THE STAHL REPORT

The Contrarian Series

July 9, 2020

Carnival Corp

(BUY)

Price: $14.91
52-Week Range: $7.80 - $51.94
Shares Outstanding: 721m
Market Capitalization: $10,750m

Ticker: CCL
Dividend: None
Yield: n/a

Valuations within this text are based on a $14.91 share price

Exclusive Marketers of The Stahl Report

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Investment Thesis

Carnival, the largest cruise ship operator in the world, is currently suffering one of the worst periods in its history. Since March 2020, the company's cruise ships have been docked and are not expected to resume normal operations until at least September or October of this year. This means that no meaningful revenue is being generated during this COVID-19-related shutdown, and Carnival is sustaining a monthly cash burn rate of $650 million.

Despite this predicament, it raised roughly $10 billion, mostly in debt capital, in very short order. At the end of May 2020, Carnival had $7.6 billion in cash and available liquidity. If operations are able to resume by October 1st, using the current monthly cash burn rate, approximately $5 billion in remaining excess liquidity would be available. Clearly, in a best case scenario, Carnival could survive and gradually begin to rebuild its prior base of cash flow.

In this type of outcome, it is salient to assess the future earnings power, which will initially be below historic levels due to the additional interest expense associated with the new debt. The $9 billion in debt raised since March will require approximately $726 million in annual interest expense. If one were to use the $3.3 billion in operating income generated in 2019 as a forwarding-looking earnings baseline, Carnival could produce after-tax income of $2.3 billion (after making adjustments for the recent debt and equity capital raises). Assuming operations are fully restored, the company could perhaps earn $3/share, which is meaningfully lower than the $4.32/share reported in 2019. However, even at a P/E ratio of 12x, which is well within historical parameters, the shares would be worth $36.13 – a 142% potential return from the current share price.

Although this return could be achieved in a short period of time (meaning, 1-3 years), it does not come without the obvious risks. In fact, the entire industry really faces a binary outcome. If health authority-mandated restrictions are eliminated, future cruise ship booking levels suggest a fairly rapid recovery in passenger attendance rates. On the other hand, health and safety concerns could certainly continue to delay a resumption in cruise activity. Even though the largest operators such as Carnival have sufficient liquidity to withstand a shutdown lasting throughout this year, a prolonged period of inactivity would deplete this cash and perhaps force an existential crisis throughout the industry.

In light of this, one must balance the observable risks with the prospect of an industry recovery and the substantial share price expansion that would follow. At the moment, it appears that a chance of recovery is still well within reason and, consequently, the shares are recommended for purchase.

Company Description

Operations

Carnival is by far the largest cruise ship operator in the world. In terms of passengers carried, it accounted for 43% of the entire industry in 2019. The second largest, Royal Caribbean, accounted for 22%. Thus, these two companies alone control nearly two-thirds of the whole industry. This is somewhat logical, because enormous amounts of capital are required to build the increasingly sophisticated ships (i.e., high barrier to entry). Moreover, ports do not have unlimited docking space, so in theory a flood of new entrants to the market would certainly pose some structural capacity issues.

Carnival operates a variety of cruise brands, each providing a different level of service, itinerary, and entertainment options. The flagship brand, Carnival Cruise Lines, serves mostly the North American market, with 18 ports throughout the United States. The 27 Carnival-branded ships provide numerous food, entertainment, and offshore excursion options, and have recently added celebrity dining features that include restaurants branded by Emeril Lagasse and Guy Fieri. In addition, the company has on order a new ship, the Mardi Gras, that will be docked in Long Beach, California, and will feature the first ever roller coaster at sea. Passengers typically book packages ranging from 2 to 24 nights to destinations that include the Caribbean, Bermuda, Canada, Mexican Riviera, Alaska and Hawaii.

The Princess line, with 18 ships, travels to all seven continents, providing 380 ports of destination around the world. The company markets this as a premium cruise package, with travel options that include South America, the Panama Canal, Europe, Asia, Mexico, Australia, and the Bahamas.

