

Equity Research

PRA Health Sciences, Inc.

PRAH: Initiating Coverage At Outperform

• **Summary.** We are initiating coverage of PRA Health Sciences, Inc. (NASDAQ: PRAH) at Outperform, with a DCF-derived 12-month valuation range of \$25-26. As a pure-play clinical CRO, PRA benefits from the secular growth trends driving clinical research providers. We believe the company has more margin expansion opportunity than certain peers, which should combine with below-the-line tailwinds to drive 20%+ EPS growth. We believe PRA may also experience less bookings volatility due to its heavy footprint in functional outsourcing (although the absolute level of bookings and also the revenue growth of that business could be lower than average). We set our 2014E/2015E EPS at \$1.06/\$1.31.

• **Clinical pure-play.** PRA derives 100% of its revenue from clinical development, which we view as the portion of the drug development value chain with the best fundamentals. Beyond the growth of overall development spending, CROs benefit from increases in outsourcing penetration. The penetration driver makes clinical CROs a secular growth industry, in our view. Barring significant pharma M&A, we believe the industry can grow 6-8% (half from growth in development spending; half from increases in penetration). Larger CROs should be able to add another 100-200bps of growth from market share gains. Growth beyond 7-9% could come from a focus on higher-growth niches or higher-growth client segments.

• **Margin upside.** In Q3 2014, PRA posted operating margins of 12.4%—lower than most peers. ReSearch Pharmaceutical Services, acquired in Q4 2013, had poor margins due to mispriced contracts and poor utilization. Since closing the acquisition, we believe PRA has resolved about 75% of these issues, but functional business (the focus of RPS), will naturally be lower-margin work than full service business. That said, we believe PRA can achieve 200bps of consolidated margin improvement over the next 3-5 years due to the remaining 25% of RPS synergies as well as efficiency improvements in the core business. Declining interest expense and a declining tax rate should allow EPS growth to exceed 20%.

• **Lower bookings, lower volatility.** We believe PRA's functional business is likely to grow more slowly than full service over the long run, since a) the client base is primarily large pharma and b) we believe functional outsourcing provides less value to the drug development process. If we assume functional will grow slower than full service, the manner in which PRA has chosen to book the work (adding one quarter at a time to backlog) likely means book-to-bill for functional work will be below 1.1, but generally more stable. Because bookings volatility is a concern for CROs, we think adding stability to bookings could be a positive.

Valuation Range: \$25.00 to \$26.00 from NE to NE

Our valuation range is DCF-based (WACC = 8.5%; terminal NOPLAT growth = 2%) and represents 19.6x our 2015 EPS estimate. Risks include: (1) project cancellations or delays due to client M&A, economic weakness, pipeline reprioritization, or compound failure; (2) a reversal in the trend toward increased outsourcing; (3) regulatory risks; (4) significant financial leverage; (5) integration risks, and (6) controlled company status.

Investment Thesis:

Between high-single digit revenue growth, ongoing margin expansion, and a reduction in interest expense, we believe the company will be able to generate solid 20%+ earnings growth for several years, which we believe is attractive growth at current valuation levels.

Please see page 14 for rating definitions, important disclosures and required analyst certifications

All estimates/forecasts are as of 12/08/14 unless otherwise stated.

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Outperform / V

Sector: Pharmaceutical Services

Market Weight

Initiation of Coverage

	2013A	2014E	2015E	
EPS		Curr.	Prior	Curr. Prior
Q1 (Jan.)	NE	0.18 A	NC	0.29 NE
Q2 (Apr.)	NE	0.33 A	NC	0.32 NE
Q3 (July)	NE	0.30 A	NC	0.34 NE
Q4 (Oct.)	NE	0.29	NE	0.36 NE
FY	0.22	1.06	NE	1.31 NE
CY	NE	NE		NE
FY P/EPS	100.3x	20.8x		16.8x
Rev.(MM)	\$833	\$1,265		\$1,360

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
V = Volatile, * = Company is on the Priority Stock List

Non-GAAP EPS excludes amortization of purchased intangibles and certain non-recurring items.

Ticker	PRAH
Price (12/05/2014)	\$22.06
52-Week Range:	\$18-23
Shares Outstanding: (MM)	60.0
Market Cap.: (MM)	\$1,323.6
S&P 500:	2,075.37
Avg. Daily Vol.:	0
Dividend/Yield:	\$0.00/0.0%
LT Debt: (MM)	\$932.0
LT Debt/Total Cap.:	56.0%
ROE:	29.0%
3-5 Yr. Est. Growth Rate:	22.0%
CY 2014 Est. P/EPS-to-Growth:	NM
Last Reporting Date:	10/31/2014

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters

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Together we'll go far



Investment Thesis

Summary. We are initiating coverage of PRA Health Sciences, Inc. (NASDAQ: PRAH) at Outperform, with a DCF-derived 12-month valuation range of \$25-26. As a pure-play clinical CRO, PRAH—the fifth largest player, by our estimate—benefits from the secular growth trends driving clinical research providers. We believe the company has more margin upside than many peers, which should combine with declining interest expense to drive solid 20%+ earnings growth. We believe the company may also experience less bookings volatility due to its heavy footprint in functional outsourcing (although the absolute level of bookings and also the revenue growth of that business could be lower than average).

Clinical pure-play. PRA derives 100% of its revenue from clinical (phase I-IV) development, which we view as the portion of the drug development value chain with the best fundamentals. We believe clinical CROs can meaningfully outgrow the low-to-mid-single digit growth of overall development drug spending due to persistent increases in outsourcing penetration. The penetration driver makes the industry a secular growth industry, in our view. As evidence, Exhibit 1 shows quarterly and trailing twelve months (TTM) industry book-to-bills going back to 1998. It is clear that book-to-bills decline during waves of big pharma M&A, but we think the fact that industry TTM book-to-bills trough at about 1.1 during each M&A wave supports a secular growth view of the industry. Barring significant pharma M&A, we believe the industry can grow 6-8% (half from growth in development spending and half from increases in penetration). Larger CROs should be able to add another 100-200 bps of growth from market share gains. Growth beyond 7-9% could come from a focus on higher-growth niches or higher-growth client segments.

