

CARNIVAL CORPORATION STRATEGY REPORT



GRIFFIN CONSULTING GROUP

Benjamin Levin

Jennifer Jones

Tom Slade

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EXECUTIVE SUMMARY

Carnival Corporation is the world's largest cruise ship company, with 52% market share in early 2012. It operates a fleet of 101 ships, serves 8.5 million guests per year and has 10 distinct cruise lines under ownership. Historically, cruising has been an immensely profitable business, and Carnival has distinguished itself as the best operator in the industry. However, amidst lower-than-expected growth and a moribund economy, Carnival's share price has fallen by more than 50% since its 2004 peak.

Among its many strengths, Carnival counts its relatively strong balance sheet, diversification globally, superior experience and sourcing, and a favorable market caused by the rise of the affluent and aging. These strengths will ensure that Carnival remains the top industry player, although they do not guarantee success.

Unfortunately, the global cruise markets have seen declining margins and relatively slow growth since their halcyon days in the 1990's and early 2000's. Carnival's safety record is below industry average, and it is threatened by geopolitical and natural disasters.

In the short term, Carnival will need to clear a number of hurdles. Controlling residual damage from the *Costa Concordia* by quick, confidential settlements should be a priority. Fuel prices will continue to be a major driver of costs, and Carnival should also freeze its dividend and raise additional capital in order to fund expansion and restrict debt.

In the long term, Carnival must accomplish three key tasks. First, it should change its relationship with travel agents to become a more collaborative partnership able to weather technological changes in the industry. Second, Carnival should restrict its capacity growth to drive prices up and restore margins. Finally, the company should realign its capacity increases towards high growth markets in Australia, Asia, and Germany, while restricting the market and raising prices in North America.



COMPANY BACKGROUND

“Our mission is to deliver exceptional vacation experiences through the world’s best-known cruise brands that cater to a variety of different lifestyles and budgets, all at an outstanding value unrivaled on land or at sea.”

HISTORY

Before there was a cruise industry, a company called Canadian Pacific Railway had begun filling demand for cross-continent freightliners – giant ocean liners that could ship cargo across the ocean in days. Once air travel became popular in the 1960s, shipments were transferred to cargo planes, reducing demand. Cruise industry pioneer Ted Arison founded “Carnival Cruise Lines” in 1972, beginning with a purchased freightliner, renamed the *Mardi Gras*. Beginning with the concept of “fun ships,” Ted Arison slowly grew the fleet through the 70s, adding two more ships, the “Queen Anna Maria” and “Festivale,” as demand increased. By 1982, Carnival had ordered their first newbuild ship. In 1984, Carnival launched the first cruise industry advertising campaign on network TV with spokeswoman Kathie Lee Gifford.

In 1974, Ted Arison displayed his entrepreneurial spirit by purchasing full ownership of Carnival Cruise Lines with \$1 in cash and \$5 Million in debt. Over a decade later, it had become one of the worlds most popular cruise lines. Carnival Cruise Lines made its initial public offering in 1987, issuing 20% of their common stock. Using the inflow of about \$400 million, the company grew through acquisition during the following 15-20 years. Instead of launching a new cruise line from scratch, Carnival bought a smaller operator in a target sector. Using its decades of operating experience, the company then improved operations and invested heavily, growing its component brands.

Some of these acquisitions include:

- Holland America Line (1989) – included niche operator Windstar Cruises
- Seabourn Cruise Line (1992) – upscale, luxury brand
- Costa Cruises (1997) – Italy based contemporary brand



- Cunard Line (1998) – premium operator; built the Queen Mary 2, the world’s largest ocean liner at 150,000 tons

In 2003, Carnival Corp merged with P&O Princess cruises, the largest cruise line operator in the UK at the time, making Carnival the biggest cruise ship company in the world. Carnival now encompasses 10 major brands across markets in the United States, Europe, and Asia.

COSTA CONCORDIA INCIDENT

The recent sinking of the *Costa Concordia* has had serious consequences for Carnival. On January 13, 2012, the *Costa Concordia* hit a reef off the coast of Tuscany, and began taking in water to the engine rooms. The incident was initially reported to port authorities and passengers as a “black out” or “electrical problem.” The ship drifted for more than an hour while the captain delayed evacuation procedures. Eventually, the ship listed, trapping passengers inside as evacuation finally proceeded. 4,252 people were aboard, nearly three-quarters of them passengers. The final casualty toll was 30 dead and 64 injured, launching a firestorm of media attention. Compounding Carnival’s problems, in late February of 2012 a fire on the *Costa Allegra* left 636 passengers and 413 crew member stranded without power 200 miles southwest of the Seychelles. While the ship was quickly recovered and no one was injured or killed, a second round of negative publicity and public questions over the safety of the cruise ship experience ensued.

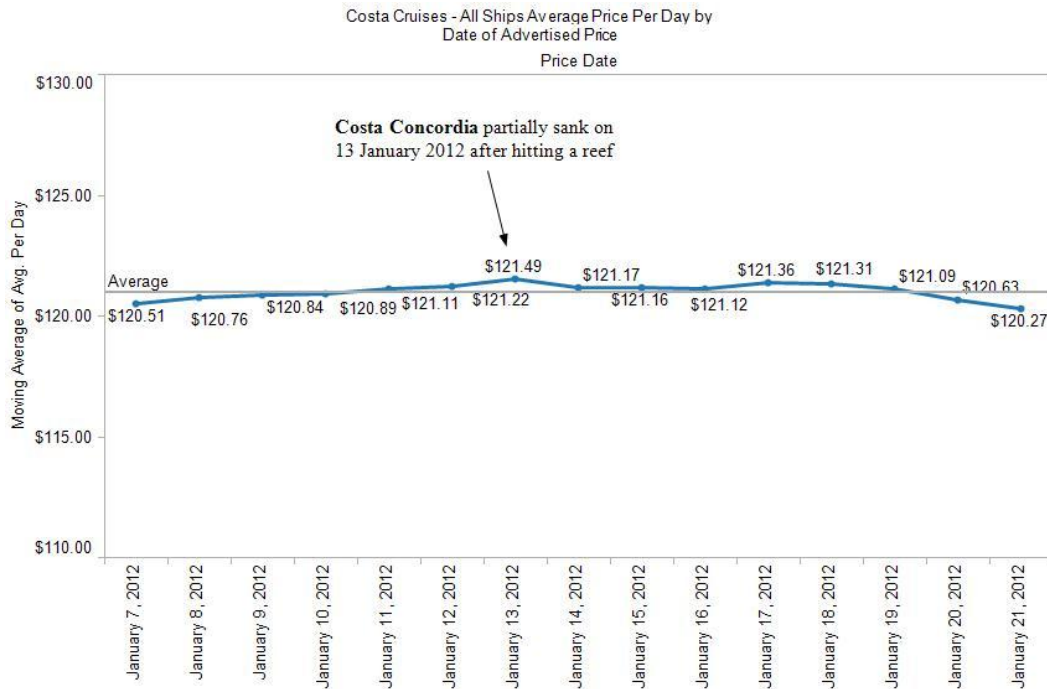
While the human cost of the tragedy is most important, the financial and business costs to Carnival are also substantial. In the short term, although the *Costa Concordia* was insured with a \$10 million deductible, the value of its bookings has been lost.¹ Since the gross revenues from this ship might reach \$100MM per year, this is a significant amount of money even for Carnival. Additionally, the sinking has triggered several lawsuits. Six passengers have sued, with many more to follow, and at least one crewmember filed a \$100,000,000 complaint.

The evidence for short-term pricing and demand effects is mixed. Shortly after the incident, Carnival suggested that bookings have dropped some percentage in the “mid-teens” for this time of year, and reached their low on January 16, 2012. This was said to



cut profit by between \$155 million and \$175 million in 2012. However, prices for Costa cruises overall have been flat since the incident:

COSTA CRUISE PRICING



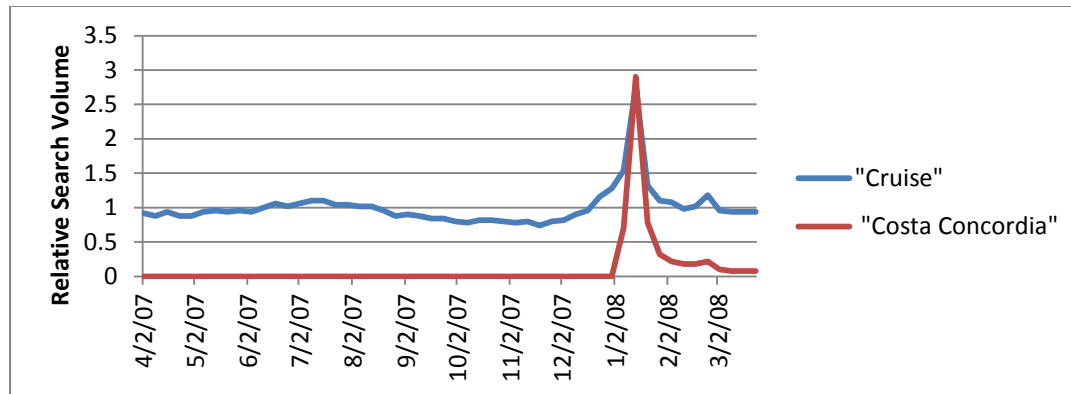
Source: CruiseMarketWatch

Since cruises price to fill capacity, this would suggest that the *Concordia* incident did not affect demand strongly. It is also possible that while keeping advertised prices flat, Costa has been obliged to offer deep discounts to its travel agents.