Holland America is a European-themed cruise experience that travels to over 425 destination ports. Guests are provided with European-inspired accommodations, dining, and entertainment options on vacations that can be booked for up to 128 days.

The Seabourn line, comprised of five ships, is an ultra-luxury offering, characterized by smaller ships that provide suite-only room accommodations. Passengers receive customized individual service, upscale dining options, and personalized offshore excursion opportunities. In fact, on the Seabourn Venture, a ship that is scheduled for delivery in 2021, two submarines are carried on this ship that take passengers on underwater excursions at various destinations. Seabourn carries passengers to exotic locations, typically on cruises that last from 7 to 100 days.

Carnival also operates various international cruise lines that are specific to each country. For example, Costa is an Italian brand that carries passengers from Italy to destinations around the world. Other international brands include P&O Australia, AIDA (Germany), and P&O U.K.

While the international operations certainly diversify the revenue stream, North America remains the company's largest market. In 2019, 55% of sales were generated in this region, which is shown in the table below.

Table 1: Carnival Geographic Revenues, 2019

Region	Revenues	*% of Total*
North America	$11,502	*55.2%*
Europe	6,318	*30.3%*
Australia/Asia	2,632	*12.6%*
Other	373	*1.8%*
Total	$20,825	

($ in millions)

Passenger Growth Characteristics

Although the industry has existed for decades, cruise ships as a form of vacation actually have a very low penetration or population utilization rate. For instance, in the United States and Canada, only 3.9% of the total population purchased a cruise ticket in 2018. In other parts of the world, the rates are similarly low: Australia/New Zealand 5.2%, U.K. 3%, Germany/Italy: 2.1%.

Despite this, the passenger growth rate over the last several years has been remarkably steady. At the industry level, the number of passengers carried has increased by 5.4% annually since 2007. Importantly, there has been positive growth in each year during this time, not interrupted even by the Credit Crisis of 2008/2009. Carnival has managed to expand its passengers carried by 4.4% per annum over this time period, somewhat closely matching the industry trend, as shown below.

Table 2: Carnival Passenger Growth Rate

Year	Industry	*% Change*	Carnival	*% Change*
2019	30,100,000	*5.6%*	12,900,000	*4.0%*
2018	28,500,000	*6.7%*	12,400,000	*2.5%*
2017	26,700,000	*10.1%*	12,100,000	*5.0%*
2016	24,250,000	*4.5%*	11,522,000	*6.3%*
2015	23,200,000	*5.3%*	10,837,000	*2.6%*
2014	22,040,000	*2.3%*	10,566,000	*5.0%*
2013	21,540,000	*3.5%*	10,061,000	*2.4%*
2012	20,820,000	*1.6%*	9,829,000	*2.8%*
2011	20,490,000	*7.4%*	9,559,000	*4.5%*
2010	19,070,000	*8.4%*	9,147,000	*7.4%*
2009	17,590,000	*8.0%*	8,519,000	*4.1%*
2008	16,290,000	*2.1%*	8,183,000	*6.7%*
2007	15,950,000		7,672,000	
Annl'zd %:	*5.4%*		*4.4%*	

The consistency of passenger rates is indicative of the customer base which, while relatively small, is quite loyal. Traditionally, cruise vacations appealed to the aging or retired segment of the population. This is because there is a convenience factor not found in most land-based vacation options. A cruise experience allows the passenger to visit multiple destinations, without having to fly or drive to different locations, change hotels/rooms, unpack multiple times, all of which require additional time that most individuals would rather spend on leisure activities (and most cruise companies contract with a travel agency that can also book air travel to the origination port, providing another element of convenience). Most cruises currently available offer the convenience of an all-inclusive package that appeals not only to elements of the older population, but also to families with children.

In fact, the availability of entertainment on cruise ships is actually somewhat astonishing. In addition to the customary unlimited amounts of food and beverages, standard features such as maid service, pool access, group activities, gym access, water slides, and child care provide traditional vacation/hotel amenities. Moreover, some ships now offer more exotic offshore excursions, comedy clubs, jazz bars, galas and balls, casinos, luxury spas, and roller coasters. All of this appears to be not only solidifying the recurring loyalty of the customer base, but also very gradually expanding the passenger market to new demographics.

