KeyBanc Capital Markets

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HEALTHCARE: Life Sciences Tools & Services

Earnings Recap / Estimates Change

INC Research Holdings, Inc.

INCR: Impressive Margins Sooner than Expected, but Now What?

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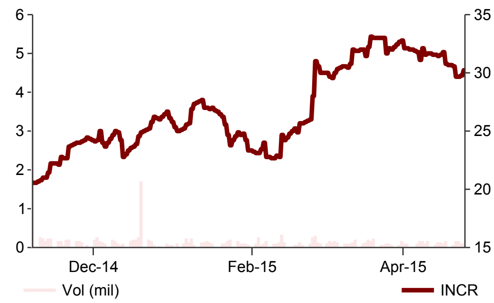
We reiterate our SW on INCR on valuation despite an impressive (and mostly sustainable) 20%-plus 1Q15 EBITDA margin. Our concern now is that R4Q book-to-bill totaled only 1.11x on low cancellations, and EBITDA margins are approaching mgmt's long-term target of ~20%. Private equity liquidations as part of a pending secondary offering may further weigh on the share price.

NASDAQ: INCR	
Rating:	**Sector Weight**
Price Target:	**NA**
Price:	**$35.31**



Sources: Company reports, FactSet, KeyBanc Capital Markets Inc.

Company Data

52-week range	$20 - $35
Market Cap. (M)	$2,161.0
Shares Out. (M)	61.20
Enterprise Value (M)	$2,454.5
Avg. Daily Volume (30D)	107,831.0
SI as % of Float	1.9%
SI % Chg. from Last Per.	171.1%
Book Value/Share	$7.32

Sources: Company reports, FactSet, KeyBanc Capital Markets Inc.

Key Investment Points

We are significantly increasing our 2015 adj EPS estimate to $1.47 (from $1.23), which is roughly in the mid-range of mgmt's upwardly revised guidance of $1.40-$1.52 (from $1.19-$1.29). With a strong 1Q15 adj EBITDA margin of ~21% (ex. one-time items), INCR should comfortably reach mgmt's long-term adj EBITDA margin target of ~20% on a full-year basis. This is much sooner than we had expected. Our updated 2015 EPS estimate also benefits from: i) ~$0.06 related to one-time settlements; and ii) ~$0.05 related to an opportunistic refinancing. *Notably, we have not yet modeled in $150M of planned share repurchases (~$0.08 of potential EPS upside) associated with a pending secondary offering.*

We are also increasing our 2015 organic, constant currency revenue growth to 15.3% (from 14.1%), which calculates to revenues of $893M. Management tweaked its full-year revenue outlook to $880M-$905M from $870M-$900M. In our view, INCR's elevated revenue growth reflects that a large portion of its clinical trial project backlog is now in the patient enrollment and monitoring phases (which have higher burn rates).

Astellas Pharma (~11% of revenues) appears to be successfully transitioning to a full service (programmatic) relationship, and INCR has already won bids on three full clinical projects with Astellas. **Otsuka revenues declined sharply** to ~$20M in 1Q15 (from ~$26M in 1Q14) due to project timing. We expect Otsuka to return to a 10%-plus client for the rest of 2015 based on management's comments.

Estimates

FY ends 12/31	F2014A	1Q15A	2Q15E	3Q15E	4Q15E	F2015E	F2016E
EPS (Net)	**0.83**	**0.42**	**0.30**	**0.36**	**0.39**	**1.47**	**1.66**
Previous	--	0.27	--	0.32	0.34	1.23	1.44
Revenue (M)	**$809.7**	**$211.5**	**$218.2**	**$227.5**	**$236.2**	**$893.4**	**$980.5**
Previous	--	$208.7	--	$227.7	$237.0	$891.6	$980.7
EBITDA (M)	**$145.3**	**$51.2**	**$41.5**	**$44.7**	**$46.6**	**$184.0**	**$196.2**
Previous	--	$37.8	$39.7	$41.4	$43.1	$162.0	$183.1

Sources: Company reports, FactSet, KeyBanc Capital Markets Inc.

Valuation	INCR's current intra-day trading price implies a 20.8x multiple of our revised 2016 adjusted EPS estimate of $1.69, which is a ~12% premium to the current CRO group average (~18.6x). In our opinion, this premium multiple fairly reflects INCR's recent EBITDA growth momentum -- offset by higher bookings volatility and balance sheet indebtedness.
Investment Risks	INCR operates in a competitive industry against other providers that have similar services. The Company's ability to generate revenue and earnings growth is contingent on trends in global biopharmaceutical R&D spending and the propensity of biopharmaceutical firms to outsource R&D and sales activities to third parties. Furthermore, a significant portion of INCR's revenues are generated from clinical trials in central nervous system (CNS) disorders and oncology.