The long-term consequences of the *Costa Concordia* disaster are still unknown. On one hand, the vivid images of the *Concordia* lying on its side and the continuing litigation will give the story considerable legs. However, while public interest in the accident initially spiked hugely, publicity and public awareness as measured by search data shows that *Costa Concordia* has largely receded from the general consciousness, implying that its impacts may not be long-lived:



CRISIS-RELATED SEARCH VOLUME



Source: Google Trends

In any case, it is imperative that Carnival and Costa manage the incident, Costa publicity, and the brand of the overall cruising experience carefully through the next few months. For specific suggestions on steps the company should take, see *Recommendations: Costa Concordia PR* and *Recommendations: Instill a Culture of Safety*.

BUSINESS MODEL AND OPERATIONS SUMMARY

Carnival is a single-industry firm with no diversification; the company earns the entirety of its revenues from its 10 cruise lines. Each cruise line operates globally and is targeted at one or more nationalities. As an example, while Costa is focused the German, French, and Italian markets, its ships might be found anywhere in the world.

CARNIVAL CORPORATION CRUISE LINES

Brand Name	Passenger Capacity	Target Market	Market Segment
Carnival Cruise Lines	58,273	USA	<i>Mass Market/Discount</i> "Carnival Cruise Lines is the best-known cruise brand in North America and the most profitable in the world."
Princess	36,900	United Kingdom	<i>Mass Market</i> "Princess is a global cruise and tour company"



			operating a modern fleet of 17 ships carrying more than a million passengers each year."
Costa Cruises	29,286	Italy, France, and Germany	<i>Mass Market</i> "Based in Genoa, Italy, Costa Crociere is the leading cruise company in Europe and South America, operating a modern fleet of 15 ships."
Holland America	23,492	USA	<i>Premium</i> "...Holland America Line is recognized as the undisputed leader in the cruise industry's premium segment."
P&O Cruises	14,610	United Kingdom	<i>Mass Market</i> "...market-leading P&O Cruises has been operating cruise ships for more than 170 years and combines innovation, professionalism and unrivalled experience..."
AIDA	14,248	Germany	<i>Mass Market/Discount</i> "AIDA ships incorporate the successful elements of upmarket clubs and resorts in the premium and four-star range, with a host of on-board amenities and facilities that attract younger, more active vacationers."
Cunard	6,670	United Kingdom/USA	<i>Premium</i> "Royalty, celebrities and voyagers from every walk of life have enjoyed Cunard's classic luxury experience based on the history and tradition of transatlantic liner service."
P&O Cruises Australia	6,242	Australia	<i>Mass Market</i> "...in the past five years P&O Cruises has expanded its operations from one cruise ship, based in Sydney, to three cruise ships sailing year round..."
IberoCruceiros	4,176	Spain	<i>Mass Market</i> "IberoCruceiros is one of the top operators in the fast-growing Spanish- and Portuguese-speaking cruise markets."



The Yachts of Seabourn	1,974	United Kingdom	<i>Ultra-Deluxe</i> “...ultra luxury cruising vacations in a unique, small-ship style...”
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Cruising has historically been a very profitable. The average cruiser spends \$237 per day, of which approximately 80% is ticket cost (the remainder is split between onboard purchases and offboard tours). The two largest costs for Carnival are typically cruise agent commissions and fuel. Cruise agents have historically been paid around 20% of ticket price in commissions, and fuel costs have recently exploded along with the price of oil, moving to almost 20% of total costs (see *SWOT: Fuel Prices and Financial Analysis: Operating Metrics Analysis*).

Cruise ships typically operate with three classes of crew. The first is the officers: typically from Greece, Italy, or the UK, these professionals are highly paid and given ultimate command of the ship. The second is entertainers and waitstaff: typically lower-paid, but from the same countries as the cruisers that they serve. Finally, most of the ships' crew is drawn from developing countries. While pay is low by US standards, the \$400-\$700 monthly pay can represent an attractive opportunity for these workers, who often work 10-month contracts without being able to see their homes and families. Turnover is high, and few of the crew see working on a cruise ship as a viable long-term career.

Overall growth in the cruise industry has been robust since the 1990s. According to Cruise Market Watch:

Worldwide, the cruise industry has an annual passenger compound annual growth rate of 7.38% from 1990 – 2015. Growth strategies to date have been driven by shorter cruises, more local ports, more destinations and new on-board/on-shore activities that match demands of consumers. The industry is also expanding rapidly internationally and has yet to maximize all its online potential.

Market growth slowed during the Great Recession, although compared to some other consumer discretionary products, cruising has held up relatively well.



FIVE FORCES FRAMEWORK



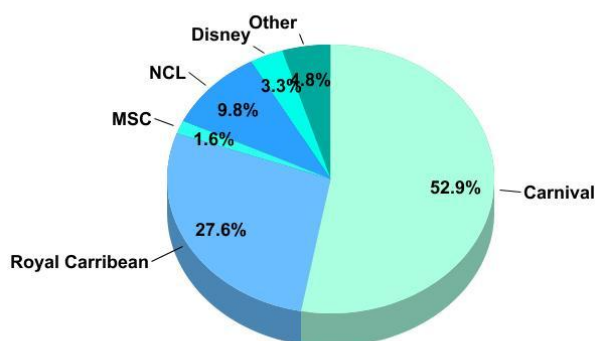
INTERNAL RIVALRY

Carnival is the leading company within the cruise line industry due to its multiple fleets and significant international presence. There are significant barriers to entry and exit within the cruise line industry, which has resulted in a high concentration ratio. The cruise line industry is effectively an oligopoly market, where several major cruise liners make up more than 90% of the market shares. Carnival is constantly engaged in marketing and pricing battles with these competitors, making internal rivalry central to the industry. Additionally, cruise lines have historically been subject to heavy M&A activity, and Carnival sometimes competes to acquire even more share.

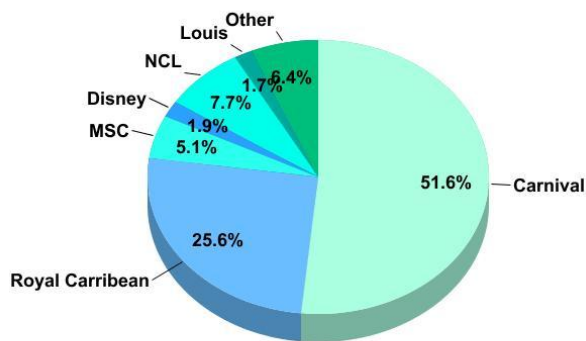


CARNIVAL MARKET SHARE

2011 North American Cruise Market Share



2011 Rest of World Cruise Market Share



Overall, Carnival Corporation dominates the industry, with 52.9% of the North American market share and 51.6% of the rest-of-world market share. Its most formidable competitor, Royal Caribbean, has only 27.6% of the North American market share and 25.6% of the rest-of-world market share. Such high market concentration means that there is the potential for collaboration among industry leaders, which might in turn reduce the possibility and intensity of price competition. In practice, however, Carnival undercuts this standard Industrial-Organizational model. By having its various cruise lines compete against each other in the key European and North American markets, Carnival intensifies internal competition.

The cruise line industry has relatively high competitor diversity and a moderate level of product differentiation. Carnival and Royal Caribbean are each more than 3x the size of the next largest competitor. Smaller cruise lines tend to specialize in options for a particular demographic or geographic region. As previously noted, Carnival Corporation's multiple brands create a competitive rivalry within the company; however, each brand caters toward a slightly different demographic or specializes in a particular market or geographic region. For example, its original Carnival brand pioneered shorter, less expensive cruises, while its Princess brand offers a more



luxurious experience. Princess does compete, however, with the slightly more upscale Holland America line.

