targeted towards Asia. Their holdings cover a wide range of markets and segments worldwide. They are also able to redeploy their assets to markets where they can maximize returns. Combined, Royal Caribbean serves 408 destinations in 103 countries on all seven continents. Their advanced bookings for 2015 are at high levels, reflecting customer demand.

Four New Top of the Line Ships

Royal Caribbean International has ordered two new Quantum-class ships and two new Oasis-class ships. The 4,180 berth Quantum-class ship Quantum of the Seas was delivered in 2014 and is already operation, and the other two Quantum-class ships will be delivered in 2015 and 2016. These ships will increase their area of operations and allow passengers to have a premium experience. Additionally, in May 2015, Royal Caribbean will station Quantum of the Seas in Shanghai[19], demonstrating their desire to capture the 16% CAGR growth rate in Asia and the Pacific. Royal Caribbean has recently announced they will station the Quantum-class Ovation of

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[19] Royal Caribbean to send newest, hottest ships to China. USA Today. Retrieved 4/10/15. http://www.usatoday.com/story/cruiselog/2014/04/16/royal-caribbean-quantum-china/7781397/

the Seas, to be delivered in 2016, in Tianjin, China[20]. In additional, Royal Caribbean International has two 5,400 berth Oasis-class ships to be delivered in 2016 and 2018.

TUI Cruises has on order 3 new 2,500 berth ships, Mein Schiff 4, Mein Schiff 5, and Mein Schiff 6 for delivery in 2105, 2016, and 2017. Additionally, Celebrity Cruises has on order two 2,900 berth "Project Edge" ships for delivery in 2018 and 2020.

These larger cruise ships will allow Royal Caribbean to take advantage of economies of scale within a ship. Larger cruise ships have lower costs and higher profits per passenger, due to decreased fuel consumption per passenger mile traveled. They can also fit more and different varieties of amenities compared to smaller ships. Larger ships tend to be targeted towards the contemporary or premium segments of the market while smaller ships may be targeted towards the luxury segment.

Weaknesses

Access Limited to Port Cities

The nature of cruising limits itineraries to port cities, whereas flying or driving opens up many more itinerary possibilities. Ships take a long time to travel significant distances, and can only deliver passengers to port cities for short periods of time; the average shore leave in the

[20] "Royal Caribbean to send another hot new ship to China." USA Today. Retrieved 4/10/15. http://www.usatoday.com/story/cruiselog/2015/03/25/ovation-royal-caribbean-china/70417010/

Caribbean was only 4.3 hours[21]. This is good for travelers who want to visit many port cities, but may not be for travelers who want to explore a city in depth. Additionally, hub ports, where passengers begin and end their cruise, need to have easy access to an airport, as most passengers fly into the hub port. All these considerations limit the where ships are stationed and where they can visit.

Volatility of Fuel Prices

An unexpected decrease in the price of crude has resulted in a global downfall in the price of petroleum based fuels. Royal Caribbean's fuel costs are largely dependent on market prices, which have been shown to be quite volatile, especially in 2008-2009 and 2014-2015. Uncertainly in fuel prices, one of the biggest expenditures of cruise companies, makes it difficult to have efficient operations. Royal Caribbean has implemented fuel hedges to reduce volatility, but past hedges have been negatively impact as a result of this unexpected movement. Moving forward, Royal Caribbean should be able reposition their fuel hedges in this low fuel price environment to operate with significantly lower fuel costs. They have taken steps to address this weakness and increase the fuel efficiency of their fleet, which has resulted in a 21% improvement in energy efficiency since 2005; their energy consumption per guest is the lowest in the cruise industry[22].

Operational Issues

Royal Caribbean has a lot of long term debt, and a high debt/equity. It's reliant on its cash flows

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[21] "The Cruise Industry." The Geography of Transport Systems. Retrieved 4/10/15. http://people.hofstra.edu/geotrans/eng/ch7en/appl7en/ch7a4en.html

[22] RCL 2014 Annual Report

and drawdown of credit facilities to meet its debt repayments. Interruptions to its normal revenue streams can have adverse effects on its ability to stay solvent. It is also a high capital investment industry with high fixed costs and vacancy issues. Selling at a discount to cover fixed costs can damage brand reputation, but not doing so can have negative effects on the bottom line.

Industry Weaknesses

The industry itself has a few weaknesses in how it's structured. Cruises ultimately provide an experience, and target middle and upper class markets. Lower income consumers do not have the discretionary funds to spend towards vacationing nor can they easily justify a nonmaterial purchase. Cruise lines are also reliant on travel agencies to refer customers and book their tickets. This means that the decision of a few people can have drastic effects on revenues. It is additionally a seasonable industry, with consumers creating an ebb and flow of demand in the face of constant supply. This means that prices fluctuate between seasons and the most desired dates. Cruise lines redeploy ships to combat this issues, but need to be able to accurately gauge demand in markets.

