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BTN Thursday Thoughts

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Potpourri

At the midpoint of earnings season we like to collect various tidbits from press releases and conference calls that pertain to recent themes we have explored in previous Thursday Thoughts. Below are such recent comments as well as an earnings preview on Charles River (CRL) based on earnings quality trends as of the 9/17 quarter.

Opportunities Remain in Infrastructure

Many people wonder if there is still opportunity in infrastructure given the move in some of the equities following Donald's Trump's campaign promises to push for more investment in this area. As we discussed last week, AT&T (T) has a government contract called First-Net to build a 5G network to link all the various first responder emergency personnel in the country. President Trump wants to see 5G go nationwide, and AT&T plans to use this program as the backbone to start 5G for everyone.

Blackstone is one of the largest asset managers in the world and has been setting up an infrastructure investment fund during 2017 as well. It has started with some private investments in pipelines, which is not really what most people are thinking about when infrastructure is mentioned. As far as the traditional infrastructure areas

such as airports, roads, ports, bridges, and investments in internet capacity and speed, Blackstone's Steve Schwatzman and his deputy Michael Chae laid out a great case for the opportunity that exists in these areas. They highlighted that private investment will play a large role in the total infrastructure investment, that deregulation is actually the key to make building it much faster, and the fact that many of these types of projects have historically been under-managed and not subject to cost-cutting efficiency.

Steve Schwarzman at Blackstone:

> "The U.S. is estimating to be roughly $2 trillion minimum short in terms of what's optimum to have in infrastructure. And I think the state of the Union of President mentioned that he had a proposed package of $1.5 trillion. For people like ourselves in our fund, we've geared it to the private sector, because it's very kludgy historically trying to do things with couple of sectors.
>
> The two pieces of what the President mentioned, the first was timing, **the U.S. is the slowest** -- I can't say it's the slowest country in the world, because I haven't surveyed every country but it's completely an outlier in the developed world. **It takes typically 10 years or more to get things approved - in Canada and Germany, for example, it's two years.** So we're five times less effective, which increases the cost of everything that gets done, discourages people from taking new projects and basically limits the asset class and that's that. And of course not all things the governments do could be bought by the private sector, because a lot of them don't have cash flow.
>
> But to the extent that they do, this provides additional opportunities to put money out in scale. And that would be a -- could only be, I believe and my General Counsel maybe jumping up and down, but it could only be a good thing in principle to have more opportunities of different types. And the question is how much money will go into these. So the proposal I think, it's a mix proposal of federal government money, state and local, and private public partnerships and that gets up to that $1.5 trillion number. We're in the private partners focused on private partnership, and that would be cherry on a sundae for us.
>
> We have the sundae in terms of what we think we're going to be doing in the private sector, but its only upside if you will from more things to finance. But particularly if they can agree on just the efficacy of doing infrastructure, try

not to make it the least competitive country in the developed world to give us a shot, and that's got to be very good for this overall asset class."

Michael Chae at Blackstone:

"I'm going to chime in and just look at it from the perspective of the fund, and not so much the country. We don't need any improved legislation or regulatory system to invest this fund really well. There is tons of existing assets out there. One of the fine characteristics are some of these infrastructure assets, many of which are in protected industries, regulated industries. By definition, the structure of a true infrastructure business gives it a quasi-monopoly. And many of those companies are actually rewarded based on what they have invested after all their costs are recovered. So there's no incentive at all for those companies to be run better and sharper and crisper. And that's just not the environment that they exist in.

So we think that there is tons of targets out there where we can bring our value creation capabilities which are honed in highly competitive private sector industries and imply this industry and create tons of value, even in the existing regulatory scheme, what Steve talked about will be fantastic. I'm all for it, and I think we're getting both -- we talk to both republicans and democrats, no one wins with this ridiculously slow system we have. But I think there is tons to do even without it."