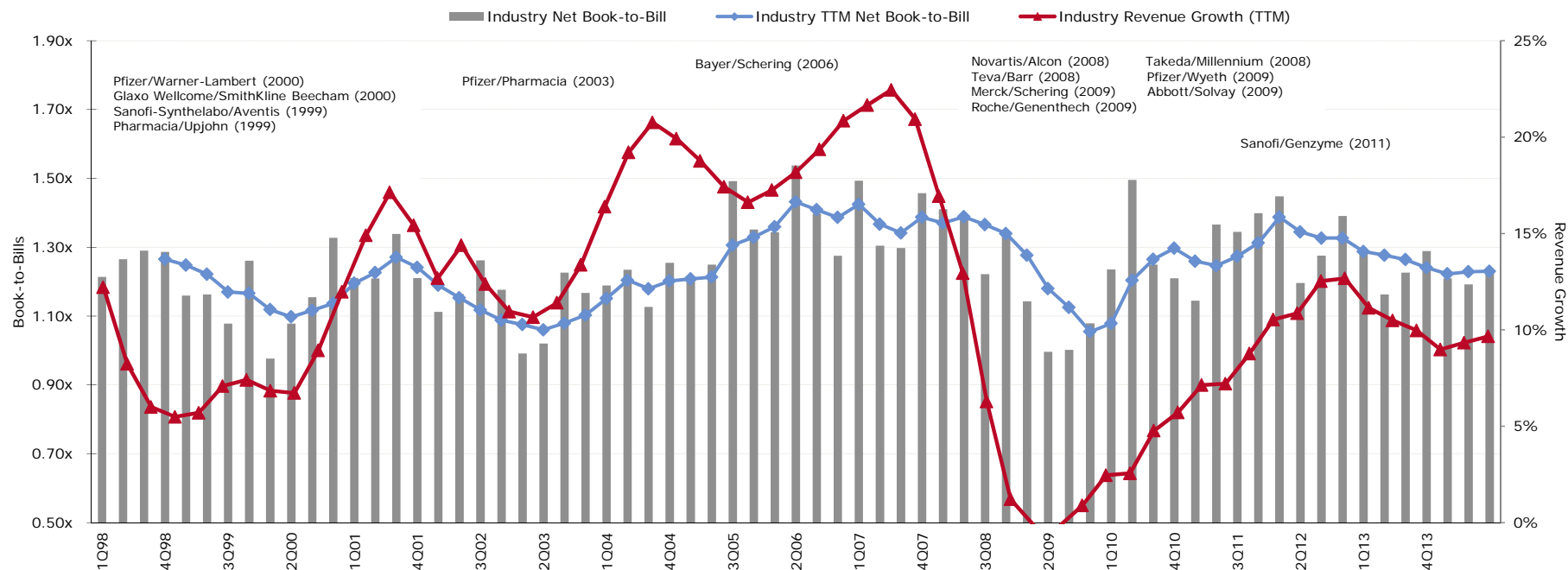
Margin upside. In Q3 2014, PRA posted operating margins of 12.4%, which is lower than most peers. ReSearch Pharmaceutical Services (RPS), acquired in Q4 2013, had poor margins due to mispriced contracts and poor utilization. Since closing the acquisition, we believe PRA has resolved about 75% of these issues, but functional business, which was the focus of RPS, will naturally be lower-margin work than full service business (lower risk means lower profitability). That said, we believe PRA can achieve 200 bps of consolidated margin improvement over the next 3-5 years due to the remaining 25% of RPS synergies as well as efficiency improvements in the core business. Revenue growth plus margin expansion should result in mid-teens operating income growth. Declining interest expense and a declining tax rate should allow EPS growth to exceed 20%.

Lower bookings, lower volatility. PRA groups its functional and embedded business into a unit called Strategic Solutions. (To avoid confusion with the other common use of the term "strategic" in the CRO space to describe large partnerships, and to avoid confusion between functional and embedded services, we will refer to Strategic Solutions simply as the functional business). PRA's functional business largely consists of the RPS business acquired in 2013 and now makes up about one-third of total company revenue.

We believe PRA's functional business is likely to grow more slowly than full service over the long-run because a) the client base is primarily large pharma rather than faster-growing biotech, and b) we believe functional outsourcing provides less value to the drug development process. To elaborate, we believe full service, programmatic outsourcing within a partnership structure adds the most value because it allows the CRO to bring the full scope of its expertise and experience to bear on the process (witness Pfizer's dramatic shift from functional to full service to drive better efficiencies). Functional and embedded outsourcing, on the other hand, gives the CRO less room to leverage its own capabilities but is more stable work. We think the inherently lower margin nature of functional outsourcing has to do both with the lower risk involved in the contract structure but also the reduced value added to the overall development process.

If we assume functional will grow more slowly than full service, the manner in which PRA has chosen to book the work (adding one quarter at a time to backlog) likely means book-to-bill for functional work will be below 1.1, but generally more stable. Because bookings volatility is a concern for CROs, we think adding stability to bookings could be a positive.

Exhibit 1. Long-Term Industry Book-to-Bill Trends



Source: Company Filings, Wells Fargo Securities, LLC

Investment Risks

Cancellations and delays. In our view, the greatest risks to a clinical CRO (including PRA) are cancellations of backlog, negative scope modifications to booked contracts, delays in starting new projects, and delays in signing new orders. Cancellations and delays can occur for numerous reasons, including (1) the failure of experimental drugs for scientific reasons, (2) a restructuring or reprioritization of pipeline at a pharma customer, (3) disruptive mergers and acquisitions (M&A) in the customer base, (4) lack of financing, and (5) competitive losses.

Significant leverage. By our estimate, PRA will close 2014 with a leverage ratio of about 5.3x trailing-twelve-months (TTM) EBITDA. This leverage ratio is much higher than other public companies in the sector (Quintiles is the next highest at 3.0x). PRA's leverage creates higher default risk, should the company lose a significant amount of business for any reason. Leverage also constrains PRA's ability to make additional investments, should attractive opportunities arise.

Integration risk. The 2013 acquisition of RPS increased PRA's revenue base by about 60% and was a transformative acquisition. RPS, however, operated at very low margin (less than 5%) due, in part, to mispriced contracts. PRA has improved the discipline around pricing and has achieved certain synergies. However, we believe some integration risks remain.

Foreign exchange exposure. PRA has exposure to foreign exchange fluctuation, since the currency mix of revenue and costs are not necessarily matched. The company receives 80-85% of revenue in USD and has 55-60% of costs in USD. Meanwhile, EUR makes up 10-15% of revenue and 15-20% of costs, while GBP is a minor amount of revenue but 5-10% of costs. Other currencies make up a minor amount of revenue but nearly 20% of costs.

Controlled company status. Following the IPO, KKR will continue to own approximately 60% of shares outstanding, effectively limiting the ability of other shareholders to exert influence on management. As such, the company is classified as a "controlled company" under NASDAQ rules, which permits the company certain exemptions from corporate governance requirements, such as director independence.

Reduced disclosure under the JOBS Act. According to the Jumpstart Our Business Startups Act of 2012 (JOBS Act), for which PRA currently qualifies, the company is an emerging growth company, which permits reduced reporting and other regulatory requirements, which may offer investors reduced visibility or reduced assurances regarding the effectiveness of financial control.

