# PUBLICATION

## Cruise Industry Opportunities – Land and Sea

**April 11, 2019**

### Introduction (Anchors Aweigh)

The cruise industry, with new ships and new product niches, has been the fastest growing segment of the leisure travel market over the last ten years. Based on the number of ships under construction and new entrants into the market, this trend will continue for the next several years. According to the Cruise Line International Association (CLIA), the industry capacity in 2018 was 260,000 rooms (in cruise industry parlance, that is 520,000 berths, which is measured by person assuming two per cabin). Compared to the broader leisure industry, opportunity abounds for continued growth. The state of Florida has 440,000 hotel rooms, with 120,000 in Orlando alone. The number of total annual cruise passengers is expected to grow from 27 million in 2018 to more than 39 million in 2027, with 106 new ships already on order to be delivered over the next ten years. The trends behind this growth include new entrants to the market and a boom in expedition/experiential cruising in addition to organic growth. The trend of new players in the industry has been primarily driven by the entry of well-known hospitality brands. Although the industry's growth also creates business opportunities for companies providing services and products to the leisure industry, this article will focus on the expansion of existing brands that create new cruise products.

Ritz Carlton, under the brand "Ritz Carlton Yacht Collection," and Virgin Group, under the name "Virgin Voyages," each have three ships under construction. Lindblad Expedition Cruises also operates ships under the National Geographic brand. Disney Cruises has been a player in the cruise industry for 20 years.

Other hospitality companies continue to explore options to monetize their brands and marketing infrastructure in the cruise industry. Companies that pursue this growth opportunity should not do so without performing a serious analysis.

### Business Structures (The Midnight Buffet)

Disney, Virgin and Ritz-Carlton have each structured their entry into the cruise market differently. Disney took the traditional approach with a significant capital investment to own its ships and set up a separate cruise organization with marketing, sales, hotel operations and ship/technical operations distinct from Disney's other operating businesses. This approach is operationally complex and involves a unique set of regulatory and legal rules and standards foreign to most hospitality organizations.

Virgin Voyages has been funded by Bain Capital. Reportedly, Virgin has contributed its brand and management efforts in exchange for equity in the cruise company, which operates as a stand-alone entity, and a licensing fee. The capital for Ritz-Carlton Yacht Voyages was provided by the private equity firm Oak Tree Capital Management (as reported by Oak Tree). Ritz-Carlton will receive a licensing fee, oversee the hotel and spa operations of the ships and provide marketing and sales functions (which will take advantage of its past guest lists and rewards program). It is unclear whether the technical and navigational aspects of the ships will be managed by a third-party ship management company or whether the owner entity will operate the ships themselves. Regardless, Ritz-Carlton will not be involved in the technical and navigational management functions of the ships. The use of ship management companies and third-party ownership is very common in the shipping and cruise industry and is very similar to the structures used in the hotel industry.

National Geographic has entered into a pure licensing agreement and sells cruises through its travel services group.

The simplest structure for an existing brand to enter the market is very similar to the model used in the hotel industry. A third party will provide the capital for and own the ships and will most likely hire the technical management company to operate the ships. The brand company will either: (1) time charter (i.e., lease the ship with the owner maintaining responsibility for the navigation, technical management and maintenance of the ship); or (2) simply license its name and contract to market and sell the passenger accommodations. The brand can either operate the onboard hotel, food, and beverage and entertainment itself or outsource the hotel management of the ships. Variations of these structures have been used in the creation of some of the industry's most successful luxury and expedition cruise products.

Additional ownership structures have been utilized on a limited basis. Luxury ships currently operate with condo-type ownership structures. Vacation ownership of cruise ships is recognized under the Florida Vacation and Timesharing Act. Cabin blocks on existing cruise lines and ship charters have been utilized as product offerings by vacation clubs.