One additional factor increasing internal rivalry in cruising is the industry's high exit barriers. It is difficult for a cruise liner to sell their assets and exit the industry. This increases competition within the industry somewhat, as there is inflexibility in capacity adjustment, meaning that companies will undercut their prices to boost sales when overall demand is low. Switching costs between competitors are effectively non-existent, particularly since loyalty programs, which are common for hotel chains and airlines, have yet to substantively catch on in the cruise line industry, which constitutes a risk for Carnival Corporation.

SUPPLIER POWER

Supplier Power within the cruise line industry is moderately strong. Most of a cruise ship's supplies are bought on an open, competitive market. Carnival Corporation stated in its most recent Annual Report that its "largest purchases are for fuel, travel agency services, food and beverages, air transportation services, port facility utilization, repairs and maintenance, including dry-docking, advertising and marketing, hotel and restaurant products and supplies, communication services, and the construction and refurbishment of our ships". The threat of integration by these suppliers is very low.

One notable exception is Carnival's newbuilds. There are only 6 major shipyards that have recently built cruise ships, and 2-3 more that either perform conversions or have built ships before 2000. Capacity and capability at these main builders is also limited, so Carnival Corporation relies on a limited number of manufacturers for its newbuilds. The high supplier power within the shipbuilding is weakened because the relationship is symmetrical: cruising is a similarly concentrated market. Additionally, the massive purchase value of a new ship provides a sizeable incentive for ship suppliers to provide cruise liners with competitive pricing.

Additionally, cruise ship companies such as Carnival face extensive switching costs, both in building and running a ship. Switching a ship's manufacturer is hugely expensive for cruise companies because, typically, the shipbuilder owns the right over a ship's design, which means that, in switching shipbuilders, cruise line companies have



to incur high monetary and time costs in redesigning the ship. Such a switch can cost the cruise line company millions of dollars. Further, there is high input differentiation between ships, meaning that, while there are alternatives for the majority of supply components (both in ship construction and in cruise service), the cruise ship company markets specific ships and amenities to the consumer, thereby increasing switching costs and supplier power. Lastly, while it is not infeasible for Carnival to substitute their ships for one another if they have maintenance problems with a ship scheduled to cruise, it is preferable for them to have easy access to a number of dry-docks around the world, in order to maintain their ships most efficiently. This can be very costly for Carnival since there are a limited number of dry-docks, and it gives dry-dock owners considerable supplier power. For this reason, Carnival owns forty percent of The Grand Bahama Shipyard at Freeport, Bahamas. It shares ownership with its main competitor, Royal Caribbean, who also owns forty percent of the shipyard, as well as with Grand Bahama Port Authority, a private entity, who owns the remaining twenty percent. The shipyard has three floating docks, which is usually more than adequate to serve Carnival and Royal Caribbean's maintenance needs, allowing them to rent use of the docks to other cruise ship companies as needed.²

BUYER POWER

Buyer power within the cruise line industry is relatively low. By contrast to most other vacations, more than two thirds of cruises are still booked through travel agents.³ Carnival states that no one group of travel companies makes up more than 10% of their business, signaling that buyer concentration is low, which reduces their power. Further, customers are spread around the world and do not have any mechanisms through which they can express a collective voice or exert collective power, leaving them with minimal control. Additionally, customers do not have the ability or resources to create the cruise experience by themselves – it is, by nature, a highly packaged deal. This prevents the fragmentation of the cruise in the way that other types of vacation packages have fragmented as mechanisms and companies have emerged through which customers can more cheaply book and customize individual pieces of their vacation (i.e. booking one-way flights, booking flights and hotels separately, etc).



Buyer power is increased by relatively undifferentiated product offered by high-end cruise companies and internet search engines which enable comparisons of price and specifications across multiple locations, brands, and companies. In addition, the continued high reliance on travel agencies increases buyer power because travel agencies make volume purchases and can demand lower prices based on the volume of customers they refer to specific companies. Relative to Carnival, however, most travel agencies are quite small. No single agent represents more than 10% of Carnival Cruise Line's bookings.⁴

ENTRY AND EXIT

The risk of entry of new competitors to the cruise line industry that could provide a plausible threat to Carnival Corporation in core markets is low. Entry into the high-end cruise line industry requires capital of approximately \$1 billion since it costs, on average, \$400 million to build a ship. Further, large cruise ships employ hundreds of sailors and crew that are trained for sea duty. This means that, in order for a cruise to be successful, its employees need to have specific knowledge and skill sets, which necessitates training, creating substantial additional costs and. This is a significant barrier to entry for any new competitor wanting to build a new cruise line from scratch.. Lastly, brand recognition is very important in the cruise line industry, which means that it would take time for a new competitor to build an identity and reputation, slowing or preventing their ability to compete with an established company such as Carnival Corporation.

In Asia, however, Carnival might be more concerned about new entrants. Asian operations, markets, and customers are much less defined than in the Americas or Europe, and expectations of cruise quality and scale are lower. There are numerous Asian entrepreneurs and companies that might be able to tap into this fast-growing market.

SUBSTITUTES AND COMPLIMENTS

Considering that a cruise is a vacation for most customers, the cruise line industry faces a significant threat of substitution from other types of vacations. Travelling by air land has traditionally been less expensive than cruises. Any vacation can be substituted for,



and there is not a high cost to change, which makes the threat of substitution seem very high. Customers who are apt to go on a cruise might instead choose an all-inclusive resort vacation if the price and service appears more appealing. Others might choose to go on an adventure vacation, such as a safari, or an all-inclusive travel itinerary that allows them to visit multiple destinations within the same trip. However, cruise liners, such as Carnival Corporation, aggressively promote the high level of service they offer, the convenient, all-inclusive nature of their cruises, and, particularly since the economic downturn, have striven to aggressively price their cruises in order to make them price-comparable to and more appealing than potential alternative vacations. In addition, the experience offered by a cruise is very unique, and differs from other types of vacations enough that customers who prefer cruises are likely to choose them over other types of vacations, so long as the cost is not a substantial barrier. That said, the recent incident with one of Carnival Corporation's Costa ships has likely increased the substitution of other, ostensibly less risky, vacations by potential customers.

GROWTH-SHARE MATRIX ANALYSIS

Carnival Corporation consists of 10 semi-autonomous cruise lines, each with its own set of concerns, strategic view, and market characteristics. However, shareholders and upper management need to see these separate units as a whole, and make decisions based on total shareholder return. In order to better understand and conceptualize Carnival's diverse businesses, we employ a Growth-Share Matrix analysis.

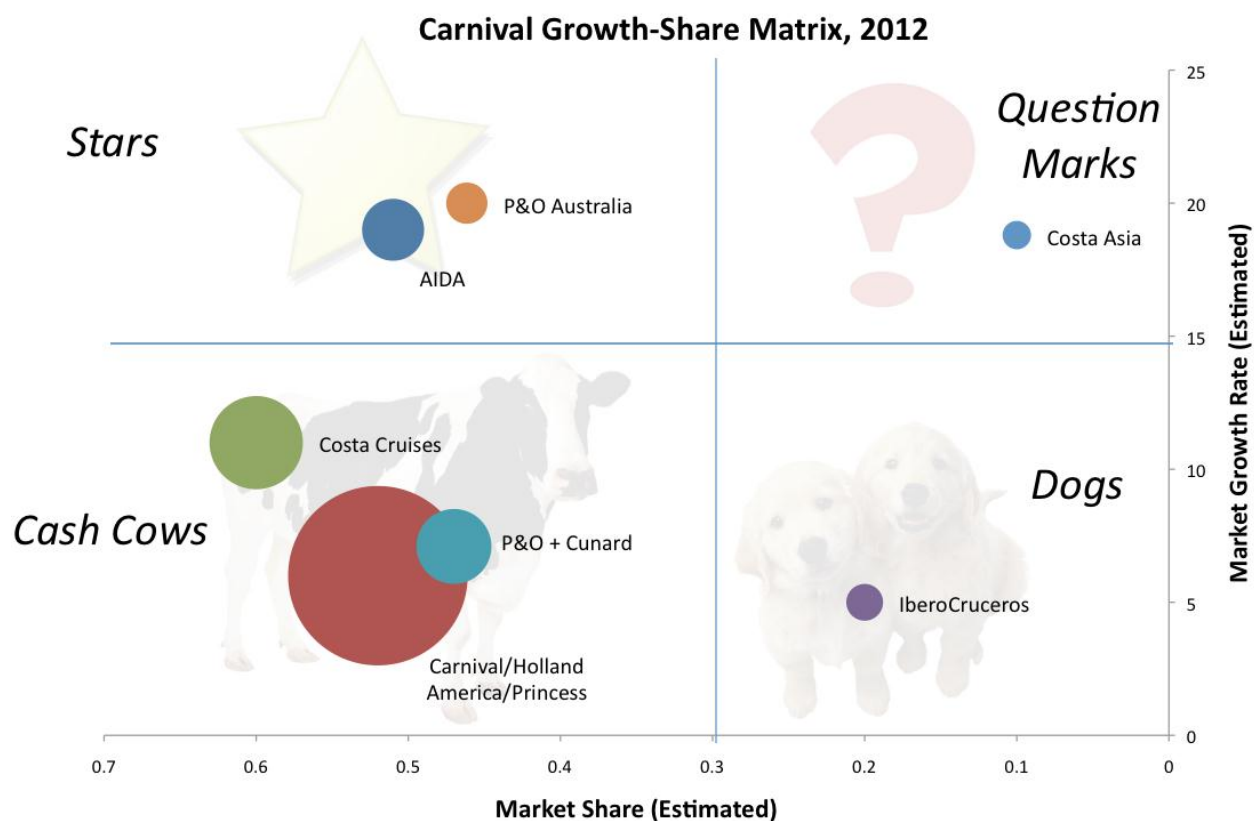
The Growth-Share matrix plots market share on the X axis and market growth on the Y axis. This segregates business units into one of four categories.