Opportunities

Expansion into High Growth Asia/Pacific and Latin America

Royal Caribbean has many opportunities to expand its operations. Expansions into Asia and Latin America will allow them to access untapped markets. Cruising is a high growth industry in Asia. Additionally, the Cuban market recently opened up, which will allow Royal Caribbean to increase the range of their itinerary offerings. Redeploying ships to Asia and Latin America will reduce excess capacity in the Caribbean, reducing the need to offer heavy discounts to fill rooms.

China perhaps represent the biggest opportunity for Royal Caribbean, as there are more people in the Chinese middle class than in the entire US population[23]. Chinese guests are also high-yielding customers, who pay a lot for tickets and buy a lot on board. Royal Caribbean International has moved Quantum of the Seas to Shanghai to capture the Chinese consumer who likes luxury goods and things that are more international. The 2016 Ovation of the Seas will accomplish the same goal in Tianjin, China. Their joint venture with Ctrip.com, SkySea Cruises, will have a completely Chinese guest experience, allowing them to better segment the market.

Technological Innovation

Royal Caribbean also has the opportunity to change how cruises are sold and priced. There is a significant opportunity to shift booking to online portals, which will reduce the fees associated with travel agent commissions. This biggest barrier is simplifying the booking procedure so anyone can navigate through it without the expertise of a travel agent. This goes hand-in-hand with targeting younger demographics, who are most likely to complete online bookings. The average customer age is between 40 and 65, whereas the millennials represent the biggest growth segment. On the back-end, data analysis can give insight into how to improve advertising and find the triggers that prompt people to book cruises. Technological innovations can also be used for dynamic pricing of onboard amenities to increase the ability of cruise lines to price discriminate. Implementation of technology can decrease operating costs and give insight into

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[23] "These 2 Markets Are Helping Royal Caribbean Cruises Ltd. Surge Ahead." The Motley Fool. Retrieved 4/10/15. http://www.fool.com/investing/general/2015/02/07/these-2-markets-are-helping-royal-caribbean-surg-2.aspx

ways to increase efficiency.

Threats

Economics and Market Weakness

Royal Caribbean faces many potential threats, both market based, and specific. The industry is heavily affected by the state of the global economy; weakness of the economy in Europe, and slowing growth in Asia may impact growth projections. Fluctuation in the exchange rate can also have a negative effect on the profits of Royal Caribbean; drops in the Euro will decrease demand or revenue in USD for the European segment. Fuel is also a large cost for cruise ships operators, and fuel costs might increase in the future despite hedging.

Brand Damage

Acts of terrorism or norovirus breakouts on ships can influence customer demand for specific ships or for cruising in general. Additionally, destination countries may face political issues closing off possible itineraries. Weather and natural disasters can also affect cruise ships in the middle of the ocean. The brand damage and decrease in demand from these events can reduce Royal Caribbean's ability to meet its debt payments. Royal Caribbean also faces legal proceedings and lawsuits from customers that may have had a bad cruise experience, as well as potentially from crewmembers unsatisfied with working conditions. Negative publicity can leave a lasting image in consumer's minds, affecting future cruising considerations.

Changes in Section 883 of the Internal Revenue Code

Royal Caribbean, and the cruise industry in general, under Section 883 of the Internal Revenue Code does not have to pay US corporate taxes for income derived from the international operation of ships. Since cruising mainly consists of sailing in international waters and visiting international ports, Royal Caribbean has been able to avoid paying US corporate taxed on a significant portion of its revenue. Any changes that prevent Royal Caribbean from qualifying under Section 883 for corporate tax exemptions would reduce their net income and may affect their ability to stay solvent.

Strategic Recommendations

Expand the market

An important part of generating growth is expanding the number of customers who go on cruises. The best way to do this is through peer to peer referrals and through direct marketing. Many cruise goers are repeat customers, but that limits the potential for growth, since demand among that sub-segment is unlike to grow rapidly. Royal Caribbean should implement a stronger benefits program for repeat customers, to capture ensure they remain with Royal Caribbean rather than switching to other companies based on price along. Part of that should include discounts for referring repeat customers, which would tackle the issue from two perspectives; increasing loyalty and expanding the customer base. They can also begin immediate marketing towards potential guests who live within driving distance of departure ports. They are much more likely to cruise, and spontaneously cruise, since they do not have to deal with air travel arrangements[24]. Geographic targeting towards this customer segment will allow Royal Caribbean to expand its market and increase cruise demand, filling its rooms with customer willing to pay higher prices.

Royal Caribbean should also utilize guest feedback and research to develop their marketing and business strategies. Customer analytics can help them identify drivers of cruising demand, and also pinpoint services customers are willing to pay a premium for. By gaining information about the things that affect customer satisfaction, Royal Caribbean can improve customer referrals.

