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Carnival Corp
CCL: XNYS (USA)

View Stock Summary

Morningstar Rating for Stocks	Fair Value	Economic Moat	Capital Allocation
★★★★★	$27.50	Narrow	Standard

Rerating Carnival's Moat to Narrow as Brand Continues To Carry Relevance With Consumers

Jaime M Katz • Jan 11, 2024

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Business Strategy and Outlook

Carnival remains the largest company in the cruise industry, with nine global brands and 92 ships at the end of fiscal 2023. The global cruise market has historically been underpenetrated, offering cruise companies a long-term demand opportunity. Additionally, the repositioning and deployment of ships to faster-growing and underrepresented regions like Asia-Pacific had helped balance the supply in high-capacity regions like the Caribbean and Mediterranean prior to the pandemic, a factor which the firm can again utilize to help optimize forward pricing. With an European demand profile that has recently returned to normalized levels, we believe there is plenty of support for improving economic performance at Carnival.

Since consumers resumed cruising in summer 2021 (after a year-plus no-sail halt), cruise operators have been able to reassure passengers of both the safety and value propositions of cruising, all while offering a holiday product at 25%-50% less than land-based alternatives. We expect this discount to shrink over time, bolstering pricing growth as Carnival lifts pricing toward parity aided by the firm's brand intangible asset. This, along with full occupancy and little near-term price pressure, sets Carnival up for medium-term yield gains. On the expense side, with ongoing cost optimization initiatives and rationalized spending on pandemic protocols, spending should be well managed, resurrecting a cost edge. However, higher-than-normal dry dock days along with foreign exchange headwinds could crimp profitability intermittently.

These above factors should lead to average returns on invested capital including goodwill, that will again surpass our 10% weighted average cost of capital estimate. While we don't expect this to occur until 2027, we project earnings before interest to return to prepandemic levels by 2026. Although we believe Carnival has carved out a broad offering across demographics, the product still has to compete with other land-based vacations and discretionary spending for share of wallet, bounding our moat rating to narrow.

Bulls Say, Bears Say

Bulls

As Carnival continues to optimize occupancy, passenger counts and yields could rise at a faster pace than we currently anticipate.

A more efficient fleet composition (after pruning 26 ships between 2020-22) may benefit the cost structure to a greater degree than initially expected, with the fleet at full deployment.

Despite a temporary pause in Asia-Pacific, a return to the market remains promising after COVID-19, as the four largest operators had capacity for nearly 4 million passengers in 2020, signaling an opportunity for long-term growth with a returning consumer base.

Bears

The media accessing negative experience commentary regarding cruise incidents could weigh on Carnival's brand image and pricing leverage, making new cruisers hesitant to try cruising. A decrease in new cruisers leads to fewer repeat cruisers.

Higher commodity prices, particularly in energy, could affect profitability, especially as firms maintain compliance with IMO 2020 guidelines and face an EU emissions tax.

New COVID-19 variants, the reinstitution of no-sail orders, geopolitical concerns, or border closures could further pressure profits, leading to additional liquidity concerns.

Financial Strength

We believe Carnival has secured adequate liquidity to operate undisturbed if demand softens as a result of macroeconomic uncertainty, with around $2.4 billion in cash and investments and more than $5 billion in total liquidity at the end of November 2023. This should help finance any cash demands with the fleet now deployed—during the early part of the pandemic, Carnival's cash burn had run around $500 million or more per month. The company has raised significant levels of debt since the onset of the pandemic with $31 billion in total debt, up from around $12 billion at the end of 2019.

We believe the company is focused on reducing debt service as soon as reasonably possible in order to reduce future interest expense. It has also actively pursued the extension of maturities, limiting the cash demand on debt service over the near term. We don't anticipate an imminent credit crunch in the near term, as long as capital markets continue to function properly. Liquidity remains accessible, as Carnival has access to a $2.1 billion multicurrency revolving credit facility.

Additionally, in order to free up cash to support operating expenses, Carnival eliminated its dividend in 2020 ($1.4 billion in 2019). Another $6.4 billion in current customer deposits were on the balance sheet, offering working capital that can be utilized to run the business and indicating demand for cruising still exists. And equity markets have also been accommodating, with the company facilitating a $1 billion equity raise in July 2022, indicating access to cash remains, although we don't believe Carnival will affect any further equity issuances over the near term.

