Royal Caribbean International: Financial Analysis and Recommendations

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Royal Caribbean International

Financial Analysis and Recommendations

By
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Chapter 1: General Company Information

Royal Caribbean Cruises, Ltd. is an international cruise line that is publically traded on the New York Stock Exchange. It is the second largest cruise line in the world, controlling five brands, 42 ships, and contracts for many more. Royal Caribbean also has part ownership of TUI Cruises and related assets through a 50 percent joint venture. Their headquarters are in Miami, Florida, but the company offers cruises to over 490 destinations in all seven continents. Departure points across the globe allow the company to reach nearly every existing market. Using a strategy of innovation and increasingly lavish offerings, Royal Caribbean had net income over $764 million for the 2014 fiscal year.

Company History

Leisure cruises set sail for the first time in the mid-1800s. These first primitive ships killed thousands by sinking, running aground, or burning, yet more and more cruises were being offered. In the early 1900s, the infamous *Titanic* had its maiden voyage on which two-thirds of its passengers and crew were killed. While fleets grew World War I began. A German submarine sank the *Lusitania* killing over one thousand passengers. Attacks on non-military ships continued, even those serving as hospitals. These unarmed cruises were vulnerable and were exploited throughout the war. Even without intentional sinking in wartime, cruises' engines failed, hulls got holes in them, and ships collided. Consequently, in the next world war, many passenger vessels were converted for military use (Polsson).

Before Royal Caribbean Cruises, Ltd, (RCL) was created, a number of innovations took place. Ships became quicker. In1970, a jet passenger service could cross the Atlantic Ocean in less than a week compared to a starting point of over two weeks. Ships could circumnavigate the globe with predetermined arrival dates. Radar was added to non-military vessels. Air conditioning came aboard. Over two thousand passengers could sail on the largest ships. First-class only cruises were available, and offered the first excursions. By choosing locations near the equator, companies were starting to offer cruises all year long (Polsson).

Miami was already becoming a very common departure point by the time the first Royal Caribbean ship, the *Song of Norway*, was built. Klosters Rederi, the predecessor of Norwegian Cruise Lines, had three and four day packages to travel between Miami and the Bahamas. This line had three ships in use or under way before the *Song of Norway* had her maiden voyage in 1970. Royal Caribbean introduced new ships in 1971 and 1973. Creating Royal Caribbean was not an extremely creative idea. Arne Wilhelmson and Edwin Stephan, the founders, simply took advantage of an industry in its growth phase and applied their business expertise (Bayley).

Wilhelmson was an investor that graduated from Harvard, and Stephan was a famous businessman working in Florida. They understood the community and marketed to them accordingly. The two founders took advantage of Florida's wealthy citizens and offered them a luxury vacation cruise to the Caribbean for a few days. Their largest investors were Norwegian shipping magnates, who gave them the capital to build unique ships. The *Song of Norway* was known for its lounge cantilevered around a smokestack. Stephan added this design after being inspired by the Seattle Space Needle. This feature was added to many of the future ships in Royal Caribbean's line (Polsson).

As the market became more competitive, companies were quicker to copy others in the industry to stay ahead. Norwegian Cruise Line developed Great Stirrup Cay into the first private island owned by a cruise line. In 1978, the *Song of Norway* was elongated in Finland by cutting it in half and adding a middle section over eighty feet long. Competitors later used this process on their fleets as well. As more ships were created, new features were advertised to gain market share. For example, Princess Cruises built a ship where every cabin had at least one outside window. In 1998, Royal Caribbean launched *Sovereign of the Seas*, which was the first large modern cruise ship. It weighed 73,000 tons and carried 2,690 passengers. Finally, the market got closer to maturity and companies slowly began to merge. In 1990 Admiral Cruises was acquired by Royal Caribbean, now named Royal Caribbean International (RCL). In the mid-1990s, RCL sold off its oldest ships. Carnival Cruise Line gained significant market share in Miami, and Walt Disney Company entered the industry. In 1999 Disney Cruise Line hosted its first wedding on its private island Castaway Cay. *Voyager of the Seas* sets a record for most passengers on a cruise with 3608 guests. Throughout the 2000s Royal Caribbean renovated and built more ships than most companies. In 2007 Royal Caribbean Cruises launched CDF Croisières de

France, a new brand for the market in France. The next year Royal Caribbean International's *Independence of the Seas* cruise ship made its first public appearance in Southampton, England. It is the world's largest cruise ship weighing 160,000 gross tons, and having a passenger capacity of 3,634. The ship sailed on a 14-day Mediterranean cruise and an 11-day Canary Islands cruise (Polsson).

Media and advertising surrounding the industry has majorly influenced its performance. The Love Boat aired in 1977, and the *Island Princess* and *Pacific Princess* from the Princess Cruises fleet were used to produce it. Its ten-season run increased the popularity of vacation cruises. Postage stamps across the world were issued depicting various ships. In 1979, *Cruise Travel*, an American magazine, was published. In 2001, The Travel Channel aired a behind-the-scenes documentary on *Voyager of the Seas* called *Voyager: Beyond the Cruise.* For the next five years, they aired similar shows called *Great Cruises: Radiance of the Seas*, *Great Cruises: Adventure of the Seas*, and *Samantha Brown's First Cruise*, based on a cruise to the Mediterranean aboard *Brilliance of the Seas,* and *Great Cruises: Freedom of the Seas with Samantha Brown*. In 2005, Disney hosted a fundraising event for Make-A-Wish Foundation and raised $2 million. Norwegian Cruise Line was the first to have a celebrity christen a ship, which soon became a common strategy. Because the industry was gaining popularity, an unused life jacket from the *Titanic* ship sold at an auction for $68,500. To compete with Disney's kid-themed cruises, Royal Caribbean International's *Freedom of the Seas* cruise ship offered a special Nickelodeon cruise of the Western Caribbean (Polsson).

New ports and regulations began to standardize the industry. The Grand Turk Cruise Center at Turks & Caicos was a $42 million port facility. It was built to hold two of the largest cruise ships that existed. A fire aboard a Princess Cruise led to changes in procedures of many companies. “The District Court of Southern Florida ordered Norwegian Cruise Lines to pay $13.75 million to victims of a boiler explosion aboard the SS *Norway* in 2003, and $1 million in fines for gross negligence,” (Polsson). “In New York Harbor, a routine inspection over three days of Peace Boat Organization's 1200-passenger *Clipper Pacific* cruise ship (originally *Song of Norway* 1970) by the US Coast Guard identified 67 deficiencies,” (Polsson). “The American Environmental Protection Agency publishes a Clean Water Act General Permit that will allow cruise ships to dump unlimited quantities of untreated "graywater" into the ocean just a mile from U.S. shores,” (Polsson).

Currently customers are focused on extravagant excursions, comparable rates, big balconies, catering to allergies and diets, pollution, and onboard entertainment. Ships are trying to accommodate these demands, follow increasing regulations, and keep expenses down (Bayley).

Economic Timeline

Royal Caribbean was founded in a post-war economy that saw significant growth until the Cold War redirected investments. As space travel came to the forefront, computer technology and information systems gave the economy another serious boost. In 1961, the Vietnam War added demand for military goods and services. When that military market dissolved the economy again had to refocus its efforts elsewhere, benefitting the private sector (Economic Timeline).

Deregulation of airlines in 1978 led to deregulation of many other industries as well. In the case of cruising, companies may have benefitted from more regulations. There were still significant deaths at sea caused by malfunctions, fires and wrecks. After the Cold War, investments in the private sector benefited all cruise lines (Growth).

In 2005, Hurricane Katrina hit the Gulf Coast, a major cruise departure port and oil rig resource. This natural disaster increased oil prices and led to a decrease in demand for cruises. Soon after Hurricane Rita hit the already devastated area, and made the situation bleaker.

The world went into a global recession in 2008. High unemployment rates indicate the lack of disposable income during this time period. Because people could not afford luxury cruises, and most of the company's revenue comes from US sales, Royal Caribbean had a much smaller market to influence. As the US economy emerges from the recession the effects have diminished (Economic Timeline).

Company Operations and Analysis

Royal Caribbean's main source of revenue is ticket sales. Onboard and other revenue make up the rest. By buying a ticket, a customer receives a room, meal plan, access to entertainment, and other amenities. Onboard revenue refers to when customers buy extra drinks or meals, pay for spa treatments, buy souvenirs, etc.

Company headquarters are based in Miami, Florida, but they are incorporated in Liberia. Their fleet travels to over 490 destinations located on all seven continents. Departure points are categorized into seven regions: North America, South America & the Caribbean, Northern Europe, Italy & Turkey, Dubai, and, Asia & the Pacific, Spain, Portugal, & France. Royal Caribbean also owns its own island called CocoCay in the Bahamas (Bayley).

Segmentation

While Royal Caribbean International owns five cruise brands and has 50% ownership of another, their financial statements are all reported together. They each cater to a different market within the cruise industry. Brands have their own marketing and assets, but they all "have similar itineraries as well as similar cost and revenue components," (Form 10-K). Because their offerings and market characteristics are so similar only one segment is reported. The Chairman and CEO, Robert Fain, has oversight over all six brands. Singular oversight enables better resource management for each region's brands. Figure 1 shows the areas that each brand markets to, and Figure 2 differentiates each line's ships and ship characteristics.

Figure 1

Royal Caribbean International				
Celebrity Cruise Line	Pullmantur	Azamara	CDF Croisieres de France	TUI Cruises
•United Kingdom	•Spain	•Europe •Asia •Austrailia	•France	•Germany •Russia

(Form 10-K)

The slightly darker shaded ship names in Figure 2 have been ordered, but have not been completed.

Figure 2

Fleet Data			
Royal Caribbean International	Year in Service	Estimated Capacity	Gross Tons
Quantum of the Seas	2014	4,100	167,800
Allure of the Seas	2010	5,400	220,000
Oasis of the Seas	2009	5,400	220,000
Independence of the Seas	2008	3,600	158,000
Liberty of the Seas	2007	3,600	158,000
Freedom of the Seas	2006	3,600	158,000
Jewel of the Seas	2004	2,100	90,000
Mariner of the Seas	2003	3,100	142,000
Serenade of the Seas	2003	2,100	90,000
Navigator of the Seas	2002	3,100	142,000
Brilliance of the Seas	2002	2,100	90,000
Adventure of the Seas	2001	3,100	142,000
Radiance of the Seas	2001	2,100	90,000
Explorer of the Seas	2000	3,100	142,000
Voyager of the Seas	1999	3,100	142,000
Vision of the Seas	1998	2,000	78,000
Enchantment of the Seas	1997	2,250	74,000
Rhapsody of the Seas	1997	2,000	78,000
Grandeur of the Seas	1996	1,950	74,000
Splendour of the Seas	1996	1,800	69,000
Legend of the Seas	1995	1,800	69,000
Majesty of the Seas	1992	2,350	74,000
Anthem of the Seas	2015	4,100	
Oasis 3	2016	5,400	
Oasis 4	2018	5,400	
Ovation of the Seas	2016	4,100	

Figure 2 Continued

Celebrity Cruises			
Celebrity Reflection	2012	3,052	126,000
Celebrity Silhouette	2011	2,850	122,400
Celebrity Eclipse	2010	2,850	122,000
Celebrity Equinox	2009	2,850	122,000
Celebrity Solstice	2008	2,850	122,000
Celebrity Xpedition	2004	100	2,000
Celebrity Constellation	2002	2,050	91,000
Celebrity Summit	2001	2,050	91,000
Celebrity Infinity	2001	2,050	91,000
Celebrity Millennium	2000	2,050	91,000
Celebrity Century	1995	1,800	71,000
Edge 1	2018	2,900	
Edge 2	2020	2,900	
Pullmantur			
Horizon	1992	1,400	47,000
Empress	1990	1,600	48,500
Sovereign	1988	2,300	73,000
Monarch	1991	2,350	74,000
Azamara Club Cruises			
Azamara Journey	2004	700	30,000
Azamara Quest	2006	700	30,000
CDF Croisieres de France			
Horizon	1990	1,400	47,000
Zenith	1992	1,400	47,000
Tui Cruises			
Mein Shiff 3	2014	2,500	100,000
Mein Shiff 2	2011	1,900	74,000
Mein Shiff 1	2009	1,900	74,000
Mein Shiff 4	2015	2,500	
Mein Shiff 5	2016	2,500	
Mein Shiff 6	2017	2,500	

Besides these reported entities, Royal Caribbean International is an equity investor in a number of "variable interest entities," which are not required to be reported, only noted. They do not control over 50% of the company, so they do not have undisputed voting rights. RCL is not able to receive returns or absorb losses. These entities include Grand Bahama Shipyard, Ltd., Pullmantur Air, and TUI Cruises (Form 10-K).

The Value Chain

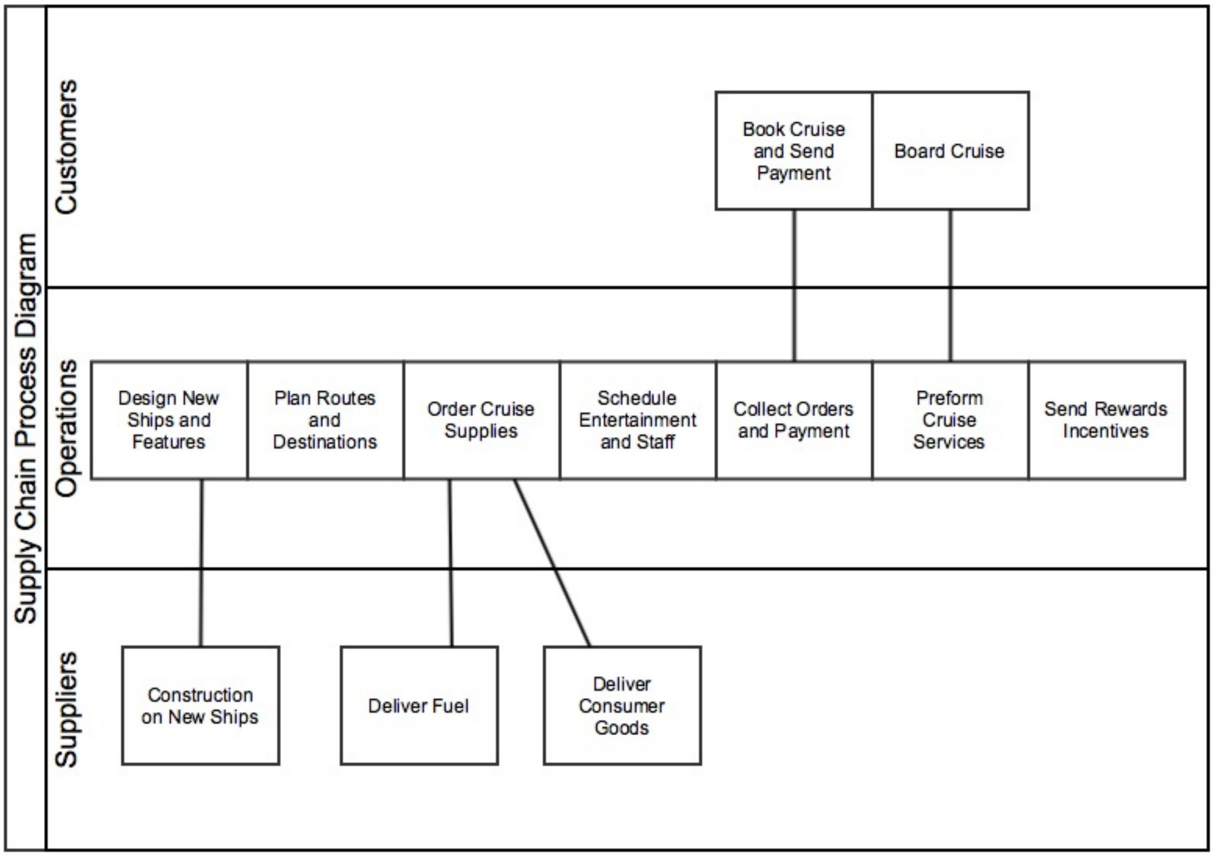
Primary activities are those that are crucial to business operation. They include inbound logistics, operations, outbound logistics, marketing and sales, and services. Inbound logistics for Royal Caribbean refers to receiving fuel, merchandise, and food when ships are docked. Operations management refers to overseeing excursions, entertainment, and dining details. Outbound logistics refers to preparing each customer's specific package and making sure that they get all they paid for. Marketing and sales involves advertising to customers to interest them in booking a cruise. This could be in a newspaper, magazine, online, or a commercial. Service involves the value of the product after it has been purchased. This requires addressing any problems for the customer aboard the ship or giving them rewards for booking another cruise.

Secondary activities support the primary activities. They include purchasing, human resource management, technological development, and infrastructure. Purchasing would involve buying quality goods for an acceptable price. This connects to inbound logistics because one must purchase from an acceptable supplier and make proper arrangements to be sure to receive them on time. Human resource management places people with desired skills in the best-fit positions. They are in charge of hiring, training, and firing. If effective employees are not hired, then guests will have a poor experience. Technological development involves having an effective website that is easy to book reservations on. All of the information systems should be linked flawlessly so everyone receives the right charges and privileges on a cruise. Finally, the infrastructure is the backbone of a business. The corporate accountants, legal advisors, and administrative positions are part of operations management. They oversee that each task is completed correctly and fix underlying problems in the company.

Business Process Diagrams

The following diagram, Figure 3, displays broad categories of activities that add value to RCL's service offering. Each of these activities is happening at all times for different customers. They are necessary for operations and maintaining adequate market share. This list is not comprehensive as other activities are important to the value chain as well.

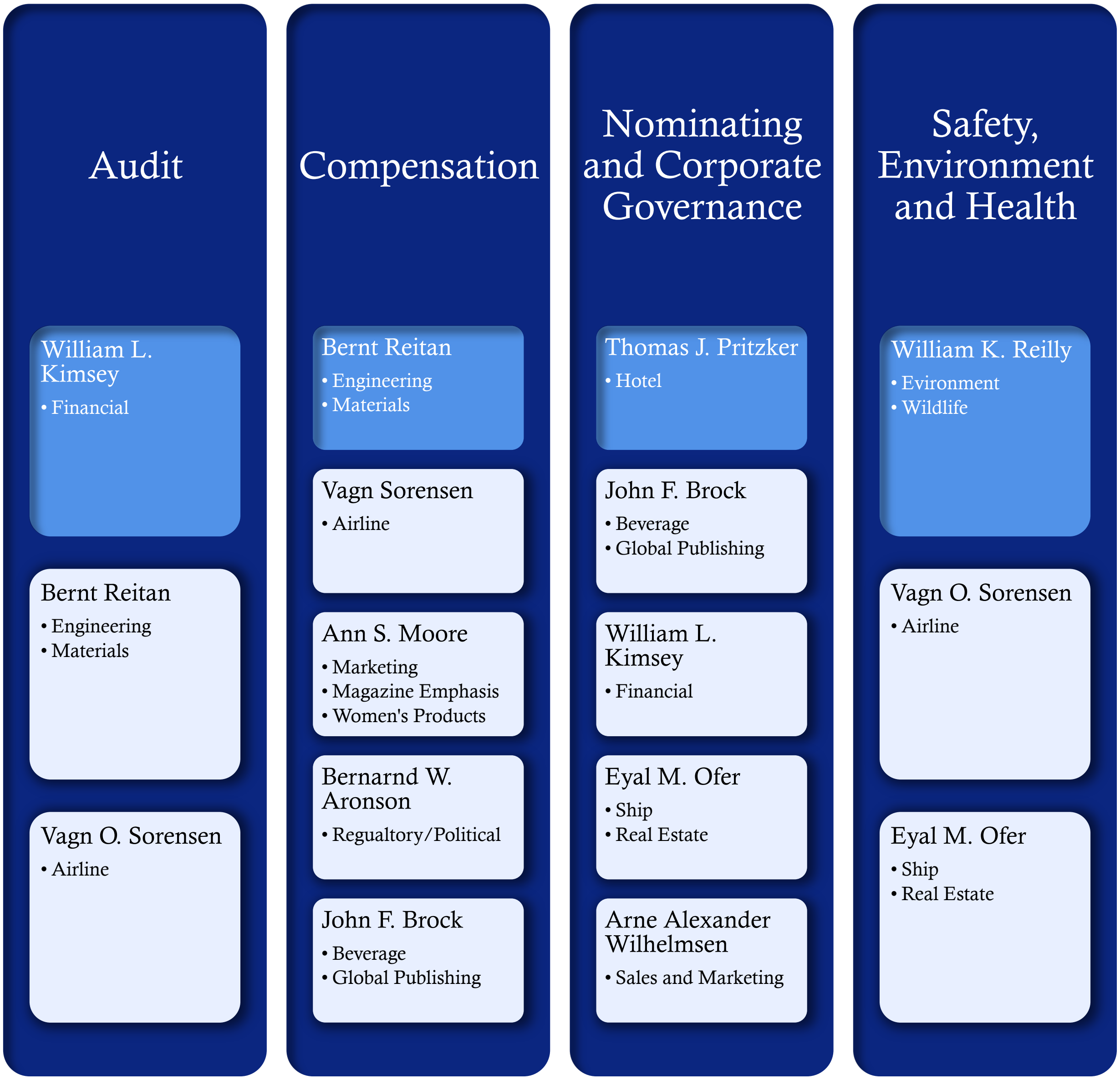
Figure 3



Board of Directors

Royal Caribbean's Board of Directors has four committees: the Audit Committee, the Compensation Committee, the Nominating and Corporate Governance Committee, and the Safety, Environment, and Health Committee. The Chairman, Robert Fain, is also the CEO (Hodges). Figure 4 describes the expertise and committee assignments of each member. The Chairmen are listed first.

Figure 4


Audit
William L. Kimsey
• Financial
Bernt Reitan
• Engineering
• Materials
Vagn O. Sorensen
• Airline
Compensation
Bernt Reitan
• Engineering
• Materials
Vagn Sorensen
• Airline
Ann S. Moore
• Marketing
• Magazine Emphasis
• Women's Products
Bernarnd W. Aronson
• Regualtory/Political
John F. Brock
• Beverage
• Global Publishing
Nominating and Corporate Governance
Thomas J. Pritzker
• Hotel
John F. Brock
• Beverage
• Global Publishing
William L. Kimsey
• Financial
Eyal M. Ofer
• Ship
• Real Estate
Arne Alexander Wilhelmsen
• Sales and Marketing
Safety, Environment and Health
William K. Reilly
• Evironment
• Wildlife
Vagn O. Sorensen
• Airline
Eyal M. Ofer
• Ship
• Real Estate

Chapter 2: Strategy within Industry and Geographical Analysis

Mission

Royal Caribbean's mission is broken into seven statements. The first is "We always provide service with a friendly greeting and a smile" (Bayley). This emphasizes the importance of customer service to the company.

The second statement focuses on being proactive. They are expected to use marketing research to provide customers with services they have not even realize they value yet. "We anticipate the needs of our customers" (Bayley).

"We make all efforts to exceed our customers' expectations" (Bayley). The company holds themselves to a high standard of quality. "We take ownership of any problem that is brought to our attention" (Bayley). The company values efficient problem-solving.

"We engage in conduct that enhances our corporate reputation and employee morale," (Bayley). Effects on the environment and communities influence corporate reputation. Taking steps to address these concerns will increase favor among Royal Caribbean's markets and consumers. The company values its employees and creating an enjoyable work environment. This could address anything from work hours, pay, vacation and sick days, harassment prevention, and getting feedback from all levels of employees.

Corporate reputation closely relates to ethics. Since Sarbanes-Oxley, companies have increased their awareness of ethics issues. Assessing risks and monitoring corporate controls can hinder ethics violations that can be potentially fatal in business today. Lawsuits can also arise from harassment in the workplace or wrongful termination, etc. By stating that they value respect for all, Royal Caribbean starts with preventative actions instead of punitive action later. "We are committed to act in the highest ethical manner and respect the rights and dignity of others" (Bayley).

