

October 29, 2015

INC Research Holdings, Inc.

Post-Call Model Changes; Significant Estimate Increases After Another Robust Quarter

- Conclusion.** We are updating our model for INC Research to reflect the very strong numbers released Thursday morning, October 29. The third-quarter results exceeded our target for EPS by \$0.14 (including stock-based compensation expense), revenues by \$2.5 million, gross margin by 420 basis points, and net bookings by \$49 million. Margins were helped by \$4.9 million in nonrecurring expense reduction, which added \$0.05 to the bottom line. Looking beyond this benefit, the normalized results still exceeded our EPS estimate by \$0.09.
- INC is leading the CRO group at present in growth trends, with a 20% constant-currency revenue increase and a trailing-12-month book-to-bill ratio of 1.3 times. Single-digit revenue increases and a 1.2 book-to-bill ratio have been more typical for the peer group. Despite the impressive top-line results, margins have also been strong in total and in the rate of change. EBITDA margins in the quarter were up more than 500 basis points to 23.62% if we ignore the one-time expense benefit, indicating good pricing discipline as well. What is allowing the impressive share gains in a market we believe is growing in the 6%-7% range? We suspect the success is coming from a focus on specialty categories that are attracting the most development spending, such as cancer and CNS disorders. The company is also known for efficient study start up processes, which likely resonates with clients looking for improved R&D productivity.
- In light of a \$0.14 beat (\$0.09 ignoring the expense benefit) and \$0.19 guidance increase, we are increasing our full year 2015 EPS estimate (excluding stock based comp) by \$0.19, to \$1.94 (up 134%). We are also increasing our 2016 EPS estimate (excluding stock-based compensation) estimate by \$0.16, to \$2.23 (15%). We reiterate our Outperform rating despite the stock's premium valuation given the impressive earnings momentum and share gains.

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Stock Rating: **Outperform**
Company Profile: **Aggressive Growth**

Symbol: INCR (NASDAQ)
Price: \$39.67 (52-Wk.: \$20-\$52)
Market Value (mil.): \$2,252
Long-Term EPS Growth Rate: 20%
Dividend/Yield: None
Fiscal Year End: December

	2014A	2015E	2016E
Estimates			
EPS Q1	\$0.12	A\$0.42	NA
Q2	\$0.27	A\$0.47	NA
Q3	\$0.28	A\$0.58	NA
Q4	\$0.26	\$0.48	NA
FY	\$0.93	\$1.94	\$2.23
CY		\$1.94	\$2.23

Valuation			
FY P/E	42.7x	20.4x	17.8x
CY P/E		20.4x	17.8x

Trading Data (FactSet)			
Shares Outstanding (mil.)			56
Float (mil.)			5
Average Daily Volume			402,922

Financial Data (FactSet)			
Book Value Per Share (MRQ)			5.0
Return on Equity (TTM)			-8.1

Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

INC Research is one of the top 10 largest CROs, with an annual revenue base exceeding \$800 million. Founded in 1985 as a niche CRO focused on central nervous system disorders, INC now employs 5,400 associates across 50 countries, and its focus has broadened to include oncology and other complex diseases.

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- **Model Changes.**

- We now assume 2015 revenue for INC of \$912.5 million—up 14% from 2014 as reported and 18.7% constant currency, and up \$6 million from our previous model.
- We now model adjusted EBITDA margin of 23.2%, up from 21.4% previously, and earnings per share of \$1.94 excluding stock compensation expense (compared with \$1.75 previously).
- While we project revenue growth to be negatively affected by 470 basis points in 2015 due to the strong dollar, we note that INC's global cost structure offsets the top-line headwind and results in a neutral impact to the operating line.
- We now assume 2016 revenue for INC of \$1.01 billion—up 11.0% from 2015 estimates.
- We estimate adjusted EBITDA margin of 23.2%, up from 22.0% previously and flat with 2015 EBITDA margin, and earnings per share of \$2.23 excluding stock compensation expense compared to \$2.07 previously.
- We are assuming a more modest EPS increase next year because of an \$0.08 nonrecurring benefit the company has realized year to date. Given the surprising margin leverage of late and management comments about re-investing in growth, our 2016 model conservatively assumes flat margins.

- **Valuation and stock thoughts.** INC now trades at 19.7 times our revised 2016 EPS estimate of \$2.17 (including stock-based compensation expense). The clinical CRO peer group now trades at 16.7 times after the recent correction, down from 20 times a few months ago. We believe INC's premium valuation is justified given the stronger relative growth, but we do see the risk of some multiple compression given cooling biotech sentiment and concerns about price inflation scrutiny and pharma consolidation. We maintain our Outperform rating on INC despite the premium valuation given the company's very encouraging earnings momentum. Our updated model can be found below in exhibit 1.

Our model is included on the following page.