### Minimizing Risk (Batten Down the Hatches)

The simple structure adopted by Ritz-Carlton best minimizes the business risk involved in entering the cruise industry. The capital investment is obtained from private equity or other private investors. Private equity funds have been enamored with the industry, in no small part due to highly successful cruise industry private equity investments in recent years. Several of those investments have achieved very successful exits recently. In a number of jurisdictions, owning ships has considerable tax benefits, including accelerated depreciation, that also attract investors to this asset class. If structured correctly, current U.S. law (Section 883 of the Internal Revenue Code) exempts cruise lines that own and operate ships engaged in international commerce from tax on income "effectively connected" to the operation of those ships. This exemption includes income earned from itineraries that start and end in U.S. ports, provided the voyage includes international ports of call. Most U.S.-based cruise lines only pay taxes on the income derived from land tours occurring in the U.S. These tax benefits are achieved through a combination of incorporation in certain favorable jurisdictions and registration of the ships in favorable jurisdictions that have treaties with the U.S. or provide similar tax benefits to U.S.-registered ships. The tax structures are too complex to cover in this article but meeting the requirements is typically achievable.

A number of businesses and investment funds have business models based on the ownership of ships that are leased or chartered to operating companies. SunStone Ships, located in Miami, currently owns 14 ships and has three expedition ships under construction in China. It owns the ships and provides technical and navigational management through an affiliate and offers hotel management through a separate affiliated ship management company. SunStone does not own or operate the ships under its own brands but exclusively for third parties that market and sell the accommodations under various brands. V-Ships Group, based in Monaco, has managed technical and navigational operations for some of the world's top luxury cruise brands and hundreds of ships, including passenger and cargo under such management.

The use of ship management companies to operate ships for third parties that sell transportation on the ship is extremely common in both the cargo and passenger shipping industries. The operation of a cruise ship is very complex from an engineering and marine perspective. In addition to the navigation and propulsion of a massive ship, the operation involves electrical generation and distribution equivalent to that of a small city, sewage and waste treatment, water treatment, HVAC and the hotel, catering and entertainment operations of a large resort at sea. The difficulty of operating an economically scaled ship management organization of this type is often viewed as a barrier to entry for the industry. However, experienced ship management companies that economically operate hundreds of ships successfully can bridge that gap and risk.

## Risks (Perils of the Sea)

The business risks of entering the cruise industry can be reduced dramatically through the capital provided by various investors in the ships and by the expertise and management scale provided by ship management companies. Liability risks can be minimized in this structure by avoiding ship ownership and properly contracting for ship management. However, due to the unique nature of maritime law and the relationship between a seller of ocean travel and a passenger, it is important for counsel to carefully construct the management arrangements, the ticket contracts and materials shared with consumers, and structure an effective risk management plan.

Although liability and business risks can be minimized, risk to the brand can only be reduced by considerable diligence. Such risks primarily involve negative public relations from serious casualty incidents, environmental violations or incidents and ship breakdowns creating passenger distress. The allure of ocean travel benefits sales efforts but also attracts intensive media coverage when negative incidents occur. Ship safety practices, environmental protection and ship maintenance and management are highly regulated by various international conventions including the Safety of Life at Sea Convention, the Convention for the Prevention of Pollution from Ships and the International Ship Management Code for Safety and the Prevention of Pollution. Ships calling in U.S. ports are additionally subject to strict U.S. laws and U.S. Coast Guard inspections and monitoring. The only way for a brand manager to minimize the risk of a safety, environmental or operational incident that would damage its brand is to pick its partners carefully and establish a rigorous audit program. The ability to perform audits and monitor the manager's compliance program must be clearly stated in the management or charter agreements. For a variety of reasons, including expertise and the attorney-client privilege, these audits should be managed and performed by technical experts engaged by counsel.

## Conclusion (Landfall)

The cruise industry continues to grow rapidly, with most industry experts and players highly optimistic about the future (as evidenced by the current ship order book). Conventional wisdom has previously held that the industry's barriers to entry – access to significant start-up capital, operational scale and marketing/sales scale – are overwhelming. However, in the last 15 years, numerous start-ups have achieved impressive success, and for a strong leisure industry brand these barriers can be overcome easily. Investors have shown eagerness to provide capital and are much more willing to invest when an established brand is tied to the project. The operational scale can be overcome through the ship owner or brand's use of a large reputable ship management company. The marketing, sales and branding scale is essential but can be managed by the brand and brand owner.

We cannot possibly cover all of the issues to be encountered by a hospitality brand entering the cruise industry in this article but we have addressed the significant deterrents. With an even keel and a wide berth, the opportunities are an open sea. There is no downside to exploring the opportunity to participate in this high growth sector of the hospitality industry. Do not miss the boat, be left high and dry, etc. (Apologies, but all puns intended).