Economic Moat

We are restoring our narrow moat rating for Carnival, after stripping its moat designation at the start of the COVID-19 pandemic, as we see a line of sight to excess economic rents over a 10-year horizon. We believe Carnival’s moat stems from three sources, including efficient scale, brand intangible assets, and cost advantage. We had taken our moat rating to none, given the uncertainty around the duration of lockdowns and the impact to ROICs. However, recent performance, along with our projected outlook, indicates that ROICs should prove even better than the prepandemic period over our forecast, reaching 18% at the end of our forecast versus 10% in 2019 (when the firm previously held a narrow moat rating) versus our 10% weighted average cost of capital estimate.

To start, we think efficient scale is a key moat source, which has often been evident in highly capital-intensive industries like the cruise industry. This is attributable to the cost of ships (which can run as high as $1 billion for new builds), elevating the capital requirements of operators, and the high fixed costs attributable to the business (we estimate more than two thirds of costs are fixed in the short run).

Additionally, we believe there are significant barriers to entry lending to an efficient scale moat source. In our view, new entrants are unlikely to have access to the cheap financing through export credit facilities, making the cost of ship builds prohibitive. Export credit agencies, or ECAs, offer loans, guarantees, and insurance to help local companies (shipbuilders) limit the risk of selling goods and services abroad. With lower counterparty risk comes lower interest costs. For example, Carnival pays 3% or less on most of its ship financing; smaller players, like Ritz Carlton (currently a part of narrow-moat Marriott), tend to tap the public markets for new ship financing, paying higher rates, crimping near-term returns. And these financing partners were accommodative during the pandemic, postponing amortizing payments while the industry was unable to operate. In addition to special financing for those working with shipyards, there is limited worldwide shipbuilding capacity, making the rapid ramp of a new fleet nearly impossible. Carnival currently has three ships on order for delivery through 2025, while brands like Virgin and Disney have only one and two, respectively, queued for delivery over the same time horizon.

Further evidence of efficient scale stems from sunk costs and historical precedent. As proof of the deep pockets required to facilitate capacity and passenger growth while remaining a mainstay in the industry, Carnival already had invested $40 billion in net property, plant, and equipment, or PP&E, as represented on its balance sheet on Nov. 30, with ships, ship improvements, and ships under construction representing the majority. Also, with regard to new entrants, our methodology indicates that if a market has seen little entry or exit over an extended period, efficient scale is more likely to be present, which has characterized the cruise industry over a multiyear horizon. Buoying our stance on efficient scale underpinning its narrow moat, Carnival represented 44% of global market share in 2016 while, in 2022, it held around 40% market share—even after accounting for the nearly 30 ships that were scrapped or sold since the pandemic—and we see little to suggest a change in its position going forward given earlier mentioned constraints.

We also believe Carnival has a brand intangible asset edge, primarily evidenced by pricing power, industry concentration, and risk aversion that educates purchasing decisions. Pricing power has been exhibited more consistently among the cruise operators in the years leading up to, and post, the pandemic. Carnival closed in on its 2019 net yields per diem in 2023 and is set to surpass prepandemic pricing in 2024. This five-year turnaround in pricing is much faster than the last industry downturn—by 2019, Carnival had still not returned to 2008 prices, despite 11 years passing. Moreover, we think Carnival should be able to grow pricing by around 3% annually over our forecast, modestly ahead of the 1% the firm captured in the five years prior to the pandemic, and above the sub-2% inflation Morningstar is projecting for inflation growth between 2024-27.

We believe this is a byproduct of better revenue management systems, more dynamic pricing, and incrementally enhanced marketing by income and age demographic depending on the brand, itinerary, and price point of the offering. And, from a sourcing perspective, Carnival is uniquely positioned to take advantage of oscillating global demand to maximize price by focusing on consumer geographies with the healthiest appetite for travel. The company has the highest percentage of passengers from outside North America, at 35%, although this metric has historically been closer to 45% given the localized branding Carnival's product lines offer (for example, Aida in Germany and Costa in Italy). We expect the percentage of internationally sourced customers will creep back up again when the global economic and political environments stabilize. This allows Carnival to reallocate ships to the markets that have passengers with the most resilient spending patterns at any given time.

Furthermore, we believe that shying away from discounting to fill the ship and moving to a marketing-focused strategy has brought a more rational line of thought to pricing across the industry over the last five years. Norwegian's prior CEO Frank Del Rio spearheaded the market to fill strategy, preferring to highlight the firm's idiosyncratic offerings rather than lowering prices to maximize occupancy. This strategy helps clearly convey to consumers that to get the best deal and room of choice, booking early is the best strategy and that as the sail date comes closer in, pricing increases are likely and cabin selection becomes limited. Additionally, to prevent pricing pressure during times of waning demand, the company toggles its strategy to add sweeteners (excursion or spa credits, for example) to the product package to entice consumers to come on board, optically holding its total price firm. Utilizing this bundling mechanism helps set consumer expectations on pricing—without systemic discounting, it is unlikely for per diem pricing to be as volatile as in the past. This better protects returns during cyclically weak periods, which we believe is a widespread goal across the industry.

