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RCL – Royal Caribbean International – Short – Current Price: $70 – Price Target: $36.66 (Book Value)

For a bit of background, my initial short thesis highlighted the reasons why Royal Caribbean is a highly leveraged, highly cyclical business that doesn't generate economic profits or free cash flow, and arrived at the conclusion the company had roughly 61% downside based on nose-bleed valuation levels and macro-economic risks that were quickly approaching. There have been a few material developments since the release of my initial thesis, on September 2nd, that deserve to be addressed. In addition I'm providing addition analysis that illuminates why Royal Caribbean's current business model is inherently flawed, and will continue to degrade shareholder value of time. I'll also analyze an egregious accelerated share repurchased program that was announced and executed at an all-time high share price, an all-time high valuation, and one that management and the board personally sold heavily in to. In addition, I'll take another look at why Royal Caribbean is over-earning on a GAAP P&L basis, and why typical price to earnings multiples used by many analysts who cover the name are irrelevant. So although the stock has experienced a sharp move downward since the beginning of the year, down roughly 32%, I believe the market cap will continue to gravitate towards the intrinsic value of the company's equity (book value), at $36.66 per share.

One of the primary risks I highlighted in the initial write-up was the fact that RCL had given disappointing guidance for four straight quarters. This trend continued in 3Q15 and 4Q15 as the company's "beat" lowered adjusted EPS expectations by $0.13 in 3Q15 and $0.02 in 4Q15, despite missing revenue expectations on both occasions. Concurrent with the company's 3Q15 results RCL offered guidance of $0.90 per share for 4Q15, coming in $0.07 below analysts' expectations. However, the company also initiated a $500M share repurchase program, $200M of which would be repurchased in an accelerated fashion. The repurchase program and the "beat" were enough to provide a subsequent 3.5% increase in the stock that day, October 23rd. The company's 4Q15 release was not greeted with such adoration. On February 2nd the company showed that it had generated revenue of $1.9B, missing estimates by $60M, and adjusted EPS of $0.94 per share, "beating" estimates that called for $0.92. In addition RCL provided guidance for 1Q16 and F2016, both of which fell below street estimates. For 1Q15 the company is expecting $0.30 per share in adjusted EPS, while the street had been looking for $0.46, and for F2016 the company is expecting $5.90-$6.10, while the street had been expecting $6.27. The guidance would represent 50% growth in 1Q16 and 24% in F2016, taking the mid-point of guidance. However, I believe there is material downside to full-year guidance and street estimates based on a quickly deteriorating economic environment in the US, Europe and APAC. Management's guidance for fiscal 2016 assumes NRY to be flat to up 2% (up 2%-4% on a constant currency basis) and net cruise costs per APCD to be down 2.5%-3.0%, this on the back of an increase in capacity of 6.3%. 6.3% is the highest capacity growth since 2011, and 2%-4% NRY growth would be essentially the highest growth during that same period. Opinions can differ, but I would characterize the current environment as "less optimal" than that time period, and yet management is generally expecting higher price growth on significantly higher capacity growth. As a reminder, adjusted EPS is highly sensitive to

NRY growth, moving by roughly $0.30 for each 1% move in NRY. For some historical context, NRY fell by 12.3% in 2009, so it's not out of the question that NRY growth could be negative given a tough, deteriorating economic backdrop. Therefore, while I think RCL will likely "beat" its lowered 1Q16 adjusted EPS expectations, I am highly skeptical of the fiscal year guidance of $5.90-$6.10, and my current estimate using points within management's guidance is $5.42.