"We are loyal to Royal Caribbean and Celebrity and strive for continuous improvement in everything we do" (Bayley). Continuous improvement means analyzing existing offerings for areas to modify them constantly, and effectively. Also to continuously improve, companies must engage in environmental scanning to recognize opportunities and threats. Then they must act accordingly to compete with other companies within their industry. Some mission statements are much more vague. They allow for interpretation of what their business is, but Royal Caribbean is loyal to its original purpose. They are committed to the success of their brands.

Vision and Values

Their first purpose is to generate returns for shareholders. They intend to create returns "by empowering and enabling our employees" (Bayley). Again the importance of employee morale is emphasized. Royal Caribbean understands the potential benefits of utilizing front-line employees. The most feedback occurs where the most customer interaction is. Top-level managers and executives have little to no customer contact. Therefore they must collect opinions, ideas, and observations from every level to have the most knowledge about how to improve services offered, and deliver the best vacation experience.

As mentioned in their mission, Royal Caribbean cares about its corporate image. Moreover, the last phrase in its value statement is "enhancing the well-being of our communities" (Bayley). The company gives back to its communities across the world in various ways.

Strategy

Sometimes official values and mission statements do not align with the strategy a company is implementing. Oftentimes, executives do not realize they are contradicting their own pronouncements. Strategies can be categorized into cost leadership, product differentiation, or focused market. Companies rarely succeed by cutting costs and differentiating their product simultaneously.

In Royal Caribbean's case, they have a clear focus on product differentiation. They continuously design state of the art luxury ships to impress customers. They offer unique features that challenge competitors.

Outputs

Royal Caribbean's outputs are cruising experiences, which include activities, food and drinks, and room rentals. This is a normal luxury good. IBISWorld also includes deep-sea shipping companies in RCL's industry. Royal Caribbean is very different from shipping companies and its strategy is wildly different. Cruising demand dropped drastically with the recession, but has steadily grown around two percent each year for the past four years. After this period of economic downturn, consumers are hesitant to book lavish and expensive vacations. They compare prices and options very thoroughly before making a decision. Inland vacation spots are in direct competition, but are not technically included in the industry (Soshkin).

This hesitation and publicized cruising accidents have hindered the cruise lines recovery, "Per capita disposable income is only expected to increase at an annualized 1.4% over the five years to 2015, with no growth reported in 2013" (Soshkin). The demand for vacations is directly tied to disposable income. Demand for cruises goes up as other travel prices increase. Cruising is relatively less expensive than many other types of vacations. Most passengers were not quite as affected by the recession as others, because cruisers are typically more affluent, and older couples or families (Soshkin).

Figure 5

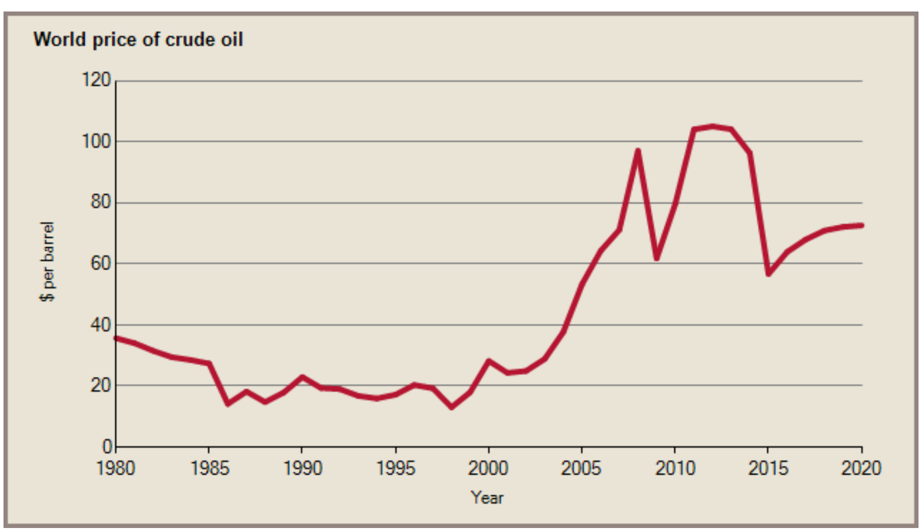
(Soshkin)

The reputation, and profitability of the cruise line industry as a whole was affected by accidents in 2012. The *Costa Concordia* sank, and another ship in the Indian Ocean carrying 1,000 people caught fire, cutting off electricity. Potential new passengers were wary of being subjected to similar incidents and decided on alternate vacations (Soshkin).

Inputs

The most consistent input cost of cruise lines is fuel. The world price of crude oil affects the how much each cruise costs the company. Without competition companies could just pass on the increased cost to consumers. Unfortunately, high competition in the industry holds prices steady and diminishes profits (Soshkin). The price is volatile, and generally imported to the United States. If the Keystone XL pipeline is approved, it could add to the supply in the United States. Royal Caribbean and other cruise lines rely on the supply in Iraq, Libya, China, and Russia.

Figure 6

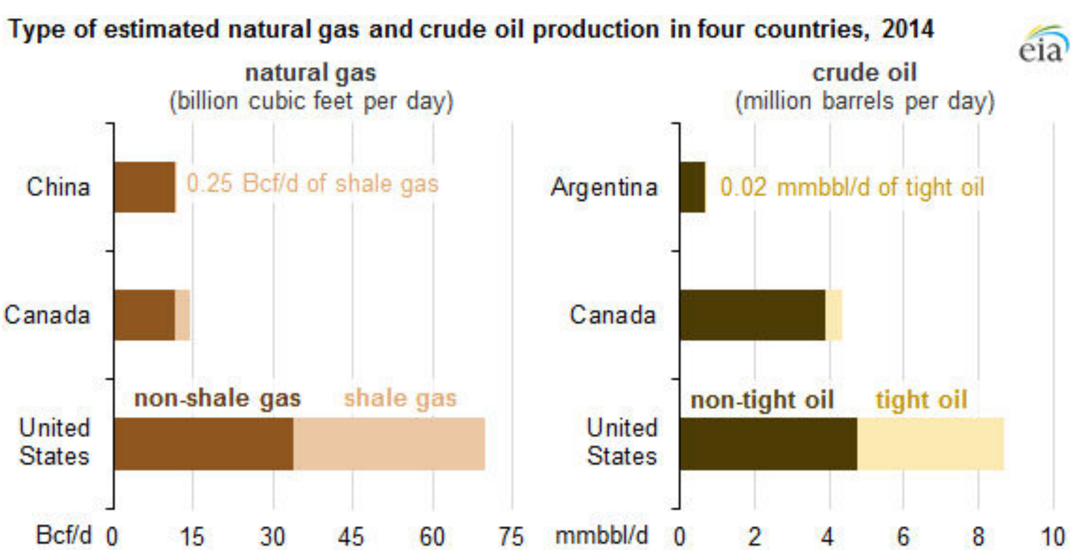


(Soshkin)

See geopolitical risks for more about this volatility. Concern for the environment is causing investors to look into alternative sources for fuel. This concern has directed investment away from current oil expansion. This falling demand may influence prices in the future (Soshkin).

Most of the world's shale gas is produced in the United States. All countries that produce commercial amounts of shale gas and crude oil are growing and at a faster rate than other resource production. Exploration intended to find shale gas is occurring in Algeria, Australia, Columbia, Mexico, and Russia. "The logistics and infrastructure necessary to support this level of activity, including the drilling and completion processes, the manufacturing of drilling equipment, and the distribution of the final product to market are not yet evident in countries other than the United States, Canada, China, and to some extent, Argentina" (Aloulou).

Figure 7



http://www.fairfieldsuntimes.com/business/article_12b7abc6-b6f9-11e4-a16e-c7039d4cd6cf.html?mode=story

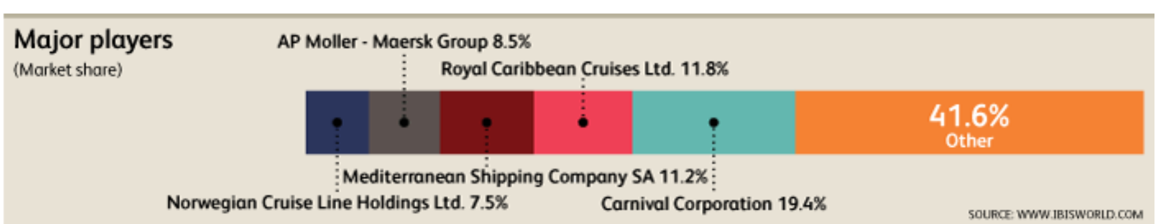
The ship building industry creates the equipment that makes cruises possible. Every ship is custom-made and varies heavily in price, size, and amount of passengers. Technology used on ships changes with every time that one is built. Timing of ordering new ships is limited by capital and demand. They have to grow demand past a certain point to add a new ship to the fleet. In some cases, they just replace an old ship, and the selling price of the old ship covers some of the cost of the new one. There are limited producers because it is a difficult market to break into.

US shipbuilding ports are not large enough to build cruise liners of today's magnitude, so all shipbuilding must be done offshore. Royal Caribbean primarily uses Norwegian contacts for these ships (Soshkin).

Major Competitors

Carnival Corporation is the largest entity in the Ocean and Coastal Transportation Industry for the US. If this did not include shipping companies, they would hold a percentage larger than 19.4 percent of the market. Royal Caribbean has the second largest stake in the industry over all of the shipping companies (Soshkin).

Figure 8



The Mediterranean Shipping Company is the world's second largest shipping company, but this industry's third largest player. That is because this industry discussion is limited to the United States. Their headquarters are in Geneva, Switzerland. This company owns MSC Company, a cruise line. MSC is the fourth largest cruise company in the world. Mediterranean Shipping owns some of the largest ships in the world to transport goods. Currently they are trying to increase their size by forming an alliance with other companies. If they successfully join forces with Maersk they would have a serious hold on the Asia-Europe market for shipping services (Soshkin).

AP Moller – Maersk Group has the next largest share of the market. They have base operations in Copenhagen, Denmark. Shipping is not their only service. They also work in energy, banking, supply-chain management, and port terminal services. They follow MSC as the second largest shipper in the United States. Chinese regulators are trying to prevent them from creating an alliance because they would be too powerful (Soshskin).

Norwegian Cruise Line Holdings Ltd. is the third largest cruise line in the world. Because Royal Caribbean and Carnival have established brand loyalty in the United States, Norwegian focuses more on European markets. To break into the American market they have established dominance over Hawaii (Soshkin).

IBISWorld indicated the above-mentioned competitors, but there are many global lines that Royal Caribbean competes with. Also all cruise lines in general compete with on-shore vacation spots, especially resorts, theme parks, and casinos (Soshkin).

Carnival Cruise Line

Carnival has headquarters in Miami, Florida, and London, England. They own 101 ships under several brand names. These names include are Carnival Cruise Line, Cunard, Holland American Line, and Princess Cruises. They offer cruises all year to the Caribbean, but they also offer seasonal options to Mexico, Europe, New England, Canada, Alaska, the Baltic, Hawaii, South America, the British Isles, and Panama (About Carnival).

Figure 9

Carnival Corporation (US operations) – financial performance**

Year*	Revenue ($ million)	(% change)	Operating Income ($ million)	(% change)
2009-10	6,655.7	3.0	1,064.4	8.7
2010-11	6,948.9	4.4	986.1	-7.4
2011-12	7,075.7	1.8	964.9	-2.1
2012-13	6,800.6	-3.9	694.3	-28.0
2013-14	7,012.2	3.1	656.6	-5.4
2014-15	7,327.7	4.5	718.1	9.4

*Estimates; **Year-end November

SOURCE: ANNUAL REPORT AND IBISWORLD

Figure 10

Royal Caribbean Cruises Ltd. (US operations) – financial performance*

Year	Revenue ($ million)	(% change)	Operating Income ($ million)	(% change)
2010	3,713.9	16.8	441.4	67.3
2011	3,844.0	3.5	475.1	7.6
2012	3,920.8	2.0	402.1	-15.4
2013	4,139.1	5.6	415.0	3.2
2014	4,241.0	2.5	472.0	13.7
2015	4,453.1	5.0	536.9	13.7

*Estimates

SOURCE: ANNUAL REPORT AND IBISWORLD

As shown in the graph above, Carnival Corporation's operating income decreased throughout the recession while Royal Caribbean's mostly increased (Soshkin).

Geopolitical Risks

Royal Caribbean relies on international suppliers for fuel and shipbuilding. Currently Libyan pipelines and oil ports have been under attack and some have gone on strike. The National Oil Corporation has warned consumers that they cannot buy crude oil from anyone else. Because there are two governments feuding in Libya, it is dangerous to support either one (Oil Output 900,000 Bpd).

Iraq has the largest supply of oil in the world, and, as in Libya, violent forces are at work in the country overtaking oil stations. They understand that people care when you interfere with oil, because it messes with the global economy. Therefore, the all crude oil stations, ports, etc. will be at risk indefinitely (Mahmoud).

Porter's Five Forces

Royal Caribbean is increasing the competition among its fellow cruise lines. By launching new ships and adding unseen features, they are raising the bar every time they add to their fleet. Their introduction of two new classes of ships in half a decade shows the speed with which they are leading the industry. Each of the Oasis cruise ships cost $1.5 billion, and holds 5,400 passengers. That is much larger than the next largest ship in the market, which is also owned by Royal Caribbean (Soshkin).

Figure 11

Barriers to Entry checklist	Level
Competition	High
Concentration	Medium
Life Cycle Stage	Mature
Capital Intensity	High
Technology Change	High
Regulation & Policy	Medium
Industry Assistance	Medium

SOURCE: WWW.IBISWORLD.COM

Barriers to entry are a main force against the threat of new entrants. Technology change led by Royal Caribbean makes it difficult for potential competitors to keep up. It would also take an immense amount of capital to enter the market. Also prices offered would have to be comparable. Gaining the amount of investors necessary to open business is an almost insurmountable feat. Cruise lines should be more wary of shipping companies adding a division under their umbrella. They have the expertise to accumulate ships and already have loyal investors (Soshkin).

Shipbuilders as the main suppliers do not have significant pull on the industry. Because there are so few cruise lines with ships of this magnitude, suppliers are in competition with one another to have these contracts. This pushes the price down, and keeps these ships affordable.

Consumers have a lot of power over the industry. They can easily compare prices and amenities online and choose which cruise to book. As mentioned, buyers can also choose another type of vacation. The industry is not that important to the buyers because they use their disposable income to book a cruise. It is not a necessity. Buyers cannot backward integrate, and cruise lines cannot forward integrate. Switching costs occur when a cruise offers rewards for booking with them many times.

Substitutes are varied. Vacationers have ample options when traveling. However, cruising has been differentiated from other vacations. Most cruises are all-inclusive, and they are usually less expensive than traveling to all-inclusive resorts. The amount of substitutes is balanced by the product differentiation and lower cost of the cruising industry. However, if macroeconomic forces influence buyers, they may sway their vacation interests. As seen during the recession, buyers may choose either to not vacation or to take smaller trips.

Figure 12

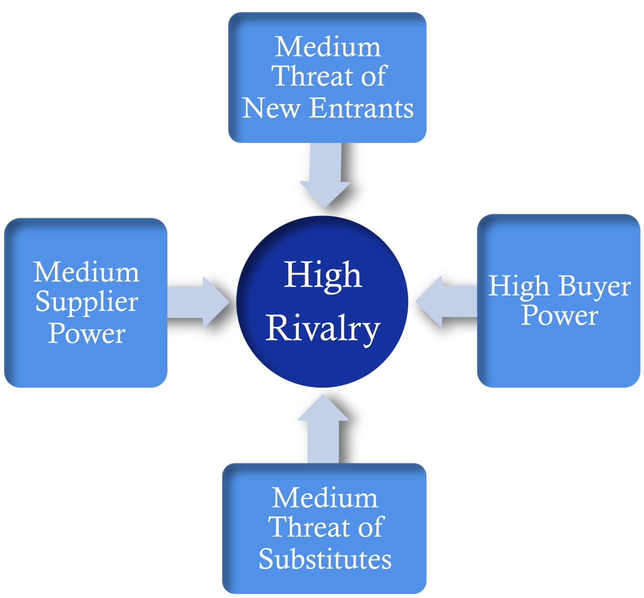


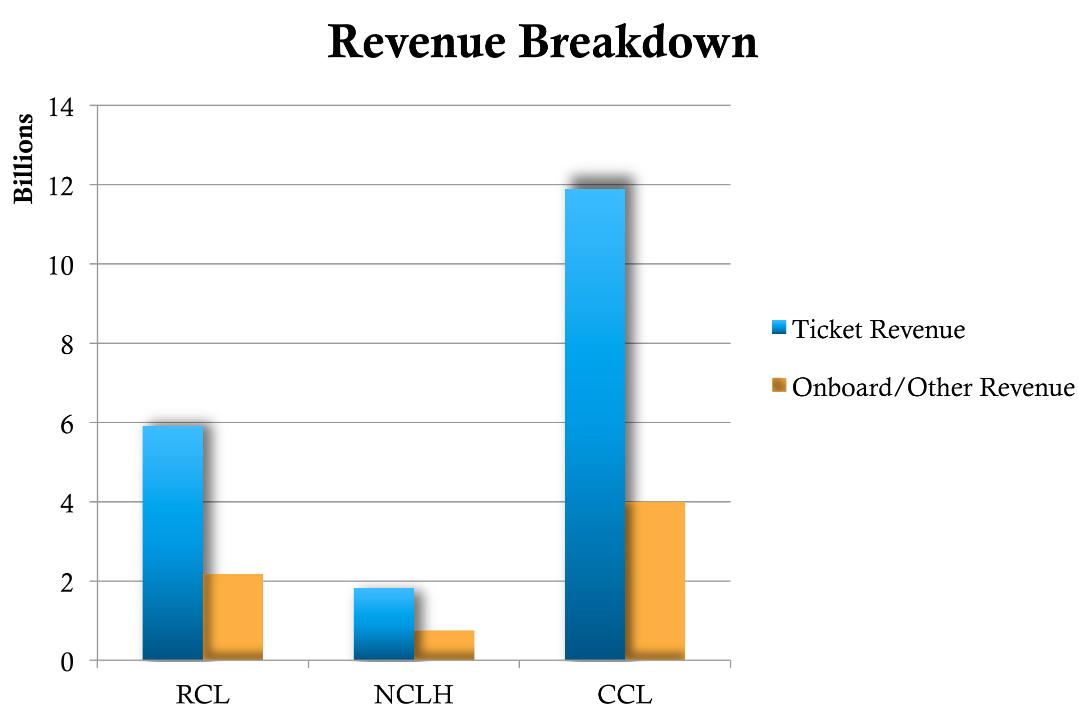
Figure 13

Strengths
Innovation
Largest Ships and Most Features
Customer Loyalty
No Significant Ship Accidents
Weaknesses
Less Market Share
Pricing for Product Diff.
Opportunities
Economic Restoration
Backward Integration
Threats
Strategy Replication
Oil Prices

Chapter 3: Financial Statement Analysis Part 1

Royal Caribbean's two main competitors are Carnival Corporation and Norwegian Cruise Line Holdings Ltd. RCL still has a much smaller market share than Carnival, but the following sections compare them on other grounds (Form 10-K).

Figure 14



The economic and performance indicators specific to this industry are annual number of passengers; size, capacity, cost, age, and number of ships; and number of ports. Some of this data is shown below in Figure 15.

Figure 15

	Ship Capacity	Avg. Capacity	Ship Cost (000s)	Avg. Ship Cost (000s)	Number of ships
Carnival Corp.	208,302	2062	43,419,000	429,891	101
Royal Caribbean Cruise Line	98,750	2409	24,086,639	587,479	41

Asset Composition

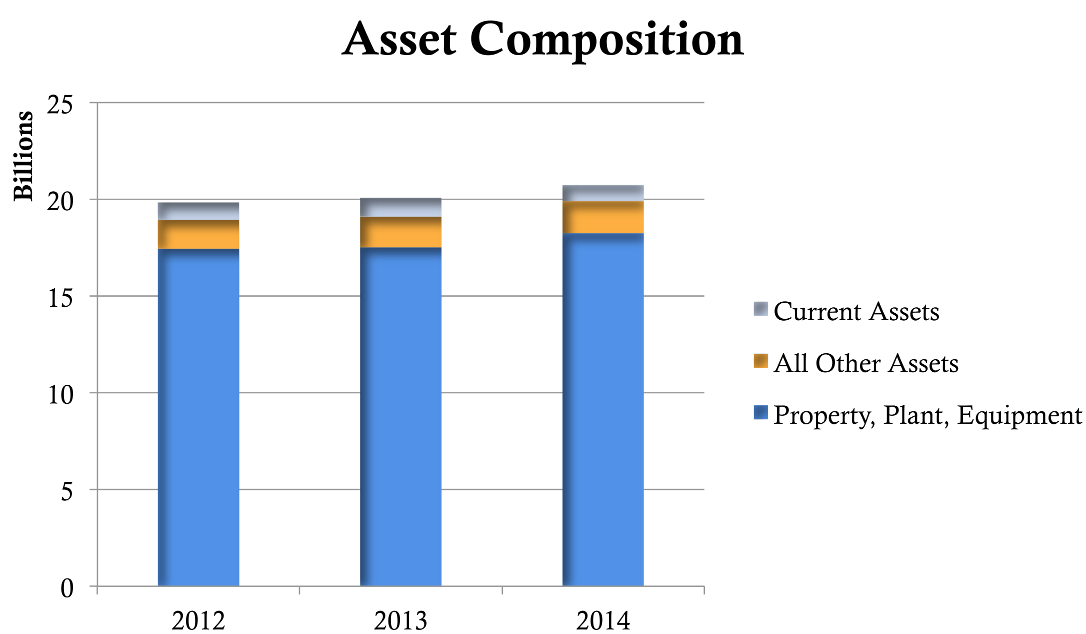
Current assets include cash, receivables, inventories, prepaid accounts, and derivative financial assets. These have low relative balances compared to other industries.

Goodwill is calculated separately for Pullmantur from the rest of Royal Caribbean's holdings each year. According to their 10-K, necessary impairments are recognized, which are determined using a GAAP's two-step goodwill impairment test.

Other assets refer to intangible assets and variable interest entities. The only intangible asset owned by Royal Caribbean is the right to Pullmantur's trademarks and trade names. These are reviewed for impairment each year, and the last impairment was recognized at 2012 year-end. This year, the fair value was four percent higher than the carrying value, so no impairment was recorded (Form 10-K).

The plant, property, and equipment balance is the largest and most important aspect of this industry's assets. This includes ships, ship improvements, ships under construction, land, buildings, computer software and hardware, and transportation equipment. To get the net balance, subtract accumulated depreciation and amortization. These assets are recorded at cost less accumulated depreciation. However, they are regularly reviewed for impairments.

Figure 16



The company can still be considered relatively liquid because there is a market for their ships and land. They sell their older ships to smaller cruise lines that can renovate them. This enhances their image as a premier cruising option because their average ship age decreases. As onboard amenities evolve older ships no longer meet minimum requirements. They must either be renovated or sold to maintain Royal Caribbean's image. Other leading brands are similarly structured simply due to the industry's financial requirements.

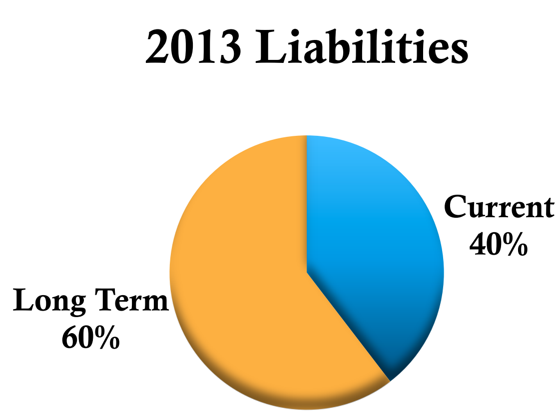
Under these circumstances, Royal Caribbean must monitor assets and liabilities very carefully to ensure that their cash flow can cover the current portions of their debt. In other words, their financial flexibility is low.