Company Overview

PRA Health Sciences is a pure-play clinical (phase I-IV) contract research organization (CRO). By clinical revenue, we believe the company is fifth largest in the industry. With investors now choosing among five public companies deriving a significant majority of revenues from clinical contract research, we believe differentiation becomes a key question. Exhibit 2 shows some of the key quantitative measures to consider when differentiating CROs (setting aside valuation for a later section in this report).

- **Financial.** PRA is the fourth largest public CRO, following ICON. However, it has the lowest operating margin among public companies, which is due primarily to the acquisition of RPS, which operated at a low-single-digit margin. The company has the highest leverage ratio in the sector.
- **Business mix.** Like INC, PRA is a pure-play clinical CRO, but it derives about one-third of its business from functional outsourcing (which includes embedded services). We believe most other CROs derive less than 10% of revenue from functional business. In addition to its functional business, PRA has a larger phase I business than peers, as a percentage of revenue. Phase I, however, has been a volatile market in recent years.
- **Customer concentration.** PRA's top client concentration is less than 10%, which compares favorably to peers. The top five client concentration (38% of revenue) is the median of the public group.
- **Therapeutic mix.** PRA derives 35-40% of revenue from oncology, which we believe is higher than peers on a percentage of revenue basis. Oncology is a high-growth therapeutic area, which should keep revenue growth at the higher end of the industry range, although as noted in our thesis, we believe the addition of RPS may dilute revenue growth slightly.
- **Geographic mix.** We do not believe geographic mix is a significant differentiator among INC, PRA, ICON, and PAREXEL. In our view, only Quintiles can claim to have a truly more global footprint than the other public companies.

The bottom line in terms of quantitative differentiation is that PRA's most differentiated aspects are as follows: (1) lowest margin in the group, (2) highest leverage in the group, (3) the largest phase I and functional businesses among public peers, and (4) significant focus on oncology.

Exhibit 2. A Comparison Of Metrics Across Public Clinical CROs

	INCR	PRAH	ICLR	PRXL	Q
Financial Profile					
TTM Revenue (MM)	\$ 770	\$ 1,242	\$ 1,458	\$ 1,982	\$ 4,106
TTM EBITDA Margin	18.2%	13.1%	16.5%	14.8%	16.7%
Leverage	2.8x	5.3x	-	1.3x	3.0x
Employees	5,400	10,300	10,700	15,980	32,100
Revenue per employee (000s)	\$ 154	\$ 121	\$ 145	\$ 123	\$ 132
Business Mix					
Phase I	4%	10%	5%	8%	2%
Phase II-IV Full Service	89%	57%	80%	73%	67%
Phase II-IV Functional	7%	33%	8%	5%	5%
Central Lab	-	-	7%	-	6%
Stand Alone Technology	-	-	-	14%	-
Contract Sales	-	-	-	-	20%
Preclinical/Other	-	-	-	-	-
Total	100%	100%	100%	100%	100%
Customer Mix					
Top Client	15%	8%	31%	17%	8%
Top Five Clients	34%	38%	52%	47%	35%
Therapeutic Mix					
Oncology/Hematology	20%	37%	26%	30%	21%
CNS	45%	20%	16%	12%	26%
Other	35%	43%	58%	58%	53%
Total	100%	100%	100%	100%	100%
Geographic Mix					
Europe	38%	32%	42%	36%	40%
U.S.	48%	58%	46%	46%	35%
APAC & ROW	14%	10%	12%	18%	25%
Total	100%	100%	100%	100%	100%

Source: Company data and Wells Fargo Securities, LLC estimates

RPS. A key part of PRA's growth strategy hinges on leveraging the RPS acquisition, in our view. We think RPS was a poorly managed asset for many years, as evidenced by its perennially underperforming margin. PRA has benefitted from the synergies associated with right sizing the RPS cost structure and rationalizing pricing, with additional synergy opportunities still remaining. However, fully realizing the potential of the deal goes beyond cost synergies and managerial improvement to significant cross selling opportunities. RPS predominantly serves large pharma, while legacy PRA was focused on a biotech-centric client base. Thus, the deal allows PRA to cross-sell its full service offering into RPS's large pharma customer base. It also gives PRA enough scale to compete for larger partnerships, where it has already seen some success following the acquisition.

Exhibit 3 offers an illustration of the difference between functional and full service structures. In the full service model, a given CRO handles all functions across a single trial (in our illustration, CRO 1 would handle all functions for trial A, while CRO 2 would handle all functions for trial B, for instance). In a functional model, a given CRO handles a single function across all trials (in our illustration, CRO 1 would handle clinical operations across trials A, B, C, and D, while CRO 2 would handle data management across trials A, B, C, and D).

Exhibit 3. Full Service Model Compared To Functional Model

		Trials					
		A	B	C	D		
Functions	Clinical Operations	X	X	X	X	Functional CRO 1	
	Data Management	X					Functional CRO 2
	Medical Writing	X					Functional CRO 3
	Training	X					Functional CRO 4
		Full Service CRO 1	Full Service CRO 2	Full Service CRO 3	Full Service CRO 4		

Source: Wells Fargo Securities, LLC

RPS specializes in a subset of functional outsourcing called embedded outsourcing. In an embedded structure, a CRO assumes responsibility for a pharmaceutical company's workforce in a given functional area (re-badging is the common term), but the trial is still run on the pharmaceutical company's systems and in the pharmaceutical company's facilities, despite the employees now being on the CRO's payroll. This contrasts with traditional functional outsourcing, in which employees conduct trial work using the CRO's systems and facilities.

PRA's "Strategic Solutions" business is about one-third of total company revenue and encompasses both traditional functional outsourcing as well as embedded outsourcing. Embedded outsourcing encompasses about two-thirds of the Strategic Solutions business, with traditional functional outsourcing making up the remaining third. The embedded model tends to be focused on large pharma customers since smaller biotechs and pharmas do not usually have their own systems.

From an economic standpoint, we believe full service (particularly under a partnership structure) creates the most value for sponsors because it gives the CRO the most control, allowing the CRO to drive efficiencies into the process. Under functional or embedded models, the pharmaceutical company maintains more control over the entire process, pushing the CRO's role closer to a staffing provider. As a result, functional or embedded work tends to be lower margin, in our view.

Technology. PRA offers its own clinical trial management platform, which is basically a backbone cloud to which other systems can be connected. The company also has a proprietary informatics solution, which processes 30 different data streams using a proprietary algorithm to provide useful information for making the clinical trial process more efficient.

The degree to which PRA's technology is a differentiator remains an unanswered question. Quintiles, ICON, and PAREXEL each boast their own technology platforms, each having its own strengths and weaknesses.

Addressable market. As shown in Exhibit 4, we believe the total addressable market (TAM) for clinical CROs is about \$40 billion and is about 50% penetrated, making the clinical CRO market about \$20 billion. We believe the top nine CROs in total account for about 60% of the market, and within that group, PRA is the fifth largest, with about 6% market share.