While the recent precipitous decline of the company's value is clearly due to concerns regarding the company's first quarter and fiscal year 2016 outlook, as well as potential macro-economic hurdles, the biggest red flag since my initial write-up is one of the most appalling share repurchased I've ever seen. As mentioned previously the company announced a $500M share repurchase program concurrent with its release of 3Q15 results, $200M of which would be executed in an accelerated fashion. Again this could be debated, but to me the only reason to do an accelerated share repurchase is if the stock is clearly beaten down without regard for "intrinsic value", or if management feels business is going to accelerate in such a manner that the current share price represents an incredible opportunity to buy the stock. This is also assuming that the company has a solid balance sheet, and perhaps has cash earning a return of zero that is burning a hole in its pocket. None of these situations were present when RCL announced its $200M accelerated buyback program on October 23rd. At $95 per share the stock was trading within 2% of an all-time high and at an all-time high valuation. In addition the Chinese stock-market and economy were clearly faltering, and now we know that in fact some of the distributors in that country were actually *losing* money on the tickets they were selling (Tickets in China are sold on a distributor basis). Meanwhile oil was crashing, industrial production was one month from printing a negative number, and generally economic indicators were slowing. Moreover, at that time Royal Caribbean had a mere $147M in cash on its balance sheet to go along with $905M in short term debt (not to mention $7.6B more in long-term debt). You might be thinking to yourself, "Well those facts may be true, but perhaps management knows something the public doesn't." Fair enough. Perhaps management knew something I didn't, in which case they would perhaps buy some personal stock given this opportunity. At the very least they wouldn't sell their shares into this accelerated share repurchase, right? Wrong. Management and the board outright sold shares into what appears to be one of the more misused accelerated share repurchase programs in history. It wasn't just one or two members, either. A total of five members of management and the board sold heavily into this program. They didn't even wait one day before blowing out of their personal holdings. CEO Richard Fain sold 80,516 shares ($7.9M) the very day after announcing the ASR. Not to be outdone, COO Adam Goldstein cashed-in 90,000 shares on the same day! All totaled the executives sold 384,779 shares at an average price of $99.12, pocketing just over $38,000,000. The real rub is how the stock, and company, has performed since that time. Given the current price of $70 per share, those sales "saved" the members of management over $11,000,000, while investors who have held through the downturn have been steamrolled.

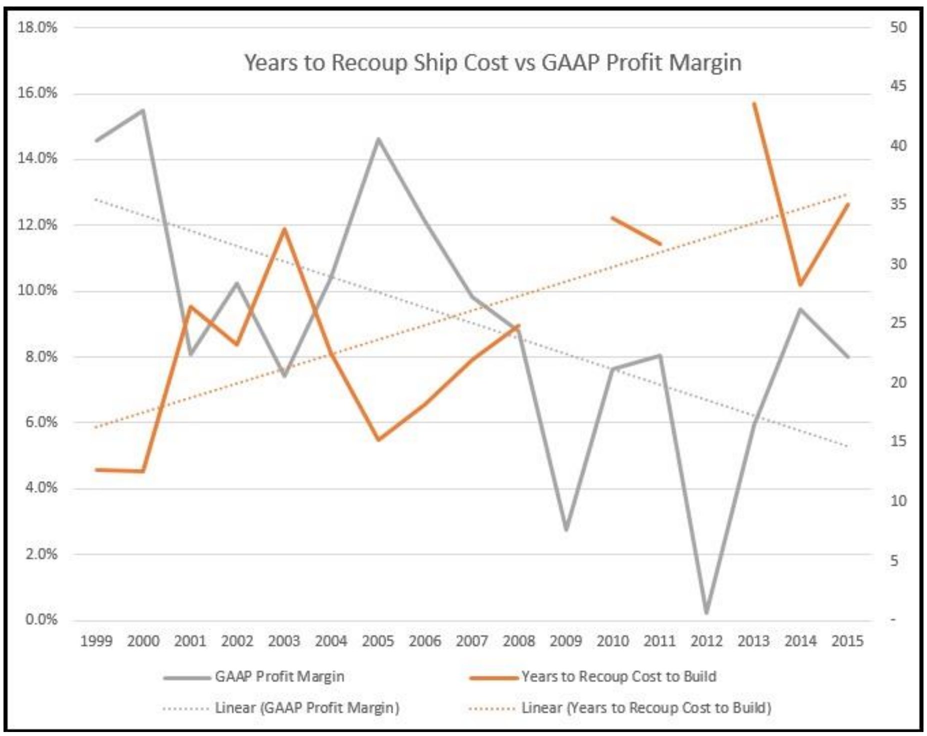
Executive	Shares Sold	% of Holdings	Avg. Price	Total Value	Amount "Saved" Vs. Current Price
CEO Richard Fain	150,516	14.1%	$ 99.15	$ 14,923,661	$ 4,387,541
COO Adam Goldstein	90,000	26.2%	$ 98.88	$ 8,899,200	$ 2,599,200
EVP Harri Kulovaara	8,228	23.1%	$ 100.32	$ 825,433	$ 249,473
Pres. Jorge Vilches	1,035	7.7%	$ 98.50	$ 101,948	$ 29,498
Director Eyal Ofer	135,000	95.8%	$ 98.75	$ 13,331,250	$ 3,881,250
Total	**384,779**		**$ 99.12**	**$ 38,081,492**	**$ 11,146,962**

Perhaps the most egregious sales belonged to Eyal Ofer, a member of the board of directors that authorized the ASR. He took the opportunity to nearly liquidate his entire RCL stake, cashing in more than $13M in outright sales, "saving" almost $4M prior to the subsequent crash. All told the company has squandered more than $50M due to the timing of the ASR, during a period when RCL investors saw roughly $5.5B in market cap evaporate.