1. "Cash cows" are stable markets with dominant share. They should be run for cash, with the proceeds used to fund other parts of the business or returned to shareholders
2. "Stars" are strong brands in fast-growing markets. They should be given ample capital in order to keep pace with acquisitions.



3. “Question marks” are brands that are relatively weak, but are in an attractive market. Question marks can either be sold for an attractive price or heavily invested in to be transformed into stars.

4. “Dogs” are weak brands in stagnant markets. They should generally be divested, ignored, or spun off.



Notes: Size of bubble indicates total berths in Q4 2011. Yachts of Seabourne excluded as insignificant. Market growth rates are preferentially calculated from 4-year average 2007-2011, though some are more recent or use 2010 data only. Market shares are calculated from national figures, specific to one line only.

Sources: 2011 Carnival Corporation 10K, European Cruise Council – “2010/2011 report” and “Statistics and Source Markets 2010,” International Cruise Council Australasia – “Cruise Industry Report Australia 2010,” Cruise Market Watch – “Market Share,” MarketingTeacher – “Carnival Cruises SWOT”

In Carnival’s core markets of the United States, United Kingdom, and Continental Europe, cruising is growing steadily but unspectacularly, and Carnival has a dominant market share. These are classic “cash cow” businesses, and should be hugely profitable for Carnival in the long term. While there are clearly still areas of improvement for these brands, the biggest mistake would be to overinvest in them.



Carnival also has two “star” businesses: Australia and Germany. These are potentially crucial brands to Carnival, and should be given the capital needed to grow aggressively. In the cruise business, this means adding capacity, and AIDA in Germany is getting that: 4 of the next 10 Carnival ships will be AIDA. P&O Australia is allocated no newbuilds over the next several years, but older P&O ships might be transferred to the Australian operations, as has happened in the past.

The company’s Asian operations – operated by Costa Cruises and marketed exclusively to Asian passengers – have explosive growth characteristics, but remain one of Carnival’s weaker markets. For a full analysis, see *SWOT: Exploding Asian Market*.

Finally, there is the unfortunate case of IberoCruceiros. While the Spanish and Portuguese economies were booming, Carnival launched IberoCruceiros to so as not to be excluded from a fast growing market by established players such as Royal Caribbean’s Pullmantur. However, the Great Recession and the Euro debt crisis have reduced this once-expanding market into a slow-growth backwater in which Carnival has a remarkably weak business. Further, the prospects for Iberia are unlikely to improve in the short term, since even the best-case-scenario for the Eurozone countries sees Portuguese and Spanish austerity deep into the 2010’s. Given these unfavorable characteristics, Carnival should accelerate its orderly withdrawal from the Iberian market. In December 2011, the *Grand Voyager* in the IberoCruceiros fleet left to become the *Costa Voyager*. In addition to the sale of its ships, Carnival might also be able to sell some of its business, bookings, and travel agent relationships to an existing player.



SWOT ANALYSIS



STRENGTHS

Dominant Market Share

Carnival's biggest strength is its huge scale and scope. It is twice as large as its biggest competitor and competes in nearly every market and segment worldwide. This gives Carnival tremendous power over the cruise industry as a whole. It enables the company to undertake projects that grow the industry, gives it a platform for continued acquisitions and M&A activity, and helps Carnival negotiate with major manufacturers of cruise ships.

Operational Excellence & Experience

Carnival has achieved below-industry-average costs and above-average revenue historically. This is largely due to the company's immense experience in owning and operating cruises, as well as some smart strategic plays. That advantage makes expanding into new markets vastly easier for Carnival than for a smaller player or upstart firm.



Carnival also has the largest pool of data to draw on to determine what does and does not work, and has the most experienced marketers of cruises in the world. These “soft” advantages let Carnival potentially segment its customers more efficiently than competitors.

WEAKNESSES

Uncoordinated Business Operations

Historically, Carnival has been run by the Arison family as a coalition of largely independent businesses. Each cruise line largely manages its own customers, marketing, distribution, sales, ports, and logistics. This approach has had benefits: internal competition means that each line operates better than any would in isolation.

The single biggest change that Carnival should implement to take advantage of its overall market share is to reduce the number of new ships ordered companywide. Standard Industrial Organizational theory says that in a concentrated, the leader should tend to restrict capacity in order to bring overall prices up. With its current ships on order, Carnival is slated to increase its market share slightly – the exact opposite of ‘correct’ competitive behavior. We believe that this is likely because each cruise line takes projected costs and benefits when ordering new ships, not realizing that each new order drives down prices across the industry and into Carnival’s other brands. Accordingly, in order to better exploit its strategic position, Carnival should reduce new ship production somewhat and re-invest the money into retrofits and marketing – spending which will help improve overall fleet quality without saturating the market.

Some marketing efforts also seem to be driven by a catch-as-catch-can approach to the company’s operations. *Carnival Spirit* was recently based in Australia, catering to the Australian market – where P&O Australia and Princess already control more than a 50% share.

Poor Safety Record

The *Costa Concordia* tragedy has only been the most recent in Carnival’s safety woes. Shortly after, the *Costa Allegra* suffered an engine fire and was adrift in the pirate-ridden Indian Ocean for several days. These large, visible accidents require that a cruise ship be



scrapped or drydocked for months, and they also generate huge negative publicity, hurting both Carnival and the cruise industry as a whole.

Lower-profile problems can also have significant impacts. Two such problems are viral outbreaks and persons lost at sea. Viral outbreaks – usually of norovirus – typically necessitate the return of a ship to home port, a burst of negative publicity in newspapers, television, and industry blogs, and refunding many passengers. Overboard incidents’ have effects that are harder to predict: the company is often faced with lawsuits and negative news stories.⁵

Carnival has a notably worse safety record than other cruise companies. While there is no public database of major cruise accidents such as the *Costa Concordia* disaster, the Center for Disease Control does track all major viral outbreaks on cruise lines. In the 2009-2011 period, Carnival-owned companies accounted for 56% of all viral outbreaks, compared to a 48% average market share ($p=.11$).ⁱ Additionally, Princess Cruises had 10 outbreaks, or 20% of *total* outbreaks, despite only having a 6% market share ($p=.001$). The company is also thought to have a worse safety record for persons lost at sea, especially in the Carnival brand: of the 179 disappearances since 2000, Carnival Cruise Line alone accounts for nearly 30% of them.⁶

These statistics suggest that risk is not simply inherent to the business of cruising: it varies across company and even more strongly across brand lines. The single largest step Carnival could take is integrating safety as a key value in its corporate culture. Carnival’s current values are summarized on a recruiting website: “Quality. Service. Hospitality. Friendliness”.⁷ Adding a corporate focus on safety is not a short-term solution, but if successfully implemented in the long term Carnival could significantly reduce downside risk.

OPPORTUNITIES

Strongly Favorable Demographics

In the cruise industry, the under-65's are considered "the young set." As populations across Europe and North America age, Carnival’s target market is growing larger. We

ⁱ According to a simple Binomial Differences test; not adjusting for length of cruise



believe that Carnival is already well positioned to take advantage of this trend: its branding, segments, and market share make it the best-positioned cruise line overall.