Exhibit 4. Phase I-IV Market Share And Size (2014E)

Company	2014E Mkt Share
Quintiles	15%
PAREXEL	10%
Pharmaceutical Product Development (PPD)	9%
ICON	7%
PRA Health Sciences	6%
inVentiv Health	4%
INC Research	4%
Covance	4%
Medpace	2%
Others	40%
Total	100%
Total CRO Market (MM)	\$ 20,000
Total Addressable Market (MM)	\$ 40,000
Penetration	50%

Source: Company filings; Wells Fargo Securities, LLC Estimates

Facilities and operations. The vast majority of operations are conducted out of 75 offices in 35 countries, all of which are leased. The company also has eight leased phase I facilities in the U.S., The Netherlands, and Eastern Europe, with over 450 beds in total. The company's headquarters are located in Raleigh, North Carolina.

As of September 30, 2014, the company had 10,600 employees, 50% of which are in the U.S. and Canada and 32% of which are in Europe, with the remainder in Africa, Latin America, and the Asia Pacific region.

Company history. PRA Health Sciences was founded in 1976 as the Anti-Inflammatory Drug Study Group (AIDS Group) with a focus on data management in rheumatology studies. The company changed its name in 1982 to Pharmaceutical Research Associates (PRA) amid the AIDS scare in the early 1980s. By 1991, PRA had opened its first office in Europe and had expanded its focus beyond anti-inflammatory to become a full service CRO.

In 1996, PRA was acquired by the Carlyle Group. In 2001, the Carlyle Group sold PRA (at that time known as PRA International) to Genstar Capital Partners. Through this period, the company augmented its capabilities with bolt-on acquisitions. PRA's major acquisitions are shown in Exhibit 5.

In 2004, Genstar took the company public, with the stock trading on the NASDAQ as PRAI. PRA continued acquiring smaller CROs over the next three years, before being taken private again by Genstar in 2007. In 2008, the company moved its headquarters to Raleigh, North Carolina from Charlottesville, VA, and in 2010, current CEO Colin Shannon replaced outgoing CEO Terry Bieker.

After several years without significant acquisitions, PRA's activity picked up again in 2011. Notably, the company also increased its service offerings in China through a joint venture with WuXi PharmaTech in 2012.

In 2013, KKR acquired PRA from Genstar for \$1.3 billion and merged the company with ReSearch Pharmaceutical Services (RPS), which KKR acquired only one month after it acquired PRA. In 2014, the company was renamed PRA Health Sciences.

Exhibit 5. Recent Acquisitions.

Transaction	Date Closed	Type	Payment (MM) & Consideration		Location	Annual Rev (MM)	Notes
CRI Lifetree	Dec-13	A	\$ 77	Cash	New Jersey	\$40	Early stage patient population studies in CNS
RPS	Sep-13	A	\$ 268	Cash	Pennsylvania	\$440	Embedded service CRO
Itociu	Mar-13	JV	\$ 0	Cash	Japan	NA	JV w/ RPS for Japanese services; PRA owns 49%
ClinStar	Feb-13	A	\$ 45	Cash	Russia	\$30	Eastern European CRO
WuXi	Dec-12	JV	\$ 5	Cash	China	NA	Clinical CRO services in China; PRA owns 49%
Kinship	May-11	A	ND		India	ND	Software development
Pharmacon	2007	A	ND		Germany	ND	Phase I
Pharma Bio-Research	2006	A	ND		The Netherlands	\$40	Early phase and bio-analytical
Sterling Synergy	2006	A	ND		India	ND	
GMG BioBusiness	2005	A	ND		UK	ND	
PerinClinical	2004	A	ND		India	ND	
Valid-Trio	2004	A	ND		Russia	ND	
ClinCare Consulting	2003	A	ND		Russia	ND	
Staticon	2002	A	ND		Spain	ND	
CroMedica Int'l	2002	A	ND		Canada	ND	
ARCAM	2000	A	ND		France	ND	
Valorum	1999	A	ND		UK	ND	
Int'l Medical Technical	1997	A	ND		Kansas	ND	Phase I unit

Source: Facset; Company filings; Wells Fargo Securities, LLC

A=Acquisition; D=Divestitures; L=License; JV=Joint Venture; ND=Not Disclosed; NA=Not Applicable

Leadership. We believe PRA has a strong management team characterized by a notable amount of management experience at Pharmaceutical Product Development. Consistent with PRA's status as a controlled company, the company has found that only one director is independent, although we expect the board to become more independent over time.

Exhibit 6. Board

Name & Current Responsibilities	Age	Class*	Primary Association(s)	Other Current Boards
Colin Shannon <i>Chairman (since 2010)</i>	55	Exp. 2016 Not Independent	*PRA Health Sciences, Inc. - President & CEO	
James C. Momtazee <i>Director (since 2013)</i>	42	Exp. 2016 Not Independent	*KKR - Member, Head of the Americas Health Care	*Lake Region Medical
Ali J. Satvat <i>Director (since 2013)</i>	37	Exp. 2015 Not Independent	*KKR - Director - Health Care industry team	*Coherus BioSciences
Jeffrey T. Barber <i>Director (since 2013)</i>	61	Exp. 2015	*Fennebresque & Co. - Managing Director	*Ply Gem Holdings *SciQuest
Max C. Lin <i>Director (since 2013)</i>	33	Exp. 2017 Not Independent	*KKR - Director - Health Care industry team	*Biomet

Source: Company filings; Wells Fargo Securities, LLC

*Classified Board with staggered terms; Directors are Independent unless stated otherwise
Current as of December 2014