Operating History

The historically stable passenger growth rate discussed in the previous section has provided a solid base for Carnival's revenues. Since 2007, sales have expanded by 4% annually, which is more or less the historical rate of increase in carried passengers. Of note, as well, was the company's performance during the Credit Crisis. As a provider of a truly discretionary product, one might expect that the severe consumer financial stress during that period would have contracted the cruise ship business substantially. However, revenues declined by only 9.9% in 2009 (relative to 2008), and Carnival actually achieved $1.8 billion in net income. While one might view the current loss of revenues being mandated by government agencies as an aberration, under normal recessionary pressures, the cruise business has proven to be somewhat durable.

Table 3: Historical Carnival Revenues

Year	Revenues
2019	$20,825
2018	18,881
2017	17,510
2016	16,389
2015	15,714
2014	15,884
2013	15,456
2012	15,382
2011	15,793
2010	14,469
2009	13,460
2008	14,947
2007	13,033
Annl'zd %:	*4.0%*

In contrast, the company's profitability has been far more variable, due in no small part to the cost of fuel. The glaring weakness in the business is that cruise companies have not been able to raise ticket prices to a sufficient degree to mitigate the impact of periodic increases in fuel prices. As shown below, this expense can consume as much as 15% of revenues, which was the case during the 2010-2014 period of higher oil prices. Last year, fuel costs represented only 7.5% of total revenues, demonstrating that this is a volatile item on the income statement.

Table 4: Annual Carnival Fuel Expense

Year	Revenues	Fuel Expense	% of Revenues
2019	$20,825	$1,562	7.5%
2018	18,881	1,619	8.6%
2017	17,510	1,244	7.1%
2016	16,389	915	5.6%
2015	15,714	1,249	7.9%
2014	15,884	2,033	12.8%
2013	15,456	2,208	14.3%
2012	15,382	2,381	15.5%
2011	15,793	2,193	13.9%
2010	14,469	1,622	11.2%
2009	13,460	1,156	8.6%
2008	14,947	1,774	11.9%
2007	13,033	1,096	8.4%

Naturally, there is an inverse correlation between fuel costs and earnings. During the 2011-2014 period, Carnival's operating margin was only 9%-11%. Following the swift decline in oil prices, operating profitability improved to a high of 18.7% in 2016, when fuel accounted for only 5.6% of overall sales. While this is largely out of the company's control, it is important to recall that Carnival has successfully managed this variability over time, and remained solidly profitable during normal operating conditions.

Table 5: Historical Carnival Profitability

Year	Operating Margin
2019	15.7%
2018	17.6%
2017	16.0%
2016	18.7%
2015	16.4%
2014	11.2%
2013	8.7%
2012	10.7%
2011	14.3%
2010	16.2%
2009	16.0%
2008	18.3%
2007	20.9%

Valuation

The Carnival shares have lost nearly 70% of their value since February 2020. Despite this, the company still has an $11 billion market capitalization, so it is apparent that investors believe there is a more than reasonable possibility the company will survive the present circumstance. The market capitalization is a reflection of not only the anticipation of a resumption in cruise service later this year, but also the historic earnings power. In the two preceding years, Carnival earned over $4/share, and nearly doubled its profit since 2015, as presented below.

Table 6: Historical Carnival Earnings Per Share

Year	EPS
2019	$4.32
2018	4.44
2017	3.59
2016	3.72
2015	2.26
2014	1.56
2013	1.39
2012	1.67
2011	2.42
2010	2.47
2009	2.24
2008	2.90
2007	2.95

Simplistically, the shares trade at 3.5x last year's reported earnings. However, it is virtually certain the company will not achieve these earnings this year or even in 2021. Any prospective return or valuation must be based on a reasonable estimate of forward-looking profits.