Huge Job Growth Behind the Scenes of E-Commerce

In the 12/21/17 edition of *BTN Thursday Thoughts,* we noted that contrary to the thought that online sales involves less physical space and fewer employees, actions by many companies actually show that it uses more of both. The WSJ published news from the Bureau of Labor Statistics this week that online related jobs including fulfillment centers and delivery services are expanding even faster than initial estimates.

Update on Opportunities in US Chemicals

US chemicals were an area we think could see big benefits according to Byron Wien's *Top 10 Surprises for 2018* calling for commodity inflation – largely from oil and faster economic growth pushing demand. **The US chemical sector is an area that could benefit from both rising demand with stronger pricing and subdued feedstock cost**

inflation. In terms of feedstocks, EPD (Enterprise Products Partners), DWDP (DowDuPont), and LYB (Lyondellbasell) all reported 4Q'17 earnings and were in unison:

Hurricane Harvey and cold weather DID disrupt some of the supply movement of Natural Gas Liquids and the refining of them via crackers that were idled during bad weather. However, all see supply still exceeding demand and will keep pricing for these feedstocks low.

LYB's Bob Patel noted, **"The production of ethane was kind of the order of 1.6 million barrels per day, consumption was about 1.3 million barrels per day. So we still have more ethane production than demand.** And this is in a backdrop where propane and butane weren't really in the mix because they were quite expensive [and thus didn't compete with ethane very well]. So as we move through this year and as propane and butane prices moderate, I think that, combined with more ethane coming to market with new fracs and new pipelines form the Permian, **we continue to believe that there's enough ethane nearby the Gulf Coast to supply the new crackers that will come online. And if anything, as you mentioned, higher oil prices will likely increase the output of ethane**, especially from the Permian. So we are watching it, but we continue to believe that ethane supply will be sufficient, if not in excess as we move through the year."

James Fitterling, COO of Materials Science Unit for DowDuPont, added:

> "I think we now look for growth and be a still solid and about 3.7% growth rate as we look forward. China obviously has continued to grow actually; the emerging markets are continuing to grow. So **while new polyethylene capacity has come on in the U.S., not enough has come on really to keep up with the market growth rate.** And if you look at what is happening right now actually ethylene is longer than polyethylene in the Gulf Coast. We don't have enough plans right now in the Gulf Coast to convert it also. I think you're going to see things are going to be a lot more balanced in 2018 and 2019 than people anticipate."

Tony Chovanec SVP at EPD, sees plenty of feedstock, "And with the plentiful ethylene that we have and that number growing especially when you look at the Delaware Basin, people understand this. So, if they're coming [Foreign companies building new US chemical plants] I believe."

Jim Teague EPD's CEO added:

> "Yes, one other thing, and it gets back to our ethane export also, it's a big -- **when crude oil goes up natural gas doesn't, it makes this heck of lot more attractive than it was this time last year."**
> "While the folks don't realize that by 2021 just the state of Texas will be the largest producer of ethylene from steam cracking in the world and that's not counting what is happening across the border in Louisiana. That's in our backyard and the resulting rapid growth in ethylene combined with increased international demand for markets like Asia, creates an ideal scenario in which markets are brought can diversify their supply towards cost advantage U.S. feedstocks."

Second – With these lower feed costs, the chemical companies expect to see strong pricing and strong volumes. In addition, faster economic growth should help drive demand further. LYB reported over 40% EPS growth before the positives of tax changes and DWDP had 18% EPS growth in the 4Q.

LYB noted that the world demand for Polyethylene is rising at 4% annually and the world could absorb 12 new high-scale high-density plants over the next three years. Low density polyethylene could support 14 new plants. Thus, operating rates should remain above 90%.

DWDP added:

> "In fact, for the first time in many years we are seeing broad based synchronous growth around the world. In developed economies in particular, we continued to see strong leading indicators of broad based and sustainable growth. In addition, we see the comprehensive tax reform in the United States as a catalyst for increased domestic capital investment, which will take advantage of enhanced competitiveness and pro-business investment incentives. We are also bullish on developing economics with the emerging middle class in India, China, Africa and the Middle East continued to support sustainable growth."

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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