Indeed, to take full advantage of this trend, Carnival needs to ensure that baby boomers currently in their 50's and early 60's embrace the cruising experience. One way to do so would be to identify individuals poised to take their first cruise, or entering a new stage of life where frequent Mediterranean getaways are a realistic possibility. For instance, Carnival might extend a special offer with a discounted price to a recently retired executive or a recently-rich inheritor. Currently, the nature of Carnival's customer data does not permit this datamining, since the company gets little data from travel agents. For details on how this might be made possible, see *Recommendations: Bring the Travel Agent Relationship into the 21st century.*

Exploding Asian Market

Asian customers accounted for only 9.8% of global cruise revenues in 2010. However, this market segment grew by almost 40%, driven by a new, affluent class and aging demographics across the Asia-Pacific region.⁸ If properly tapped, Asia could be as important a market as North America for Carnival within the next 10-20 years.

Unfortunately, Carnival has lagged behind in the Asian market as a whole. After an exploratory and failed bid in Asia in the early 2000's, Carnival recently set one ship to capture the Asian market – on 6 months of time per year. Worse, this ship belongs to Costa, apparently because Costa CEO Luigi Foschi has some experience in Asia.⁹ Clearly, a more considered approach is required.

There are three strategies that the company might adopt in response to this opportunity. First, Carnival could continue to ignore Asian customers. There is nothing wrong with this approach *per se*: the company's historic strength has been in marketing and execution to Western customers, and success in any Asian venture cannot be assured. However, since the market is so quickly expanding, we believe that there is potential for growth.

Second, Carnival could grow its business organically in Asia, either by expanding current cruise lines to include Asian-language service and Asian ports of destination, or by introducing a new brand into the region.



The third and most intriguing option is to pursue an acquisition with Star Cruise Line. This possibility is discussed in the *Star Cruises Acquisition* section of this report.

THREATS

Geopolitical Instability

In 2011, the Arab Spring revolutions caused significant upheaval across the Eastern Mediterranean. While laudable from a democratic perspective, these types of disruption also tend to shut down cruises. While the Eastern Mediterranean is a relatively small market, Carnival must watch for future threats and react appropriately.

Obviously, most geopolitical threats are unavoidable from Carnival's perspective. However, most cruisers are not wedded to a specific destination. If Carnival is prepared to pivot quickly from one region to another, then the losses from these cruises can be minimized.

Fuel Price Risk

Fuel costs constitute a significant small portion of Carnival's cost structure. In 2011, even though fuel prices were relatively high by historical standards, total fuel costs were \$2.19B, or about 20% of total cruise operating expenses. Additionally, fuel costs are much more volatile than other costs, creating more short-term risk. This proportion, unfortunately, has grown sharply:

FUEL COSTS OVER TIME

	2011	2010	2009
Avg Cost/ton fuel	\$646	\$489	\$363
Proportion of Cruise Costs	21.7%	18.2%	14.1%
Cost/ALBD	\$31	\$24	\$18

Cruises have two main weapons against high fuel prices: pricing and derivatives. Because all main cruise lines price to fill capacity, at first glance they would appear to



have little market power in response to short-term fuel price changes. However, recently Carnival and other cruising companies have imposed modest “fuel surcharge fees.” These fees often are not apparent until quite late in the cruise booking process, so these surcharges upset relatively few customers and add some extra revenue.

After being stung by high prices in FY2011, Carnival has entered into a series of derivative hedgesⁱⁱ to help control risk. In particular, the company entered into several zero-cost “collars,” which effectively establish a maximum and minimum fuel price. These hedges are equal to approximately 10% of expected fuel consumption in FY2012-2015. While this is a good first step, it has two principal shortcomings. The first is that the hedges are relatively small: a 10% hedge will still mean a significant shortfall if oil prices rise rapidly. The second is that these collars only enter into effect if oil prices rise above \$125. In 2011, oil prices were comfortably below this level, but fuel prices still hit Carnival’s bottom line hard.

In the short-term, to effectively control for fuel price risk, Carnival should expand its existing oil hedges. The case for doing so is obvious: Carnival’s wellbeing is negatively correlated with the price of oil, and a supply shock could destroy the company’s profitability in the short term.

Additionally, Carnival might consider putting pressure on its shipbuilders to deliver more fuel-efficient designs. While the technical feasibility of this approach is beyond the scope of this report, there is potential for differentiation and innovation. As by far the largest newbuild purchaser Carnival is in a position to assume leadership and request innovation.

FINANCIAL ANALYSIS

While Carnival is a profitable company in reasonable financial health, its financial profile has deteriorated markedly in the last several years. Despite the growing

ⁱⁱ These hedges are actually against the Brent Crude oil index, not the marine fuel that Carnival’s ships consume. Historically, the Brent Crude price and marine fuel prices have exhibited a .98 correlation. For more information, see: http://www.unctad.org/en/docs/dtltlb20092_en.pdf



passengers carried, number of ships, and revenues over the past several years, margins and net income have declined. This has triggered a fall in the share of Carnival, signaling a decrease in the company's attractiveness to investors and value to shareholders. In the long term, in order for Carnival to regain its former value, its margins must improve—and since the company represents about 50% of the cruise market as a whole, that almost certainly means increasing the total market.

However, should these trends reverse themselves, Carnival will be well placed to grow. In addition to a growing core business, Carnival has robust ability to borrow at low rates and raise additional capital, creating the possibilities of additional investment or acquisitions.

Finally, Carnival's stock price has suffered hugely since 2005. This is due to a variety of factors: lower dividends, weak growth in the cruising sector, the *Costa Concordia* incident, and reduced dividends. We believe that the key to restoring investor confidence is to show rising industry-wide cruise usage and stronger revenue/bed in the future.

However, should these trends reverse themselves, Carnival will be well placed to grow. In addition to a growing core business, Carnival has robust ability to borrow at low rates and raise additional capital, creating the possibilities of additional investment or acquisitions.

PROFITABILITY & RETURNS

Historically, Carnival Corporation has been extremely profitable; indeed, was the most profitable leisure company in the world. While Carnival remains a profitable company, that profitability slipped by 22% in the 2009 fiscal year, due to the effects of the Great Recession and the attendant drops in sales and pricing. Within one year, revenues rebounded strongly, and in 2011 revenues hit an all-time high, growing by almost 10%. However, driven by an increase in COGS and SG&A, operating income failed to respond, and total levels of income have never regained their 2008 high.

KEY INCOME METRICS

	2011	2010	2009	2008	2007
Revenues	15,793.0	14,469.0	13,460.0	14,646.0	13,033.0



<i>Growth</i>	9.15%	7.50%	(10.17%)	12.38%	
Operating					
Income	2,283.0	2,286.0	2,154.0	2,755.0	2,725.0
<i>Growth</i>	0%	6%	-22%	1%	
Net Income	1,912.0	1,989.0	1,802.0	2,364.0	2,442.0
<i>Growth</i>	-0.99%	2.45%	-6.75%	-81%	

Source: Carnival 10K

In the future, net revenues are almost certain to increase in the medium-term. Carnival is expecting to launch four ships in FY2012, in time for the high summer season: the *Carnival Breeze* and *Royal Princess* in North America, and the *AIDAmara* and *Costa Fascinosa* in Europe. Together, these four ships will increase capacity by more than 10,000 beds, leading to higher total incomes. Four more new ships will be launched from FY2013-14, further building Carnival's revenue base.

Looking below the bottom line, however, profitability results are even more troubling for Carnival and the cruising industry. The stagnant overall profitability 2009-2011 has occurred while Carnival increased its fleet quickly through new construction. Total cruise beds rose from 162,000 in 2008 to 195,000 in 2011, a 20% increase. Since cruising is a naturally capital-intensive business, and recent Carnival cruise ships have anywhere from \$250MM to \$875MM, it is also useful to examine Carnival's returns on assets:

KEY RETURN METRICS

	2012E	2011	2010	2009	2008	2007
Return on Invested Capital	6%	7%	7%	7%	10%	10%
Return on Assets	5%	6%	6%	6%	8%	9%
-Profit Margin	12%	15%	16%	16%	18%	21%
-Asset Turnover	0.4	0.4	0.4	0.4	0.4	0.4
Return on Equity	7%	8%	9%	9%	12%	13%

The picture here is grim. Carnival's returns on invested capital, total assets, and equity have all declined in lockstep over the past 5 years, as the company's liabilities remained roughly stable but net income declined. These declines in measured productivity of capital, additionally, are due largely to profit margins. To further examine why Carnival's margins have declined – and how the company might respond – we turn to analyzing Carnival's operations.