To this end, let us review the measures recently taken to address the lack of revenues since March. Carnival issued 72 million shares at a price of $8, raising $575 million (which will increase the outstanding share count to 756 million). An additional $4 billion was raised through the offering of 11.5% notes due in 2023. Then, $2 billion worth of 5.75% convertible notes due in 2023 was issued. Finally, an existing $3 billion credit facility was fully drawn, providing a cumulative total of $9.6 billion in capital since March[1]. Consequently, any future earnings will be reduced by the added interest expense and per share earnings will be diluted somewhat by the new shares.

As of May 31, 2020, Carnival had $7.6 billion remaining in available cash and liquidity. Currently, the monthly cash burn rate (i.e., cash operating expenses, capital expenditures and other capital commitments) is $650 million. If, as anticipated, some operations resume by October 1st, this four-month period will consume $2.6 billion in cash. However, it is not likely that all operations will resume simultaneously, so one should expect that there will be additional cash burn, even after October. As $5 billion in remaining capital should be

[1] Carnival is considering another $3 billion in capital through a new loan facility that could be priced at LIBOR plus 7.5%. This likely will be used to refinance the $2.4 billion in debt that is maturing in 2020.

available at that point, it appears that sufficient liquidity exists to withstand reduced operating capacity for the remainder of 2020.

The salient consideration is the degree to which operations may begin to normalize in 2021. If this indeed transpires, it is not unreasonable to believe that within two or perhaps even three years the company's capacity utilization might return to historical levels. As to future earnings, operating income in 2019 was $3.276 billion. Excluding any successful efforts to either reduce or refinance the current debt load, total interest expense might be $946 million ($220 million of existing expense plus roughly $726 million related to recent offerings)[2].

After subtracting interest, pre-tax income in this outcome would be $2.33 billion. As a Panama-incorporated company, Carnival pays little in the way of corporate taxes, generally less than 5%. Using the effective 2019 tax rate of 2.3%, Carnival would produce $2.276 billion in net profit. The pro-forma share count should be 756 million, so per share earnings would be $3.01.

For the purpose of this report, a modest 12x P/E multiple is used to determine the future share price. However, this historic average is closer to 17x, so there could well be considerable valuation optionality not included in this analysis.

Table 7: Historical Carnival P/E Ratio

Year	P/E
2019	10.1x
2018	13.0x
2017	19.9x
2016	14.9x
2015	21.3x
2014	28.2x
2013	28.2x
2012	23.2x
2011	12.5x
2010	18.1x
2009	14.9x
2008	6.3x
2007	15.1x

[2] It is roughly assumed that the $3 billion credit facility drawn in March 2020, as it is a LIBOR-plus loan, might incur an interest rate of 5%.

Even at a 12x earnings multiple on the reduced profit base, the shares would be worth $36.13, some 142% higher than the current price. This type of return provides allowance for an analytical error pertaining to the timing of a presumed recovery. For instance, if this were to take five years, the annualized profit would be 24.8%. Moreover, this does not account for future interest expense reduction. If Carnival is viewed as a much more healthy and creditworthy company, it should be able to refinance the emergency debt issued this year at rates far below this level (for example, if the 11.5% notes could be refinanced at even 7%, the company would save $180 million a year in expense, or $0.24/share).

Opponents of this line of reasoning surely will highlight the prospect of a longer-than-anticipated operational shutdown, which would clearly place the balance sheet at risk at some point next year. Even though Carnival has adequate access to capital at present, an increasingly negative operating outlook could reverse this circumstance quickly. This is an observable risk the investor must weigh, because the dynamics of health agencies' responses to COVID-19 are unpredictable. Some investors also question the passenger demand level even when Carnival places ships back into service.

To this point, the future demand for 2021 ticket purchases has been encouraging. Through May 2020, the company reports that next year's bookings are within historical parameters, indicating a somewhat normal demand level into 2021. Since the cruise companies are using the downtime to install medical grade ventilation systems and other health safety features, the loyal customer base may actually emerge rather unphased by the events of this year and resume normal ticket buying patterns.