Given the percentage of repeat travelers in cruising and the aversion of travelers to trying another brand with a different experience, we believe stickiness exists for those that have already traveled satisfactorily on one of the existing cruise brands. For comparison, hotel operator chains get around 50% of room nights booked by loyalty members on average, around the slightly more than 50% repeat customers at Carnival (last disclosed, 2021). This is evidenced by the leading market share Carnival has held (by berths). As noted earlier, this hasn't changed materially in recent years. And we don't expect this to change significantly over the decade ahead, given the ship builds already on the orderbook. We surmise Carnival will continue to drive relevance through its capital expenditure programs aimed at elevating the brands by enhancing the product while in dry dock. This is evidenced by the solid performance of recently refurbished ships that have been put back into existing markets in recent years, garnering improved yields (often a high-single-digit or more above than existing hardware) versus pre-dry dock performance.

Lastly, we think Carnival holds a cost advantage moat source benefiting from proximity, buying power, and low-cost financing. As Carnival home ports well-demanded ships in more locations outside of the traditional Florida market, they are closer and more accessible to potential consumers, which should support a stable growth rate of new cruisers. Currently, Carnival has 18 U.S. port choices to embark from, helping reach a significantly higher proportion of the population. For example, the populations of the greater Los Angeles area (around 13 million), New York (24 million), and Seattle (4 million) together represent 41 million potential travelers, more than 12% of the U.S. population, and represent key markets Carnival has home ported ships.

More passengers provide broader scale benefits for the cruise companies, allowing for the delivery of the product at a cost lower than its smaller peer group. Prior to the pandemic, Carnival paid a mid-20% level of net cruise costs on SG&A, while Lindblad, a publicly listed competitor with 17 ships (with capacity under 150) spent more than 50%, indicating that size provides scale efficiency gains. In our opinion, limited global shipbuilding capacity should keep Carnival relatively larger than numerous other operators over the long term, keeping the cost spread wide. Furthermore, below the line, debt financing costs will provide another cost edge to Carnival, as cheaper ship funding through the earlier discussed ECAs will facilitate lower relative interest rates to the peer set. We don’t expect this option to disappear as its purpose is to incentivize foreign companies to support employment in certain industries (shipbuilding). The incumbent cruise operators have articulated such a factor is imperative to continue to participate in new orders.

Fair Value and Profit Drivers

We are lifting our per share fair value estimate for Carnival to $27.50 from $24, stemming from multiple changes to our model. On the plus side, roughly $7 is attributable to a longer stage 2 time horizon associated with a narrow moat rating. However, this was partially offset by slower long-term capacity growth of 2.5% (versus 2.7% prior) in the latter half of our forecast, and nudged up costs per diem (just under 2% from 1.5% prior).

Our other long-term estimates remain unchanged from Carnival's fourth quarter update. At that time, we incorporated continued momentum in consumer interest for the cruise product. For 2024, Carnival offered an outlook for net yield growth of 8.5%, above the 6% we forecast previously. With two thirds of capacity already booked for the year ahead, we see little risk to pricing growth expectations over the next few quarters, as consumers are still booking farther out than in the past, leaving a whopping $6.4 billion in customer deposits on hand. The cost outlook for 2024 was in line with our 4.4% increase excluding fuel, which is higher than optimal, but is impacted by 586 drydock days and modest inflationary pressures (together around 4%).

With cruisers back to traveling in full force, Carnival should see 2024 pricing surpass 2019 levels, as future cruise credits are in the rearview window and consumers continue to seek experiences that provide value. As demand normalizes longer term, we think pricing could grow at a low-single-digit clip (averaging around 3% between 2024 and 2033) as willingness to socially gather remains. We see total costs rising around 2% on average over the next decade.

With the industry back in operation, opportunities to improve Carnival's operating margins should surface; this includes increased scale as occupancy is maximized, improved brand awareness via tactical marketing spend, and better profitability as a result of mix (with numerous underperforming ships sold or scrapped since the beginning of the pandemic), which should increase adjusted EBITDA margins around 29% at the end of our forecast. This is higher than the 27% EBITDA average the company was able to achieve in the five years ending 2019.

