



Analyzing Royal's Earnings Call

When Royal Caribbean held their first quarter earnings call with Wall Street financial analysts back on May 1, company leaders reported both disappointing phone volume and problems with close-in bookings for the lower-priced product during the early part of the year. There were the usual success stories about cost control initiatives and growth outside of North America, but the tone wasn't as upbeat as usual. Not surprisingly, cruise stocks dropped off slightly after the earnings call.

However, when Royal held its second quarter earnings call with Wall Street this week, it was far more upbeat. "What is it different today that's making us feel better?" queried Chairman/CEO Richard Fain. "The real question is: what was the anomaly that was happening earlier in the year? What we're seeing today, hopefully, is more moving back to a more normal environment, as opposed to the, hopefully, somewhat of an anomaly that we experienced in the first quarter."

As part of the good news, Royal Caribbean President Adam Goldstein reported: "We are seeing encouraging strength in close-in bookings. This phenomenon applies across our various product regions, but it's most noticeable in the Caribbean seven-night segment."

And close-in bookings are strong at Celebrity as well. President Dan Hanrahan said, "We are encouraged by the quality of the in-season demand we are seeing--Europe, in particular, has been strong."

Yet even with all those positive reports, Royal's stock dropped a few percent along with the rest of the Dow Jones this past week. The timing was unfortunate, as this earnings call was generally upbeat. 2007 has been a tough year for Royal overall on Wall Street, and right now some financial analysts are pushing cruise line stock in the same way agents are pushing cruises: buy now because it's a good value.

The Cruise Industry's Invisible Hurricanes

The term "invisible hurricane" has been used in the media to describe various mechanical breakdowns hampering oil refineries this year--it may as well apply to the cruise biz, as the lines are having an invisible hurricane of their own with rising fuel costs affecting all aspects of the business, most notably with middle income Americans tightening purse strings. It's not clear yet if Royal will add a fuel surcharge to the ticket prices.

As a matter of fact, during the earnings call, Hakan Ipekci of Merrill Lynch asked, "Now that oil or fuel expenses have risen substantially again, what's your view on a potential fuel surcharge on the ticket prices, passing on the fuel costs to the customers?"

Chief Financial Officer Brian Rice responded: "It is something we've looked at. There is a little bit of a legal concern before we can pass on a fuel surcharge. As you

may recall, years ago, we entered into a compliance with the Attorney General's office in terms of passing on anything that is non-governmental taxes; anything that was not paid to a government could not be classified as a taxing fee. Also, we view fuel surcharges as something that is more for a shorter term spike in fuel prices. It is something we keep an eye on, but at this time we have no immediate plans to do so."

However fuel prices affect sailing prices, this won't be a short-term issue. One report recently pointed out that Carnival Corp. saw increases of about 8% in its fuel prices for 2004, followed by a 32% increase in 2005, and 34% in 2006. While fuel price increases have flattened this year, in its most recent report Royal said that fuel prices increased 8% from the most recently reported levels on May 1, averaging \$443 per metric ton compared to the previously disclosed price of \$412 per metric ton.

So just as Carnival Corp. cut their guidance for the year, last month, citing fuel, Royal lowered their earnings outlook for the year, citing fuel as one of the causes.

Energy Efficiencies

During the conference call, management mentioned efforts to curb fuel consumption. "If you look at our fuel costs estimate, while it is still painful, it is lower than it would have been based on our earlier forecast of consumption and today's fuel price," said Fain. "We've mitigated the cost increase with our fuel savings program, which has proven to be more successful than anticipated."

As one example, Hanrahan provided an update on the installation of diesel engines on Celebrity ships. "On the last call, I mentioned we completed installation on the first diesel engine on *Millennium*," he said. "Since that call, we have completed the installation of a diesel engine on *Constellation*. The *Millennium* is fully commissioned, and we are excited about the results. Last year, we reported the annual savings would be in the range of \$4 million to \$6 million per year per ship, but based on the initial results...it now looks like we will be on the high side of that range."

He added the diesel engines run more efficiently and burn less fuel. "By the end of 2008, the company will have completed diesel installations on all eight of the gas turbine ships of the combined fleet," said Hanrahan.