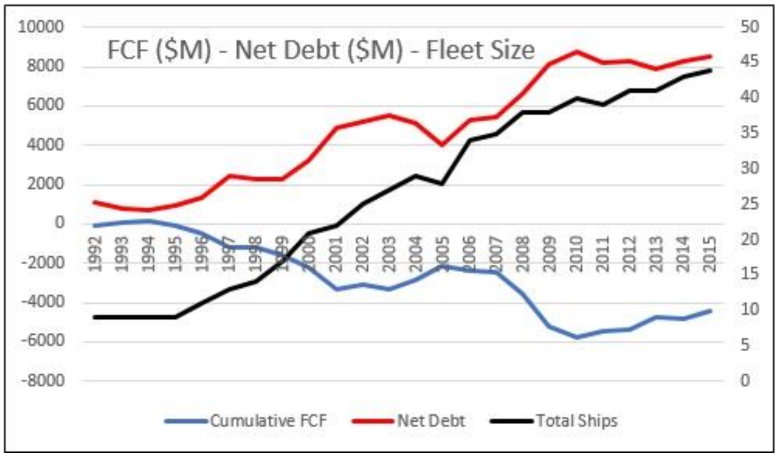
Building off the analysis from my initial report, which shows that the company doesn't create value because RCL hasn't generated a return on its invested capital above its weighted average cost of capital over the past 15 years, the following data set further exemplifies why Royal Caribbean's business does not create value over the long term. I began by isolating the annual GAAP profit per APCD (available passenger cruise days) based upon the company's reported results, and divided that result by 365 to arrive at a daily profit per APCD. APCD is a measure of capacity based on a double-occupied room over a given period of time, in this case over a fiscal year, and therefore my resulting number is essentially a profit per available room on a yearly basis. The next step in the process is analyzing how many days it takes to recover the initial cost, on a per-berth basis. For this I started with my previous analysis on how much it costs to build a cruise ship, and in this case what that number is on a per-berth basis.

Cost per Berth 2010-2015	$233,258
Cost per Berth 2000-2009	$182,207
Cost per Berth 1990-1999	$144,835
CAGR (1995-2015)	2.4%

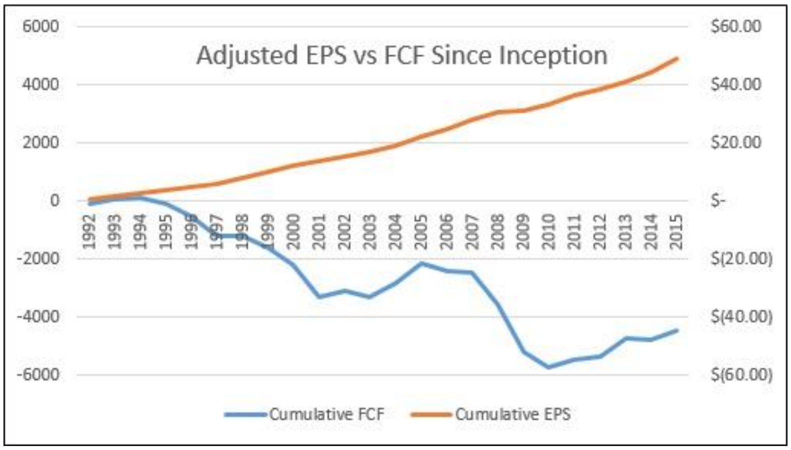
In order to estimate the initial cost-per-berth during any given year, I took the average cost during the first period ($144,835 during the period of 1990-1999), assumed the average cost was $144,835 in 1995, and then used the CAGR (2.4%) for the entire time series to extrapolate the data between 1999 and 2015. I then divided the construction cost per berth by the daily profit per APCD to arrive at an estimated duration that it would take to earn-back the cost on initial construction (divided by 365 to translate to years). The resulting data is illuminating in that it shows the amount of time it takes to recoup the initial cost of a ship has been steadily increasing over the past 16 years. To simplify the data I've removed the data from 2009 and 2012, in which the implied years to recoup the cost per berth was 94.7 years and 1094 years, respectively. Obviously 2009 was a tough year from a macroeconomic perspective, while 2012 included the initial write-down of Pullmantur assets (There have been subsequent write-downs, including 2015).