Carnival has generated ROICs including goodwill around our weighted average cost of capital assumption of 10% between 2016 and 2019 (coming in at 10.4% in 2017) thanks to improving brand equity, the expansion of the yield management platform (to facilitate strategic pricing), and strict cost containment; however, we expect this metric to remain a bit depressed as a result of a high invested capital base (due to significant capital raises during the pandemic) and don't anticipate the metric will surpass our WACC until 2027.

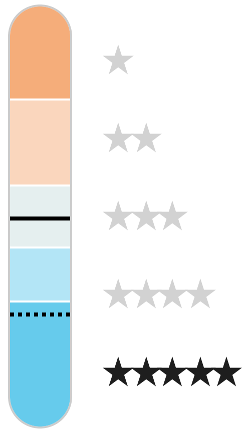
Price vs Fair Value View History >

CCL is trading at a 46% discount.

— Fair Value
$27.50
Jan 11, 2024

Uncertainty
High

····· Price
$14.78
Feb 26, 2024



1-Star Price	$42.63
5-Star Price	$16.50
Economic Moat	Narrow
Capital Allocation	Standard

Terms ⓘ

Risk and Uncertainty

Despite the fleet being redeployed, we still rate Carnival's Uncertainty as High, given the cyclical nature of the business. Carnival faces a number of risks that may affect its value. First, self-inflicted headline and media risk could frame the business poorly, as it did in 2012-13; however, while Carnival implemented a plethora of measures to prevent self-imposed future mishaps from weighing on the business performance, it had been more difficult to escape the fallout from COVID-19 (despite it being an exogenous event). Carnival could be subject to higher product governance costs as the firm maintains improved quality and safety controls as a result of COVID-19, which we capture in our forecast. Second, global economic and political uncertainty could be problematic (for example, the Russia-Ukraine and Israel-Hamas conflicts). Further uncertainty surrounds eurozone economics, financial austerity, and terrorism incidents.

Changes to maritime rules could also impact Carnival's business. In the past, cruise operators have had to reduce sulfur emissions. In response, Carnival had implemented scrubber technology onto much of its existing fleet to ensure compliance with global rules. But this retrofitting came at an explicit cost. While some new ships ordered are set to be powered by LNG, which is better suited to sulfur emission rules, Carnival could be subject to costly environmental compliance when global rules change again.

From a macro perspective, if global economic growth slows, exacerbated as a result of another pandemic or persistent inflation, capturing the same allocation of discretionary dollars as in the past will likely be more difficult than in prior periods. Additionally, a longer-term concern is that changes to the company's tax status under the U.S. Internal Revenue Code could affect profitability.

Capital Allocation

Our Capital Allocation Rating for Carnival is Standard. Forecast adjusted returns on invested capital, including goodwill (10% on average over the next five years) are set to align with our weighted cost of capital estimate (at 10%) over the next few years. The balance sheet is on the mend after COVID-19, considering the company's high revenue cyclicality and operating leverage. Just 14% of the company's $31 billion debt load is coming due between 2024-25, leaving lower liquidity concern now that the firm has returned to profitability. We expect the net debt/EBITDA multiple to fall back under 4 times in 2026, improving the financial flexibility of the balance sheet.

From a leadership perspective, prior Chief Operating Officer Josh Weinstein took the helm at Carnival in August 2022, while prior CEO Arnold Donald moved to vice chairman of the board (Micky Arison remains chairman of the board). We generally prefer the separation of the chairman and CEO roles to promote independence and believe Arison, Donald, and Weinstein will continue to bring tremendous experience and insights regarding forward strategies for the company, so the evolution of leadership is viewed favorably. Given the slow global resumption of sailing, most significant investments were via drydocks as ships came out of layup, but we expect this spend will continue in 2024 in support of elevated brand investments. Historically, the most significant investment has stemmed from the purchase of new ships and refurbishments of the existing fleet.

Furthermore, we deem cash distributions as appropriate, with the management team returning capital to shareholders when optimal. As such, it suspended share repurchases early in the COVID-19 cycle and eliminated dividends. In considering the condition of the balance sheet, we don't expect either effort to resume until 2026, as debt paydown will likely take precedence for the use of excess cash.

Stock Analyst Note

Carnival, Royal Caribbean, and Norwegian Capture Narrow Moats With Better ROICs in View

Jaime M Katz • Jan 11, 2024

Company Report

Carnival Sailing Into Wave Season With Robust Booking Profile Intact, Signaling Solid Travel Demand

Jaime M Katz • Dec 26, 2023

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