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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Charles River Laboratories (CRL) EQ Review Update-6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	NA

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

We initiate coverage of Charles River Labs (CRL) with a 4+ (Acceptable)

CRL posted EPS of $1.62 in the 6/18 quarter. This was 16 cents ahead of the consensus, but 14 cents were a result of higher gains from venture capital investments.

The bulk of CRL's revenue is derived from the delivery of services under contract which are recognized over time. Therefore, there is a relatively large degree of estimation and management judgement involved in arriving at reported revenues and profits. This requires special attention to determine the reliability of reported results. In short, we do not see anything in the 6/18 results indicating results have been overstated. We briefly discuss the recent trends in key accounts and trends to keep an eye on below.

Review of Revenue Recognition Trends

The majority of CRL's revenue relates to services under contract which are recognized as the work is done. By nature, determining the timing of recognizing revenue on the income statement requires a large degree of estimation and management judgement which leaves open the possibility of distortion in reported results. While we noted in an earlier review

that receivables were outrunning sales as deferred revenues were declining, this trend has now reversed itself, making us much more comfortable with recently-reported revenues and profits. The following table shows the trend in client receivables, unbilled receivables and deferred revenues:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Client Receivables	$372.36	$343.55	$335.84	$321.47	$306.24	$301.25	$284.00
Unbilled Receivables	$108.58	$98.80	$96.30	$103.39	$94.52	$84.84	$82.20
Total Receivables	$480.94	$442.35	$432.14	$424.86	$400.75	$386.09	$366.20
Short-Term Deferred Revenue	$130.39	$98.47	$117.57	$108.98	$119.34	$127.59	$127.73
Customer Contract Deposits	$37.54	$23.57	$0	$0	$0	$0	$0
Client Receivable DSOs	58.1	63.5	64.0	63.2	59.6	61.7	55.5
Unbilled Receivables DSOs	16.9	18.3	18.4	20.3	18.4	17.4	16.1
Total Receivable DSOs	75.0	81.7	82.4	83.5	78.0	79.0	71.6
S/T Deferred Revenue Days	20.3	18.2	22.4	21.4	23.2	26.1	25.0
Rec.DSOs less S/T Def. Rev. Days	54.7	63.5	60.0	62.1	54.7	52.9	46.6

In the 6/18 quarter, total receivables (client and unbilled) days of sales (DSOs) declined by 3 days compared to the year-ago period. Meanwhile, short-term deferred revenue days of sales declined, which is ordinarily a concern as it could indicate more aggressive revenue recognition. However, when deferred revenue is recognized, it must first be moved into accounts receivable (if a bill is sent) or unbilled revenue (if a bill is not sent). Therefore, for a complete analysis, one must subtract deferred revenue days from accounts receivable DSOs and track the resulting number. In this case, receivable DSO minus deferred revenue days for the 6/18 quarter was flat versus the year-ago period. Note that is before any adjustment for the receivables added from the 4/3/18 acquisition of MPI Research. We view this as a positive sign for the quality of recently reported revenue.

In addition, the company also recorded substantial customer contract deposits, shown in the table above. These are very similar to deferred revenue in nature, indicating more conservatism in revenue recognition.

We also call to attention that under the new ASC 606 guideline for revenue recognition, CRL has begun to report several new metrics which will be useful in future analysis. One very interesting item is the disclosure of revenue expected to be recognized in the future from current performance obligations in contracts existing at the end of each period. This information is shown in the below table:

Revenue Expected to Be Recognized Under Performance Obligations as of:

	6/30/2018	3/31/2018
Less than 1 year	$715.40	$204.87
1-3 years	$374.95	$310.03
4-5 years	$128.50	$0.00
>5 years	$115.49	$0.00
	$1,334.33	$514.90

This data is not provided on a historical basis, so we cannot analyze the trend prior to the 3/18 quarter. Nevertheless, the strong sequential improvement in the 6/18 quarter seems to bode well for future growth as well as offering no indication of aggressive recognition.

On a final note, we point out that the company has begun to break out its long-term deferred revenue as a separate item in the footnotes. On the balance sheet, short-term deferred revenue has always been reported as its own line item while long-term deferred revenue is lumped into other liabilities, making it impossible to observe trends in the long-term component. (This is why the above table utilizes only short-term deferred revenue.) Long-term deferred revenue for the last three quarters was $11.3 million, $10.3 million and $8.3 million. Given its relatively small size, it is not likely that historical balances materially impacted the above analysis, but this will nonetheless be an important item to monitor going forward.

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 recent 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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