Royal also has an aggressive hedging program in place for purchasing fuel. "Our hedging strategy really is about managing risk," said CFO Brian Rice. "We're not speculators. We're not tracking the markets daily trying to understand and be oil speculators. What we're trying to do is manage a cruise line and the volatility that fuel prices have on our income statement. We're very happy at the 40% to 60% range [of hedged purchases]. We do want to be able to participate if oil prices come down."



Supply vs. Demand

So Royal is being proactive about conserving fuel, but there were questions about the effect of oil prices on consumers. For instance, Dominique Mielle of Canyon Capital said: "We're back to an environment where oil is very high and probably weighs on the consumer wallet. The housing crisis is in a full swing. I am having a difficult time understanding why it is that you're observing a better pricing environment and better booking environment...For qualitative assessments, what is causing this? Do you think you're a leading indicator of consumer weakness and that the consumer has adapted to the new cost structure, or is there anything else you can think about?"

Fain responded: "I do think there were very specific factors that affected us starting at the end of the last year. One of the things we've often said about the cruise industry is that it's recession-resistant, not recession-proof; nobody is. But we think we are more insulated from that because of the value proposition. Cruising turns out to be a good value, it is in fact cheaper than other vacations that give you equivalent experience and satisfaction.

"What happens in a recession, or what happens when people are worried about pocketbooks--whether it be fuel or housing prices or what have you--is that people tend to do more research, tend to make stronger comparisons, and tend to put higher premiums on vacations with a known fixed cost.

"I think all of those things come together and help explain why we are recovering as quickly as we are. I think the real issue is maybe: why did we feel it earlier than some other segments of the market? I think of earlier as being an anomaly rather than the recovery being an anomaly."

It was an upbeat reply, but financial analysts during the earnings call pointedly asked about future growth, essentially trying to understand how the company can continue to spend on growing the product, when middle income consumers are struggling, especially with the great volatility of fuel prices.

Steve Kent of Goldman Sachs noted: "Recently, Carnival management has alluded sort of on and off they might be willing to slow down cap ex[penditures] as they get further out. When I look at your cap ex program, it is pretty heavy up through 2010. Just give us a sense when you will slow down the ship building? Even with this environment, maybe it's stabilizing, but I don't think any of us would characterize it as robust..."

Fain's response indicated growth will continue. "In fact, we are running now at a lower capacity increase year over year than we were over the previous five

years, so there already is in fact some kind of slow-down...partially because ship prices have gone up and demand isn't as robust today as we'd like it," he replied. "But even given today's market, we think the industry continues to be strong and resilient, continues to grow, and we would expect to see continued modest growth, more along the lines of what we've been doing recently

One reason for the optimism is the continuing global growth which was emphasized during the call. Tellingly, shortly after the call Royal announced a new homeport: Colon, Panama, in which Europeans and Central Americans are seen as prime market. Royal Caribbean will 17 southern Caribbean cruises ex. Colon effective December 2008. Ports of call include Cartagena, Santa Marta, Aruba, Bonaire and Curacao.

More Cruise Consolidation?

Historically, cruise consolidation has occurred during somewhat difficult times for the industry--note the battle for Princess, which was launched just two months after September 11, 2001. So not surprisingly, there were a few questions geared on Royal's view of growth through acquisition. Scott Barry of Credit Suisse asked: "You outlined the \$8 billion capital program you have through 2011. Would you be willing to take on even more leverage to make another acquisition?"

Fain, answered, "Under the right circumstances, definitely yes."

Later, Tim Conder of A.G. Edwards asked Fain that if he was considering acquisitions, where would his leanings be? "Would you go more upscale to Azamara or downscale to RCI?"

Fain responded: "We would look at this opportunistically. There are not a lot of acquisition candidates out there--I should make it clear--but I think we are diversified, and we have the advantage of that, and we would look at the return that any particular investment would give, whether it was upscale or more mainstream."

As For Azamara...

Judging from the comments of Celebrity/Azamara President Dan Hanrahan, it doesn't look like there is a priority on growing the Azamara brand in the near future.

David Leibowitz of Burnham Securities asked, "Two vessels, no matter how boutique they are, does not a fleet make. What are the realistic expectations to how large a fleet Azamara will in fact contain over the next few years?"

Hanrahan replied, "The price of ships is very high right now and driven by the Euro. It is also driven by the subcontractors, so at this point there is no immediate plan to add ships to Azamara, but it is something that obviously we'll be evaluating as we go. At this time, we don't have any plans to add ships."