Equity and Debt Financing

They borrow money in accounts called unsecured revolving credit facility, senior notes, and term loans. To finance their Oasis ships the company entered into various credit agreements that will be amortized over the next twenty years. They are guaranteed through COFACE. One agreement was for approximately $1.1 billion and interest on the loan "will accrue either (1) at a fixed rate of 3.82% (inclusive of the applicable margin) or (2) at a floating rate equal to LIBOR plus 1.10%." The other was for approximately $215.9 million, and "interest on the loan will accrue either (1) at a fixed rate of 2.53% (inclusive of the applicable margin) or (2) at a floating rate equal to LIBOR plus 1.20%" (Form 10-K).

RCL issues a steady amount of common shares each year. Retained earnings have fluctuated, but that is most likely biased by the recession. All liabilities are listed in the balance sheet. The footnotes did mention that employees have tried to make claims against the company, but were denied by the Supreme Court. They may have to settle some arbitration in the next year, but they do not expect any material issues.

Figure 17

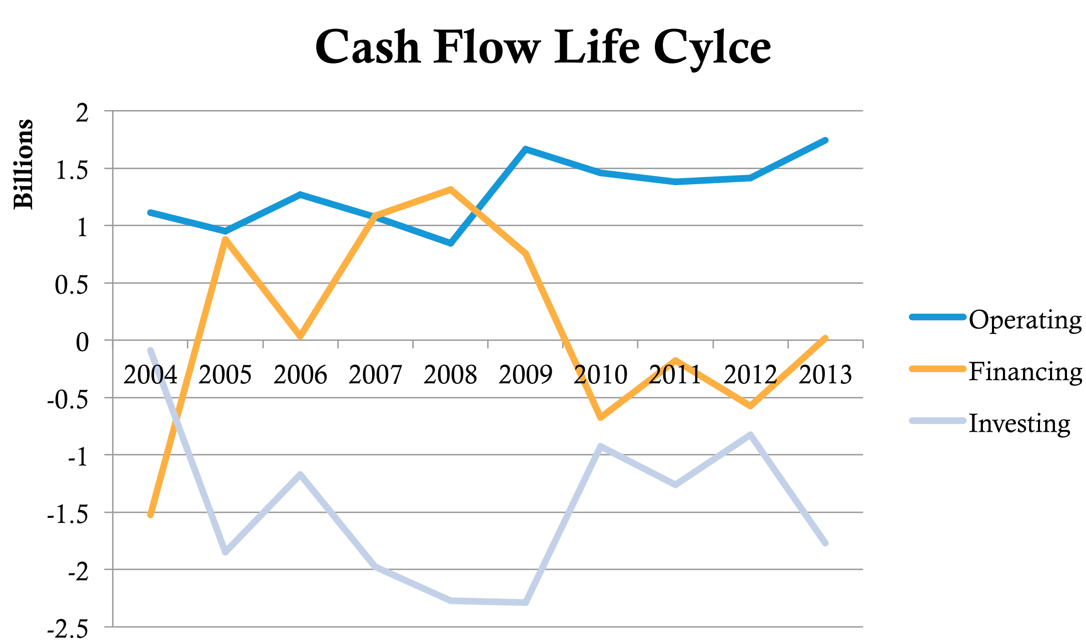


Current liabilities are a much greater portion of total liabilities than current assets are of total assets. This makes the company more risky. The only reason they are relatively liquid is because their cash turnover is so quick. They cannot readily implement new ideas without raising a significant amount of cash. Therefore, they are financially inflexible.

Cash Flows

Because investing activities have never been positive the data suggests that the company has not completed its growth life cycle. Based on this information alone one may assume that Royal Caribbean and its competitors will continue to grow revenues quickly until they hit maturity. Factors from the macro-environment, such as the recession, may have skewed cash flow activities.

Figure 18



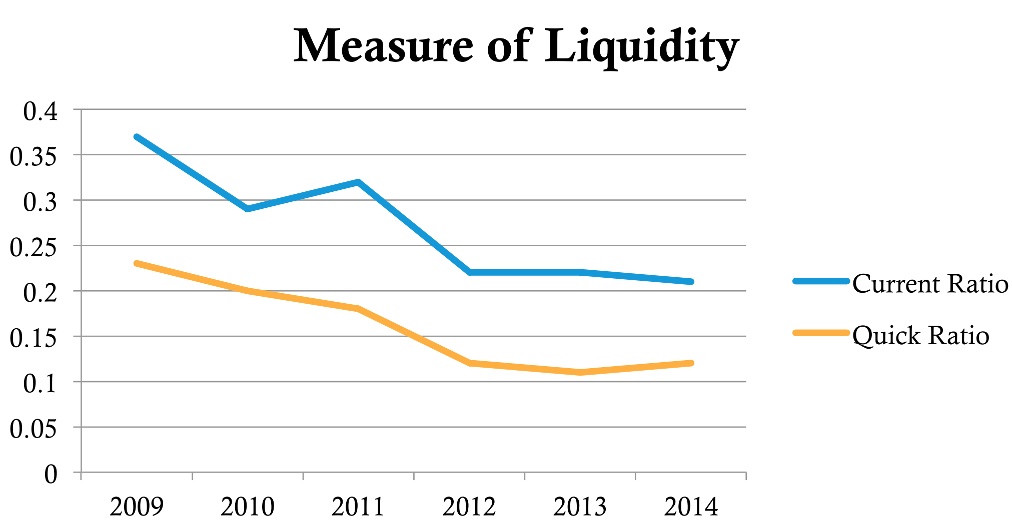
However, other sources such as IBIS suggest that the industry has already reached the mature portion of its life cycle. IBIS says that the industry's growth is primarily dependent on economic factors such as wages, production, and currency values in the United States. This is characteristic of mature industries (Soshkin).

The economy is recovering from a recession, so per capita disposable income is rising. Therefore, from 2010 to 2020, IBIS expects an average growth of two and one-half percent each year. Based on the estimate that 20 percent of the market is retired, demand should increase significantly due to the increase in population age and income.

Liquidity

Over the last five years, cash and cash equivalents at year-end has varied between $189,241,000 and $419,929,000. Liquidity can be measured by the current ratio, the quick ratio, and the cash ratio. The current and quick ratio measure how well short-term assets can cover current liabilities. Royal Caribbean's liquidity seems to be decreasing each year. However, by examining, another perspective develops.

Figure 19



The cash conversion cycle (CCC) is a measure of how quickly a company's cash flows through their operating cycle. It is measured by adding days inventory outstanding with days sales outstanding, and finally subtracting days payable outstanding. The lower it is the faster and more liquid the company. Currently, Royal Caribbean's CCC is less than one day. In 2009, it was still only 5 days. RCL has a low cash balance, but it turns over that cash very quickly.

Current Ratio

Figure 20

Current Ratio	2013	2012	2011	2010	2009
Norwegian	.17	.17	.19	.21	N/A
RCL	.22	.22	.32	.29	.37
Carnival	.22	.29	.25	.21	.22

All companies in the industry have abnormally low current ratios. Usually, a good current ratio is 1. They also have a negative working capital, which increases negatively with their size. Cruise lines main assets are ships and land, which are classified under plant, property, and equipment. They have fewer current assets than other industries, but they require lots of debt to afford remodeling, new construction, and new properties. These results are not alarming, because they are normal for the company structure.

Figure 21

Working Capital	2013	2012	2011	2010	2009
Norwegian	-892,564	-780,160	-665,303	-515,076	N/A
RCL	-3,310,636	-3,178,091	-2,098,354	-2,429,427	-1,722,639
Carnival	-54,18,000	-4,783,000	-551,900	-4,793,000	-4,511,000

Solvency

Earnings Solvency in the industry increases from NCLH to RCL to CCL. CCL has such higher revenue that other companies barely compare their times interest earned ratio.

Figure 22

Times Interest Earned	2013	2012	2011	2010	2009
Norwegian	1.41	1.89	1.67	1.32	1.58
RCL	2.40	1.13	2.44	2.36	1.63
Carnival	6.22	4.24	4.89	6.17	6.21

In the same order, the companies have greater equity than debt. Generally, a good debt to equity ratio would be under 40 percent. Again, in this particular industry, that is not the standard. However, by reducing their ratios, these companies may draw more lenders and investors.

Figure 23

Debt to Equity	2013	2012	2011	2010	2009
Norwegian	1.19	1.48	1.65	1.84	N/A
RCL	.92	1.02	1.01	1.15	1.12
Carnival	.63	.63	.64	.62	.63

Earnings Per Share

Figure 24

Basic EPS	2013	2012	2011	2010	2009
Norwegian	.50	.95	5.99	1.09	3.22
RCL	2.16	.08	2.80	2.55	.76
Carnival	1.59	1.39	1.67	2.43	2.51

Below, Figure 25 shows the components of EPS. There is a trend of common shares increasing consistently each year. Net income is more erratic. If common shares were decreasing, one could speculate that the company was trying to manipulate their earnings per share to publish for stockholders. By buying treasury stock, they could increase EPS without any actual increase in earnings. However, this particular condition is not a concern at Royal Caribbean as shown by this table.

Figure 25 (in thousands)

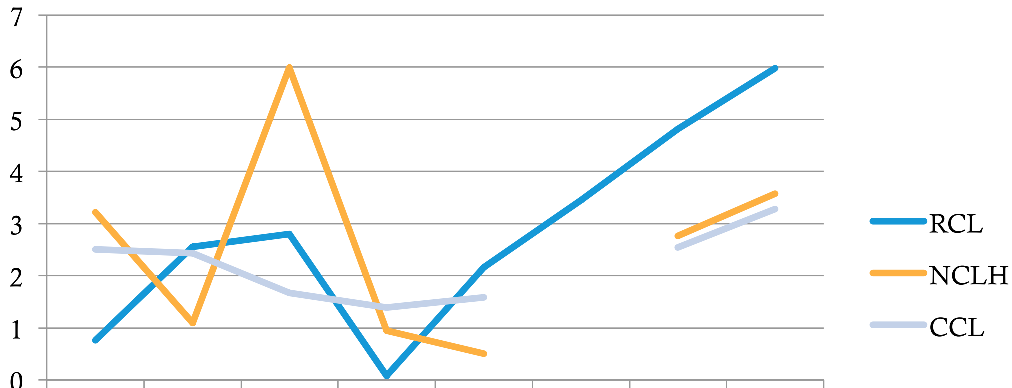
RCL	2013	2012	2011	2010	2009
Net Income	473,692	18,287	607,421	547,467	162,421
Common Shares	219,638	217,930	216,983	215,026	213,809

Royal Caribbean's strategy is to grow revenues by investing in new ships and remodeling older ships. It is difficult to find a trend in net income because of the bias from the recession. To influence EPS, managers have spent more on marketing every year. By researching what customers are willing to pay for and advertising their ships' features, Royal Caribbean hopes to grow market share and revenues.

According to analysts associated with YahooFinance, the EPS for 2015 and 2016 is expected to be 4.81 and 5.98, respectively. The trend will approximate the following chart. Analysts expect a consistently higher EPS for RCL and its competitors, but RCL should have an overall higher EPS for the next two years.

Figure 26

Historic and Predicted EPS



	2009	2010	2011	2012	2013	2014	2015	2016
RCL	0.76	2.55	2.8	0.08	2.16	3.45	4.81	5.98
NCLH	3.22	1.09	5.99	0.95	0.5		2.76	3.58
CCL	2.51	2.43	1.67	1.39	1.59		2.54	3.28

Chapter 4: Financial Statement Analysis Part 2

When using ratios and account balances for financial analysis, we must be wary of intentional manipulation of the data. Executives often receive bonuses based on their performance, which is in turn measured with ratios and other financial information. Sometimes employees receive stock options as compensation. If they increase the stock price, they can exercise their options and sell them at a profit.

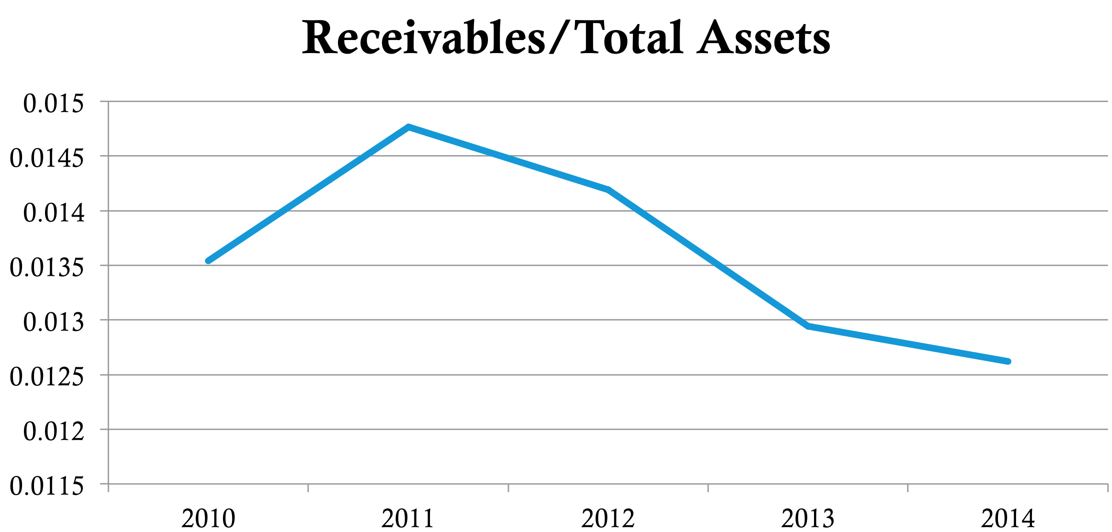
All managers deal with the pressure to stay within their budget. By keeping some things off of the balance sheet, or waiting until after close to put in a purchase, managers can make it seem like they did not exceed their budget. Debt covenants can require companies to maintain certain financial ratios. This could be especially detrimental if the company cannot make an immediate repayment of the debt upon breach of the covenant.

We can detect these manipulations with changes in ratios and other data over time. If a trend line differs from industry data, especially in a mature industry like Royal Caribbean's, tampering should be considered as a factor. The following sections analyze accounts receivable, inventory, revenue, and property, plant and equipment. They also make note of potential executive influence.

Accounts Receivable

Royal Caribbean's customers are mostly wealthy families. They do not sell their services to businesses, so their customers are just consumers. They vary in credit-worthiness and mostly pay in advance for their cruise experiences with at least a deposit.

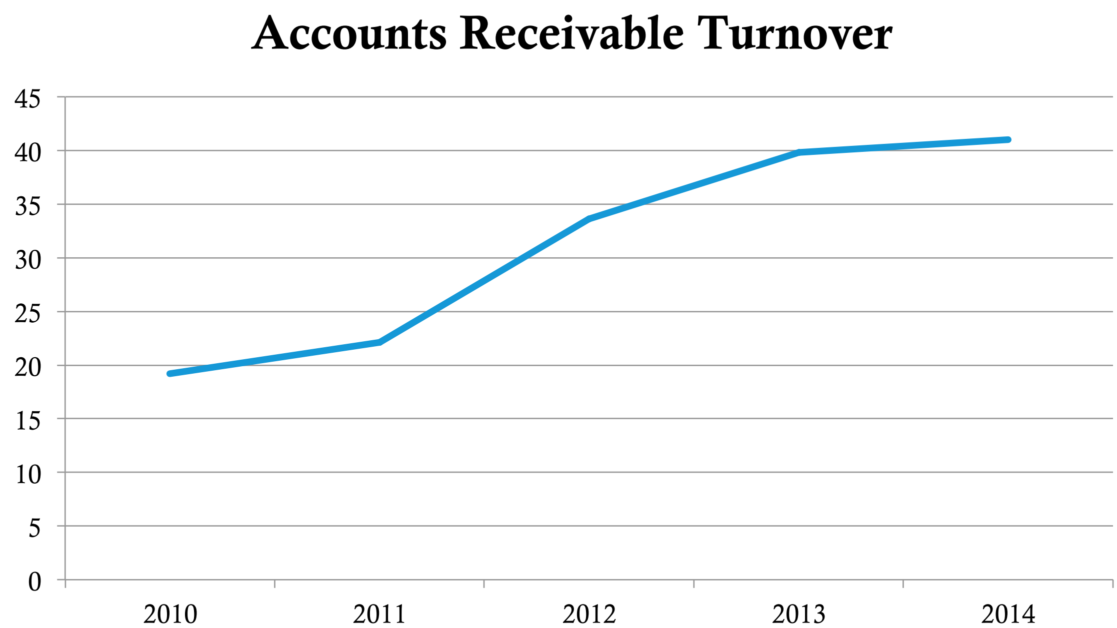
Figure 27



United States customers are given more trust with credit transactions. Accounts Receivable as a percentage of total assets is mostly decreasing. This suggests that the business is generally shrinking, not growing.

On the other hand, revenues are going up. Therefore, this is not just a smaller amount of credit sales due to lower sales. They are more efficient than usual in collecting payments.

Figure 27

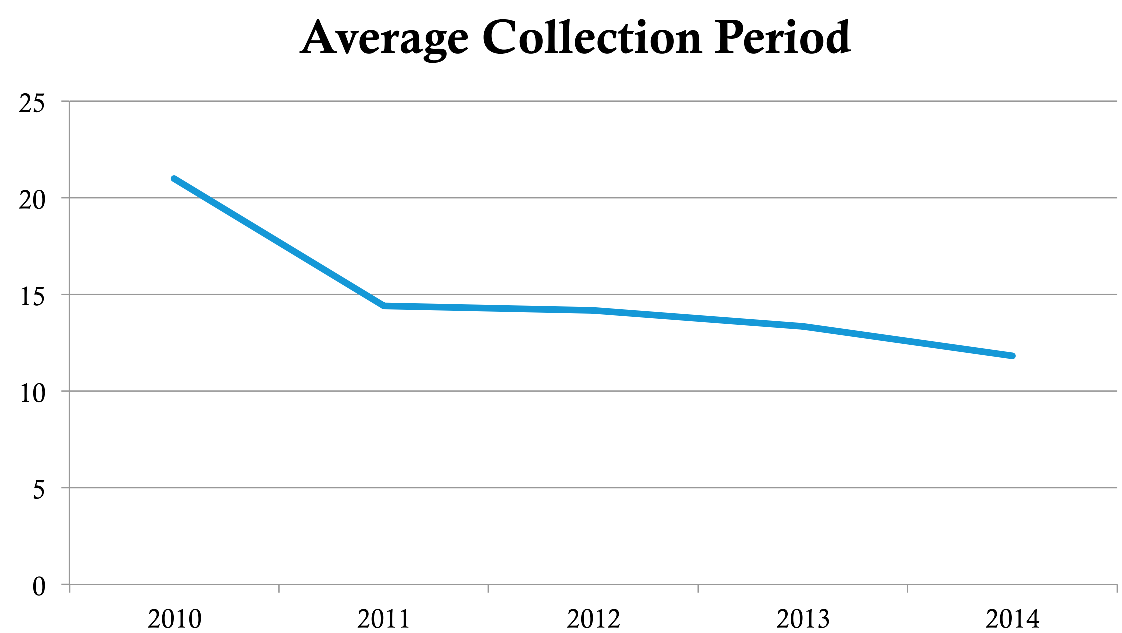


RCL is collecting their receivables quicker. This chart uses all sales instead of credit sales, because they do not report just credit sales. The increase is good for cash flow and makes it easier for the company to cover their liabilities. For comparison in 2014, Carnival's Accounts Receivable Turnover was only 24.97, much lower than Royal Caribbean's.

Because this period is decreasing, it shows that customer payments are more regular. One could speculate that customers have more stable incomes after coming out of the recession. Most customers pay for cruises with excess income. Because more people had more income they were more reliable when paying for their cruises.

Neither bad debt expense nor allowance for doubtful accounts is listed or mentioned within the 10-K.

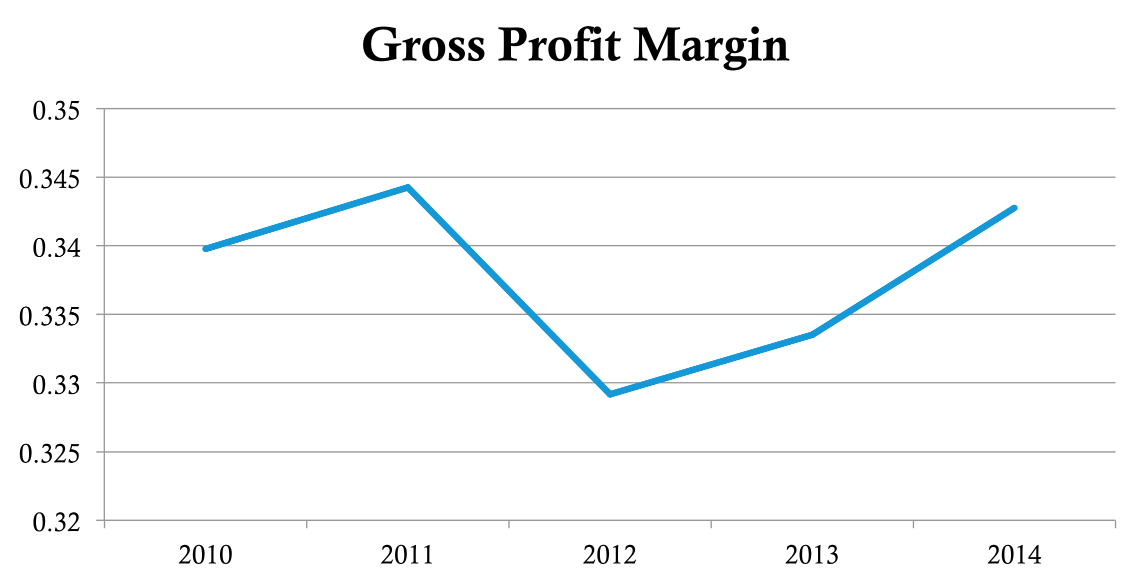
Figure 28



Inventories

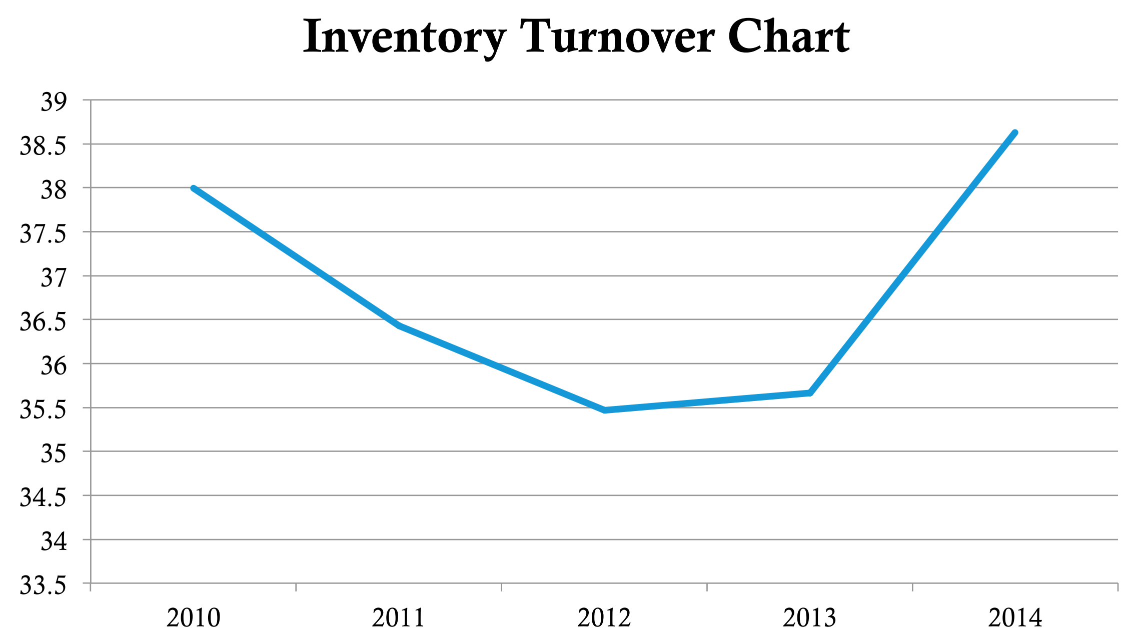
Inventories consist of provisions, supplies and fuel carried at the lower of cost (weighted-average) or market.

