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Keeps rolling along

Evan Lorenz writes:

The bargain bin is usually the last place to look for a dominant company, especially during a seismic bull market, but that's where you'll find Charles River Laboratories International, Inc. these days (CRL on the New York Stock Exchange). It deserves an upgrade, as we are about to demonstrate.

Charles River is descended from Charles River Breeding Laboratories, a 1947 creation of the young veterinarian Henry Foster. Spotting an unmet market need, Foster filled it with lab rats, which he supplied to Boston's rapidly growing pharmaceutical industry. The founder's son, James, succeeded as CEO in 1992. By 1999, James had led a management buyout and acquired Sierra Biomedical, Inc. The action was an augury of the 70 or so acquisitions that the company would subsequently complete. The cost was $5.6 billion, and the result was 25 years of average annual revenue growth of 11.5%.

Today's Charles River offers rats and mice and apes and more. Its biggest source of revenue is the division of discovery and safety assessment, which assists in the search for new drug candidates and has a suite of tests to determine if a promising molecule is safe ($2.5 billion in the 12 months ended Sept. 28, 2024). Lab animals ranks second ($820.9 million), and manufacturing solutions, which tests for unwanted microbes on the pharma factory line and performs other quality-control and outsourced manufacturing services, comes in third ($766.3 million).

It's hard to overstate Charles River's reach. It breeds half of the lab rodents sold in North America and Europe. The customer has his pick: rats (or mice) with weak immune systems, those with human cells or tissues or ones that are susceptible to cancer, dementia and other specific disorders. Over the past five years, Charles River has had a hand in four out of every five drugs approved by the U.S. Food and Drug Administration.

No single customer contributes more than 3.5% of revenues, with biotech and big pharma dominating the mix. Two-thirds of the top line is sourced in North America.

The pharmaceutical industry always needs new drugs, but spending to discover the next best thing is cyclical. Loss-making biotech firms invest when they can raise money. Thus, the subsector pares back when the IPO and venture market slows down. Established pharmaceutical companies retrench when their profits fall.

In the EZ-money era of 2020–21, early-stage biotech companies saw an influx of cash from venture capitalists and the public markets alike. Fundraising dried up following the brief bear market of 2022 and is yet to fully recover. The pharma industry received a double bump from the pandemic, first in the form of government subsidies to develop a cure and then from the surge in vaccine revenues. Now, after the pandemic (and post the election), government assistance has withered away and inoculation sales have plummeted. Moderna, Inc.'s revenues are estimated to have collapsed to $3.3 billion in 2024 from $19.3 billion in 2022.

The 2022 Inflation Reduction Act has exacerbated the down cycle. The legislative centerpiece of the Biden administration allows the Centers for Medicare and Medicaid Services to renegotiate prices for a small circle of drugs each year (20 in 2029, from 10 in 2026). As high drug prices make the United States the most profitable geography in which to sell, the threat to profit margins has had a chilling affect on business worldwide. The twin miracle weight-loss medications, Ozempic and Wegovy, are among the drugs that CMS has in its crosshairs.

In the third quarter of 2024, Charles River disclosed a 2.7% year-over-year decline in revenues, paced by a 7.4% drop in its division for drug safety and assessment (both rates of change are adjusted for acquisitions and foreign-currency movements). On Jan. 14, management issued a press release saying that company-wide demand continues to languish and implied that revenues would tumble by an additional 3%–4% in full-year 2025 versus prior Street expectations of 0.7% growth.

"[T]here's definitely going to be a slowdown in R&D spending," Foster warned at J.P. Morgan's annual healthcare conference on Jan. 14. "We're seeing every pharmaceutical company in the world pull back in spending, reordering their pipelines, and softer demand than we had anticipated and we had seen previously. That seems to have stabilized, but we don't see any indications that that's going to improve anytime soon."

Charles River, the biggest and most diversified pre-clinical services provider, claims a 30% share in drug-safety testing (the runner-up has a 12% share) and charges premium prices. It's empowered by the preference of its clientele to work with a handful of vendors. But the decline in pre-clinical spending has forced price reductions even at Charles River while smaller peers vie for what's left. Charles Rivers's Ebitda margins are expected to slip to 34% of sales in 2025 from 34.5% in 2024, down from a peak of 37.7% in 2021.

Genetically engineered rodents are well and good, but researchers still require human analogues—apes—to test drug safety and efficacy. In 2023, a joint investigation by the Department of Justice and the Fish and Wildlife Service found that some of the macaque monkeys that Charles River had procured from Cambodia were illegally poached from the wild rather than raised in breeding facilities.

The charges have won the company no plaudits from animal lovers. "Monkey washing," cried People for the Ethical Treatment of Animals, in a campaign to stop the importation of Cambodian primates to the United States through Canada. Under pressure, Charles River last year abandoned plans to build a monkey-breeding facility in Brazoria County, Tex., in favor of a lower-profile alternative in Mauritius.