OPERATING METRICS ANALYSIS

From its passengers, Carnival draws revenue from three sources: ticket sales (76% in North America, 83% in EAA), onboard revenues (drinks, casino, activities, etc.), and off-board excursions. These second two accounted for only 24% and 17% of North American and EAA revenues respectively, and have not demonstrated volatility comparable to that of ticket sales. Demand can be seasonal, with revenues typically strongest in the summer months. This is especially true in Europe, where long summer vacations are expected. The standard measure of capacity is Available Lower Berth Days (ALBD), a benchmark for the least-desirable cabins on a cruise.

CARNIVAL OPERATING METRICS

	2012E	2011	2010	2009	2008	2007
Gross Revenue/ ALBD	\$216.28	\$221.74	\$209.36	\$207.23	\$241.83	\$233.46
Net cruise revenue/ ALBD	\$175.78	\$179.33	\$171.94	\$168.94	\$195.46	\$188.46
<i>Approximate Commissions</i>	18.70%	19.10%	17.90%	18.50%	19.20%	19.30%
Occupancy	106.00%	106.20%	105.60%	105.50%	105.70%	105.60%
Operating cost/ ALBD	\$147.00	\$133.44	\$130.49	\$153.93	\$140.91	\$136.09
<i>Operating Margin/ALBD</i>	28.8	45.9	41.5	15	54.6	52.4

Source: Goldman Sachs Analysis

Carnival's core business is facing both decreasing revenues and increasing costs. Lower revenues have been driven by the poor macroeconomic environment and expanding industry capacity; higher costs are attributable to fuel prices and "other."

In cruising, the revenue is driven by capacity and demand. Cruise companies usually price by capacity, with the goal of filling every cruise ship (note that occupancy is consistently over 100%). While advertised prices represent a healthy profit for Carnival, heavy discounting is often offered to favored travel agents with the goal of filling each ship well before departure. That means in the soft customer market of the last 5 years, Carnival's heavy investments served to drive capacity up and revenues down.



Of the variance in costs, a full 78% is explained simply by fuel prices. These high prices, and Carnival's potential responses, are outlined in *SWOT: Threats*.

LIQUIDITY AND SOLVENCY

While Carnival's debt position has expanded in the past few years, and reserves of cash are somewhat lower, the company's financial liquidity is not in doubt. In addition to substantial cash reserves (although it possess a current ratio of only .2), Carnival has a \$2.4B revolving credit facility currently priced at EURIBOR +65bps, and the ability to raise more financing quickly in Euros, Sterling, or Dollars.

In the long term, while Carnival has significant debt outstanding, we do not believe its solvency to be seriously in question. Total long-term debt outstanding is approximately \$9B, which is only a fraction of its net asset value. In fact, it is significantly less leveraged than its main competitor Royal Caribbean, which has a Total Debt/Equity ratio of approximately 1, compared with Carnival's .39.

STOCK PERFORMANCE AND DIVIDEND

Carnival Corporation's shares are dual-listed on the New York Stock Exchange and the London Stock Exchange. Since its incorporation in 1987, Carnival's stock price rose rapidly throughout the 1990's and fell sharply in 2000. The company's value hit an all-time high in December 2004, and has declined ever since. In the last 5 years, Carnival stock price has fallen, and failed to keep pace with the S&P 500 as a whole, although it is comparable to its main competitor Royal Caribbean:



CARNIVAL STOCK PRICE



Source: Yahoo! Finance

This stagnation has been difficult for the historically growth-oriented company that had been a star stock until the 2001 recession and again in 2003-2005. Like any stock, many factors pin down valuation. One of the most important, however, has been that Carnival's growth prospects have seemed dim. As recently as 2005, Carnival was valued at nearly 25x earnings – high, but reasonably so for a strong company in a rapidly expanding market. However, since then slower growth and falling prices have meant that the market sees Carnival less favorably:

CARNIVAL P/E RATIOS OVER TIME



Source: ycharts.com

Because the cruise market is asset-intensive and requires high levels of capital expenditure, it produces very little free-cash-flow. Market sentiment on this point is expressed eloquently by analyst Charlie Munger:



Like many asset-intensive businesses, Carnival has always been forced to reinvest the bulk of its cash flow right back into the business. In this sense, it is a true "sinkhole stock" -- or for that matter, a boat: a hole in the water surrounded by wood into which one must pour money. Even over the last 10 years, Carnival has produced meager free cash flow (\$1.56 billion), and has been forced to fund the bulk of its share buybacks and dividends from net debt issuance (\$2.155 billion).

Those dividend payments, however, have done little to prop up Carnival's stock price. Historically, management has used dividends in times of weakness to return cash to shareholders and boost price. Notably, in 2008 as the global economy entered recession, Carnival increased its dividend from 35¢ to 40¢ per share, necessitating debt issuance and prioritizing short-term valuation over long-term shareholder returns. In 2012, Carnival's dividend payout ratio is projected to reach 47%.¹⁰ While this is not unusual for a Fortune 500 company, few of the Fortune 500 have as fast-growing a market as Carnival, or such good uses for their capital. One use for that capital is outlined below.

STAR CRUISES ACQUISITION

BACKGROUND: STAR CRUISES

Star Cruisesⁱⁱⁱ is a Hong Kong-based subsidiary of the Genting Group, a Malaysian conglomerate. Founded in 1993, Star controls most of the Asian market for cruising. Its cruises tend to be shorter and with a heavier reliance on gambling revenues than Carnival or Royal Caribbean properties. Star currently operates four cruise ships full-time from its operational bases in Hong Kong and Singapore. Its passengers are sourced throughout Asia and Europe, but the majority are Chinese, Japanese, Malaysian, and Singaporean.

Despite operating an attractive business in a fast-growing market segment, Star Cruises has failed to produce shareholder returns. It has been essentially flat on a 10-year horizon and has far underperformed the Hang Seng index:

ⁱⁱⁱ Star Cruises' corporate face was recently renamed Genting Hong Kong. It continues to operate under the name Star, and to avoid confusion this report will use "Star Cruises" to refer to both Star and Genting Hong Kong



STAR CRUISES VS. HANG SENG INDEX



Source: Google Finance

It is this failure to produce returns, despite an attractive core business, that makes Star a viable acquisition for Carnival. Due to a Singapore-based business model, persistent underinvestment in customer experience, and substantial mismanagement, Star Cruises has yet to unlock its true potential.

SYNERGIES AND OPERATING EFFICIENCIES

We believe that substantial synergies exist between Carnival and Star Cruises and that both players would benefit from a merger.

First, the Asian cruise market is both unfamiliar to Carnival and substantially different from the North American and European markets. As one outraged traveler on cruisecritic.com complained of a Star Cruises voyage:

“ The food in Bella Vista was great, but the Chinese restaurant has real authentic Asian food, which is not what westerners are used to. We were very disappointed in that aspect of the cruise.”

Carnival’s current operations are not aimed towards providing “real authentic Asian food,” and the company is unfamiliar with the particularities of the Asian market. A 2010 marketing study of Asian and Western cruise passengers concluded that Asians



were more brand-conscious, spent more time gambling, and considered price a more important consideration than did Westerners¹¹.

Second, Carnival has superior management and expertise compared with Star Cruises. Passengers have frequently reported that Star Cruises suffers from indifferent staff, frequent bouts of food poisoning, and a perceived indifference to customer needs. By contrast, Carnival has a wealth of highly experienced managers on successful, smoothly-running cruise lines that could help transform the Star Cruises experience. Additionally, Carnival's superior bench of talent and sheer scale would allow Star to streamline its logistics, removing capacity issues that arise when Star ships require drydocking.

Third, Star Cruises stands to benefit from Carnival's scale and financial resources. Currently, Star acquires many of its cruise ships secondhand from its partner Norwegian Cruise Lines. Norwegian operates only 11 ships, giving Star limited selection and possibilities. If Star was partnered with Carnival's fleet of approximately 100 ships, then these transactions would be easier and more flexible. As previously noted, Carnival's IberoCrueros ships might be better deployed in Asia.