Figure 29



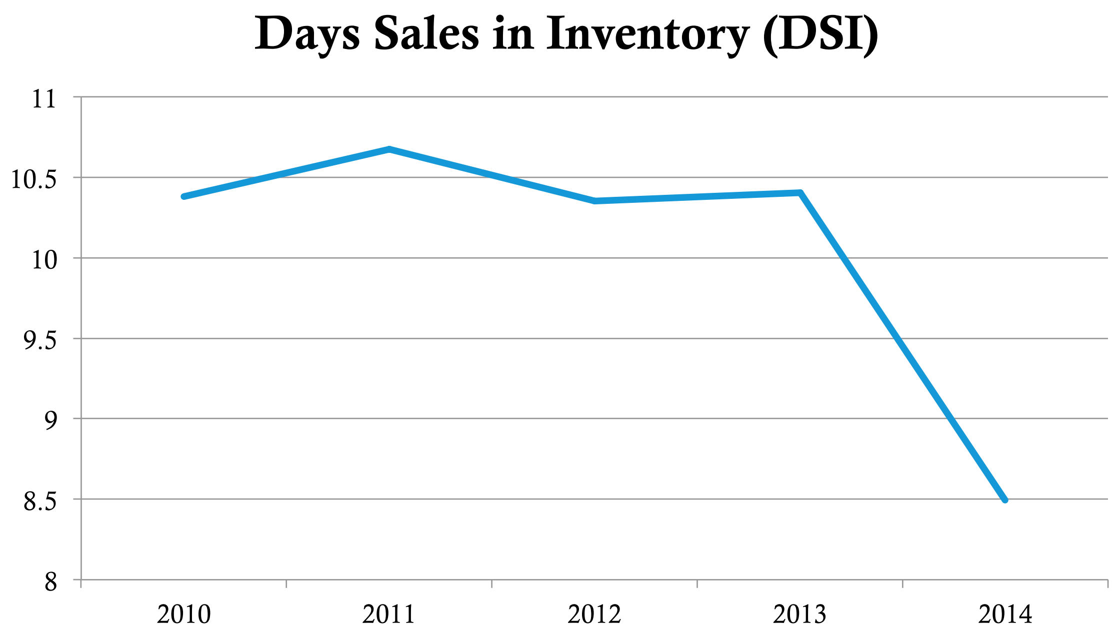
Gross profit margin is relatively consistent, with small fluctuations from year to year. To calculate this measurement, total-operating expenses was used instead of costs of goods sold. Because this is primarily a service industry, operating expenses are what it takes to deliver their "product."

Figure 30



This graph shows how many times the inventory turns over in a year. This amount has been decreasing, which could indicate that Royal Caribbean has been purchasing too much inventory. Carnival has a much lower turnover. Over the last five years, Carnival's turnover has hovered around 28.

Figure 31



A decreasing DSI is good. The lower the DSI indicates fewer inventories being held at once. This ratio essentially means that they had 8.5 days of inventory on hand during 2014. Fewer inventories means that they have less holding costs and can use that space for more lucrative purposes. This may indicate that they are implementing just-in-time methods.

Plant, Property, and Equipment

The following accounts are included under Plant, Property, and Equipment for RCL.

Figure 32 (in thousands)

	2010	2011	2012	2013	2014
Ships	20,454,964	19,958,127	20,855,606	20,858,553	21,620,336
Ship improvements	Account Unavailable	976,363	1,341,137	1,683,644	1,904,524
Ships under construction	250,702	227,123	169,274	563,676	561,779
Land, Buildings, including leasehold improvements and port facilities	16,688	360,399	377,821	394,120	349,339
Computers, Transp. Equip., and Other	905,071	748,102	698,865	771,304	889,579
Total	21,627,425	22,270,114	23,442,703	24,271,297	25,325,557
Less: Acc. Dep. and Amortization	(4,858,244)	(5,335,297)	(5,991,669)	(6,753,545)	(7,089,989)
Net PPE	16,769,181	16,934,817	17,451,034	17,517,752	18,235,568

Royal Caribbean uses cost less the accumulated depreciation to account for their largest assets and the straight-line method to depreciate them. Generally, they expect to receive fifteen percent for selling assets after depreciating them. The most common useful life they use is thirty years. Both the useful life and salvage value are based on the weighted average of the major components of the ship. Improvements are also capitalized as additions, but their service life is limited by the life of the ship or other improvements, whichever is shorter. The estimated cost and accumulated depreciation of replaced or refurbished ship components are written off and any resulting losses are recognized in cruise operating expenses.

Royal Caribbean is constantly updating its ships and building new ones. The account titled "ships under construction" refers to "progress payments," as well as general cost to begin construction. These are planning, design, interest and other association costs. Interest costs are capitalized along with the ships.

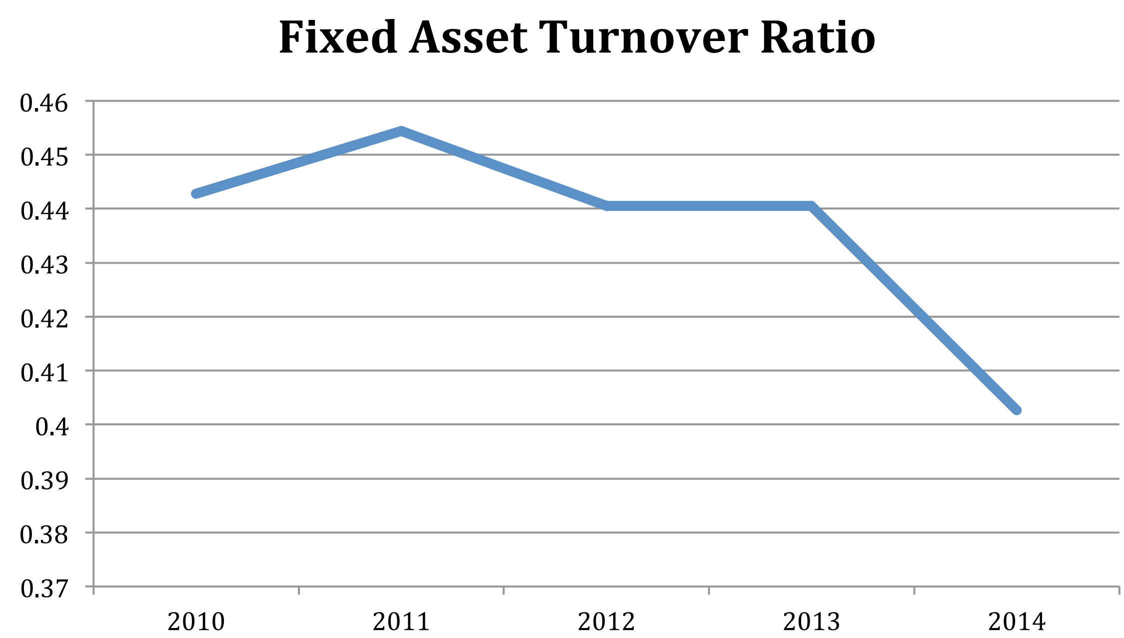
Figure 33 (in millions)

	2012	2013	2014
Interest Capitalized	13.3	17.9	28.8

They recently announced a new ship called *Harmony of the Seas*. It will be the largest in the world, breaking the record they previously held. It will be 227,000 tons, and it will cost $1.35 billion dollars to build.

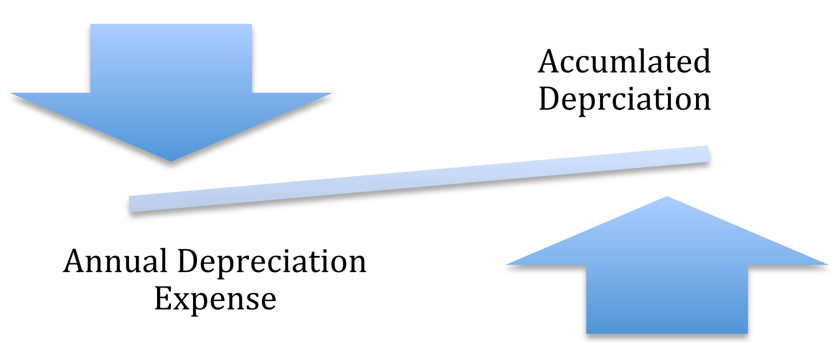
Royal Caribbean recognized an impairment on the brand name Pullmantur in 2012. In Spain, the unemployment rate was up to twenty-four percent. Therefore, the demand was extremely low for cruises in this market. "Based on our updated cash flow projections, we determined the implied fair value of goodwill was $145.5 million and recognized an impairment charge of $319.2 million. Similarly, we determined that the fair value of Pullmantur's trademarks and trade names no longer exceeded their carrying value. Accordingly, we recognized an impairment charge of approximately $17.4 million to write down trademarks and trade names to their fair value of $204.9 million" (Form 10-K). It reassesses goodwill and other fair value items each year for impairments.

Figure 34



The average age of PPE in 2014 was 9.18 years: accumulated depreciation of $7,089,989 divided by depreciation expense of $722,445. The average age can be negatively effected (decreased) by smaller depreciation or higher depreciation expense. To manipulate this information positively, an executive could increase accumulated depreciation and decrease depreciation expense. Service life and salvage value can be used to change these values. Because those are estimates, they are high risk for manipulation.

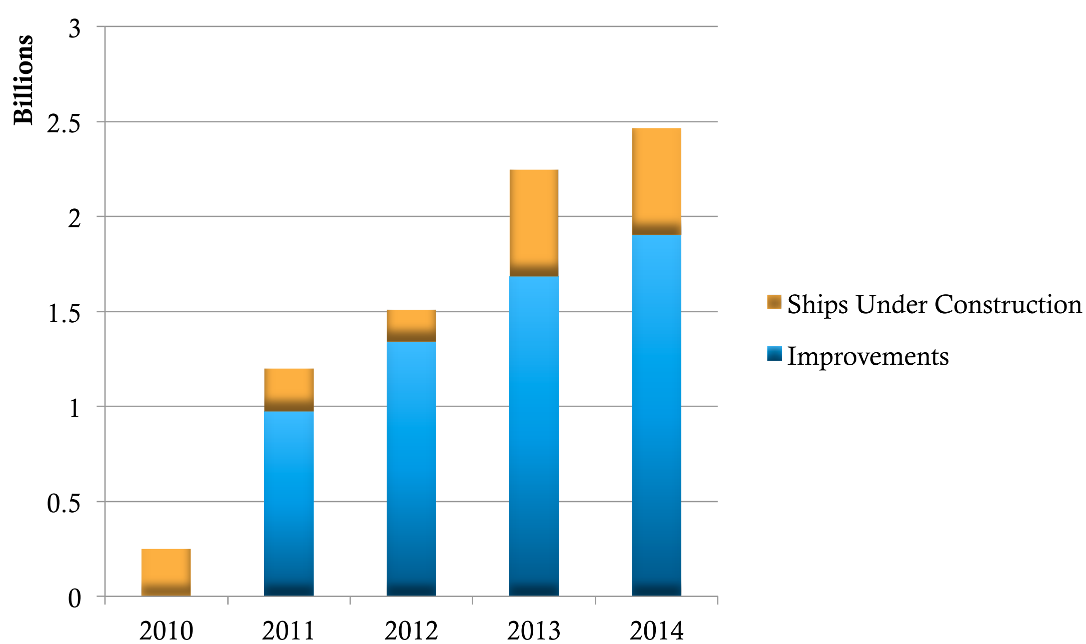
Figure 35



The average remaining useful life was 32.79 years based on PPE of $25,325,557 divided by depreciation expense. Again, an executive could manipulate depreciation expense. To change PPE, they could build or purchase new land or equipment or simply make improvements.

Royal Caribbean's strategy is offering extremely luxurious experiences. To accomplish this, they have to constantly update ships and build new ones. The breakdown of these investments shows that they spend more money on improvements. 2010 shows no improvements, because prior to 2011, the improvements were accounted for as part of ships. This shows that they are adding less than they are renovating older ships.

Figure 36



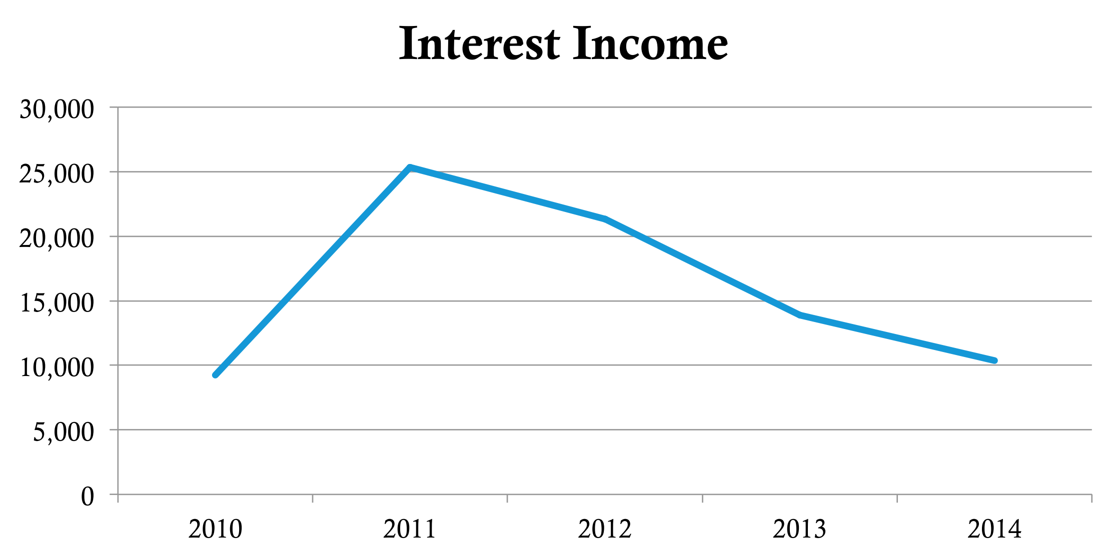
Generally, Royal Caribbean does not lease ships. They do however have joint ownership of TUI Cruises.

Chapter 5: Financial Statement Analysis Part 3

Intercorporate Investments, Goodwill

Royal Caribbean does not have a long-term investments line on their balance sheet, which indicates that they do not invest in other companies. However, they are always growing by obtaining new businesses. They own 50 percent of TUI Cruises, and 19 percent of non-core businesses associated with Pullmantur. The company uses these investments to enter new markets. This strategy enables them to offer guests new amenities associated with their cruise by acquiring specialties. The following chart shows the interest received from 2010 to 2014 in thousands.

Figure 37



The last impairment of goodwill was recorded in 2012 due to Pullmantur's brand name. It was for $319.2 million.

Restructuring

In 2013 and 2014, RCL had restructuring and related impairment charges with the following profitability initiatives:

- Consolidation of global sales, marketing, general, and administrative structure
- Pullmantur restructuring

In 2013, consolidated call centers in that were located outside of the United States. They eliminated approximately 500 shore-side positions in 2013, mostly from international markets. They had to recognize a liability for one-time terminations benefits that year. They also had contract termination costs and other related costs consisting of legal and consulting fees to implement the initiative. Restructuring exit costs were $18.2 in 2013 that year and $1.1 million in 2014. 2014 costs were related to discretionary bonus payments paid to employees whose positions were eliminated as part of our restructuring activities (Form 10-K).

Figure 38

	2013 Accruals	2013 Payments	2014 Beg. Bal.	2014 Accruals	2014 Payments	2014 End Bal.	Total Charges Incurred
Termination benefits	9,638	1,323	8,315	917	8,926	306	10,555
Contract Termination Costs	4,142	4,016	126	(58)	68		4,084
Other Related Costs	4,379	2,982	1,397	234	1,334	297	4,613
Total	18,159	8,321	9,838	1,093	10,328	603	19,252

"In connection with this initiative, we incurred approximately $7.4 million of other costs during 2014 that primarily consisted of call center transition costs and accelerated depreciation on lease hold improvements and were classified within *Marketing, selling and administrative expenses* and *Depreciation and amortization expenses,* respectively, in our consolidated statements of comprehensive income (loss)," (Form 10-K). This project is complete and should not incur any other costs.

In the fourth quarter of 2013, RCL began an initiative to sell Pullmantur's non-core businesses. This aligned with the strategy to focus on the cruise business and expand into Latin America. This eliminated 100 shore-side positions, which led to the recognition of a liability of one-time termination benefits that quarter. During the second quarter of 2014, they decided not to dismiss approximately 30 of those positions. RCL partially reversed the corresponding liability.

"As a result of these actions, we incurred restructuring exit costs of $3.2 million and $5.3 million for the year ended December 31, 2014 and December 31, 2013, respectively, which are reported in *Restructuring and related impairment charges* in our consolidated statements of comprehensive income (loss)," (Form 10-K).

Figure 39

	2013 Accruals	2013 Payments	2014 Beg. Bal.	2014 Accruals	2014 Payments	2014 End Bal.	Total Charges Incurred
Termination benefits	3,910	0	3,910	3,084	4,879	2,115	6,994
Contract Termination Costs	847	0	847	(607)		240	240
Other Related Costs	516	0	516	748	1,264		1,264
Total	5,273	0	5,273	3,225	6,143	2,355	8,498

"In connection with this initiative, we incurred approximately $8.9 million of other costs during 2014, associated with placing operating management closer to the Latin American market that was classified within *Marketing, selling and administrative expenses* in our consolidated statements of comprehensive income (loss). We have completed the restructuring activities related to this initiative and we do not expect to incur any further restructuring exit or other additional costs," (Form 10-K).

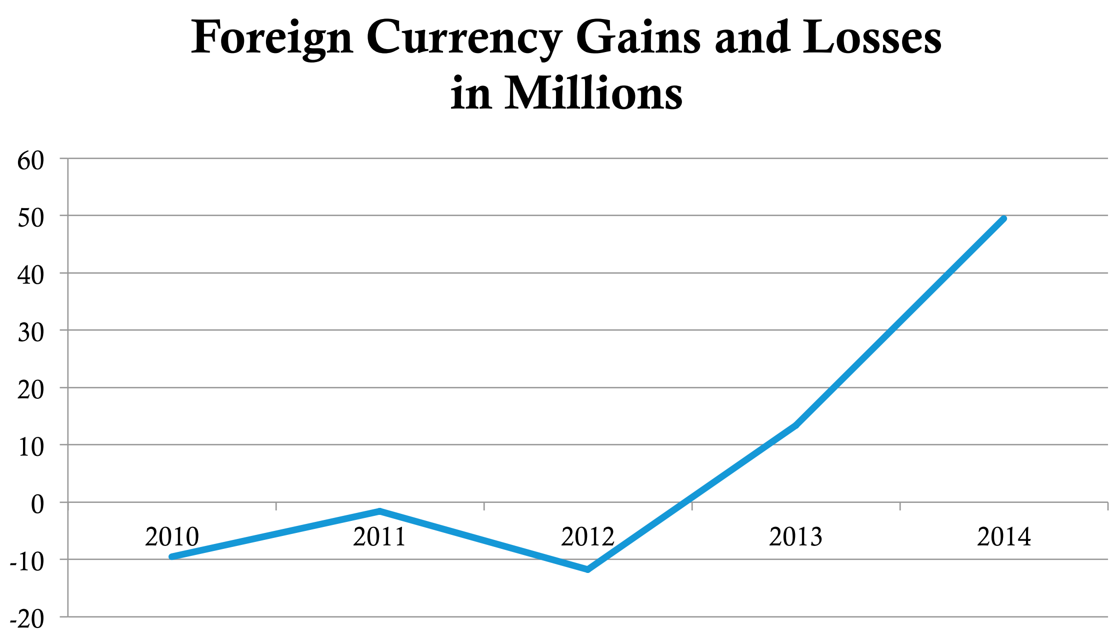
Because of the sale of these non-core businesses, they recognized a gain of $0.6 million. They now own 19 percent interest in each of the non-core businesses, with 100 percent of the aircraft business (being leased to Pullmantur Air).

Foreign Currency

RCL uses foreign exchange rates based on the exchange rates in effect on the balance sheet date. They are used to translate assets and liabilities of foreign subsidiaries from their functional currency to dollars. Revenues and expenses are translated at the weighted-average exchange rates for the period. "Equity is translated at historical rates and the resulting foreign currency translation adjustments are included as a component of accumulated other comprehensive (loss) income, which is reflected as a separate component of Shareholders' equity" (Edgar).

New measurements of assets and liabilities results in exchange gains and losses, which are immediately included in net income. However, liabilities acting as a hedge of a net investment in foreign operations or investments are not included. Last year, RCL recognized an exchange gain $49.5 million. The following chart documents the gains and losses recognized for the last five years. These were included in other income on the statement of comprehensive income and recoded on the balance sheet date.

Figure 40



RCL uses derivative and non-derivative instruments to manage their exposure to foreign currency exchange rate risk. Their ship construction contracts are most vulnerable to changes in the exchange rate. Using forward contracts, collar options, and cross currency swap agreements, they try to accommodate for this exposure. "Approximately 28.8% and 36.3% of the aggregate cost of the ships under construction was exposed to fluctuations in the Euro exchange rate at December 31, 2014 and 2013, respectively," (Form 10-K).

Most of these are accounted for as cash flow, fair value, or net investment hedges depending on their designation. "During 2013, the company entered into foreign currency forward contracts to hedge €365.0 million of our €745.0 million

5.625% unsecured senior notes due January 2014" (Form 10-K). These were cash flow hedges that matured in January of 2014.

Less often than forward contracts, they use cross-currency swap agreements, which reduce volatility from remeasurement.

> "During 2014, we maintained an average of approximately $474.0 million of these foreign currency forward contracts. These instruments are not designated as hedging instruments. In 2014, 2013 and 2012 changes in the fair value of the foreign currency forward contracts were (losses) gains of approximately $(48.6) million, $(19.3) million and $7.7 million, respectively, which offset gains (losses) arising from the remeasurement of monetary assets and liabilities denominated in foreign currencies in those same years of $49.5 million, $13.4 million and $(11.8) million, respectively," which were recognized in other income in the statement of comprehensive income (Form 10-K).

They consider their investments in foreign operations to be in relatively stable currencies. "In January 2014, we entered into foreign currency forward contracts and designated them as hedges of a portion of our net investments in Pullmantur and TUI Cruises of €415.6 million, or approximately $502.9 million, based on the exchange rate at December 31, 2014. These forward currency contracts mature in April 2016" (Form 10-K). "The notional amount of outstanding foreign exchange contracts, including our forward contracts and collar options, as of December 31, 2014 and 2013 was $3.0 billion and $2.5 billion, respectively" (Form 10-K).

For non-derivative instruments, they also denominate a portion of their debt in their subsidiaries' and investments' currencies and designate it as a hedge of these subsidiaries and investments. Debt of approximately €139.4 million and €544.9 million, or approximately $168.7 million and $750.8 million, is designated as a hedge in their investments in Pullmantur and TUI Cruises, through December 2014 and 2013, respectively.

Stock

Common stock holders have equal rights to share in dividends declared by the Board of Directors from the funds that are legally available. They do not have rights to sinking funds. The Board of Directors makes the final decisions on all declarations based on consideration of the business needs and how a dividend may support and affect the company.

"There are no exchange control restrictions on remittances of dividends on our common stock since (1) we are and intend to maintain our status as a nonresident Liberian entity under the Liberia Revenue Code of 2000 as Amended and the regulations thereunder, and (2) our ship-owning subsidiaries are not now engaged, and are not in the future expected to engage, in any business in Liberia, including voyages exclusively within the territorial waters of the Republic of Liberia" (Form 10-K). Liberia does not charge taxes or have withholdings on money paid to shareholders unless there are a resident of Liberia or another country subject to Liberian tax. These rules are derived from the Liberia Revenue Code of 2000.

In 2014, A. Wilhelmsen AS, Royal Caribbean's largest shareholder, sold $7 million of shares. He sold $3.5 million back to the company as treasury stock. He sold the rest to a financial institution. All of these shares were sold at $67.45 per share. Royal Caribbean spent a total of $236.1 million was used to repurchase this stock and record it under treasury stock (Form 10-K).

