BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Charles River Laboratories Intl. (CRL)
EQ Update- 3/20 Qtr

Current EQ Rating*	Previous EQ Rating
4-	4+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We lower our earnings quality rating to 4- (Acceptable) from 4+ (Acceptable) indicating a slight decline in earnings quality given the rise in the add-back of amortization of acquired intangibles.

- CRL acquired HemaCare Corporation on January 3 of 2020 for $380 million. Of the $376 million net purchase price, $209 million was booked as goodwill and $184 million as definite-lived intangibles. Of the intangibles, over 90% was booked as "client relationships and is being amortized over 19 years. The 19-year time frame seems somewhat long at first glance and even more so when one considers the client relationships from last year's Citoxlab deal are being amortized over 13 years. Of course, the amortization period is not relevant to non-GAAP earnings which enjoy the benefit of adding back amortization of acquired intangibles. However, amortization as a percentage of non-GAAP operating income has risen to 23% from 12% two years ago. CRL still posts solid organic growth adjusted for acquisitions so it is not dependent on acquisitions to drive meaningful growth. Nevertheless, the increase in amortization added back to non-GAAP earnings prompts us to lower our rating to a 4- from a 4+.

- CRL's effective tax rate of 14.3% was 300 bps lower than the year-ago quarter courtesy of a larger than expected benefit from stock-based compensation. This added over 6 cps to earnings growth in the quarter. However, this benefit is not material when viewed against the 38 cps earnings beat for the quarter.

- Losses from venture capital investments totaled $12.2 million in the 3/20 quarter versus $10.6 million in gains in the year-ago quarter. These gains and losses are always adjusted out of non-GAAP results. While we agree the volatility associated with these gains and losses requires some adjustments to determine a true profit growth rate, investors should remember that these amounts can regularly equal in the mid-teens as a percentage of non-GAAP net income.

- Lower stock-based compensation added about 3 cps to growth in the 3/20 quarter.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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