Exhibit 7. Senior Management

Name and Current Responsibilities	Age	Background
Colin Shannon <i>CEO (since 2010)</i>	55	*PRA Health Sciences - COO (2007-2010) *Pharmaceutical Product Development - Various roles (1995-2007) (most recently EVP, Global Clinical Operations)
Linda Baddour <i>CFO (since 2007)</i>	56	*Pharmaceutical Product Development - CFO (2002-2007) *Pharmaceutical Product Development - CAO (1997-2002) *Pharmaceutical Product Development - Controller (1995-1997)
David W. Dockhorn, PhD <i>Compliance Officer (since 2012)</i>	53	*PRA Health Sciences - Various roles (1997-2010) *International Medical Technical Consultants
Paul Bunch, PhD <i>EVP of Operations (since 2014)</i>		*CSL Behring - VP, Head of Global Project Management (2012-2014) *Covance - VP, Head of Global Project Management (2009-2012)
Willem Jan Drijfhout, PhD <i>EVP, Early Development (since 2006)</i>		*Pharma Bio-Research - (1996-2006)
Tami Klerr <i>EVP of Business Development (since 2012)</i>		*InfraCare - VP Clinical Operations *Pharmaceutical Product Development - Various roles
Haris Koffer, PharmD <i>President, Strategic Solutions (since 2013)</i>		*RPS - Various roles (2006-2013) *Quest Diagnostics - VP, Clinical Trials *Covance - VP, GM of Clinical Services
Sean Leech <i>EVP, Product Registration EAPA (since 2012)</i>		*DOCS - President (2007-2010) *ICON - Various roles (1999-2007)
Steve Powell <i>EVP, Informatics & Late Phase (since 2012)</i>		*PRA Health Sciences - Various roles (2006-2012) *Datatrial - VP (2005-2006) *AVOS Life Sciences - VP (2003-2004) *INC Research - VP (2002-2003)
Samir Shah <i>COO, Strategic Solutions (since 2013)</i>		*RPS - Various roles (2000-2013) *US Bioscience *Zeneca Pharmaceuticals *PAREXEL
Andrew Strayer <i>EVP, Product Registration Americas (since 2012)</i>		*PRA Health Sciences - SVP of operations (2011-2012) *Gloucester Pharmaceuticals - VP, Clinical Ops *Naryx Pharma - VP, Clinical Ops & Medical Affairs *Pharmaceutical Product Development - Various roles
Kent Thoeke <i>EVP, Scientific & Medical Affairs (since 2012)</i>		*PRA Health Sciences - VP Scientific & Medical Affairs (2006-2012) *Pharmaceutical Product Development - Various roles (1999-2006)

Source: Company filings; Wells Fargo Securities, LLC
Current as of December 2014

Recent Financials and Outlook

Bookings and backlog. In 2012, the company posted a 1.09 net book-to-bill (lower than normal due to a large cancellation in Q1 2012), but was then able to achieve 15% constant dollar organic revenue growth in 2013 due to accelerating backlog conversion. In 2013, the company posted a 0.93 net book-to-bill, partially due to some client attrition upon the KKR deal and subsequent acquisition of RPS in late 2013. The company has now recovered from those issues and has posted a 1.17 book-to-bill for first nine months of 2014.

For full service projects, the company books work into backlog after receiving a written or electronic correspondence confirming the award. For functional or embedded work, the company places into backlog only the anticipated revenue to be realized over the next twelve months, which should result in a book-to-bill of between 1.05-1.10 for the functional business, assuming the functional business grows 5-10% per year. Assuming the full service business can produce a 1.2 book-to-bill (the baseline assumption we use across the clinical CRO group), we believe the company's consolidated book-to-bill is likely to be closer to 1.15.

Revenue. Following constant dollar organic growth of 15.2% in 2013, we are forecasting 8.4% constant dollar organic growth in 2014. The company targets long-term revenue growth of about 8%, which is consistent with our model and consistent with a slight decline in backlog coverage and book-to-bills of 1.15-1.20.

Operating margin. Based on our estimates, which include stock-based compensation, we estimate the company will report a 12.0% operating margin in 2014, which is an increase from 10.5% in 2013. This margin is at the lower end of the group, despite excluding amortization of intangibles. The WuXi joint venture (JV) and the inherently lower margin of the functional business should keep the margin at the lower end of the group, but we believe the company still has room to improve the margin by at least 200 bps over the next 3-5 years.

Two company-specific items are worth noting when it comes to margin. First, the company has particularly high amortization of intangibles due to the implementation of push-down accounting in conjunction with the KKR transaction. The company plans to exclude amortization of intangibles from non-GAAP reporting figures, which is inconsistent with the methodologies of ICON, PAREXEL and Quintiles. We believe it is important to remember this when comparing peers.

Second, the company recognizes revenue from the WuXi Pharmatech JV because PRA believes it carries risk in the execution of those studies. The operating margin on these revenues is 0%, and the earnings are reported as "equity in earnings from unconsolidated JVs." Once the JV becomes of a material size, we believe it could distort the margin, and the company's decision to exclude earnings and losses from non-GAAP EPS creates a mis-match, in our view (we decline to allow this exclusion from our non-GAAP estimates).

Interest and other expense. We expect interest expense to decline in 2015 as the company uses IPO proceeds to repay debt. On a GAAP basis, other income can be volatile due to large FX translation gains and losses, which the company intends to exclude from non-GAAP results.

Tax rate. We believe the company should experience a declining tax rate, from about 35% in 2014 to 30% in 2015 and into the high-20% range beyond 2015.

Sharecount. The company issued approximately 19.5 million new shares on the IPO (including over-allotment), leading to an outstanding sharecount of about 59.8 million. Considering the timing of the IPO and the expected dilutive effect of options, we forecast an average diluted sharecount of 46.1 million in 2014 and 63.3 million in 2015.

Earnings per share. Rolling the above items together, we forecast EPS in 2014, 2015, and 2016 of \$1.06, \$1.31, and 1.67, respectively, representing EPS growth in excess of 20%.

Balance sheet and cash flow. The company has the highest leverage among public peers. After using IPO proceeds to repay debt, we estimate the company will close 2014 with about \$932 million of debt and \$63 million of cash for a leverage ratio of 5.3x and a net leverage ratio of 5.0x. We expect the company to continue paying down debt at a rate of about \$100 million per year. At that rate, it should take about two years to reach a leverage ratio more comparable to that of peers.

Valuation

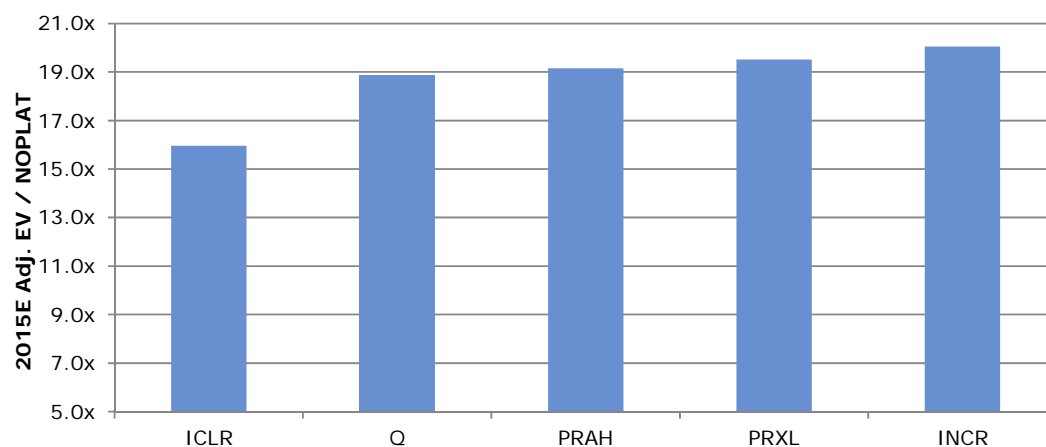
Relative valuation. Relative valuation for PRA shows the stock trading at a premium on EV/EBITDA but at a discount on P/E (see Exhibit 8). It is also problematic that PRA's EPS estimates exclude amortization of intangibles (as does INC), while ICON, PAREXL, and Quintiles include amortization. To rectify these inconsistencies, we normalize valuation multiples to correct for non-GAAP accounting differences, among other smaller discrepancies. Exhibit 9 shows the results of normalization, which puts PRA at the median of its peers.