The solid yellow line represents the implied years to recoup the initial cost of construction on a per-berth basis, while the grey solid line represents Royal Caribbean's profit margin. These two data points are obviously interconnected, but their correlation and trend is what's really illuminating. The data shows that over time RCL's GAAP profit margin has been deteriorating while the time it takes to recoup its initial investments has been increasing. My belief is that this dynamic is largely the result of increased competition and the cost needed to drive sales and increase brand loyalty and awareness. Since 1999 the world has become a more interconnected place, and not only do consumers have more options in terms of how they spend their travel dollars, but they have the ability to connect with and find those options more easily. Because of this increased competition Royal Caribbean has to spend more capital to build and maintain a premier and differentiated product, as well as marketing dollars to attract consumers to that product. As you can see in the above graph, the implied years to recoup the initial cost of the ship has untaken a step function up since 2008, sitting somewhere between 30 and 40 years. This is an issue from an economical value creation standpoint because the useful lives of these ships is more or less 30 years, and the company has funded the initial cost to build its fleet with almost $9 billion worth of debt. It is therefore my view that the value of this company has been transferred from the equity holders to the debt holders over the past 15-20 years.



Another issue regarding the viability and valuation of RCL's business is that I believe the company is over-earning on a GAAP basis, which in turn makes EPS look higher than it otherwise would be. Investors then take this inflated GAAP (or in some years non-GAAP) EPS figure, slap a multiple on it and arrive at a fair value. This is not only inherently flawed because RCL is destroying value on an annual basis because it does not earn its cost of capital, but it is also flawed because RCL is under-depreciating in its GAAP P&L based on a consistent pattern of write-downs. For example, the last four ship "evaluations" have resulted in write-downs. The first, which took place as a part of the Skysea transaction, resulted in a write-down of the Celebrity Century of $17M, or 8% of its carried book value. Something important to consider is that at the time of the sale the Celebrity Century was only 19 years old, and yet it already needed a write-down. The next three "evaluations" occurred as part of the broad Pullmantur write-down during 2015. While not specifically broken out by vessel in the most recent 10-Q, the company took a $113.2M write-down of Pullmantur vessels and aircraft. At the time the market gave the company a pass because it "beat" 3Q15 EPS expectations, and announced the aforementioned ASR, but upon further examination I believe the write-down is something investors should look at more closely. For example, three out of Pullmantur's seven vessels were merely ships that RCL had dropped into the Pullmantur brand from the more premium RCL brand. In essence the company merely transferred old, under-performing assets into a lower quality brand in a lower-quality region, and then subsequently wrote-off the assets within that lower quality entity. Perhaps a pass would be warranted if the original decisions had been made by a prior management or some other extenuating factor, but I do not believe that to be the case here. The point is that there is a consistent pattern of write-downs which leads me to believe that RCL is over-earning in its P&L by under-depreciating its assets on an annual basis, and then taking a write-down that is considered "one-time". Also, keep in mind that by writing off these assets RCL will have less depreciation in its P&L on a go-forward basis, which is a tailwind to its report EPS. The company is quick to highlight headwinds such as interest rates and foreign exchange, but it doesn't highlight the EPS tailwind due to this lower depreciation. This thesis is also validated, to a certain extent, by the long-term discrepancy between the company's non-GAAP EPS versus its cumulative free cash flow.



Overall I stand by the initial thesis that Royal Caribbean's equity value is completely out of touch with the economic reality of the situation. Based on the fact that the company is destroying shareholder value on an annual basis I do not believe RCL should trade at a premium to book value (which would not be a drastic move in relation to RCL's historical trading multiples). In addition RCL holders should analyze the accelerated stock buyback for themselves to decide if they believe management is allocating capital in a value-accretive fashion. My take is that there would be intense scrutiny of the outright insider selling during the ASR if this were a much smaller company, and the motive behind the ASR should be evaluated further. It's not hard to see how investors were lulled to sleep by the incredible momentum of RCL's share price and unabashedly promotional sell-side coverage (see the 4Q conference call Q&A for examples), but the fact remains this is a highly-levered (4x Net Debt/EBITDA), highly-cyclical business that has been destroying capital for the past 16 years. Therefore I believe there is still roughly 47% downside to the intrinsic value of the business, or $36.66 per share.