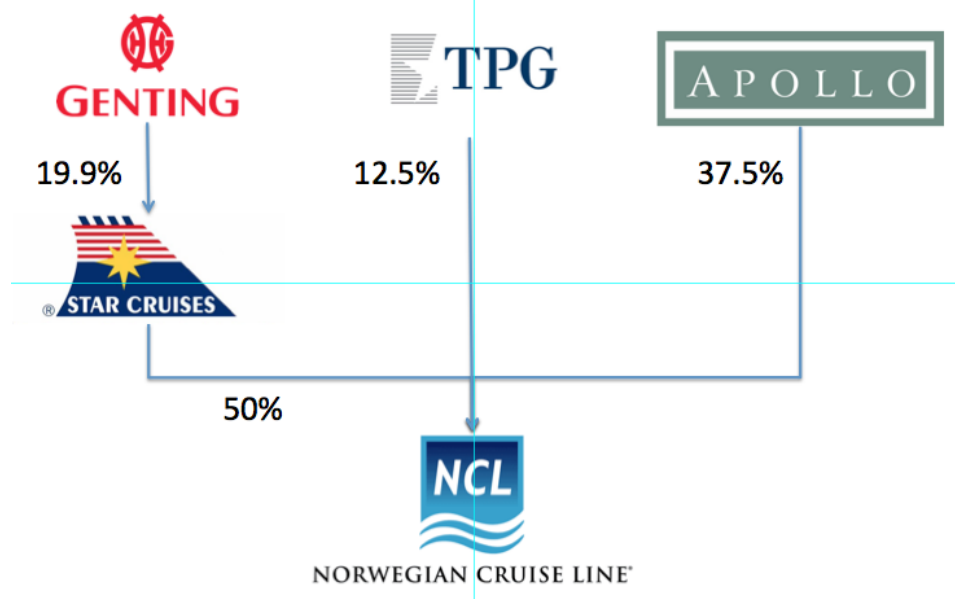
ACQUISITION AND FINANCING

Griffin Group is not an investment bank, and a detailed analysis of Star Cruises and substantial negotiations will be necessary before an acquisition can take place. Accordingly, this analysis merely aims to illustrate a few key financial issues behind a potential takeover; it is not meant to substitute for detailed Carnival research.

In order to acquire the Star Cruises brand, Carnival must deal with its somewhat Byzantine ownership structure. Star Cruises is part-owned by its parent company, the Genting Group. It also holds, as a major asset, a 50% stake Norwegian Cruise Lines (NCL), the #3 player in the market with a 7.1% market share. Apollo and TPG, two private equity firms, currently hold the other 50% of NCL. The following chart summarizes this structure:



Ownership Structure of Star Cruises



Source: Genting Hong Kong Annual Report 2011; Texas-Pacific Group

Acquiring both the Star Cruises and Norwegian brands is undesirable. Norwegian's brand, focused on upper-income Europeans and Americans, has significant overlap with Carnival's existing properties. Additionally, such an acquisition would face antitrust scrutiny since it would push Carnival's market share from approximately 50% to 60% - an unprecedented expansion in an already concentrated market. However, since Carnival currently holds approximately a 10% stake in the Asian market, antitrust attention towards a Star-Cruises-only move is unlikely.

Accordingly, a successful deal would necessitate spinning NCL off to Apollo and TPG. These firms would then be able to take the resulting company - free of its complicated corporate structure - public. (Operating problems from Star Cruises have already mooted one attempted IPO). Apollo bought its 50% share of NCL in 2007 for a \$1B cash investment. Now, NCL is worth more: its fair value may be around \$3.5B, since the company has grown its core operations and shrunk the money-losing NCL America line. Those moves have increased NCL's net income from a loss in 2009 to \$22.9 million in 2010 and \$126.8 million in 2011.¹²

If Apollo and TPG buy out Star's interests in NCL for \$1.5B, and Carnival pays a 20% acquisition premium on the remaining value, then the total acquisition price to Carnival



would be only \$1.69B. This price is substantial, but not unreasonable. It would comprise only about 6.9% of Carnival's market capitalization. If funded entirely by debt, this would raise Carnival's debt total debt to \$10.04B. While significant, this level falls far short of violating Carnival's debt covenants requiring total debt to be less than 65% of consolidated equity (\$33B). Additionally, the attractiveness of the Star Cruises property would make raising additional capital through a secondary share offering much easier.

In conclusion, we believe that the acquisition of Star Cruises could be transformative and a major source of future growth, making this possibility well worth exploring. There are substantial synergies in operations, marketing, capital structure, and ships between the two companies, and while an acquisition is made more difficult by Star's complicated ownership structure, it is a route well worth pursuing for Carnival.

STRATEGIC RECOMMENDATIONS

SHORT-TERM

Settle the Costa Concordia litigation quickly and quietly.

As discussed in Background: Costa Concordia Accident, the direct costs of the accident are likely to be relatively low. Carnival is insured both for the cost of the ship and for the litigation that will follow.

The larger problem is that the litigation surrounding the *Costa Concordia* is still a considerable news story. On March 30, the *Carnival Voyager* was briefly impounded in Galveston, Texas as security against a German passenger's \$10MM lawsuit. This event, while causing minimal operational problems for Carnival, hit wires across the world. As litigation continues, stories such as these – including interviews with terrified and injured passengers – will only grow in prominence.

In order to mitigate the PR losses from the accident, we suggest that Carnival move to offer generous, confidential settlements to many of the passengers – or pay off its insurers to do so. The insurance companies will naturally be willing to let the lawsuits play out, holding out for dismissals or smaller settlements. Since Carnival's incentives



are not aligned with its insurers' on this matter, a payment and/or the promise of future business will be necessary to get quick and quiet settlements.

The risks to this strategy are twofold. First, prioritizing settlements over litigation or stalling will certainly drive up legal costs following the accident. These costs, while not a huge problem for Carnival's bottom line considering the company's scale, will prove considerable. Second, and more seriously, this risks setting a high baseline for any future litigation. If the 30 victims of the *Concordia* were able to settle for \$1 million each, then the costs would be only .2% of Carnival's yearly revenues. On the other hand, imagine a catastrophic future accident with all passengers lost. At \$1MM for each passenger, this would add up to \$3.7 billion. Even if Carnival could ultimately settle for less than this sum, insurers are likely to take the *Concordia* settlements as a baseline when determining future premiums. On balance, however, we believe that a quick and expensive resolution is better than a long and drawn out process.

Freeze or Cut Dividends to Fuel Growth

As discussed in the *Financial Analysis: Share Price & Dividends*, Carnival has been in the habit of paying out dividends far in excess of its free cash flows, necessitating taking on long-term debt. This debt – while not extravagant for a major and stable corporation – represents capability which might otherwise make Carnival a more attractive company.

Inherently, cruising is still a hugely attractive business to invest in. It is fast growing, predictable, and historically profitable. It is also capital intensive. Accordingly, it would make sense to freeze dividend payments and further invest in cruising worldwide. Several of the initiatives described in this report will require investment. Most obviously, a takeover of Star Cruises would be expensive, but increased IT capabilities and further newbuilds for the German and Australian markets will also require expansion beyond current expectations.

Financial markets' reaction to this move must be managed carefully. A dividend cut will drive Carnival's stock down unless investors believe that this capital will be employed effectively. To mitigate this, Carnival might follow the example of Amazon. Faced with a disappointing Q1 2011, Amazon's CEO Jeff Bezos issued a letter to



shareholders explaining Amazon's investment in future technologies and defending the company's high R&D costs. After Bezos' letter was released to the public, Amazon stock recovered dramatically. Mr. Arison and Carnival might follow a similar path, explaining that dividend reductions will be re-invested in Asia and Australia, and that Carnival expects to see substantial rewards.

MEDIUM-TERM

Instill a culture of safety

As discussed in *SWOT: Weaknesses*, Carnival has a poor track record in safety on by a number of different metrics. Whether one considers recent major incidents, viral outbreaks, or passengers lost overboard, Carnival seems to lag other cruise lines. After the *Concordia* incident, Carnival announced a worldwide safety audit, but we believe that this ad-hoc measure is insufficient. To remedy this deficiency, the company should add a worldwide corporate focus on making cruising safer.

At first, this might seem like a speculative measure done for appearances. However, recent research has shown that a corporate focus on "safety climate" can be effective, especially if senior leadership backs it.^{iv} Within each cruise brand, Carnival should consider appointing a "Chief Safety Officer" to oversee the overall risks to passengers and crew. This officer would have overall responsibility and power to make changes to ensure a safe environment.

Exit from IberoCrueros

As discussed in the Growth-Share matrix analysis, IberoCrueros is situated unfortunately. With only 3 cruise ships, the brand does not have significant share in the Spanish- and Portuguese-speaking market. Worse, this market has been wracked by the Euro crisis and short-term improvement seems unlikely.

The best solution to IberoCrueros will take extract maximum value from the assets and relationships that Carnival has built over time. The assets are relatively simple: IberoCrueros ships could be repurposed for more successful lines such as Carnival or Costa Asia. On the other hand, there may be value in the market that IberoCrueros has

^{iv} Admittedly, these studies can involve small sample sizes and leave much to be desired. See Mearns, slides 23-25.



built – an acquisition by an industry leader such as Pullmantur is possible, but Carnival could also look into sale to a conglomerate entertainment company or private-equity group.