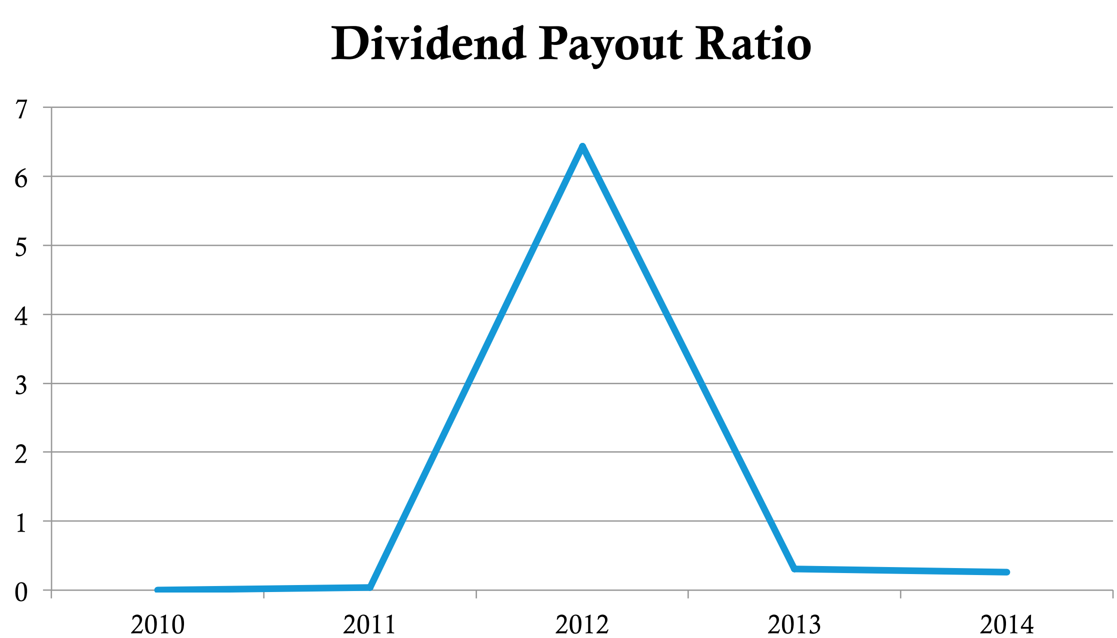
This chart of dividends shows the dividends that were declared in each quarter. They are shown as dividends declared per share, and they were all paid in the quarter following their declaration.

Figure 41

Dividends by Quarter per Share	1	2	3	4
2011	N/A	N/A	.1	.1
2012	.1	.1	.12	.12
2013	.12	.12	.25	.25
2014	.25	.25	.3	.3

In the fourth quarter of 2008, the Board of Directors discontinued dividend payment. They reinstated dividends in July 2011.

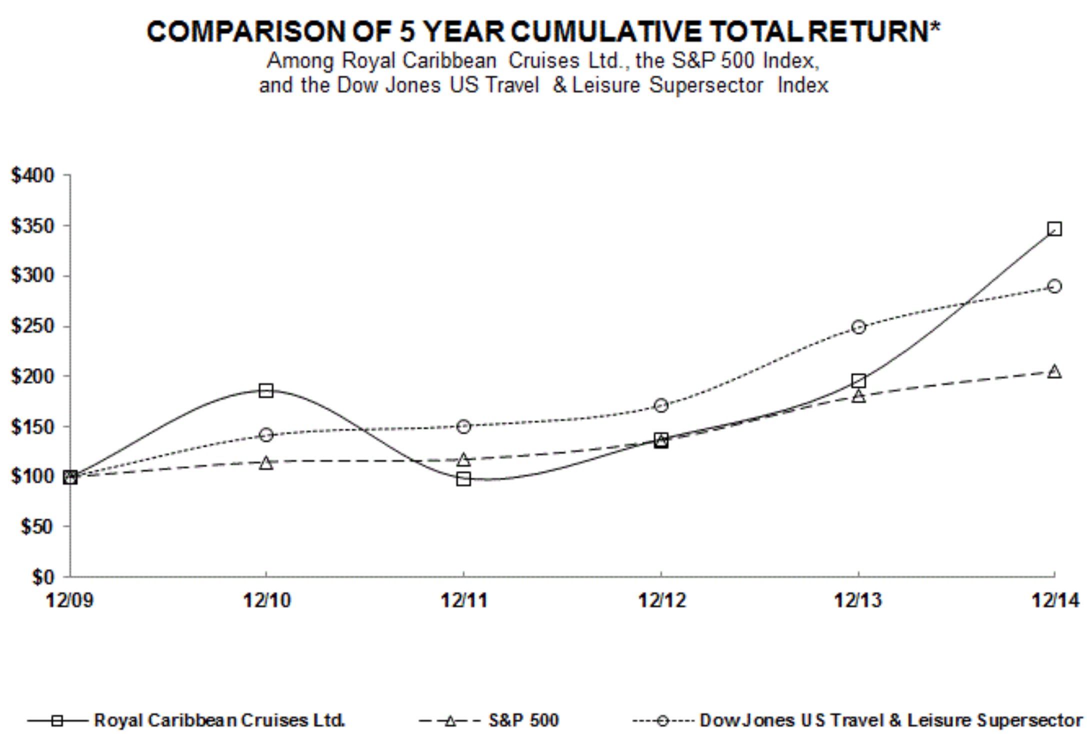
Figure 42



RCL included the following graph in their most recent 10-K. It "compares the total return, assuming reinvestment of dividends, on an investment in the company, based on performance of the company's common stock, with the total return of the Standard & Poor's 500 Composite Stock Index and the Dow Jones United States Travel and Leisure Index for a five year period by measuring the changes in common stock prices from December 31, 2009 to December 31, 2014" (Form 10-K).

They have not had any stock splits in the last five years.

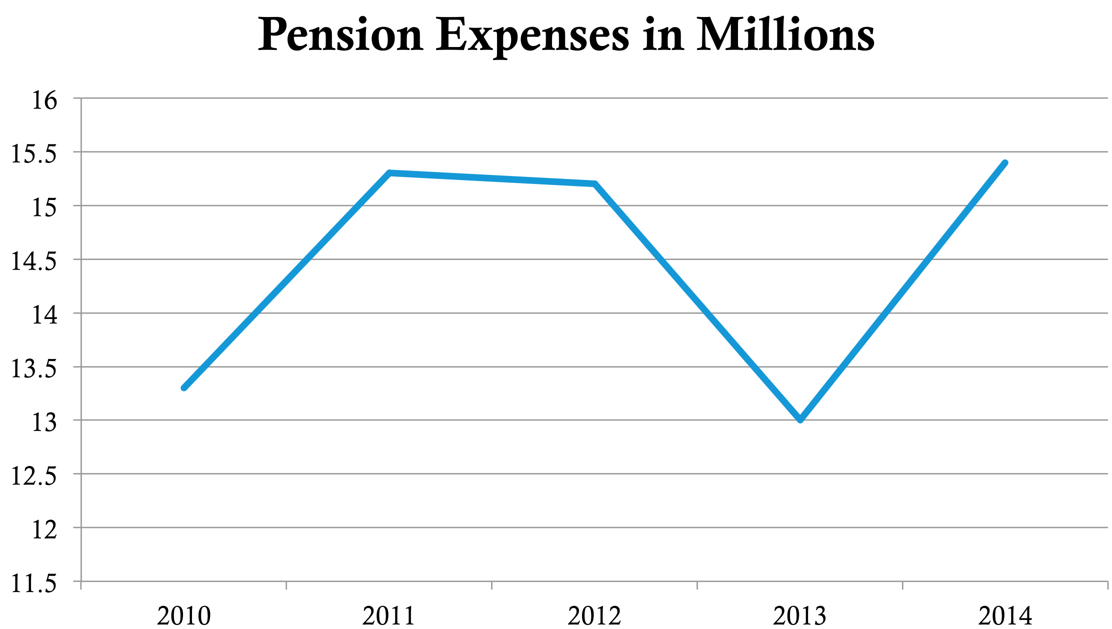
Figure 43



Pension Plans

"We maintain a defined contribution pension plan covering full-time shoreside employees who have completed the minimum period of continuous service. Annual contributions to the plan are discretionary and are based on fixed percentages of participants' salaries and years of service, not to exceed certain maximums" (Form 10-K).

Figure 44



"Pension expenses were $15.4 million, $13.0 million and $15.2 million for the years ended December 31, 2014, 2013 and 2012, respectively " (Form 10-K).

Chapter 6: Financial Statement Analysis Part 4

Operating versus Non-Operating

Operating activities are the everyday work of a business that generate revenue, market products or offerings, administer payroll, and maintain their facilities or in this case ships.

Figure 45

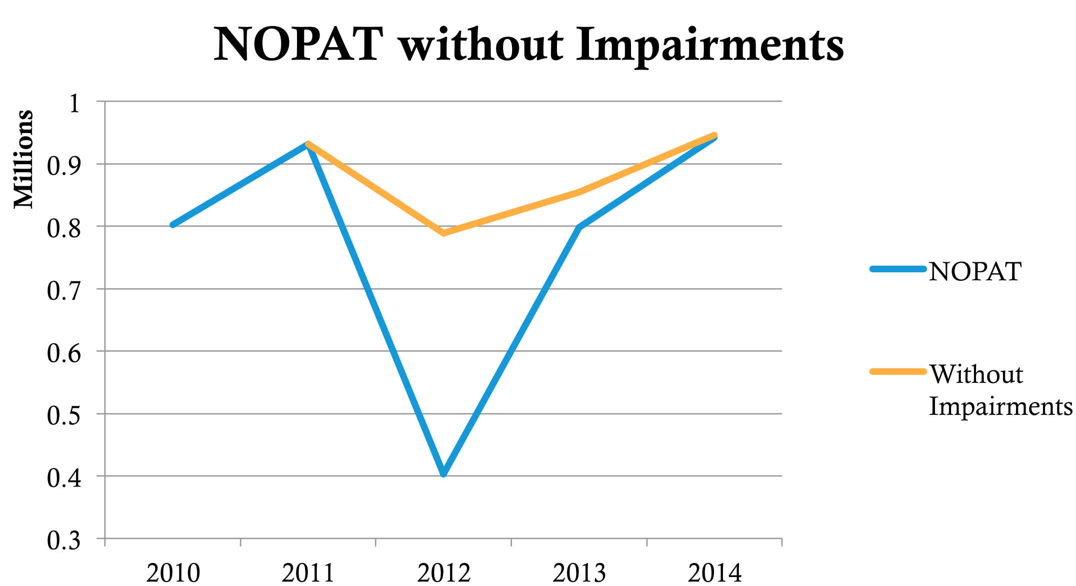
Balance Sheet		
	Operating	Non-Operating
Assets	Trade and other receivables, net Inventories Prepaid expenses and other current assets Property, plant, and equipment, net Goodwill, net Other assets	Cash and cash equivalents Derivative financial assets
Liabilities	Accounts payable Accrued expenses and other liabilities Customer deposits	Current portion of long-term debt Accrued interest Derivative financial instruments Unsecured revolving credit facility Unsecured senior notes & senior debentures Unsecured senior notes Unsecured term loan Capital lease obligations Other long-term liabilities
Equity		All shareholders' equity accounts

Line items on the balance sheet and income statement can be broken down into operating and non-operating groups. Royal Caribbean's operating and non-operating accounts are as follows.

Figure 46

Income Sheet	
Operating	Non-operating
All revenues Commissions, transportation, & other expenses Onboard & other expenses Payroll & related expenses Food expenses Fuel expense Other operating expenses Marketing, selling & administrative expenses Impairment of Pullmantur related assets Restructuring & related impairment charges Other income (expense)	Depreciation & amortization expenses Interest income Interest expense, net of capitalized interest Extinguishment of unsecured senior notes

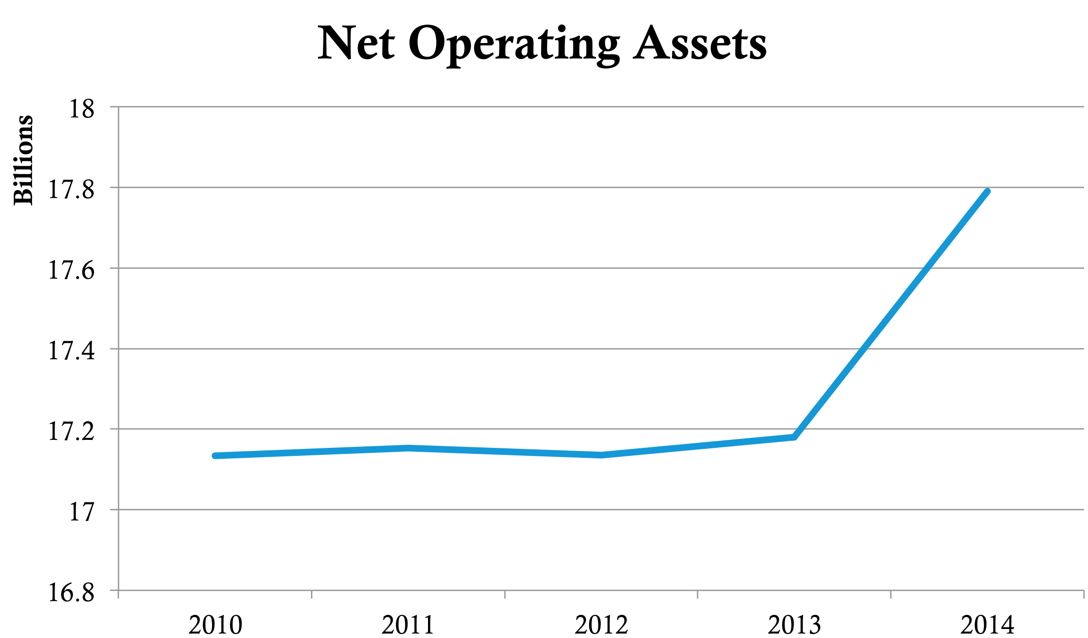
Figure 47



Royal Caribbean's NOPAT is the same as their net operating profit before tax because they have not been charged for material income tax in the last five years. They are currently not subject to United States' income tax laws according to Section 883 of the Internal Revenue Code (Form 10-K).

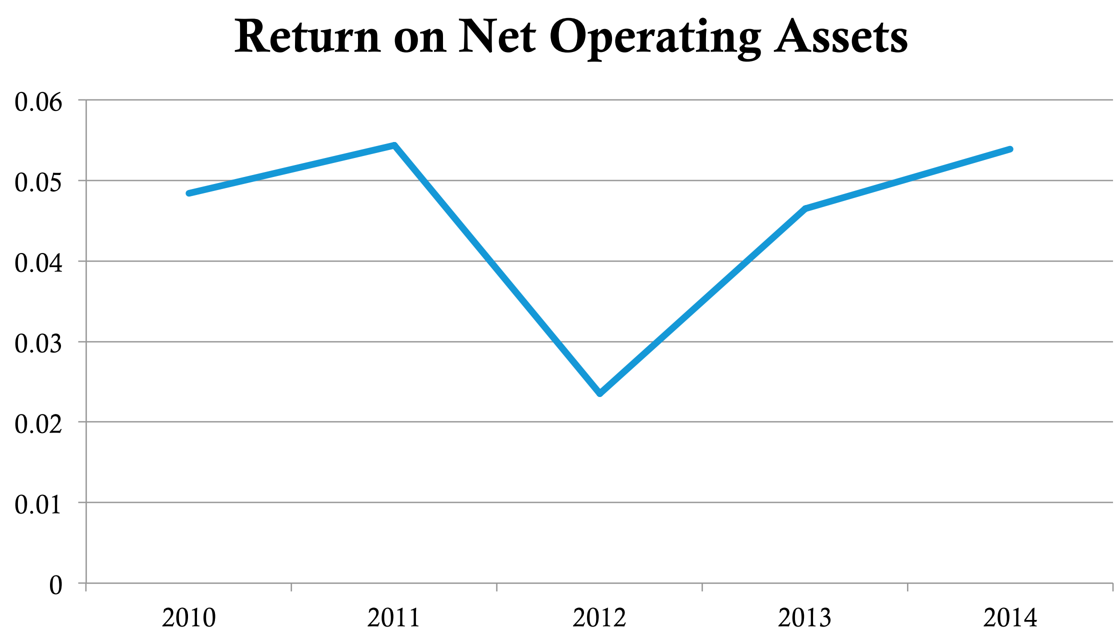
Notice the extremely low NOPAT in 2012. In 2012, RCL recognized an impairment of $385 million on Pullmantur related assets. This impairment is directly related to the $589 million drop in net income from 2011 to 2012. Related impairment and restructuring charges were recognized in 2013 and 2014 as well. As the graph shows, NOPAT would be much more consistent if these impairments had not of occurred.

Figure 48



Net operating assets, NOA, shows the excess of operating assets over operating liabilities. This obvious increase of nearly $611 million in 2014 is largely due to an increase in the ship account. The asset, ships, increased by almost $762 million, while other operating accounts held relatively constant. RCL added their first Quantum class cruise ship that year, called Quantum of the Seas. Washington Time's lists it at $935 million. It will be based in China for the summer of 2015 (Chan).

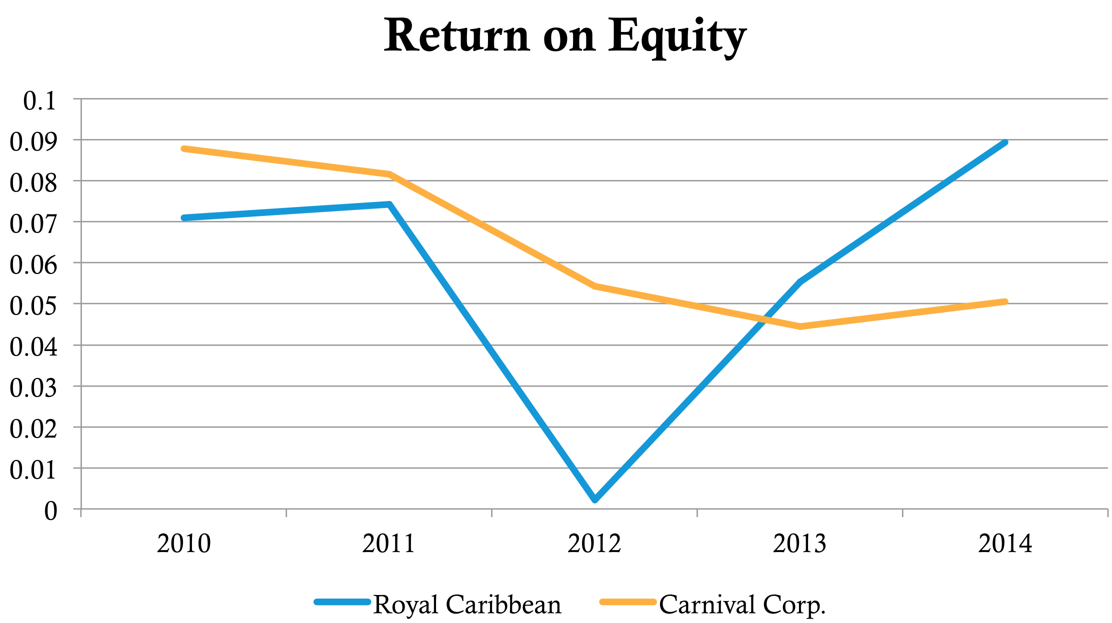
Figure 49



Return on net operating assets, RNOA, is calculated by dividing NOPAT by average NOA. The major spikes in NOPAT and NOA make variations in RNOA as well. The impairments especially cause a lower return in 2012 and beyond.

Carnival's ROE is included for comparison. They have similar trends, but Royal Caribbean has more volatile results. While RCL did have continuously increasing net income from 2012 to 2014, they also reduced the amount of stockholders' equity in 2014. That created an even greater boost in ROE.

Figure 50



Such volatile results should make stockholders more wary of potential manipulation. In 2012, there is virtually zero ROE. That year average stockholders' equity rose by $183 million, and net income fell by $589 million. Both significantly decreased ROE.

NNE is calculated by subtracting net income from NOPAT. It is basically the effect of all nonoperating income statement accounts on net income. The greater it is the less net income is in the current period. However, non-operating expenses are often necessary for financing and investing, so they should not be minimized. Other income (expense) is an account used to include all leftover expenses that are not material enough to be listed alone. In some countries, they are charged for tax expense. This amount is contained in this account.

Figure 51

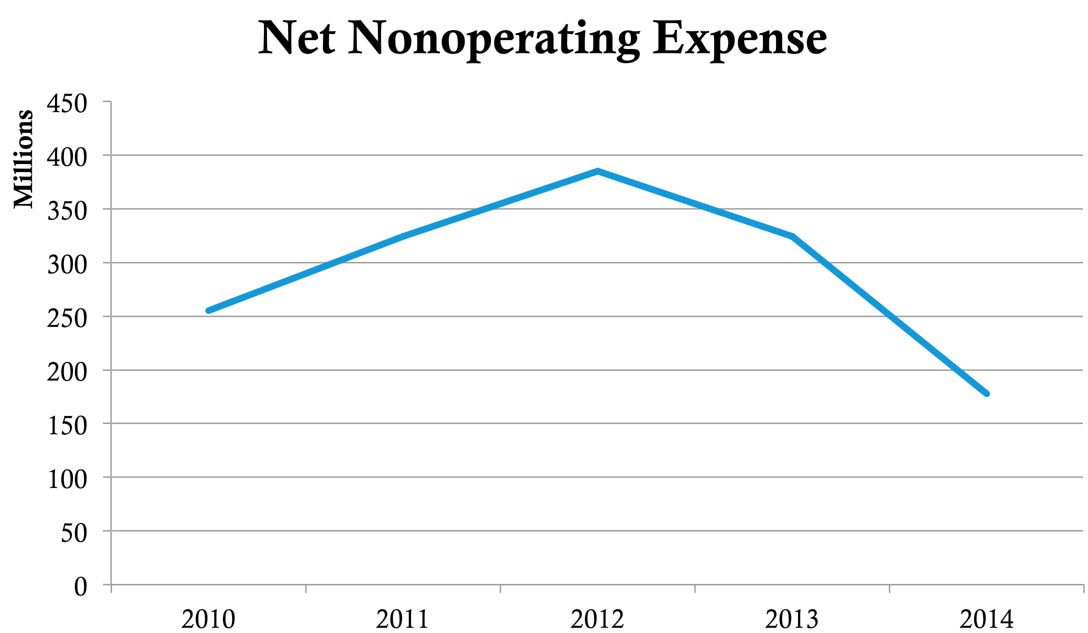
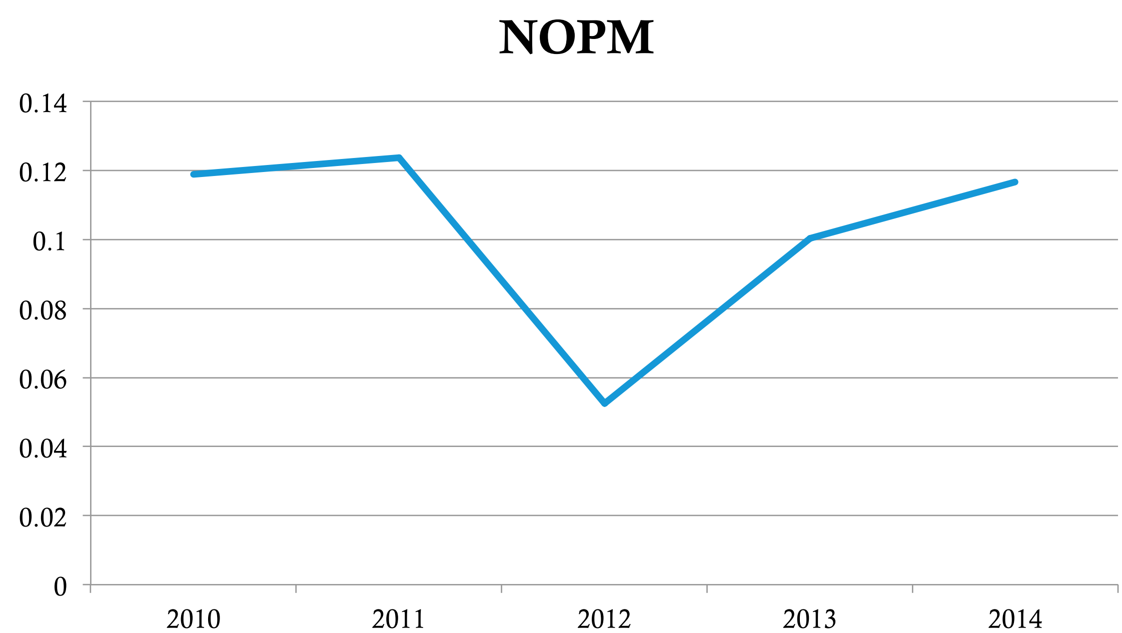


Figure 52 (in thousands)

Unusual Accounts Affecting NNE					
Extinguishment of unsecured senior notes	-	(4,206)	(7,501)	-	-
Other income (expense)	70,242	(1,726)	(42,868)	32,891	74,984

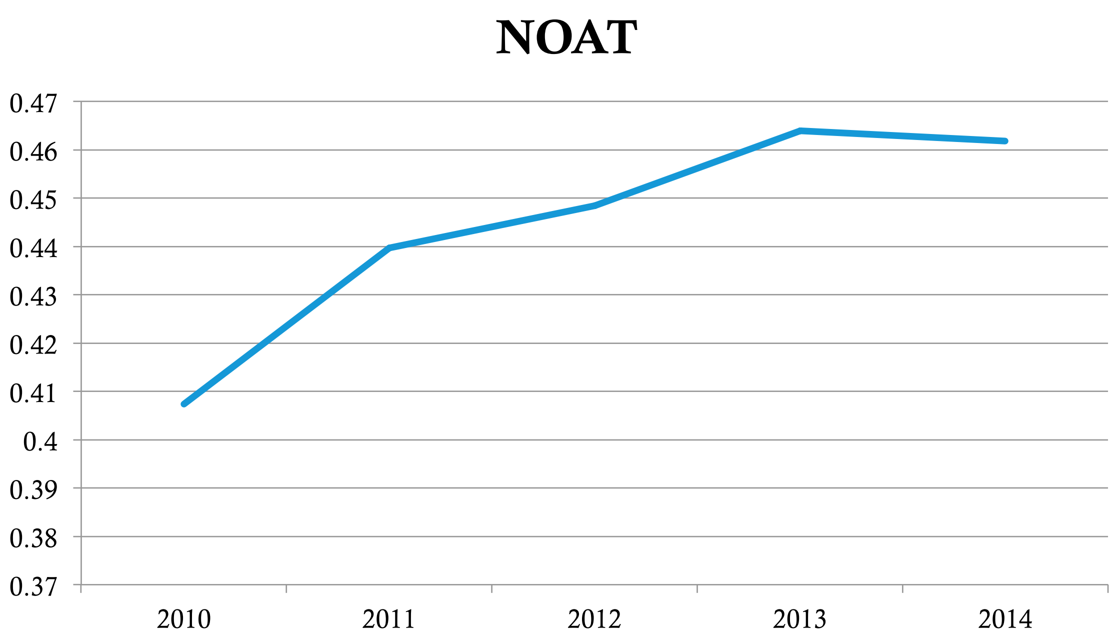
This result means that for each dollar of sales at Royal Caribbean, the company has earned between five and 13 cents of profit after all operating expenses and tax. As a reference, the median NOPM for all publicly traded firms is about six cents. Again, lower values in 2012 and 2014 are derived from impairments recorded in those years.