Exhibit 8. Comparable Valuation Table For Clinical CROs

In millions			Price	Market	Ent.	EV / EBITDA		P / E	
Company Name	Ticker	Rating	12/7/14	Cap	Val	2014E	2015E	2014E	2015E
ICON	ICLR	1	\$ 52.94	\$ 3,260	\$ 3,011	11.6x	10.6x	19.1x	17.0x
INC Research	INCR	1	\$ 23.56	\$ 1,442	\$ 1,695	11.4x	10.5x	26.1x	19.6x
PAREXEL	PRXL	1	\$ 57.18	\$ 3,146	\$ 3,209	10.8x	9.5x	23.3x	19.7x
Quintiles	Q	1	\$ 57.37	\$ 7,088	\$ 8,486	12.1x	11.6x	21.7x	19.8x
MEDIAN						11.5x	10.5x	22.5x	19.7x
PRA Health Scien	PRAH	2	\$ 22.06	\$ 1,324	\$ 2,193	12.6x	11.3x	20.9x	16.8x
PRAH PREMIUM / (DISCOUNT)						9%	7%	-7%	-15%

Source: FactSet; Wells Fargo Securities, LLC estimates

Exhibit 9. Normalized Multiples



Source: Wells Fargo Securities, LLC estimates

Absolute valuation. Our \$25-26 valuation range is derived from a ten-year DCF model using a WACC of 8.5% and a terminal growth rate of 2%. Exhibit 10 shows the details of our DCF model.

Exhibit 10. Discounted Cash Flow Summary

In millions except per share FY ending December	1 2014E	2 2015E	3 2016E	4 2017E	5 2018E	6 2019E	7 2020E	8 2021E	9 2022E	10 2023E	Term Yr 2024E
Revenue	\$ 1,265	\$ 1,360	\$ 1,482	\$ 1,608	\$ 1,745	\$ 1,884	\$ 2,016	\$ 2,137	\$ 2,244	\$ 2,333	\$ 2,380
Revenue growth		7.5%	9.0%	8.5%	8.5%	8.0%	7.0%	6.0%	5.0%	4.0%	2.0%
Adjusted EBITA	\$ 159	\$ 177	\$ 201	\$ 226	\$ 254	\$ 284	\$ 314	\$ 344	\$ 366	\$ 383	\$ 397
EBITA margin	12.5%	13.0%	13.6%	14.1%	14.6%	15.1%	15.6%	16.1%	16.3%	16.4%	16.7%
Adjusted taxes	\$ (55)	\$ (53)	\$ (57)	\$ (64)	\$ (72)	\$ (81)	\$ (89)	\$ (98)	\$ (104)	\$ (109)	\$ (113)
NOPLAT	\$ 103	\$ 123	\$ 144	\$ 163	\$ 182	\$ 203	\$ 225	\$ 246	\$ 262	\$ 274	\$ 284
Depreciation	\$ 23	\$ 24	\$ 26	\$ 28	\$ 28	\$ 29	\$ 29	\$ 29	\$ 30	\$ 30	\$ 30
Gross cash flow	\$ 126	\$ 147	\$ 171	\$ 190	\$ 210	\$ 232	\$ 254	\$ 275	\$ 292	\$ 304	\$ 314
Investment in working capital	\$ (38)	\$ (50)	\$ (28)	\$ (30)	\$ (27)	\$ (24)	\$ (21)	\$ (18)	\$ (15)	\$ (12)	\$ (12)
Net capital expenditures	\$ (27)	\$ (33)	\$ (32)	\$ (30)	\$ (30)	\$ (30)	\$ (30)	\$ (30)	\$ (30)	\$ (30)	\$ (30)
Investment in capitalized op. leases	\$ (12)	\$ (13)	\$ (15)	\$ (16)	\$ (17)	\$ (18)	\$ (19)	\$ (20)	\$ (18)	\$ (16)	\$ (14)
Free cash flow	\$ 49	\$ 51	\$ 96	\$ 114	\$ 136	\$ 160	\$ 184	\$ 207	\$ 228	\$ 246	\$ 258
Ending PP&E	\$ 75	\$ 84	\$ 90	\$ 92	\$ 94	\$ 95	\$ 96	\$ 96	\$ 97	\$ 97	\$ 97
Dep as % of beg. PP&E	29.8%	31.9%	31.2%	30.7%	30.7%	30.7%	30.7%	30.7%	30.7%	30.7%	30.7%
Discounted at:											
7.5%	\$ 46	\$ 44	\$ 77	\$ 85	\$ 95	\$ 104	\$ 111	\$ 116	\$ 119	\$ 119	\$ 1,917
8.5%	\$ 45	\$ 43	\$ 75	\$ 82	\$ 90	\$ 98	\$ 104	\$ 108	\$ 110	\$ 109	\$ 1,526
9.5%	\$ 45	\$ 43	\$ 73	\$ 79	\$ 86	\$ 93	\$ 97	\$ 100	\$ 101	\$ 99	\$ 1,238

WACC	7.5%	8.5%	9.5%
Explicit period	\$ 916	\$ 864	\$ 816
Continuing value	1,917	1,526	1,238
Value of operations	\$ 2,833	\$ 2,391	\$ 2,054
Adjusted for mid-year	\$ 3,058	\$ 2,605	\$ 2,258
Non-operating assets	\$ 19	\$ 19	\$ 19
Non-equity claims	(1,065)	(1,065)	(1,065)
Equity value	\$ 2,012	\$ 1,559	\$ 1,213
Per share	\$ 32	\$ 25	\$ 19
Implied terminal EV / NOPLAT	13.9x	12.1x	10.8x
% of value in explicit period	32%	36%	40%

Source: Wells Fargo Securities, LLC estimates

Continuing Value Assumptions	
Perpetuity NOPLAT growth rate	2.0%
RONIC in perpetuity = Year 10 WACC plus:	1.0%
Cash tax rate	28.5%
Implied terminal EV / NOPLAT multiple	12.1x
Other Data	
Non-operating assets	\$ 19
Non-equity claims (including op. leases)	\$ 1,065
Diluted shares	63
Current month	12