There is, of course, significant downside potential to this strategy. If the Iberian market recovers faster than expected, or no willing buyers emerge for the IberoCrueros brand, then Carnival would be left regretting its hasty exit. The alternative, however, is to be stuck with an uncompetitive position in an undesirable market.

Consider Star Cruises acquisition

This recommendation is considered in depth in the *Star Cruises Acquisition* section of this report. To briefly summarize, we believe that acquisition of Star Cruises is possible, would give Carnival a strong position in Asia, and would create synergies across both companies.

LONG-TERM

Use market share to differentiate between growth and mature markets, pushing prices up

In the Australian and German markets, Carnival needs to push quickly to expand. Demand is growing so quickly in these markets that if P&O Australia, Princess, and AIDA do not grow with it they risk becoming second-tier competitors. On the German front, Carnival has already adopted this strategy with its four planned newbuilds. However, in Australia more capacity is needed (for more detail, see *Growth-Share Matrix Analysis*). This might come either through an expansion of P&O Australia and Princess or marketing the Carnival brand towards young people: in all likelihood

However, in its mature North American and European operations that constitute most of the business, Carnival faces the opposite problem. Recently, capacity has grown faster than demand for the industry as a whole, pushing margins down. By taking a strategic pause on newbuilds for 1-3 years, Carnival could reverse this trend and restore the market to robust profitability. Of course, this also means a loss of market share to Royal Caribbean and other competitors, but these competitors are more leveraged than Carnival. The acquisition of a stake in Norwegian Cruise Line through Star Cruises would also help ameliorate this, by giving Carnival more share without growing overall capacity.



Bring the travel agent relationship into the 21st century

Carnival's travel agents are the lifeblood of the company. They are its principal marketing tool, main source of revenue, and relationship monitors with Carnival's guests. Unfortunately, the nature of this relationship can make it hard to take full advantage of the tools available to other businesses. As an example, Carnival has never had access to complete customer lists, and has a difficult time linking customer histories. If the Jones family cruises once a year in the Caribbean, Carnival might not even know it had repeat customers. Customers who consider – but do not purchase – a cruise are typically lost.

The solution, however, is not necessarily to move away from the cruise agent relationship. Instead, Carnival should seek to partner with its various travel agencies and gather data from them on an ongoing basis. This would have several benefits. Carnival cruise lines could be more selective in which customers to offer discounts and upgrades. Currently, upgrades tend to go to customers of high-volume travel agencies: perhaps a value proposition for the agencies, but hardly the most efficient way to allocate scarce resources. With an improved customer tracking system, and access to databases describing customers' needs and resources, Carnival could focus on giving new cruisers an amazing experience or win over profitable frequent cruisers.



APPENDIX A: CONSOLIDATED FINANCIAL STATEMENTS

INCOME STATEMENT

	Years Ended November 30,		
	2011	2010	2009
Revenues			
Cruise			
Passenger tickets	\$ 12,158	\$ 11,084	\$ 10,288
Onboard and other	3,357	3,104	2,885
Tour and other	278	281	287
	<u>15,793</u>	<u>14,469</u>	<u>13,460</u>
Costs and Expenses			
Operating			
Cruise			
Commissions, transportation and other	2,461	2,272	2,220
Onboard and other	506	474	461
Payroll and related	1,723	1,611	1,498
Fuel	2,193	1,622	1,156
Food	965	869	839
Other ship operating	2,247	2,032	1,997
Tour and other	204	212	236
Total	<u>10,299</u>	<u>9,092</u>	<u>8,407</u>
Selling and administrative	1,717	1,614	1,590
Depreciation and amortization	1,522	1,416	1,309
	<u>13,538</u>	<u>12,122</u>	<u>11,306</u>
Operating Income	<u>2,255</u>	<u>2,347</u>	<u>2,154</u>
Nonoperating (Expense) Income			
Interest income	11	12	14
Interest expense, net of capitalized interest	(365)	(378)	(380)
Gains on fuel derivatives, net	1	-	-
Other income (expense), net	10	(2)	18
	<u>(343)</u>	<u>(368)</u>	<u>(348)</u>
Income Before Income Taxes	1,912	1,979	1,806
Income Tax Expense, Net	-	(1)	(16)
Net Income	<u>\$ 1,912</u>	<u>\$ 1,978</u>	<u>\$ 1,790</u>
Earnings Per Share			
Basic	<u>\$ 2.43</u>	<u>\$ 2.51</u>	<u>\$ 2.27</u>
Diluted	<u>\$ 2.42</u>	<u>\$ 2.47</u>	<u>\$ 2.24</u>
Dividends Declared Per Share	<u>\$ 1.00</u>	<u>\$ 0.40</u>	

Source: Carnival Corp. 10K



BALANCE SHEET

	<u>November 30,</u>	
	<u>2011</u>	<u>2010</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 450	\$ 429
Trade and other receivables, net	263	248
Inventories	374	320
Prepaid expenses and other	225	247
Total current assets	<u>1,312</u>	<u>1,244</u>
Property and Equipment, Net	32,054	30,967
Goodwill	3,322	3,320
Other Intangibles	1,330	1,320
Other Assets	619	639
	<u>\$38,637</u>	<u>\$37,490</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Short-term borrowings	\$ 281	\$ 740
Current portion of long-term debt	1,019	613
Accounts payable	576	503
Accrued liabilities and other	1,123	1,094
Customer deposits	3,106	2,805
Total current liabilities	<u>6,105</u>	<u>5,755</u>
Long-Term Debt	8,053	8,011
Other Long-Term Liabilities and Deferred Income	647	693
Commitments and Contingencies		
Shareholders' Equity		
Common stock of Carnival Corporation, \$0.01 par value	6	6
Ordinary shares of Carnival plc, \$1.66 par value;	357	355
Additional paid-in capital	8,180	8,094
Retained earnings	18,349	17,224
Accumulated other comprehensive loss	(209)	(254)
Treasury stock, 52 shares at 2011 and 39 shares at 2010 of Carnival Corporation and Carnival plc, at cost	<u>(2,851)</u>	<u>(2,394)</u>
Total shareholders' equity	<u>23,832</u>	<u>23,031</u>
	<u>\$38,637</u>	<u>\$37,490</u>

Source: Carnival Corp. 10K



STATEMENT OF CASH FLOWS

	Years Ended November 30,		
	2011	2010	2009
OPERATING ACTIVITIES			
Net income	\$ 1,912	\$ 1,978	\$ 1,790
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	1,522	1,416	1,309
Share-based compensation	46	43	50
Other	48	(15)	37
Changes in operating assets and liabilities			
Receivables	(43)	106	81
Inventories	(54)	(12)	10
Prepaid expenses and other	18	(14)	7
Accounts payable	67	(36)	74
Accrued and other liabilities	(41)	81	29
Customer deposits	291	271	(45)
Net cash provided by operating activities	<u>3,766</u>	<u>3,818</u>	<u>3,342</u>
INVESTING ACTIVITIES			
Additions to property and equipment	(2,696)	(3,579)	(3,380)
Other, net	50	78	(4)
Net cash used in investing activities	<u>(2,646)</u>	<u>(3,501)</u>	<u>(3,384)</u>
FINANCING ACTIVITIES			
(Repayments of) proceeds from short-term borrowings, net	(450)	626	(288)
Principal repayments of revolvers	(13)	(350)	(1,749)
Proceeds from revolvers	8	94	1,166
Principal repayments of other long-term debt	(1,237)	(1,842)	(1,273)
Proceeds from issuance of other long-term debt	1,696	1,280	2,299
Dividends paid	(671)	(237)	(314)
Purchases of treasury stock	(454)	(524)	(188)
Sales of treasury stock	-	545	196
Proceeds from settlement of foreign currency swaps	-	-	113
Other, net	28	4	(55)
Net cash used in financing activities	<u>(1,093)</u>	<u>(404)</u>	<u>(93)</u>
Effect of exchange rate changes on cash and cash equivalents	(6)	(22)	23
Net increase (decrease) in cash and cash equivalents	21	(109)	(112)
Cash and cash equivalents at beginning of year	429	538	650
Cash and cash equivalents at end of year	<u>\$ 450</u>	<u>\$ 429</u>	<u>\$ 538</u>

Source: Carnival Corp. 10K



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- ¹ Carnival 2011 Annual Report
 - ² DNV
 - ³ CruiseMarketWatch
 - ⁴ Carnival 10K Report
 - ⁵ Ronson
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 - ⁷ CCL Careers
 - ⁸ Australasia Cruise Council
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 - ¹⁰ Goldman Sachs
 - ¹¹ Yi, Day, and Cai 2010
 - ¹² Norwegian Cruise Line 2011 Financial Release