Figure 53



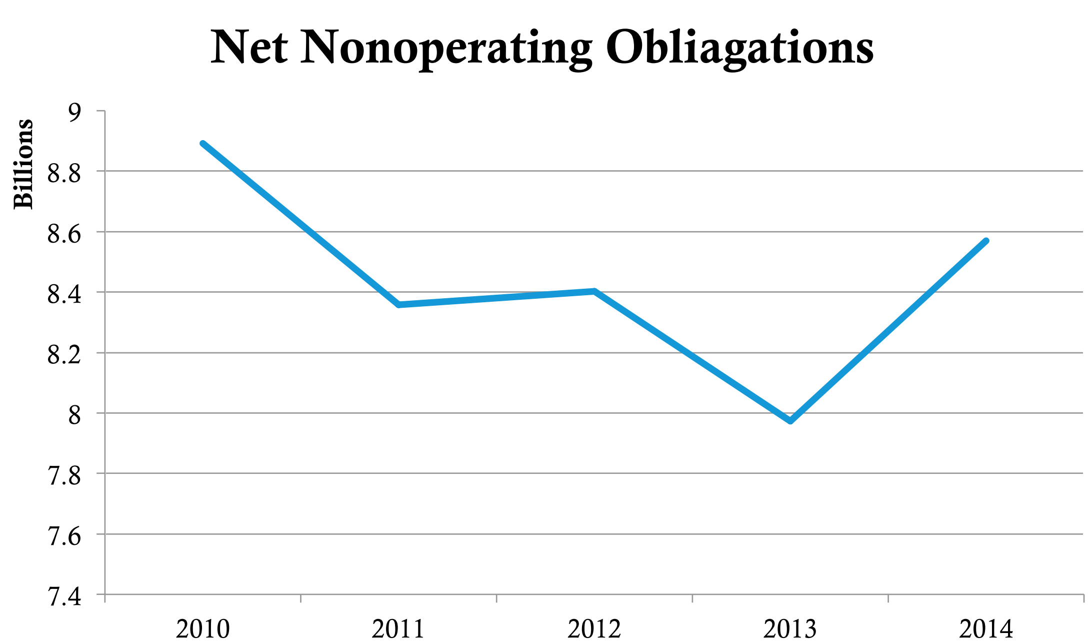
Net operating asset turnover, or NOAT, measures the productivity of the company's net operating assets. This calculation reveals the level of sales the company realizes from each dollar invested in net operating assets. All things equal, a higher NOAT is preferable. Royal Caribbean's NOAT has steadily increased, meaning that revenue is growing faster than average net operating assets (NOA). Specifically, it is increasing at a rate equal to the slope of the line graph. This calculation means that for each dollar of net operating assets, RCL has realized between 40 and 47 cents in sales. As a reference, the median for all publicly traded companies is $1.4.

Figure 54



Non-Operating Ratios

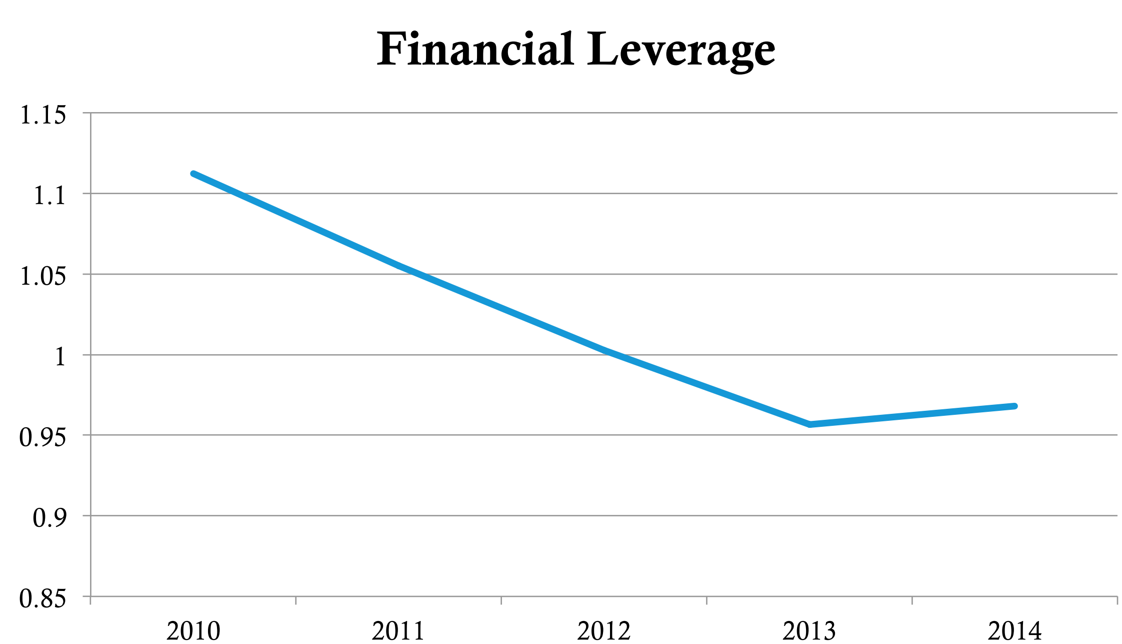
Figure 55



In general, you want NNO to be lower, because it is non-operating liabilities minus non-operating assets. As long as operating activities can offset it, an increase is not necessarily harmful to a company. In 2014, RCL doubled their unsecured revolving credit facility account and also increased their unsecured term loan line item. These obligations are related to their new ship and paying for future ships like it in the coming years.

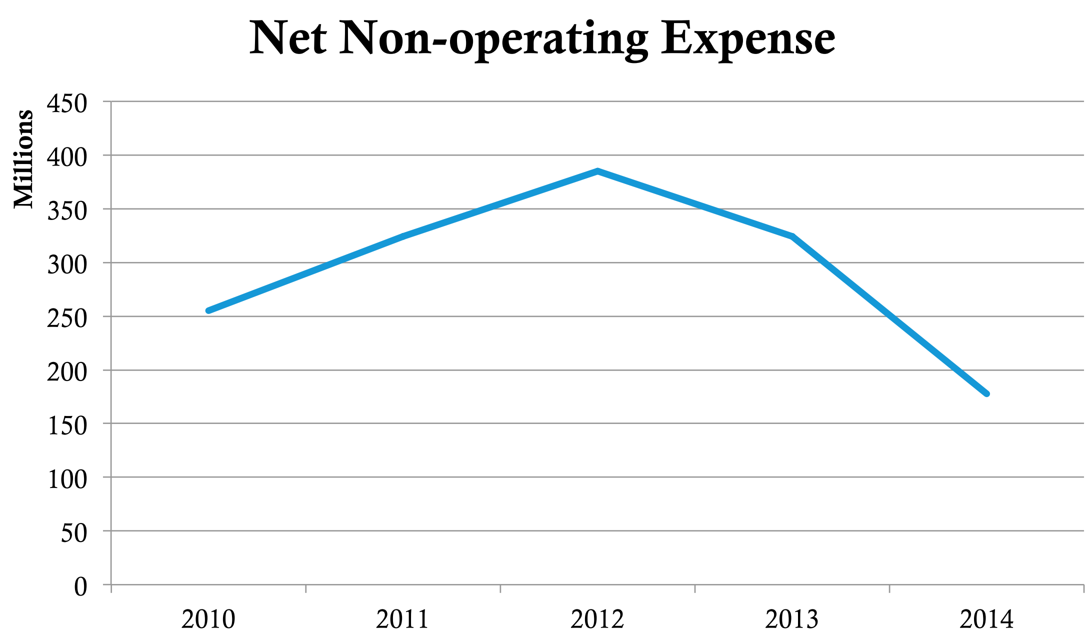
Non-Operating Return: FLEV and Spread

Figure 56



FLEV is average NNO over average shareholders' equity. Overall, these obligations are decreasing per dollar of equity. It is a component of ROE. ROE equals RNOA plus the multiplication of FLEV and the spread.

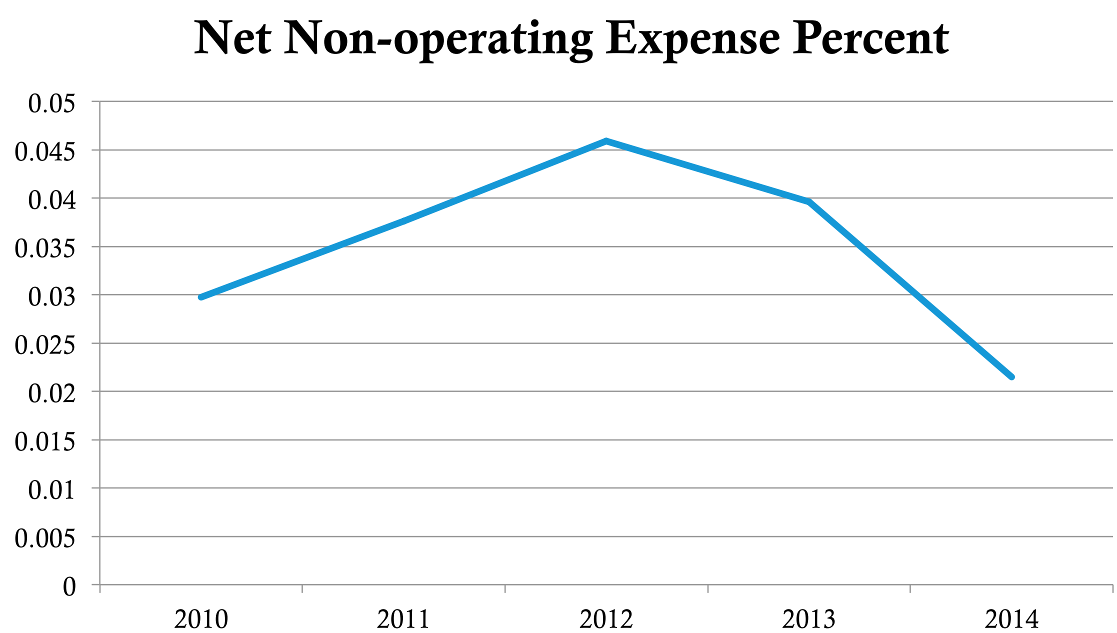
Figure 57



NNE is NOPAT minus net income. NNE stands for net non-operating expense. The highest year of expense occurred in 2012 with $385 million in NNE. Again, this is related to a low net income, which is related to a large impairment recorded in 2012. This impairment has carried through to almost every financial ratio. Recall the consistency in the NOPAT when impairments were excluded. Shareholders' may be misguided if they do not realize where these variations stem from.

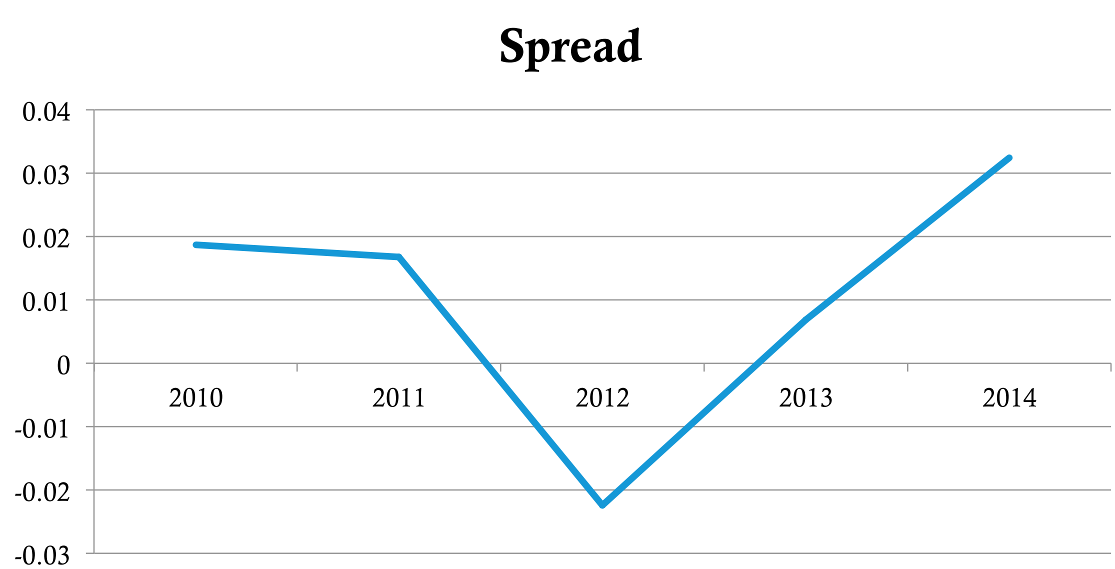
NNEP equals NNE over average NNO. It represents the amount of net non-operating obligations that are realized as expenses in the current year. The same variations are show in this ratio as well. Essentially it shows the rate that net non-operating expenses turnover.

Figure 58



The spread is calculated by subtracting NNEP from RNOA. A negative spread means that NNEP was higher than RNOA in 2012. This means the expense percentage was higher than the return percentage for non-operating activities.

Figure 59



Ratio Limitations

We should be wary of measurement limitations, non-capitalized costs, and historical costs. "Financial statements reflect what can be reliably measured. This results in nonrecognition of certain assets, often internally developed assets, the very assets that are most likely to confer a competitive advantage and create value. Examples are brand name, a superior management team, employee skills, and a reliable supply chain" (Dickinson).

"Related to the concept of measurability is the expensing of costs relating to "assets" that cannot be identified with enough precision to warrant capitalization (non-capitalized costs). Examples are brand equity costs from advertising and other promotional activities, and research and development costs relating to future products" (Dickinson).

"Assets and liabilities are usually recorded at original acquisition or issuance costs (historical cost). Subsequent increases in value are not recorded until realized, and declines in value are only recognized if deemed permanent" (Dickinson).

Chapter 7: Accounting Quality

Macroeconomic Trends

Some growth or decline may simply reflect change in macroeconomic factors. The following five factors discuss possible effects on Royal Caribbean's earnings.

Currency Strength

During the fourth quarter of 2014, Royal Caribbean had earnings of $109.8 million. That equated to 49 cents per share. Even with lower impairment charges in this period, the company did not meet analysts' expectations. For the first quarter of 2015, RCL expects to make ten to fifteen cents per share. However, analysts say that view is too pessimistic and expect 46 cents per share (Thomson).

"Analysts expected $4.93 per share. Royal Caribbean said that while it's been benefiting from lower oil prices, that's been mostly offset by the strengthening dollar. A stronger dollar can result in sales in foreign currencies translating back into fewer dollar and sap demand from international cruisers" (Royal Caribbean 4Q Results, Outlook Disappoint; Stock Drops). Because Royal Caribbean has international markets, making the same money in those countries now means taking a pay cut in US dollars.

Figure 60

They cannot charge more in those countries with other currencies, because their competitors will be able to take their market share. Cruises are too similar, and it is too easy to transfer between companies.

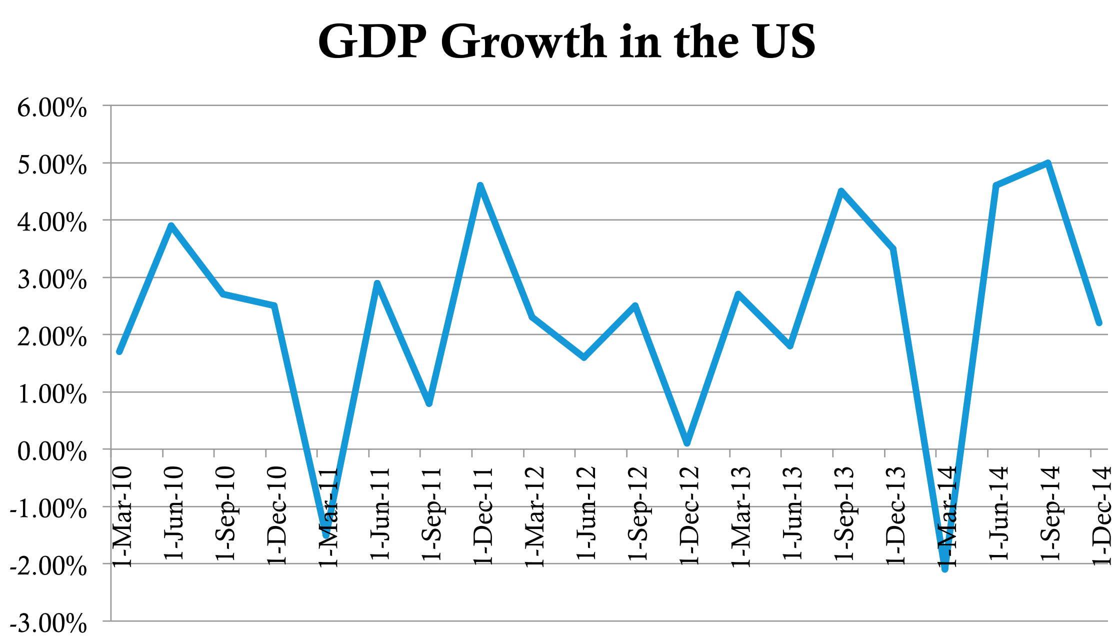
Retirement Age

While the average retirement age is not exactly a macroeconomic factor, it has an extreme effect on the cruise industry. Many people move to Florida to retire. One of the cruise industry's most profitable markets is Florida. Therefore, if the retirement age decreases, it may increase sales dramatically. In America, the average age for retiring has not changed from 66 years and is not expected to change for at least the next ten years. This factor remaining constant means that it cannot have affected Royal Caribbean's earnings. However, the average age to retire in other markets has fluctuated (Riffkin).

GDP Growth

Gross Domestic Product (GDP) is typically considered by economists to be the most important measure of the economy's current health. When GDP increases, it's a sign the economy is strong. In fact, businesses will adjust their expenditures on inventory, payroll, and other investments based on GDP output (Dickinson). The following graph shows the percent increases in GDP each year.

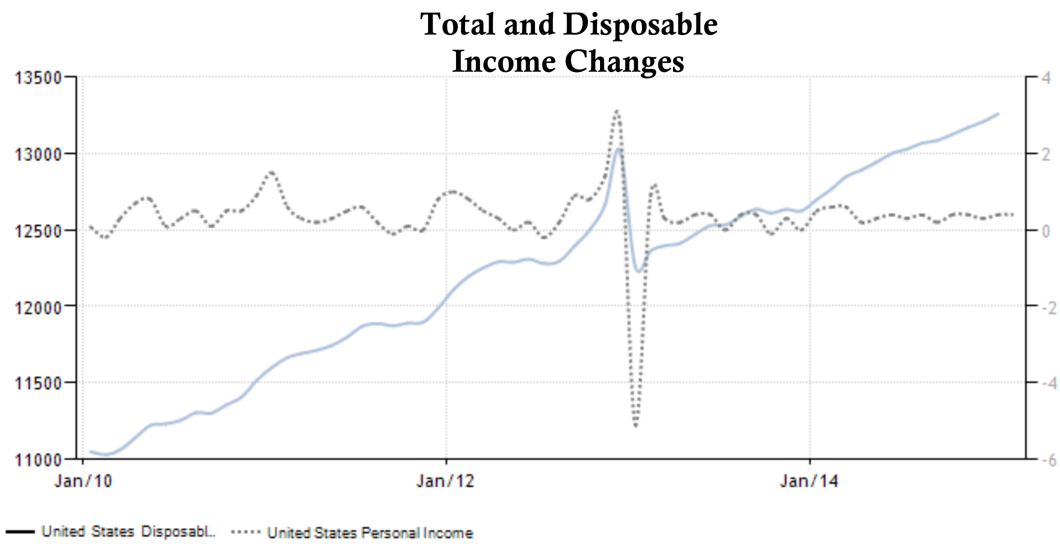
Figure 61



Total and Disposable Income Changes

Income and subsequently disposable income in the United States has been increasing since 2012. Because cruises are almost always booked using disposable income, this is crucial for growing revenues at Royal Caribbean. This economic growth is correlated with increased income of the company. When there is more disposable income, there are also more investors, so equity can grow too. If income was declining, it would be a very bad sign because prices would probably still be rising. Quality of life in America would decrease and Royal Caribbean's earnings would suffer greatly.