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[24] "The Cruise Industry." The Geography of Transport Systems. Retrieved 4/10/15. http://people.hofstra.edu/geotrans/eng/ch7en/appl7en/ch7a4en.html

Segmentation studies can help determine guests' needs, wants, and expectations, which can shape advertisements, communication, and the entire cruise process. They have numerous data from past customers but have not sufficiently analyzed it. Specifically, millennials now make up a larger portion of the population than baby boomers, the traditional customers of cruises. Identifying features that attract millennials, such as internet connectivity or social media presence, can drastically increase the market base and capture young customers for the long term.

Royal Caribbean can also expand their market by moving beyond their reliance on travel agents to sell cruises. Travel agents demand high levels of commission, which can be bypassed if customers use Royal Caribbean's online portals, or online booking websites. A solution that simplified the cruise booking process has not appeared on the market, and represents a perfect area for Royal Caribbean to develop. Online portals can also allow customers to comparison shop, and on-the-fly pricing algorithms can steer customers to Royal Caribbean's itineraries.

Focus on the right customers and markets

A reason that Royal Caribbean has been quite successful is because its cruise brands target the upper contemporary to premium sector of cruising passengers. While Royal Caribbean maintains only 23% of the market share, they also command 22% of the revenue. Carnival Corporation is the largest cruise lines operator with 48% of the market, but only has 42% of the total revenue[25]. Royal Caribbean should avoid becoming a discount cruise line like Carnival. Royal Caribbean

[25] "2015 World Wide Market Share." Cruise Market Watch. Retrieved 4/15/15. http://www.cruisemarketwatch.com/market-share/

should maintain focus on the premium segment of the market, not only because these passengers represent high revenue streams, but also because they are more consistent customers in times of economic downturns. They still have the resources to go on the cruises, while lower tier passengers may look for extreme discounts or forgo cruising altogether.

Keep building large ships

In cruising, the number of ships you have, and the number of passengers on those ships, represent your market share. There is a linear relationship between building additional ships and capturing more the market share. Building large ships allow for economics of scale to become a large factor of the final outlook. Right now Royal Caribbean International, the largest subsidiary of Royal Caribbean, has the largest cruise ships in the world, and much of their fleet are among the largest ships sailing. Large cruise ships capitalize on the fact that they are cheaper to build per passenger, cost less to run per passenger, and use less fuel per passenger mile. Royal Caribbean International is focused on expanding the largest ships in their fleet, and is expecting delivery of many super large ships in the next few years. This will allow them to increase their market share and thus their revenue. China in particular has high demands for new and innovative products, and the newest Royal Caribbean ships fit that bill. Asian customers aspire for luxury goods, and are often willing to pay premium prices. If Royal Caribbean can establish cruising as a go to vacation choice in China, they should have no trouble filling up their newest ships.

Simultaneously, they should retire their older ships to other ports or subsidiaries to expand or test out growing markets. Excess demand, especially in the Caribbean, reduces the price people are willing to pay for cruises. By removing ships from service, and shifting them to high growth markets, they can rebalance supply and demand. Smaller ships will be easier to fill in parts of Asia and Latin America where the market is not as mature. They will also be able to access more ports, which lack the infrastructure to service mega-cruise ships. They can also rotate smaller cruise ships from Royal Caribbean International to Celebrity Cruises and change the target demographic. Since premium cruises are often associated with smaller ships and higher levels of service. The economics of scale Royal Caribbean International desires and the service focus Celebrity Cruises prioritizes can be simultaneously achieved.

Focus on PR

Two major issues that can negatively affect demand for Royal Caribbean cruises are the working conditions of hired crew, and major disasters involving ships mid cruise. Customers may decrease demand of its services if the working conditions of the crew become an important consideration for selecting which ship to cruise on. It is industry practice to hire crew from third world countries to provide services were there is no direct customer interaction. This leads to abysmal working conditions and to relatively high turnover. Royal Caribbean should consider implementing changes in crew conditions to reduce turnover, and to address crew suicides. Royal Caribbean should also be prepared for disaster that cruises uniquely generate. Cruise ships are a self-contained environment which high population density which propagates the spread of infectious diseases. Royal Caribbean to ensure ships have adequate medical personnel for such contingencies. Cruise ships may travel quite far from land, which represent additional danger when hazards appear like fires or mechanical issues. Royal Caribbean should be prepared and ready to address such issues when they happen; and be prepared to the publicity and legal ramification of such events.

These strategic recommendations point to areas that Royal Caribbean can address in order to increase their growth and stability. The cruise industry still has much to grow, and Royal Caribbean has many opportunities to catch up to Carnival, in revenue if not market share. Sontag Solutions expects Royal Caribbean to remain a strong company that will continue to provide excellent experiences for its guests and generate profits for its shareholders and employees.