Conclusion

Carnival is the largest cruise ship operator in the world. Its business has been devastated this year by the mandated stoppage of worldwide cruises in response to COVID-19. Despite no meaningful revenues since March, Carnival was able to raise nearly $10 billion in capital to absorb the substantial operating losses that will be incurred until cruise service resumes later this year. If the company is able to normalize operations over a reasonable period of time, forward-looking earnings power appears to be around $3 per share. Relative to the current $15 share price, one could double one's money over the next couple of years if Carnival can merely restore prior passenger capacity. The risks to this outcome are well-documented throughout the financial media. Yet, if it is believed that the cruise ship industry is not permanently impaired and will adjust over time to current health safety recommendations, the Carnival share price could rise substantially. Thus, the shares are recommended for purchase.

CARNIVAL CORPORATION & PLC
CONSOLIDATED STATEMENTS OF INCOME (LOSS)
(UNAUDITED)
(in millions, except per share data)

	Three Months Ended February 29/28, 2020	2019
Revenues		
Passenger ticket	$ 3,234	$ 3,199
Onboard and other	1,556	1,474
	4,789	4,673
Operating Costs and Expenses		
Commissions, transportation and other	766	709
Onboard and other	471	467
Payroll and related	610	557
Fuel	396	381
Food	277	268
Other operating	1,001	759
	3,523	3,142
Selling and administrative	678	629
Depreciation and amortization	570	516
Goodwill impairment	731	—
	5,502	4,287
Operating Income (Loss)	(713)	386
Nonoperating Income (Expense)		
Interest income	5	4
Interest expense, net of capitalized interest	(55)	(51)
Other income (expense), net	(7)	(2)
	(57)	(49)
Income (Loss) Before Income Taxes	(770)	338
Income Tax Expense, Net	(11)	(2)
Net Income (Loss)	$ (781)	$ 336
Earnings Per Share		
Basic	$ (1.14)	$ 0.48
Diluted	$ (1.14)	$ 0.48

CARNIVAL CORPORATION & PLC
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in millions, except par values)

	February 29, 2020	November 30, 2019
ASSETS		
Current Assets		
Cash and cash equivalents	$ 1,354	$ 518
Trade and other receivables, net	405	444
Inventories	440	427
Prepaid expenses and other	687	671
Total current assets	2,885	2,059
Property and Equipment, Net	38,023	38,131
Operating Lease Right-of-Use Assets (a)	1,469	—
Goodwill	2,176	2,912
Other Intangibles	1,173	1,174
Other Assets	1,216	783
	$ 46,943	$ 45,058
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Short-term borrowings	$ 1,004	$ 231
Current portion of long-term debt	2,196	1,596
Current portion of operating lease liabilities (a)	168	—
Accounts payable	904	756
Accrued liabilities and other	1,754	1,809
Customer deposits	4,690	4,735
Total current liabilities	10,716	9,127
Long-Term Debt	9,738	9,675
Long-Term Operating Lease Liabilities (a)	1,312	—
Other Long-Term Liabilities	887	890
Contingencies		
Shareholders' Equity		
mmon stock of Carnival Corporation, $0.01 par value; 1,960 shares authorized; 658 shares at 2020 and 657 shares at 2019 issued	7	7
Ordinary shares of Carnival plc, $1.66 par value; 217 shares at 2020 and 2019 issued	359	358
Additional paid-in capital	8,829	8,807
Retained earnings	25,527	26,653
Accumulated other comprehensive income (loss) ("AOCI")	(2,028)	(2,066)

ɛasury stock, 130 shares at 2020 and 2019 of Carnival Corporation and 60 shares at 2020 and 2019 of Carnival plc, at cost	(8,404)	(8,394)
Total shareholders' equity	24,290	25,365
	$ 46,943	$ 45,058

This report was produced by Horizon Kinetics ("HK"). The following persons employed by HK contributed to this report: Murray Stahl, Chairman, Steven Bregman, President, and Peter Doyle, Managing Director. HK is located at 470 Park Avenue South, New York, NY 10016. At the time of this report, there are no planned updates to the recommendations. To the extend HK has provided previous recommendations concerning the same issuer(s) during the preceding 12-month period, such recommendations do not differ from the recommendations contained here.

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