RONIC = return on newly invested capital

Exhibit 11. Earnings Model

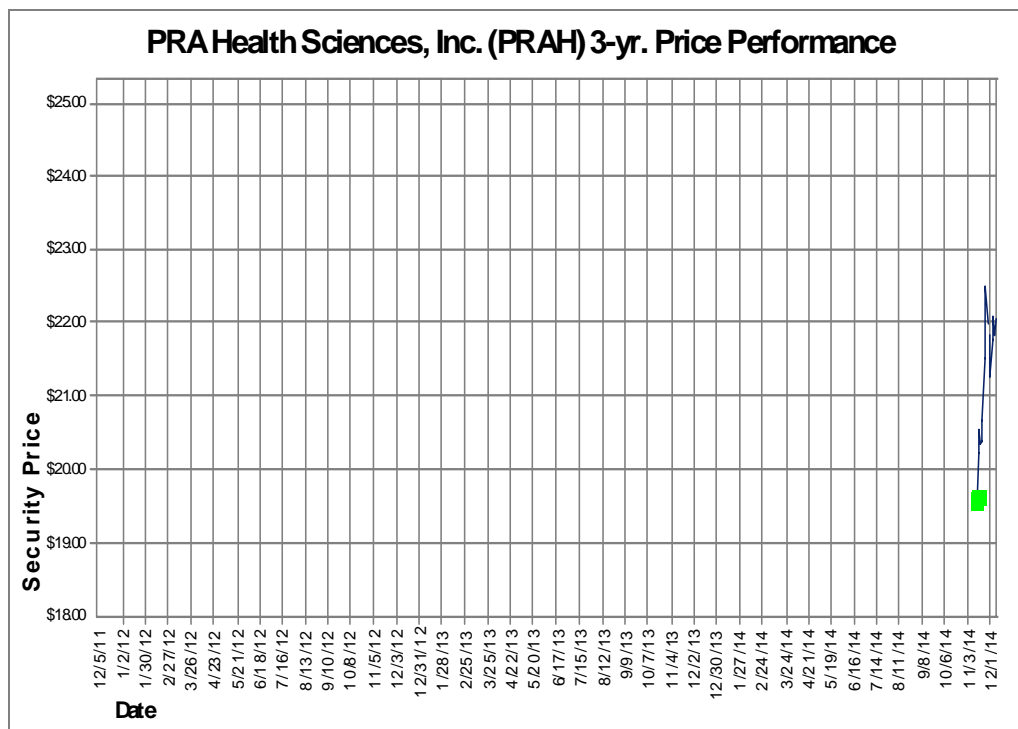
In millions, except per share

INCOME STATEMENT	2011	2012	2013	Q1	Q2	Q3	Q4E	2014E	Q1E	Q2E	Q3E	Q4E	2015E	2016E
Total revenues	\$ 548	\$ 597	\$ 833	\$ 311	\$ 311	\$ 320	\$ 322	\$ 1,265	\$ 329	\$ 338	\$ 343	\$ 351	\$ 1,360	\$ 1,482
Cost of revenues	321	359	527	215	213	216	217	861	225	230	233	238	927	1,007
Gross profit	226	239	306	96	98	104	105	403	103	107	110	113	433	475
Selling, general & administrative	135	154	201	58	54	59	59	229	58	59	60	62	239	256
Depreciation	13	15	18	6	5	6	6	23	6	6	6	6	24	26
Operating income	78	70	87	32	39	40	40	152	40	42	43	45	170	192
Interest expense and other, net	31	28	53	20	19	20	16	75	13	13	13	12	51	45
Pretax income	47	41	34	12	20	20	24	76	27	29	31	33	119	147
Provision for income taxes	15	16	24	5	6	7	8	26	8	9	9	10	36	42
Income before equity in affiliate	\$ 32	\$ 25	\$ 10	\$ 7	\$ 14	\$ 13	\$ 16	\$ 50	\$ 19	\$ 20	\$ 21	\$ 23	\$ 83	\$ 105
Equity in earnings from unconsolidated subsidiaries	-	-	(1)	(0)	(0)	(0)	(0)	(1)	(0)	-	-	0	(0)	1
Net income	\$ 32	\$ 25	\$ 9	\$ 7	\$ 13	\$ 12	\$ 16	\$ 49	\$ 18	\$ 20	\$ 21	\$ 23	\$ 83	\$ 106
Non-GAAP EPS	\$ 0.78	\$ 0.63	\$ 0.22	\$ 0.18	\$ 0.33	\$ 0.30	\$ 0.29	\$ 1.06	\$ 0.29	\$ 0.32	\$ 0.34	\$ 0.36	\$ 1.31	\$ 1.67
Non-GAAP EPS (company method)	\$ 0.84	\$ 0.80	\$ 0.63	\$ 0.20	\$ 0.36	\$ 0.34	\$ 0.31	\$ 1.16	\$ 0.30	\$ 0.33	\$ 0.35	\$ 0.37	\$ 1.36	\$ 1.69
Diluted shares outstanding	41	40	40	40	40	42	53	46	63	63	63	63	63	64
EBITDA	\$ 92	\$ 85	\$ 105	\$ 38	\$ 44	\$ 46	\$ 46	\$ 174	\$ 45	\$ 48	\$ 49	\$ 51	\$ 194	\$ 219
MARGIN ANALYSIS	2011	2012	2013	Q1	Q2	Q3	Q4E	2014E	Q1E	Q2E	Q3E	Q4E	2015E	2016E
Cost of revenue	58.7%	60.1%	63.3%	69.1%	68.5%	67.4%	67.4%	68.1%	68.6%	68.2%	68.0%	67.8%	68.1%	68.0%
Gross margin	41.3%	39.9%	36.7%	30.9%	31.5%	32.6%	32.6%	31.9%	31.4%	31.8%	32.0%	32.2%	31.9%	32.1%
SG&A / revenue	24.6%	25.8%	24.1%	18.6%	17.3%	18.4%	18.3%	18.1%	17.6%	17.6%	17.6%	17.6%	17.6%	17.3%
Depreciation / revenue	2.4%	2.5%	2.2%	1.9%	1.6%	1.9%	1.8%	1.8%	1.7%	1.7%	1.8%	1.8%	1.8%	1.8%
Operating margin	14.3%	11.6%	10.5%	10.4%	12.6%	12.4%	12.5%	12.0%	12.1%	12.5%	12.6%	12.8%	12.5%	13.0%
Tax rate	32.3%	39.4%	70.5%	40.0%	31.1%	35.3%	34.0%	34.5%	30.0%	30.0%	30.0%	30.0%	30.0%	28.5%
Net margin	5.8%	4.2%	1.2%	2.3%	4.4%	4.1%	5.0%	4.0%	5.7%	6.0%	6.2%	6.5%	6.1%	7.1%
EBITDA margin	16.7%	14.2%	12.6%	12.3%	14.2%	14.2%	14.3%	13.8%	13.8%	14.2%	14.4%	14.6%	14.3%	14.8%
CHANGE ANALYSIS YR / YR	2011	2012	2013	Q1	Q2	Q3	Q4E	2014E	Q1E	Q2E	Q3E	Q4E	2015E	2016E
Total revenues	21.4%	9.0%	39.5%	87.0%	73.5%	70.1%	7.7%	51.8%	5.5%	8.4%	7.1%	9.1%	7.5%	9.0%
Gross profit	11.7%	5.3%	28.3%	45.0%	33.6%	43.7%	12.0%	31.9%	7.2%	9.5%	5.1%	7.7%	7.4%	9.7%
SG&A	15.9%	14.1%	30.4%	12.3%	29.4%	21.1%	(0.3%)	14.2%	(0.0%)	10.5%	2.7%	4.9%	4.4%	7.1%
Depreciation	9.9%	13.6%	20.0%	42.3%	23.4%	34.7%	6.2%	25.3%	(3.3%)	20.1%	1.4%	7.1%	5.7%	9.8%
Operating income	5.4%	(11.2%)	25.5%	204.7%	41.4%	101.7%	37.9%	73.7%	22.1%	6.8%	9.3%	12.0%	12.1%	13.2%
Net income	51.5%	(21.8%)	(64.1%)	2615.4%	14.7%	NA	66.8%	444.9%	157.9%	51.9%	71.4%	47.1%	70.8%	28.1%
EPS	47.8%	(19.9%)	(64.7%)					376.2%	64.3%	(3.3%)	13.9%	24.0%	24.4%	27.1%
Diluted shares outstanding	2.5%	(2.4%)	1.6%					14.4%	56.9%	57.1%	50.5%	18.6%	37.3%	0.8%