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INCR: Impressive Margins Sooner than Expected

Revenue Outlook

We are not materially increasing our top-line estimates for 2015 or 2016 on an absolute currency basis based on the 1Q15 net bookings and backlog data. On a R4Q basis, net bookings were down ~4% YOY, implying a book-to-bill of 1.11x (vs 1.40x in 1Q14). Backlog of $1.594B was up 5.5% YOY (excluding currency).

Backlog-to-revenue conversion ("backlog burn") continues to be very strong. We are increasing our 2015 organic constant currency revenue growth to 15.3% (from 14.1%). This implies 2015 revenues of $893M. This falls in the mid-range of management's modestly increased guidance of $880M-$905M (midpoint $890M) from $870M-$900M (midpoint $885M), despite higher currency headwind of $40M (from $32M). A large portion of backlog consists of projects that are past startup (e.g., country level approvals and site initiations). Backlog conversion is faster during the patient enrollment and clinical trial monitoring phases.

Astellas Pharma (~11% of 1Q15 revenues) appears to be successfully transitioning to a full programmatic relationship from the previously functional service provider relationship. The agreement has been extended through June (from April) as INCR works through this transition. In fact, INCR reportedly already won three full programmatic projects from Astellas. The Otsuka relationship also appears strong, although revenues from Otsuka sharply declined YOY to only ~$20M (from ~$26M in 1Q14) due to project timing. We expect Otsuka to return to a 10%-plus client through the remainder of 2015 based on management's comments. INCR's overall client mix remained materially unchanged with its top five clients representing 36% of revenues in 1Q15 (vs 37% in 1Q14 and 4Q14).

Profitability

We are significantly increasing our adjusted EPS estimates to $1.49 (from $1.23) reflecting the fact that INCR is approaching its stated long-term adjusted EBITDA margin objective (of ~20%) much sooner than expected.

Our revised 2015 adjusted EPS estimate of $1.49 falls towards the top end of management's raised full-year EPS guidance of $1.40-$1.52 (from $1.19-$1.29). With a strong 1Q15 adjusted EBITDA margin of ~21% (excluding one-time items), INCR should comfortably reach management's long-term adjusted EBITDA margin target of ~20% on a full-year basis. This is much sooner than we had expected. Also, our 2015 EPS estimate benefits from: i) ~$6M (~$0.06) of benefit related to prior-period disputed cost reimbursement (from clients) and settlements of prior-period employee obligations; and ii) ~$4M of lower interest expense (~$0.05) related to an opportunistic debt refinancing expected in 2Q15.

Specifically, **INCR reported a much stronger than anticipated 1Q15 adjusted EBITDA margin of ~21% (excluding the ~$6M of one-time benefits)** – vs. our estimate of ~18%. This strong margin reflects management's success driving efficiencies in the business, including better utilization of staff and facilities as well as the rationalization of IT systems. Also, we think that a high mix of projects are in their highest revenue conversion phases -- i.e., in-patient enrollment and clinical trial monitoring. In 2Q15, we expect margins to soften a bit as backlog mix normalizes, compensation increases go into effect in April, and management steps up hiring in preparation for more clinical trials. INCR ended March with 5,500 staff, and the ~200 hires in 1Q15 mostly occurred late in the quarter. Specifically, we model adjusted EBITDA margins at ~19.5% through the rest of 2015.

Balance Sheet / Capitalization

INCR also announced this morning a secondary offering, potentially of ~8.0M shares. This secondary would primarily consist of the Company's two private equity sponsors, Avista Capital Partners and Teachers Private Capital, and, to a lesser extent, employees who had been locked up following the IPO in November.

In conjunction with this secondary, management also announced that it will buy back ~$150M of shares (or ~4.3M shares at the current share price). Net of ~$100M of additional debt expected to be used to partially finance this share buy-back, **this could potentially equate to another ~$0.08 of EPS upside. We will update our numbers as the secondary equity offering is formally announced.**