Charles River Laboratories International, Inc. at a glance

all figures in $ mns except per share data

	TTM*	2023	2022	2021	2020
revenue	$4,060.9	$4,129.4	$3,976.1	$3,540.2	$2,923.9
operating income	528.0	617.3	651.0	589.9	432.7
net income	423.8	474.6	486.2	391.0	364.3
adjusted EPS	10.14	10.67	11.12	10.32	8.13
shares outstanding	51.6	51.5	51.3	51.4	50.6
cash	210.2	276.8	233.9	241.2	228.4
debt	2,326.7	2,647.1	2,707.5	2,666.4	1,979.8
total assets	8,003.8	8,195.0	7,602.8	7,024.3	5,490.8

*12 months ended Sept. 28, 2024.

sources: company reports, the Bloomberg

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Fortunately, downshifts in spending on pharma research and development tend to be brief. "If you look at prior cycles, it looks like we might have maybe two to four quarters of impacts before demand comes back," Elizabeth Anderson, who rates Charles River a hold for Evercore ISI, tells me. Of course, it's not every cycle in which an incoming administration cancels National Institutes of Health grant meetings, as this one has just done, according to a report in the weekend *Wall Street Journal*. As in other areas of public policy, President Nos. 45 and 47 introduces great unknowns.

Lacking a crystal ball to predict when, exactly, demand will inflect higher, the C. River C-suite has turned to a self-help playbook. Foster told his audience on the Nov. 6, 2024 earnings call:

> [W]e are continuing to navigate through this challenging period by remaining laser-focused on our strategy, by aggressively managing our cost structure, by enhancing our clients' experiences to gain additional share and by protecting shareholder value. We have always distinguished ourselves through our exclusive science and preclinical focus, extending our leading position as our clients' preferred global non-clinical drug-development partner. We have navigated challenges before, and we expect to emerge from this period [as a] stronger, leaner and more profitable company and an even more responsive partner for our clients.

On that note, Charles River is embarking on a cost-cutting project that's expected to boost Ebitda by $200 million by the end of 2026. For reference, Ebitda weighed in at $1.1 billion in 2023 and an estimated $1 billion in 2024. Shrinking the workforce (down 6% between year-end 2023 and the third quarter of 2024) and reducing the real estate footprint are some of the means to that desirable end. As a result of its acquisition history, Charles River accumulated more than 150 lab sites around the world. It's closing 10% of its smaller, less profitable locations.

After announcing $1 billion in buyback authorization last August, the company repurchased $100.8 million's worth of shares in the third quarter. For scale, the current market cap stands at $8.4 billion; in the lean years of 2009–11, $686.2 million's worth of stock was bought in.

Covid was a boon to the Charles River share price if not to the Charles River people. It lifted CRL to $458 in September 2021 from $178 in February 2020, the eve of lockdowns. The shares change hands at $163.64 today. Despite the steep selloff, the price has compounded at a 9.9% annual rate since its June 22, 2000 IPO, beating the S&P 500's compound annual return by 1.9 percentage points over that span (both figures include reinvested dividends).

The Street values Charles River on adjusted earnings. Unlike many tech concerns, the biggest adjustment between earnings tabulated under generally accepted accounting principles and management's preferred metric is not share-based compensation (for which CRL does not adjust) but rather acquisition-related charges and amortizations. Out of its 2024 earnings guidance of $10.20 per share, acquisition-related add-backs (mostly in the form of the amortization of intangible assets) account for $2.85 per share.

Long-time readers may remember *Grant's* disparaging our former sparring partner Valeant Pharmaceuticals International, Inc. for doing just this (see the issue dated March 7, 2014). Valeant, which now answers to the name Bausch Health Companies, Inc., filled its drug pipeline by buying other pharmaceutical companies and then telling analysts to ignore the acquisition costs. The problem with this is that drugs have a finite patent life. So just to keep revenues flat, the drug maker had to keep getting more companies. In other words, those acquisition add-backs were not one-offs but ongoing costs. Charles River, in contrast, faces no such revenue cliff when it purchases a company that provides, say, toxicology tests.

The stock today is priced at 16.6 times the 2025 estimate for adjusted earnings, a large discount to the average 23.8 times multiple that Charles River commanded in the five years before Covid. Assuming that 2025 indeed marks the bottom of the pharma R&D spending cycle, one could say (looking at the bargain one had forehandedly purchased) that the stock traded at a discounted multiple to trough earnings.

As of Sept. 28, 2024, Charles River's balance sheet showed $2.2 billion in net debt, a sum equal to 2.2 times trailing Ebitda; operating income covered interest expense by 4.1 times in the third quarter. Ba2/double-B is how the agencies rate the balance sheet, near the apex of junk.

The Street is waiting the cycle out: There are four bulls, three bears and a baker's dozen of undecideds. Even the bears are phlegmatic, to judge by a tepid short interest ratio of 4.3%. Meanwhile, insiders have sold 59,948 shares over the past 12 months for proceeds of $14.6 million. Over that span, sales averaged $244 per share, or 44% above the current price.

In general, insiders do not hold much stock. James Foster, age 74, the founder's son, owns just 231,854 shares, which are worth $39.3 million, or 0.5% of the company.

Charles River "is a cyclical compounder going through a…cyclical downturn," George Livadas, the founder of Upslope Capital Management, which holds a position in the stock, summed up the bull case to his limited partners in his fourth-quarter letter. "Today, shares trade in line with where they did five years ago—despite revenue and FCF/share that are 50% and 30% higher (while being in the midst of a cyclical downturn—i.e., real earnings power should be materially higher)."

Agreed!

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