EBITDA	6.0%	(7.6%)	24.5%	159.2%	39.1%	89.3%	32.9%	65.4%	18.2%	8.2%	8.3%	11.4%	11.3%	12.8%
REVENUE ANALYSIS	2011	2012	2013	Q1	Q2	Q3	Q4E	2014E	Q1E	Q2E	Q3E	Q4E	2015E	2016E
Total revenues	\$ 548	\$ 597	\$ 833	\$ 311	\$ 311	\$ 320	\$ 322	\$ 1,265	\$ 329	\$ 338	\$ 343	\$ 351	\$ 1,360	\$ 1,482
Growth: core	19.1%	10.2%	15.2%	11.7%	4.1%	10.4%	7.9%	8.4%	8.7%	11.6%	9.1%	9.6%	9.8%	9.0%
Growth: FX	2.3%	(1.2%)	(0.4%)	2.5%	3.7%	0.2%	(2.5%)	0.5%	(3.2%)	(3.2%)	(2.1%)	(0.5%)	(2.2%)	0.0%
Growth: acquisitions	0.0%	0.0%	24.7%	72.8%	65.7%	59.5%	2.3%	43.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Growth: total	21.4%	9.0%	39.5%	87.0%	73.5%	70.1%	7.7%	51.8%	5.5%	8.4%	7.1%	9.1%	7.5%	9.0%
Beginning backlog	\$ 1,314	\$ 1,314	\$ 1,383	\$ 1,940	\$ 1,987	\$ 2,045	\$ 2,091	\$ 1,940	\$ 2,134	\$ 2,185	\$ 2,240	\$ 2,295	\$ 2,134	\$ 2,351
Revenue	(597)	(833)	(311)	(311)	(320)	(322)	(1,265)	(329)	(329)	(338)	(343)	(351)	(1,360)	(1,482)
Net bookings	654	774	351	372	382	374	1,479	383	392	398	407	1,581	1,718	1,718
Other adjustments	12	615	8	(3)	(15)	(10)	(21)	(3)	-	-	-	(3)	-	-
Ending backlog	\$ 1,314	\$ 1,383	\$ 1,940	\$ 1,987	\$ 2,045	\$ 2,091	\$ 2,134	\$ 2,134	\$ 2,185	\$ 2,240	\$ 2,295	\$ 2,351	\$ 2,351	\$ 2,587
Net book-to-bill	1.09	0.93	1.13	1.19	1.19	1.16	1.17	1.17	1.17	1.16	1.16	1.16	1.16	1.16
Backlog burn rate	45.4%	60.2%	16.1%	15.7%	15.7%	15.4%	65.2%	15.4%	15.4%	15.5%	15.3%	15.3%	63.7%	63.0%
OTHER	2011	2012	2013	Q1	Q2	Q3	Q4E	2014E	Q1E	Q2E	Q3E	Q4E	2015E	2016E
Cash and equivalents	\$ 109	\$ 72	\$ 58	\$ 58	\$ 49	\$ 63	\$ 63	\$ 44	\$ 47	\$ 50	\$ 42	\$ 42	\$ 42	\$ 42
Total debt	454	1,265	1,283	1,251	1,242	932	932	908	884	860	836	836	836	740
Net cash (debt)	\$ (345)	\$ (1,193)	\$ (1,225)	\$ (1,194)	\$ (1,200)	\$ (868)	\$ (868)	\$ (863)	\$ (837)	\$ (810)	\$ (793)	\$ (793)	\$ (793)	\$ (698)
Debt to TTM EBITDA	4.1x	11.3x	9.5x	8.4x	7.4x	5.0x	5.0x	4.8x	4.5x	4.3x	4.1x	4.1x	4.1x	3.2x
Cash flow from operations	\$ 99	\$ 25	\$ (40)	\$ 37	\$ 5	\$ 22	\$ 24	\$ 14	\$ 36	\$ 36	\$ 26	\$ 26	\$ 112	\$ 132
Capital expenditures	(18)	(20)	(6)	(6)	(7)	(8)	(27)	(8)	(8)	(8)	(8)	(8)	(33)	(32)
Free cash flow	\$ 81	\$ 6	\$ (46)	\$ 31	\$ (2)	\$ 14	\$ (3)	\$ 6	\$ 28	\$ 28	\$ 17	\$ 17	\$ 79	\$ 100

Source for all: Company reports and Wells Fargo Securities, LLC estimates

Company Description:

Raleigh, North Carolina-based PRA Health Sciences, Inc. (NASDAQ: PRAH) is a top-five clinical contract research organization by revenue. The company is a pure play in clinical (phase I-IV) development and is differentiated by a large footprint in non-programmatic outsourcing (e.g., functional outsourcing). It operates in one segment.

Required Disclosures

	Date	Publication Price (\$)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price (\$)
■	11/13/2014		IPO at \$18.00			

Source: Wells Fargo Securities, LLC estimates and Reuters data

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▼ Rating Downgrade	◆ Initiation, Resumption, Drop or Suspend
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Rating Code Key

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2 Market Perform/Hold	NR Not Rated
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PRA Health Sciences, Inc.

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