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FINANCIAL MODELS

Figure 1: Projected Income Statement

INCR -- GAAP Income Statements (in millions)	2013A	Fiscal Year End, December 2014 1QA	2QA	3QA	4QA	2014A	Fiscal Year End, December 2015 1QA	2QE	3QE	4QE	2015E	2016E
Net Service Revenue	**$652.4**	**$184.7**	**$203.5**	**$207.8**	**$213.7**	**$809.7**	**$211.5**	**$218.2**	**$227.5**	**$236.2**	**$893.4**	**$980.5**
Year-Over-Year Growth, % (Services)	*12.7%*	*17.0%*	*12.3%*	*15.4%*	*29.0%*	*24.1%*	*15.8%*	*7.2%*	*9.5%*	*10.5%*	*10.3%*	*9.8%*
Less: Direct Costs	(432.3)	(120.8)	(130.8)	(129.6)	(134.0)	(515.1)	(125.4)	(140.3)	(146.3)	(151.9)	(563.9)	(628.5)
Gross Income	$220.2	$63.9	$72.8	$78.2	$79.8	$294.7	$86.1	$77.9	$81.2	$84.3	$329.5	$352.0
Gross Margin, % (Services)	*33.7%*	*34.6%*	*35.7%*	*37.6%*	*37.3%*	*36.4%*	*40.7%*	*35.7%*	*35.7%*	*35.7%*	*36.9%*	*35.9%*
less: Selling, General, and Admin	(117.9)	(32.2)	(34.0)	(38.2)	(40.8)	(145.1)	(35.8)	(37.3)	(37.5)	(38.7)	(149.4)	(160.0)
less: Depreciation	(19.2)	(6.9)	(5.0)	(4.7)	(5.0)	(21.6)	(4.8)	(4.9)	(5.0)	(5.0)	(19.6)	(20.6)
less: Amortization	(39.3)	(7.5)	(6.2)	(9.6)	(9.6)	(32.9)	(9.5)	(9.5)	(9.5)	(9.5)	(37.9)	(37.9)
less: Other	(12.3)	(2.8)	(19.7)	(3.0)	(5.9)	(31.3)	(3.6)	-	-	-	(3.6)	-
Operating Income	**$31.5**	**$14.6**	**$7.9**	**$22.7**	**$18.5**	**$63.6**	**$32.4**	**$26.2**	**$29.2**	**$31.1**	**$118.9**	**$133.5**
Operating Margin % (Services)	*4.8%*	*7.9%*	*3.9%*	*10.9%*	*8.6%*	*7.9%*	*15.3%*	*12.0%*	*12.8%*	*13.2%*	*13.3%*	*13.6%*
plus: Interest Income	0.3	0.2	0.0	0.0	0.0	0.2	0.1	0.1	0.1	0.2	0.5	0.8
less: Interest Expense	(60.8)	(16.1)	(12.8)	(12.9)	(11.2)	(53.0)	(5.4)	(5.2)	(3.1)	(3.1)	(16.9)	(12.6)
plus: Other Income (expense)	(1.6)	1.4	(0.3)	5.1	(45.2)	(39.1)	3.5	(4.9)	(4.9)	(4.9)	(11.2)	-
Pretax Income	($30.7)	$0.1	($5.3)	$15.0	($37.9)	($28.2)	$30.5	$16.2	$21.3	$23.3	$91.3	$121.7
less: Provision for Income Taxes	(10.8)	(1.6)	20.6	(2.4)	(11.8)	4.7	(5.3)	(2.4)	(3.2)	(3.5)	(14.4)	(43.8)
Net Earnings	($41.5)	($1.6)	$15.3	$12.6	($49.8)	($23.5)	$25.3	$13.8	$18.1	$19.8	$76.9	$77.9
less: Class C Stock Dividends	(0.5)	(0.1)	(0.1)	(0.1)	(3.4)	(3.8)	-	-	-	-	-	-
Net Earnings to Class A and B Shares	($42.0)	($1.7)	$15.2	$12.4	($53.2)	($27.2)	$25.3	$13.8	$18.1	$19.8	$76.9	$77.9
Diluted EPS (GAAP)	**($0.81)**	**($0.03)**	**$0.29**	**$0.24**	**($0.92)**	**($0.51)**	**$0.40**	**$0.22**	**$0.30**	**$0.32**	**$1.24**	**$1.27**
Diluted Share Count	52.0	51.9	52.2	52.5	57.5	53.5	63.1	61.3	61.3	61.3	61.8	61.3
Non-GAAP Metrics												
Net Services Revenue	**$652.4**	**$184.7**	**$203.5**	**$207.8**	**$213.7**	**$809.7**	**$211.5**	**$218.2**	**$227.5**	**$236.2**	**$893.4**	**$980.5**
Year-Over-Year Growth, % (Period)	*12.7%*	*23.3%*	*27.9%*	*22.9%*	*22.6%*	*24.1%*	*14.5%*	*7.2%*	*9.5%*	*10.5%*	*10.3%*	*9.8%*
Year-Over-Year Growth, % (R4Q)	*12.7%*	*17.0%*	*21.0%*	*22.2%*	*24.1%*	*24.1%*	*21.7%*	*16.3%*	*13.1%*	*10.3%*	*10.3%*	*9.8%*
Adjusted EBITDA	**$105.5**	**$32.6**	**$35.5**	**$36.8**	**$40.3**	**$145.3**	**$51.2**	**$41.5**	**$44.7**	**$46.6**	**$184.0**	**$196.2**
Adjusted EBITDA Margin %	*16.2%*	*17.6%*	*17.5%*	*17.7%*	*18.9%*	*17.9%*	*24.2%*	*19.0%*	*19.6%*	*19.7%*	*20.6%*	*20.0%*
Year-Over-Year Growth, % (Period)	*25.1%*	*80.8%*	*43.5%*	*11.9%*	*35.2%*	*37.7%*	*57.1%*	*16.8%*	*21.3%*	*15.5%*	*26.6%*	*6.6%*
Adjusted EPS	**$0.30**	**$0.14**	**$0.18**	**$0.26**	**$0.26**	**$0.83**	**$0.42**	**$0.30**	**$0.37**	**$0.40**	**$1.49**	**$1.69**
Year-Over-Year Growth, % (Period)	*460.6%*	*-591.4%*	*182.2%*	*62.3%*	*159.0%*	*181.6%*	*207.1%*	*69.9%*	*43.5%*	*54.7%*	*79.3%*	*13.5%*