Figure 62

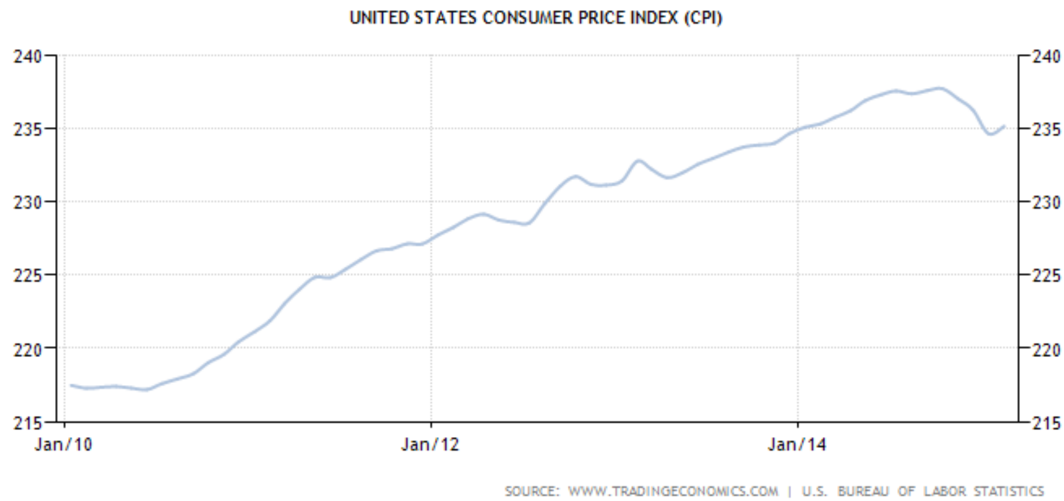


(Indicators from 196 Countries)

Consumer Price Index

While income is rising, so the cost of living is increasing, too. Consumer Price Index (CPI) reflects inflation and is calculated by measuring the costs of essential goods and services, including vehicles, medical care, professional services, shelter, clothing, transportation, and electronics. Inflation is then determined by the average increased cost of the total basket of goods over a period of time. Unless disposable income is increasing at a greater rate than CPI, then it is not relevant.

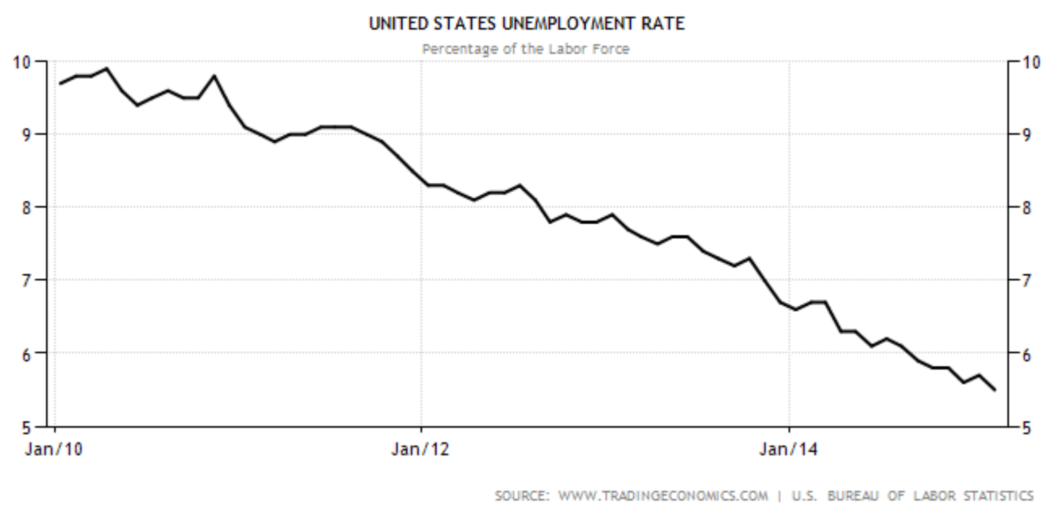
Figure 63



Unemployment Rate

The unemployment rate measures the how many people are looking for a job out of everyone in the US who is eligible to work.

Figure 64

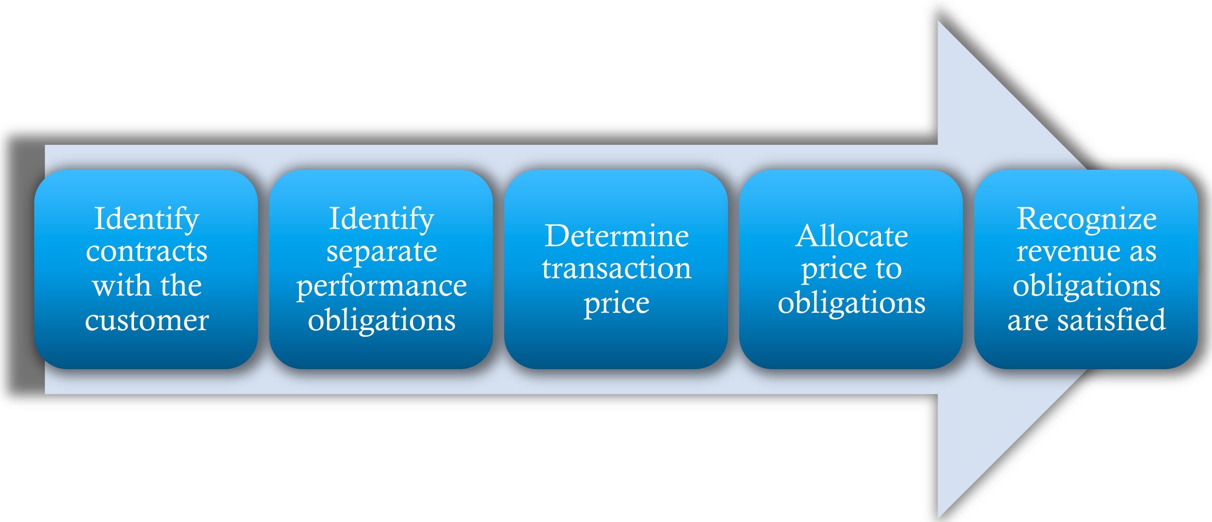


A healthy economy has an unemployment rate around three to five percent, and the US economy has not been healthy for a long time. Increased domestic jobs and re-shoring has brought the ratio back down, close to five percent. There is still a little ways to go, but analysts expect it to deflate to five percent in 2015.

Revenue Recognition

New revenue recognition standards will go into effect in 2017. Currently, GAAP says that revenue is recognized when it is earned and realizable. In the future, revenue recognition will be a five-step process.

Figure 65



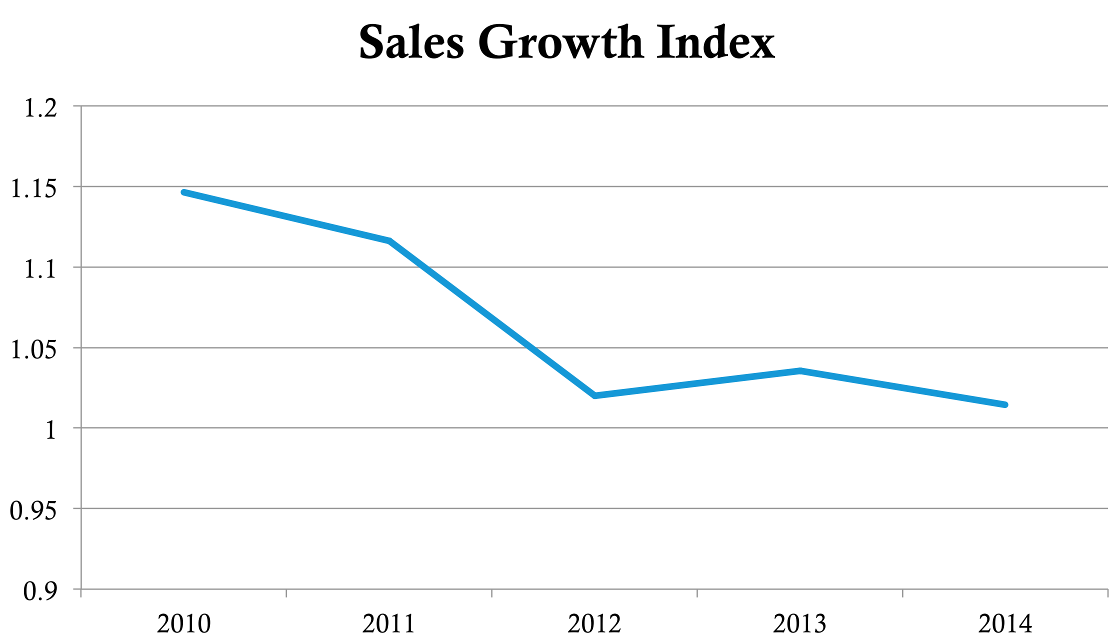
They will not be able to recognize revenue for cruises until the guests have received their vacation. This should not be a change, because they already cannot recognize revenue until it is earned.

Channel stuffing could only occur at RCL if they suppliers were selling them goods that they could not use in a reasonable time period. Executives should be wary of managers taking large discounts on goods close to the end of the period. Managers could also be getting kickbacks or extended payment terms to do this.

Royal Caribbean may have a problem recognizing gross and net sales if their clients book third-party excursions through their website. In that case, they should only recognize any net sales, because it would be similar to a consignment arrangement. They are not actually providing the services. The company is only presenting them with excursion options as a middle man. Barter transactions and bill and hold transactions should not occur under their current structure.

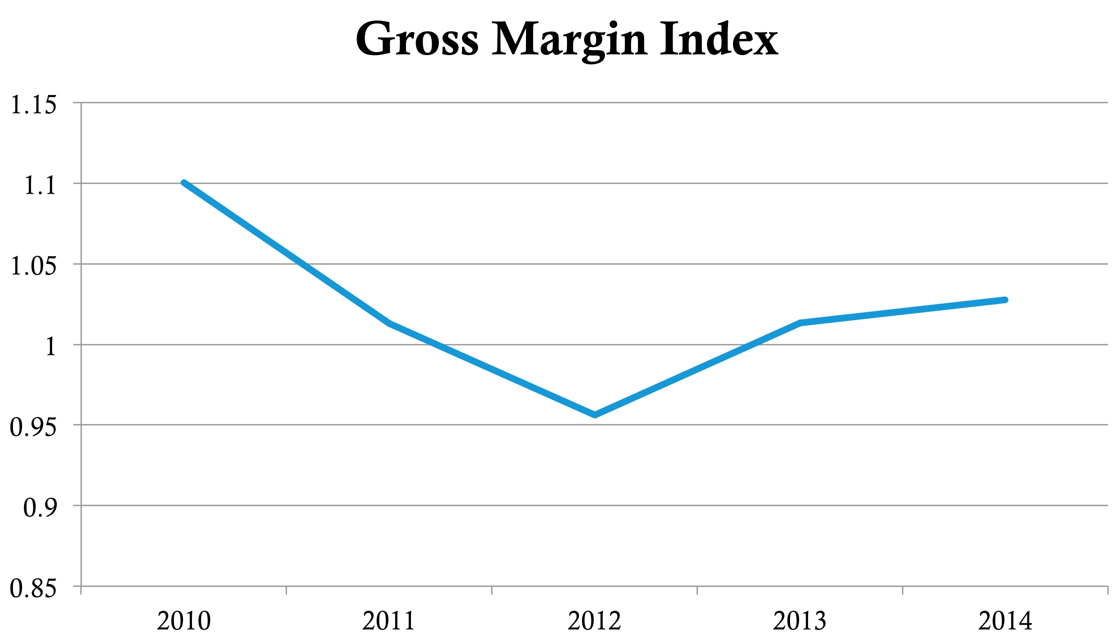
By analyzing revenue recognition using different ratios, we can check for signs of manipulation. If the sales growth index (SGI) increases exponentially and unexpectedly, it would be a major sign that managers were positively influencing the cash accrual method. However, sales growth has leveled around one percent. Therefore, it indicates that there has not been any tampering with revenue recognition.

Figure 66



Using only one ratio would be ineffective sampling, therefore we can use the gross margin index to When the GMI is greater than one the company's gross margins have deteriorated and management is motivated to show better numbers.

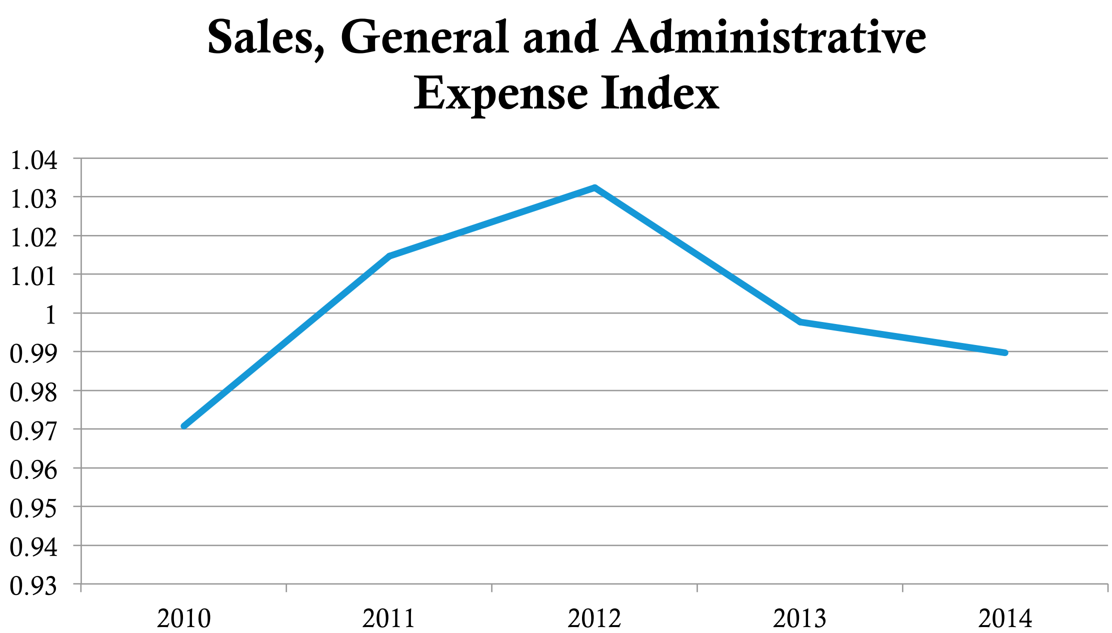
Figure 67



The sales, general, and administrative expense index, or SGAI, shows the increase in these expenses each year. If it is compared to the increase in sales using SGI, sales are increasing faster than expenses. If they were, it would be an indicator that there was manipulation to increase sales. However, expenses were increasing from 2010 to 2012, while sales were decreasing in the same period.

In 2013 and 2014, SGAI not only decreased, but also dropped below one. In 2013, the drop was immaterial, because expenses were only 99.8 percent of what they were the year before. In 2014, they were 99 percent of 2013 expenses. Comparing with the SGI, sales held a constant growth rate of one percent since 2012 to present. Therefore, it is concluded that sales are increasing more rapidly than expenses in 2013 and 2014. While the difference is small, there is still reason to look further into possible manipulation and overstated revenues.

Figure 68

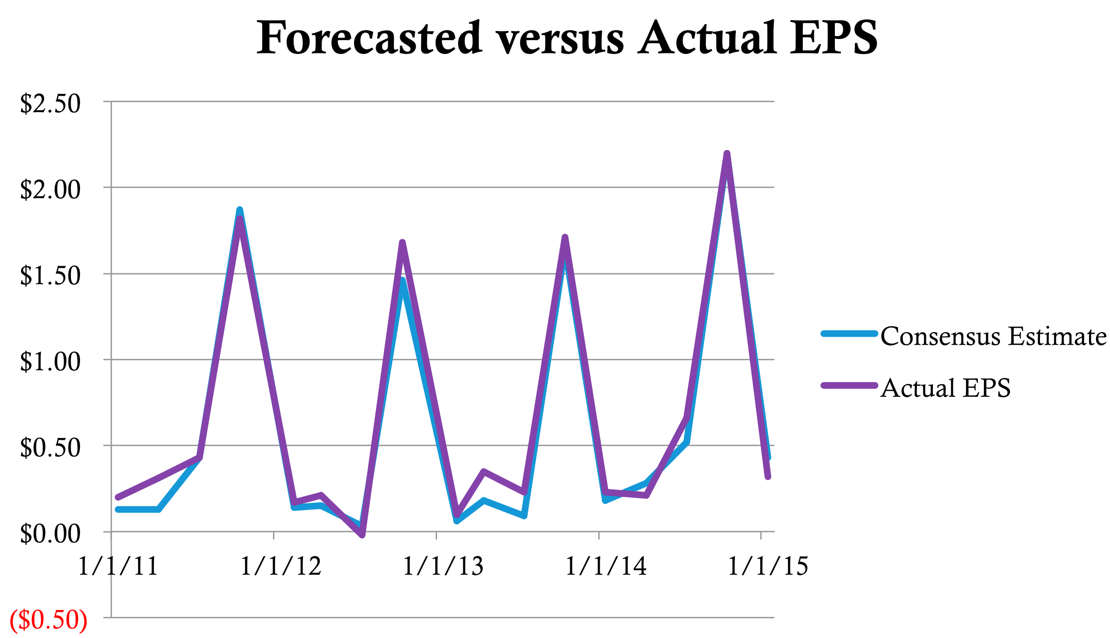


Earnings Targets

Analysts forecast earnings, so that stockholders can gauge performance. If they meet or exceed expectations, that is usually a good sign. RCL has seasonal revenues, so quarterly EPS fluctuates accordingly. The EPS reported in September is higher, because they make most of their money during cruise season. Most cruises happen in the summer months of June through August. They start to pick up in May and decrease in September again.

Shareholders were very concerned last quarter, 2014 Q4, when estimated EPS was 11 cents higher than actual EPS.

Figure 69



In response, RCL sent out a press release explaining that they had actually increased their own estimate during the year based on the strengthening of the dollar, which had less of an effect than expected by the end of the year.

> "At the beginning of 2014, the company forecasted Adjusted Earnings of $3.20 to $3.40 per share. In the first and second quarter, foreign exchange moved in the company's favor and the company increased the midpoint of its guidance to $3.45, largely to reflect that improvement. Later in the year, foreign exchange reversed direction, reversing the earlier benefit. The company's final Adjusted EPS of $3.39 was at the top end of original guidance. Interestingly, foreign exchange movements netted to approximately zero by year-end" (Hodges).

They also mentioned spending less on fuel last year, but they did purchase 1,367,000 metric tons at an average of $693 per barrel after hedging contracts. They are still waiting for the strengthening of the US dollar to affect those prices.

"Royal Caribbean Cruises Ltd. is estimated to report earnings on 04/23/2015. The upcoming earnings date is derived from an algorithm based on a company's historical reporting dates. Our vendor, Zacks Investment Research, might revise this date in the future, once the company announces the actual earnings date. According to Zacks Investment Research, based on 8 analysts' forecasts, the consensus EPS forecast for the quarter is $0.14. The reported EPS for the same quarter last year was $0.21" (Zacks Investment Research).

Royal Caribbean estimates earnings per share this quarter to be similar to analysts' forecasts of 14 cents. There official pronouncement was anywhere between 10 and 15 cents. Their strategy for the upcoming year is to double EPS and ROCI. "It's been a good year and we are looking forward to another good one in 2015," said Richard D. Fain, chairman and chief executive officer. "Our brands are performing at their strongest levels ever and our *Double-Double* program is solidly on track" (Bayley).

Manipulate Earnings

Higher Earnings

Management would be influenced to increase earnings to increase their compensation. Often companies base management's bonuses on their performance. This is measured by earnings and financial ratios based on earnings. Also they may receive stock compensation. They would benefit by having a higher earnings per share that could lead to dividends or a higher stock price.

"To illustrate, consider a bonus arrangement in which the CEO earns no bonus if earnings are below a predetermined amount, no incremental bonus if earnings are above another predetermined amount, and a predetermined percentage of earnings if earnings are between these two amounts. When earnings are below the lower amount or above the upper amount, there are incentives to manage earnings downward to improve future results. When earnings are between the two amounts, there are incentives to manage earnings upward to maximize current-period compensation" (Dickinson).

Royal Caribbean frequently enters long-term construction contracts that require estimates of progress toward completion and costs to complete. By manipulating current estimates of completion, managers can inflate their earnings. Oppositely, they can also deflate earnings by having pessimistic views of completion. This can be handled by using an independent party to estimate completion or assigning the job to someone whose personal income is not affected by the estimate.

The company should also be concerned about ship depreciation. Useful life and salvage value are both estimates. Like completion estimates, they can be manipulated to make assets appear higher and to reduce depreciation expense.

Lower Earnings

Some companies purposefully manipulate earnings to seem lower. Often this can help if they are close to being in a lower tax bracket. Tax is not material enough to motivate management in Royal Caribbean to manipulate earnings to be lower.

Consequently, the cruise unions are a more likely cause for deflating earnings. If unions push for higher wages, then the company may deflate earnings to claim that they cannot afford the increase. They may even argue that they have to cut back on wages, because earnings are so low.

Accounts receivable has to be stated at net realizable value. Managers could use pessimistic estimates of collectability to understate earnings. If they have exaggerated allowance accounts and bad debt expense, it can make their performance seem worse.

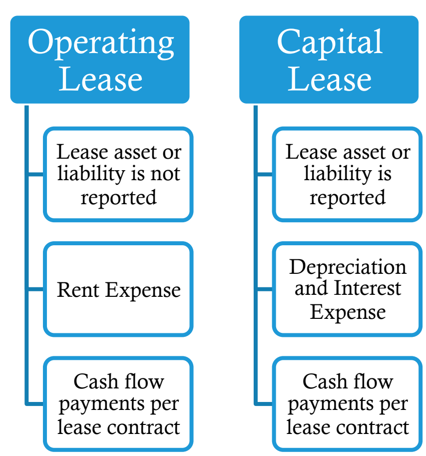
Royal Caribbean sells its older ships to smaller cruise lines. This is another area of possible manipulation. They can time these sales to augment earnings or smooth out earnings when they may not meet expectations.

Chapter 8: Equity Valuation

Leasing

Royal Caribbean utilizes two types of leases: operating and capital leases. A lease is an agreement that allows someone to use someone else's asset under certain terms. Usually, the lender, or lessor, gives unrestricted use of the asset during the contracted period. The borrower, or lessee, pays the lessor in predetermined periods and retains all responsibilities associated with maintaining the asset. The main constraint is that the lessor still owns the title to the asset and takes it back after the contract is dissolved.

Figure 70



As mentioned, Royal Caribbean uses both common types of leases. A capital lease is different from an operating lease, because the corresponding lease asset and liability are reported on the balance sheet. Under an operating lease, neither is reported on the balance sheet.

Using operating leases instead of capital leases increases NOAT, financial leverage, ROE, and RNOA. Also, "during the early years of the lease term, rent expense reported for an operating lease is less than the depreciation and interest expense reported for a capital lease. This means that net income is higher in those early years with an operating lease. Further, if the company is growing and continually adding operating lease assets, the level of profits will continue to remain higher during the growth period" (Dickinson).

To account for these perceived benefits, operating leases can be capitalized through three steps. Determine the discount rate, compute the present value of future operating lease payments, and adjust financial reporting to include present value of the lease asset and liability.

Next make adjustments.

Figure 71

Year	Operating Lease Payment	Discount Factor	Present Value
1	200,660	0.93057882	186729.946
2	139,540	0.86597694	120838.4222
3	115,255	0.805859799	92879.37116
4	117,663	0.749916061	88237.3735
5	40,769	0.697856003	28450.8914
Thereafter	40,769	1.271203795	51825.70753
	82,940/40,769		568961.7119
Remaining life in years	2.034388874		

Figure 72

Ratios	2014	Adjustments	New Ratio
NOA	17,790,392	+568961.7119	18,359,353.71
NNO	8,570,767	+568961.7119	9,139,728.712
NOPAT	941,859	-200,660 +(568961.7119/2.034388874)	1,422,795.71
Nonoperating Expense Adjustments	177,713	+(568961.7119*.0746)	220,157.54
RNOA	0.053866378	Use new NOPAT and NOA	0.102602631
NOPM	0.116655427	Use new NOPAT	0.176222599
NOAT	0.461756295	Use new NOA	0.45436384
FLEV	0.967897556	Use new NNO	1.001184529

These numbers and ratios are all higher than the previously computed numbers, except NOAT. NOAT is better if it is smaller. Managers use operating leases to keep assets and liabilities off of the balance sheet. In this case, capital leases are more favorable towards ratios and balances, but managers try to avoid recognizing more expenses and liabilities.

