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BTN Earnings Quality Review

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Charles River Laboratories International (CRL)

Despite topping both revenue and earnings targets in the 9/17 quarter, Charles River Laboratories (CRL) saw its stock price pummeled in November after lowering full-year organic revenue growth guidance to 6.5%-7.25% from the previous 7.0%-8.5% range. The midpoint of the guided EPS range was likewise lowered to $4.00 from $4.25 over expected charges related to an upcoming plant closure. However, we noted some concerning trends in the company's revenue-related accounts that may be an indicator of further upcoming revenue headwinds.

CRL's service contracts span several weeks to a few years and involve an agreed upon rate per unit of work or a fixed fee agreement. Revenue is recognized as the services are performed based on a ratio of work performed to work to be provided. Depending upon contract terms, payments may be received in advance of services being performed and revenue recognized which results in the recording of deferred revenue. In other instances, work may be done and revenue recognized before the bill is sent to the client, which results in the creation of an unbilled receivable. The below table shows recent trends in client receivables, unbilled revenues, and deferred revenues for the last few quarters on a days-of-sales basis:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Sales	$464.23	$469.13	$445.76	$466.79	$425.72	$434.06
Client Receivables	$321.47	$306.24	$301.25	$284.00	$278.04	$270.33
Client Receivables DSOs	63.2	59.6	61.7	55.5	59.6	56.8
Unbilled Revenue	$103.39	$94.52	$84.84	$82.20	$84.75	$77.51
Unbilled Revenue DSOs	20.3	18.4	17.4	16.1	18.2	16.3
Total Deferred Revenue	$108.98	$119.34	$127.59	$127.73	$119.30	$118.84
Deferred Revenue Days	21.4	23.2	26.1	25.0	25.6	25.0
Rec DSO+Unbilled DSO-Deferred Rev Days	62.1	54.7	52.9	46.6	52.2	48.1

CRL bought Brains On-Line in August of 2017 and divested CDMO business in February of 2017. Neither transaction materially impacted the above analysis.

Revenues rose by 9% in the 9/17 quarter while accounts receivable jumped by almost 16%. On a sequential basis, sales fell by 1% while receivables jumped by 5%. This led to an increase in receivable-days-outstanding of more than three days. At the same time, unbilled revenue posted a similar disproportionate increase, resulting in unbilled-days-of-sales of two days.

This would not be as concerning if there had been an offsetting increase in deferred revenues. However, exactly the opposite occurred, with deferred revenue actually declining by 8.6% on a year-over-year basis and 8.7% sequentially. This resulted in deferred-days-of-sales falling by over three days. Adding the receivables and unbilled days and subtracting the deferred days gives a good overall picture of how aggressively revenues were recognized in the period. As shown in the bottom line of the above table, receivable-minus-deferred-revenue days rose by 10 days year-over-year in the 9/17 quarter after a 7-day year-over-year increase the previous quarter.

As noted above, the company has already lowered its guidance for revenue growth in the 12/17 quarter which may be taking some of this timing of revenue recognition into account. We are therefore not adamantly predicting a revenue miss in the upcoming quarterly release slated for 2/13. Still we believe investors should be keeping a close eye on these revenue recognition metrics for any signs of further beneficial revenue timing.

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