Source: Company reports and KeyBanc Capital Markets Inc.

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Disclosure Appendix

INC Research Holdings, Inc. - INCR

We expect to receive or intend to seek compensation for investment banking services from INC Research Holdings, Inc. within the next three months.

During the past 12 months, INC Research Holdings, Inc. has been a client of the firm or its affiliates for non-securities related services.

As of the date of this report, we make a market in INC Research Holdings, Inc..

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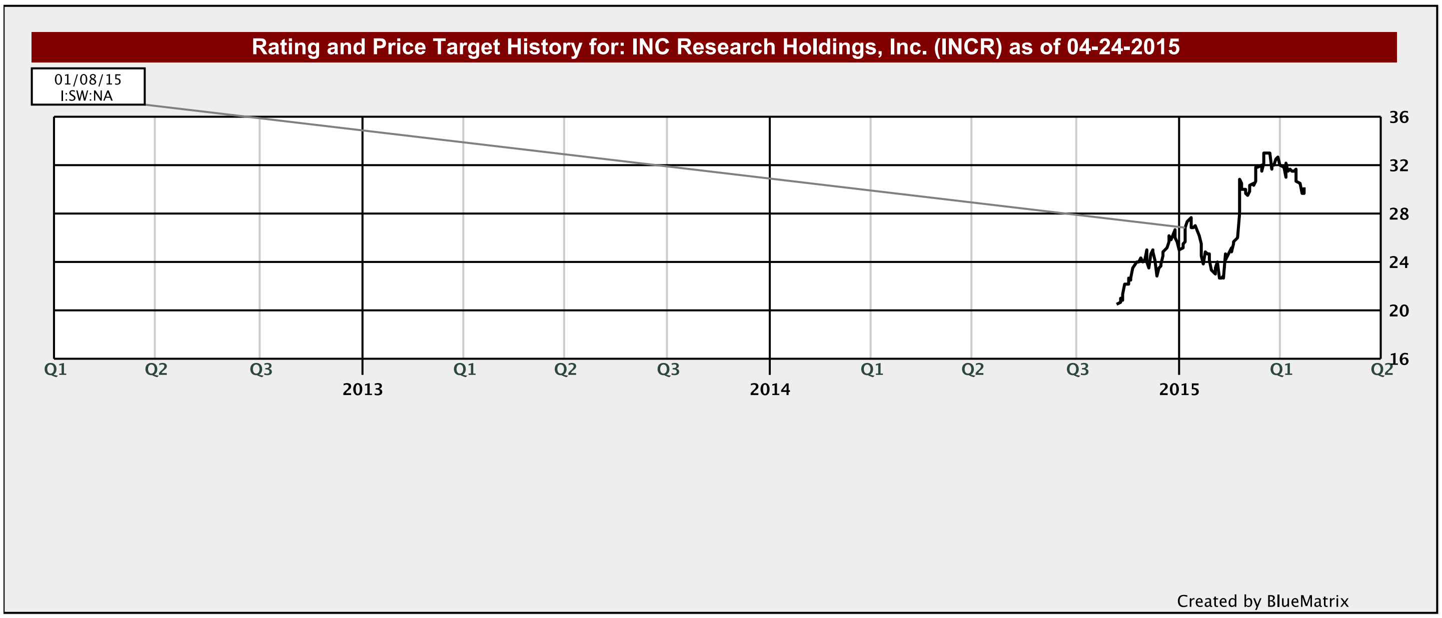
Three-Year Rating and Price Target History



Rating Disclosures

Distribution of Ratings/IB Services

KeyBanc Capital Markets

			IB Serv./Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**
Overweight [OW]	353	45.90	74	20.96
Sector Weight [SW]	394	51.24	79	20.05
Underweight [UW]	22	2.86	3	13.64

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Rating System

Overweight - We expect the stock to outperform the analyst's coverage sector over the coming 6-12 months.

Sector Weight - We expect the stock to perform in line with the analyst's coverage sector over the coming 6-12 months.

Underweight - We expect the stock to underperform the analyst's coverage sector over the coming 6-12 months.

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