Cost of Capital

Beta = 1.1

R(f)= 2.5

Spread= 6

R(e) = .025 +(1.1)(.06) = .091 or 9.1%

R(d)= weighted average effective interest rate on debt * (1- effective tax rate)

Royal Caribbean had an income tax benefit in 2014, not an income tax expense.

R(d)= 7.36% * (1 + 10.1%)

R(d)= 8.10%

WACC is the weighted average of the cost of equity capital and cost of debt capital

Equity Weight = Stockholders' Equity/(Stockholders' Equity + Total Debt)

Equity Weight= 8,284,359/ (8,284,359+ 8,443,948) = 0.495229972

=49.5%

Debt Weight = 1 – Equity Weight = 51.5%

WACC = [.495 * .091] + [.515 * .081] = .045045+.041715 = .08676 = 8.68

Stock Valuation Model

This is not a good forecast of future cash flows. Because there was heavy investing over operating profits this year, there should be higher rates of return and a positive FCFF in future years. However, using this formula, one will never have positive cash flows if you start with negative cash flows. Therefore, this particular model based on 2014 should not be used.

Figure 73- Discounted Cash Flow Model

	Reported	Forecasted				Terminal
	2014	2015	2016	2017	2018	Period
Sales Growth	1.43%	5%	5%	5%	5%	1%
Discounted Cash Flow Model		1	2	3	4	
FCFF	-26,619	-25,288	-24,024	-22,822	-21,681	-21,465
Discount Factor		0.87	0.81	0.75	0.70	1.27
PV of Horizon		-21,898.87	-19,359.69	-17,114.93	-15,130.45	-27,285.79
Cum PV of horizon	-73,504					
PV of terminal	-27,286					
Total firm value	-100,790					
Less NNO	-9,139,729					
Firm equity value	-9,240,518					
Shares outstanding	221,658					
Stock value per share	-41.69					
Current Trading price	81.47					

ROPI Model

ROPI= NOPAT- (WACC *NOA)	-170,796.192
NOPAT	1,422,795.71
WACC	0.0868
NOA	18,359,353.71

Figure 74- ROPI Model

	Reported	Forecasted				Terminal
	2014	2015	2016	2017	2018	Period
Sales Growth	1.43%	5%	5%	5%	5%	1%
NOPM	0.18					
NOAT	0.45					
Sales	8,073,855	8,477,548	8,901,425	9,346,496	9,813,821	9,911,960
NOPAT	1,453,294	1,525,959	1,602,257	1,682,369	1,766,488	1,784,153
NOA	18,703,992	18,973,998	20,587,892	20,952,092	22,664,891	21,388,262
Residual Income Model		1	2	3	4	
Required Return		1,623,507	1,646,943	1,787,029	1,818,642	1,967,313
ROPI		-97,548	-44,687	-104,660	-52,154	-183,160
Discount Factor		0.87	0.81	0.75	0.7	1.27
Horizon PV		-84474.24	-36011.06	-78485.94	-36395.85	-232833.45

Cum PV of Horizon	-235,368					
Pv of terminal	-232,833					
Total Firm Value	-468,201					
Less NNO	-9,139,729					
Firm Equity Value	-9,607,929					
Shares outstanding	221,658					
Stock value per share	-43.35					
Current Trading price	81.47					

The models performed terribly. They were biased by a negative NOPAT, which stems from high investing expenses in 2014. Using common sense, one can determine that these investments should increase future cash flows and sales. I do not expect stock price to plummet. In fact, a negative stock price is impossible. That would mean that someone was paying to get rid of it. Therefore, neither model should be used on the data. A new investor should not trust these models, and should assume stock price is actually increasing in a healthy way.

Chapter 9: Audit and Tax Recommendations

Management's Assertions

When performing an audit, management has to address five assertions. They are existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation or disclosure.

Existence or occurrence means that all accounts on the balance sheet exist and that corresponding transactions actually occurred in the period. Management is reporting that financial statement accounts are not overstated or understated. They must check that no extraneous transactions have been recorded.

Completeness means that every transaction and balance that should be reported is represented on the balance sheet.

Rights and obligations should denote appropriate ownership of accounts. Their rights to assets and liability obligations should be those of the entity, not an officer, creditor, supplier, other entity, or customer. Proper statement requires understanding current contracts of the company.

Valuation or allocation is the way that assets and liabilities are measured. Fair market value measurements are especially risky, because they are an estimated valuation. Choice of allocation methods should be appropriate for revenue and expense recognition principles. They should be congruent with GAAP and, if applicable, the IFRS.

Presentation or disclosure means that each account is classified correctly. Also, footnotes should be included where necessary. Certain contingent liabilities for example should be explained in the notes to the financial statements.

The following charts address each of these five assertions and how they apply to the asset and liability accounts on Royal Caribbean's balance sheet.

Figure 75

Assets					
	Existence and Occurrence	**Completeness**	**Rights and Obligations**	**Valuation and Allocation**	**Presentation and Disclosure**
Cash and Cash Equivalents	All bank accounts and securities should be confirmed by outside parties like the bank.	The account should include all balances of cash, petty cash, and marketable securities with original maturities of 90 days of less.	Cash should appropriately account for minimum bank balance requirements.	Bank accounts should be reconciled with book amounts of cash. Cash should be converted into US dollars accurately.	In the notes to the financial statements, a company should detail which accounts are included in cash and cash equivalents.
Trade and other receivables, net	Auditors should test accounts receivable by asking customers if they exist.	All and only receivables related to sales and trade should be included in this account.	Factoring arrangements should be considered when addressing the company's rights to receivables.	Allowances should be estimated to reduce receivables to the amount that will actually be collected.	It should be presented net of adjustments and deduct corresponding allowance accounts.
Inventories	Physical tests should match the balance on the books.	All sold inventory is removed from the balance sheet and all purchased inventory is added to the balance sheet.	Consignment goods and shipped transactions should be tested to determine whether the company has rights to that inventory.	Appropriate valuation techniques such as LIFO, FIFO, or weighted average should be applied consistently and monitored.	Valuation techniques should be explained in the notes to the financial statements.

Figure 76

Assets (continued)					
	Existence and Occurrence	**Completeness**	**Rights and Obligations**	**Valuation and Allocation**	**Presentation and Disclosure**
Plant, Property and, Equipment	These physical items should be counted to make sure that they all exist outside of the balance sheet.	This account should include the net balances of ships, ship improvements, land, ships under construction, buildings, computers, transportation equipment, and other PPE.	Appropriate leasing criteria should be met. They should only include PPE that they have the right to use or if they have not transferred ownership of it.	All PPE accounts are said to be valued at cost less accumulated depreciation. They are depreciated over the useful life of the asset using straight-line depreciation. Each ship generally has a 30 year estimated useful life and a 15 percent residual value.	Each PPE account should be listed and discussed in the notes. They should show accumulated depreciation and net balances.
Goodwill, net	There must be an excess of cost over the fair value of net tangible and identifiable intangible assets acquired for goodwill to exist.	Economic conditions, limitations on capital, changes in forecasts, fuel prices, and foreign exchange rates should be included in determining fair value.	When purchasing a company, the parent has the right and obligation to measure and record goodwill of the subsidiary.	When performing the two-step goodwill impairment test, the fair value of the reporting unit is compared to net assets. If necessary, goodwill is written down to its implied fair value.	Discussion of goodwill impairment tests and previous write-downs should be disclosed in the notes.

Figure 77

Liabilities					
	Existence and Occurrence	**Completeness**	**Rights and Obligations**	**Valuation and Allocation**	**Presentation and Disclosure**
Current portion of long-term debt	Use creditors to validate amounts and borrowing rates.	Test long-term debt to check how much is due within the period.	These current obligations should be measured to determine corresponding interest obligations.	These liabilities are those due within the current period.	Notes to the financial statements should include details about different long-term debt, rates, and when amounts are due.
Accounts Payable	Review transactions and contact suppliers to ensure their accurateness.	Accounts payable accounts correspond to purchases and current inventory.	Payables are obligations that should be paid by a specified date listed in the sales contract.	These should be recorded consistently as gross or net of the discount, depending on management's preferences.	Presentation should include accounts payable at net of a discount or at gross amounts depending on how they are valued.
Accrued interest and Accrued expenses & other liabilities	Outside sources can confirm existence of accrued liabilities and the rate at which they are accrued.	Accrued expenses include all expenses that a company has incurred, but has not paid.	Obligations are already recognized. This balance should reflect the accumulation of those obligations.	Accrued accounts should be based on appropriate rates and usage.	The notes to the financial statements should detail what accounts contribute to this balance and how they are valued.

Figure 78

Liabilities (continued)					
	Existence and Occurrence	**Completeness**	**Rights and Obligations**	**Valuation and Allocation**	**Presentation and Disclosure**
Unsecured credit accounts	The creditor can confirm existence of this account and should have source documents to rely on.	All unsecured revolving credit facilities, senior notes, senior debentures, and term loans should be included in corresponding accounts for it to be complete.	These are liabilities that represent an obligation to pay back all money that has been borrowed with interest.	Expenditures should be deducted from credit until they are paid back. Interest payable accrues on these accounts and should be at contract rates.	These are presented as a part of long-term debt on the balance sheet. The amounts due in the current period should be included in current liabilities.
Capital lease obligations	Their existence should have contracts signed by both partied involved in the transaction.	They are complete if all capital leases are included and recorded at the accurate amounts.	Capital leases require the company to pay depreciation expense and interest expense on the asset. They have a right to the asset as it is stated in the contract.	Capital leases should be properly accounted for using present value and consistent depreciation methods.	Both the asset and liability should be stated on the balance sheet, because it is a capital lease. Operating leases are not reported in this way.

Audit Risk

Plant, Property, and Equipment

The plant, property, and equipment account is the largest account on the balance sheet. Therefore, it has a large risk of being misstated simply because it has so many components.

Purposeful misstatement is fraud. Fraud stems from situations that support all three areas of the fraud triangle. They are pressure, rationalization, and opportunity. Managers at Royal Caribbean are under pressure to report higher earnings and higher assets to improve shareholder value. They may have stock-based compensation themselves. A manager can rationalize a misstatement by saying that they can fix it in the next period or that it will not affect anyone. Also, they have the opportunity to recalculate useful life and residual value. They may increase the useful life or residual value to decrease depreciation expense on the income statement. Internal and external auditors can check for this type of behavior by testing for existing controls and their effectiveness.

Primarily, an auditor should recomputed residual value and useful life. They can use fair value of similar assets at the end of their useful life to compare. Recomputation should also be based on evidence of how much it cost when it was originally purchased. Auditors can compare specific line items of the bid and contract to other existing ships. The company that built each ship can corroborate the amounts and how long different parts will last.

Secondly, they should review changes in these calculations and the procedures it takes to change them. An auditor should ask what chain of command it takes and what separation of duties exists to change these computations. Multiple managers and executives should be involved in changing measurement of ships, but smaller items should require less bureaucratic approval.

Corresponding internal controls include segregations of duties, independent verification, and authorization of activities. Implementing teams that work together to review the life of the asset in each year can establish segregation of duties. The auditing team should do independent verification, but experts on ships and ship construction should also be reviewing this. They would be helpful as members of the board of directors.

Customer Deposits

Customer deposits are the largest current liability account on the balance sheet. They represent the amount that customers have paid for upcoming cruises. This amount could be misstated as revenue before it is earned. Managers will have incentives to boost their own performance. They can increase revenue right before the period ends if some deposits are just recognized as sales. Sales representatives will be especially eager to make this type of misstatement.

Primarily, auditors should test for this by analyzing the ordinary procedure for recognizing customer deposits and revenues. They should select a sample and test to make sure that they were accounted for properly.

Secondly, an auditor should make fake deposits to test what sales representatives and managers do with them. This test is especially important near the end of the period. This is when managers will be most pressured to increase revenues.

Figure 79 (in percent)

Departure Points	2010	2011	2012	2013	2014
Singapore	17	17	17	17	17
Turkey	20	20	20	20	20
Chile	17	20	18.5	20	20
United Kingdom	28	26	24	23	21
Sweden	26.3	26.3	26.3	22	22
Denmark	25	25	25	25	24.5
China	25	25	25	25	25
Canada	31	28	26	26	26.5
Australia	39	30	30	30	30
Spain	30	30	30	30	30
Italy	31.4	31.4	31.4	31.4	31.4
Brazil	34	34	34	34	34
Japan	40.69	40.69	38.01	38.01	35.64
United States	40	40	40	40	40
United Arab Emirates	55	55	55	55	55

Internal controls that prevent this type of action are segregation of duties and maintenance of adequate accounting records. Segregation of duties should occur by forcing some people to take vacation days if they have not in a while. Other people should be able to review their work. Management who checks that all records are properly recorded can do maintenance.

Tax

The following figure lists each country that Royal Caribbean has a departure point in. They are listed from lowest to highest corporate tax rate in 2014. Note that the United States tax rate is second highest, behind the United Arab Emirates. Because the company does most of their business and has most of their market share in the United States, this rate would be most applicable to them. Also, they are incorporated in Liberia, which has a corporate tax rate of 33.3 percent as of December 2014.

Tax Credits

In 2013, there was a dispute over tax credits in Alaska, a common cruising location. Two subsidiaries of Carnival Corp. donated one million dollars to the University of Alaska. This resulted in overwhelming tax credits. "Depending upon how it is structured, as much as $800,000 of the four-year donation could be paid by the state of Alaska. The state contribution comes in the form of reduced revenues to the state treasury, brought about by tax credits provided to the donor companies" (Cole).

The donation may have cost the company only $50,000 each year, which heavily outweighs the tax breaks they received. Companies that pay taxes in Alaska qualify for tax credits when they donate to the education system. The first $100,000 gets a 50 percent tax credit. The $100,001 to $300,000 gets a 100 percent tax credit, and finally, the $300,001 up to $10 million gets a 50 percent tax credit. Essentially the company is allocating where the federal government is spending taxes and getting good publicity.

Evidently, “companies may earn federal tax breaks” (Cole). If a company falls under a federal tax bracket requiring 35 percent, a $300,000 donation can be rewarded with a federal tax reduction of over 17 percent. More specifically, they would get a tax break of $17,500. “Carnival, the owner of Princess and Holland America, doesn’t pay 35 percent in federal taxes because it is based in Panama” (Cole).

“In a July hearing, Sen. Jay Rockefeller, a West Virginia Democrat, told top executives of Carnival and Royal Caribbean International that he wants to do away with the loophole that has allowed the companies to pay an average income tax rate of about 1.3 percent over the past seven years. He said the cruise ships fly foreign flags to “maintain the fiction that you earn most of your income outside of U.S. territory” and “you do not pay your fair share of taxes in this country”” (Cole).

Cole quoted Adam Goldstein, the president and CEO of Royal Caribbean International at the time of his article. During a conference call, he said “What Sen. Rockefeller is apparently referring to as a loophole is something that has been fairly entrenched in U.S. tax law going back many decades, has been carefully reviewed by Congress with very small changes made as recently as 2003” (Cole).

This is called tax inversion. It occurs when a company is domiciled legally in a lower tax country. That is one reason for RCL to be in Liberia when most of their operations occur in the United States (Cole).

They take part in transfer pricing between TUI and Grand Bahama Shipyards. They sold a ship to TUI Cruises that they own 50 percent stake in. They get some ships repaired in Grand Bahama Shipyards, which they own 40 percent stake in. There audit states that they do not have enough of a controlling interest to influence the operations of these entities, but it should be noted that there is potential for tax evasion (Cole).

Tax Recommendation

RCL already has a difficult time realizing their deferred tax assets, because they do not have a significant enough taxable income. Their recent impairments have led to deferred tax benefits. They do not even list tax expense separately on the balance sheet. It is lumped in with interest expense and penalties related to income tax liabilities, which is labeled as other income (expense). In 2014, this number was positive. They earned more income from this account than they recognized as expense. This is also true for 2011 and 2010. Because they are not paying taxes, they probably do not need a recommendation on how to minimize them.

To compare, Carnival Corp.'s financial statements and notes have been analyzed They also do not recognize a substantial tax expense. They have paid the following amounts for the last five years, in millions.

Figure 80 (in millions)

	2014	2013	2012	2011	2010
Income Tax Benefit (Expense)	(9)	6	(4)	0	(1)

Regardless of their lack of tax expense, they can improve their business through a tax related recommendation. They should be very conscious when giving public statements and avoid drawing attention to their low, almost nonexistent tax expense. Especially in the United States, there is a stigma associated with large businesses that do not pay tax expense. In order to retain market share and keep minimizing tax, they need to create brand loyalty through relationships in communities to fall back on. A positive brand image will combat any potential criticism that may come up.

An example from Target increases the validity of the recommendation. Target donates at least five percent of income to communities each year. This and other strategic decisions strongly associate them with corporate responsibility. Relationships as strong as that are important to fall back on when bad publicity strikes. For example, Target had a breach in their customer and credit card information. They lost many customers, but that established relationship and association of corporate responsibility cushioned the negative impact.

RCL does not have that commitment to the community to rely on if a lot of attention is drawn on their lack of tax expense.

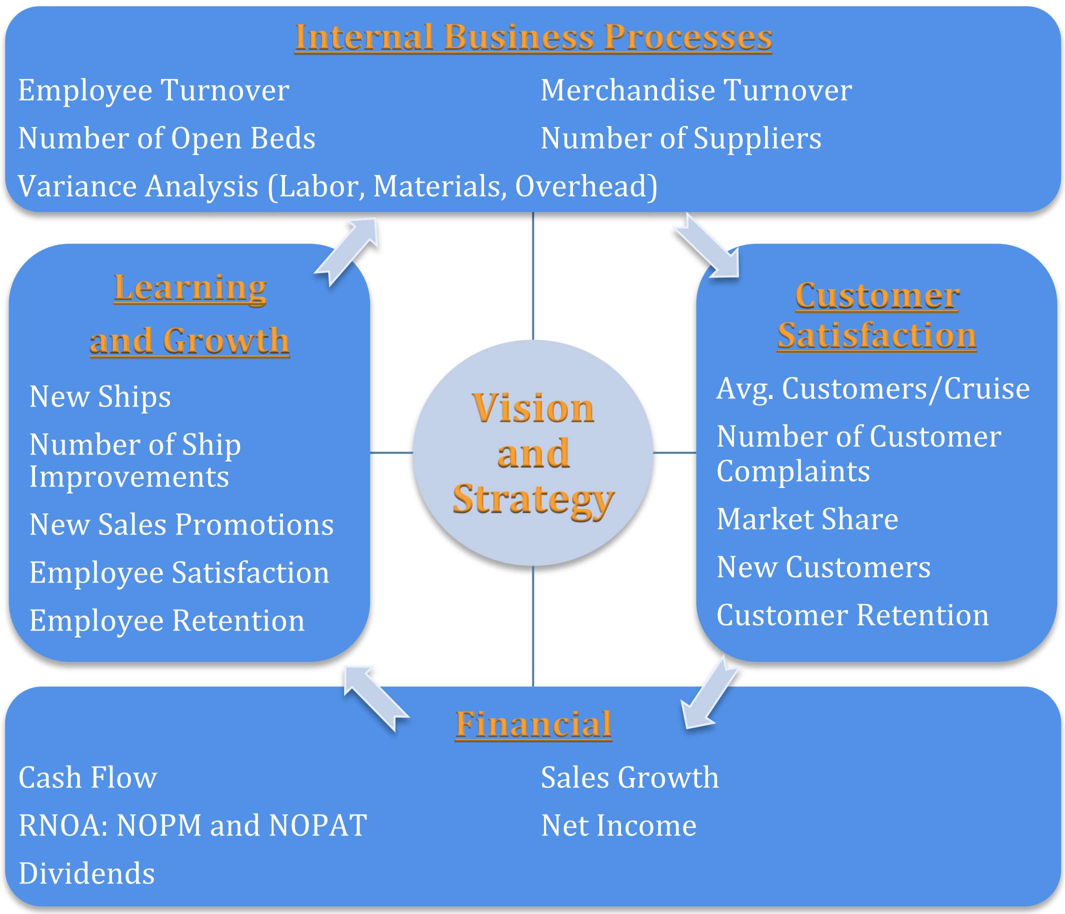
Chapter 10: Advisory Recommendations

Balanced Scorecard

The Balanced Scorecard measures financial, nonfinancial, quantitative, and qualitative aspects of a business. It assesses how well the company is working towards its long-term goals with a variety of performance measures to ensure that the business is creating value for shareholders.

The scorecard focuses on four categories: financial, customer, internal business processes, and learning and growth. The financial category measures profitability of the strategy. The customer satisfaction portion identifies targeted customer and market segments and measures the company's success in those segments. Internal business processes evaluates the ability of the company to efficiently and effectively deliver their product or service to customers. Learning and growth identifies the capabilities the organization needs to compete in the market. It also addresses innovation and its importance in evolving a business.

Figure 80



All areas of the Balanced Scorecard are meant to assess how well the company is adhering to their strategy and increasing shareholder value. Awarding managers for performance according to inconsistent goals will harm the company. Any inconsistent measurements will negatively affect every area of the business due to their causal linkages.

The arrows in the diagram represent how each area builds on the next. Learning and growth improves internal processes, internal processes improve customer satisfaction, and customer satisfaction improves financial performance.

Then, financial capital starts the cycle over again by investing in research and development.

Wayfinder Customization and Revenue Generation

Cruise lines primarily compete on the quality of their offering. Price is much less of a factor, so technological innovation is a major priority for Royal Caribbean. In their latest class of ships, RCL included "Wayfinder." Wayfinder is a guest interface that is loaded on screens in every room and at various locations on *Oasis of the Seas* and *Allure of the Seas*. It outlines different entertainment and other activities. Then, guests can get wait times and directions. This and other innovations are ongoing and being implemented into older ships (Wayfinder System).

Figure 81

(Wayfinder System)

I recommend an addition to Wayfinder. Royal Caribbean should use customer profiling to create customized schedules. Guests pay hundreds to thousands of dollars to take advantage of all that the ship offers. For better customer satisfaction, the ship should help them make it to everything that they can. This schedule should be flexible, so that guests can make changes as they go.

Each Wayfinder station in rooms should have a profile for each guest that is staying there. It should outline a suggested schedule of each day. This technology could use a short survey, age, gender, hometown, and other characteristics to profile guests. Target and Netflix use similar technology, and they have increased sales by knowing what each customer wants before they even know it. They should be able to get that schedule on an app to carry around with them as well.

Using this technology could increase sales on the ship, because people will be doing more activities. Wayfinder can suggest the optimal revenue-generating schedule, by including activities that cost money on the ship.

Overall, this interface can collect valuable customer information that can act as research for future innovations. It will increase revenue on the ship and improve customer satisfaction.

Everyone offers WiFi now anyway. It spreads people out to reduce wait times as well. When people go on another cruise with RCL, they will already have that prior information to make suggestions based on what they liked and did not like.

CocoCay Modification

Royal Caribbean should be advertising their private island, CocoCay, more. Also, they can be taking advantage of that space and developing it. I recommend adding a driving range in the middle of the island. There are already many activities shown in the map below.

Guests can rent clubs and hone their swing. Because this is highly associated with vacationing, cruisers would easily integrate this into their on-shore experience. This is also a feasible addition, because other ideas like a concert hall are too loud. They would disturb other cruisers, as well as, compromise the wildlife. The fish that people love to interact with while snorkeling would not remain in the area with loud noises.

Figure 82

(Freedom Eastern Compass & Info)

This activity also highly appeals to men who may not be as interested in lying around and improving their tan. If groups want to do separate activities, this may be something that appeals to them.

Chinese Expansion

Royal Caribbean and other cruise lines are aware of the improving economic conditions in China. They are entering that market with their newest ship, *Quantum of the Seas* (Royal Caribbean International). They are using their newest ship to gain market share early, which will increase barriers to entry for other companies. I recommend purchasing another island like CocoCay in the Bahamas. I specifically recommend purchasing Ambil Island for $19.3 million. The island is approximately 5000 acres, so Royal Caribbean has many options to develop it in the future (Ambil Island). An overall investment of $30 million will secure a place in the Asian market place. The island does have a mountain, but that creates privacy for the beaches. Hiking can be a major attraction on this island.

Figure 83

(Google)

Figure 84

(Royal Caribbean International)

Figure 85

(Google)

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