Exhibit 1. Updated INC Research Model Summary (2011 – 2017(E))

	2011	2012	2013	2014	Q1'15	Q2'15	Q3'15	Q4'15E	2015E	2016E	2017E
Service revenue	\$ 437,005	\$ 579,145	\$ 652,418	\$ 800,728	211,514	227,376	234,494	239,113	\$ 912,497	\$ 1,013,145	\$ 1,124,591
Direct Costs	279,840	389,057	432,262	515,059	125,448	138,010	135,530	144,185	543,173	608,543	674,172
SG&A	92,891	106,970	117,055	143,763	35,579	37,014	40,315	44,714	157,622	169,974	183,296
Stock-based comp expense	(1,176)	(1,248)	(2,419)	(3,370)	(707)	(913)	(1,668)	(2,000)	(5,288)	(6,460)	(6,600)
Adjusted EBITDA	65,450	84,366	105,520	145,276	51,194	53,265	60,317	52,214	216,990	241,089	273,723
Depreciation	15,700	19,915	19,175	21,619	4,766	4,420	4,357	4,782	18,325	20,499	21,931
EBITA	49,750	64,451	86,345	123,657	46,428	48,845	55,960	47,432	198,665	220,590	251,792
Interest expense	(65,482)	(62,007)	(60,489)	(52,787)	(5,305)	(4,188)	(3,037)	(3,009)	(15,539)	(9,307)	(2,927)
Pre-tax income	(15,732)	2,444	25,856	70,870	41,123	44,657	52,923	44,423	183,126	211,283	248,865
Income tax (expense) benefit	2,157	(1,653)	(9,567)	(26,223)	(14,805)	(16,077)	(19,052)	(15,992)	(65,926)	(76,062)	(87,103)
Adjusted Net Income (excluding SBC)	(13,575)	791	16,289	44,647	26,318	28,580	33,871	28,431	117,200	135,221	161,762
As reported net income	\$ (59,547)	\$ (59,114)	\$ (41,530)	\$ (23,470)	\$ 25,391	\$ 23,321	\$ 37,814	\$ 27,761	\$ 114,287	\$ 122,669	\$ 141,083
Adjusted EPS (excluding SBC)	\$ (0.31)	\$ 0.02	\$ 0.31	\$ 0.83	\$ 0.42	\$ 0.47	\$ 0.58	\$ 0.48	\$ 1.94	\$ 2.23	\$ 2.67
As reported EPS	\$ (1.36)	\$ (1.13)	\$ (0.80)	\$ (0.44)	\$ 0.40	\$ 0.39	\$ 0.64	\$ 0.47	\$ 1.89	\$ 2.02	\$ 2.33
<i>Diluted Class A common shares outstanding (in thousands)</i>	<i>43,874</i>	<i>52,228</i>	<i>52,033</i>	<i>53,859</i>	<i>63,103</i>	<i>60,464</i>	<i>58,764</i>	<i>59,376</i>	<i>60,427</i>	<i>60,578</i>	<i>60,638</i>

Margin Analysis

Gross margin	36.0%	32.8%	33.7%	35.7%	40.7%	39.3%	42.2%	39.7%	40.5%	39.9%	40.1%
SG&A	21.3%	18.5%	17.9%	18.0%	16.8%	16.3%	17.2%	18.7%	17.3%	16.8%	16.3%
Adjusted EBITDA (excluding sbc)	15.0%	14.6%	16.2%	18.1%	24.2%	23.4%	25.7%	21.8%	23.8%	23.8%	24.3%
Adjusted EBITDA (including sbc)	14.7%	14.4%	15.8%	17.7%	23.9%	23.0%	25.0%	21.0%	23.2%	23.2%	23.8%
Depreciation	3.6%	3.4%	2.9%	2.7%	2.3%	1.9%	1.9%	2.0%	2.0%	2.0%	2.0%
EBITA	11.4%	11.1%	13.2%	15.4%	22.0%	21.5%	23.9%	19.8%	21.8%	21.8%	22.4%
Tax rate	13.7%	67.6%	37.0%	37.0%	36.0%	36.0%	36.0%	36.0%	36.0%	36.0%	35.0%
Net Income	-3.1%	0.1%	2.5%	5.6%	12.4%	12.6%	14.4%	11.9%	12.8%	13.3%	14.4%

Growth metrics

Total Revenue		32.5%	12.7%	22.7%	14.5%	14.2%	15.5%	11.9%	-4.7%	14.0%	11.0%	11.0%
Constant currency growth		34.7%	12.3%	24.2%	19.4%	19.9%	20.4%	15.0%	18.7%	11.3%		
Cost of goods sold		39.0%	11.1%	19.2%	3.9%	5.5%	4.6%	7.6%	5.5%	12.0%	10.8%	
Gross profit		20.9%	15.8%	29.8%	34.6%	30.9%	34.3%	19.0%	29.3%	9.6%	11.3%	
SG&A		15.2%	9.4%	22.8%	11.6%	10.1%	6.8%	10.4%	9.6%	7.8%	7.8%	
Adjusted EBITDA		28.9%	25.1%	37.7%	57.1%	49.9%	63.8%	29.4%	49.4%	11.1%	13.5%	
Depreciation		26.8%	-3.7%	12.7%	-30.6%	-12.0%	-8.0%	-4.2%	-15.2%	11.9%	7.0%	
EBITA		29.5%	34.0%	43.2%	80.6%	60.1%	74.4%	34.2%	60.7%	11.0%	14.1%	
Net Income		-105.8%	1959.3%	174.1%	325.9%	156.5%	180.2%	86.6%	162.5%	15.4%	19.6%	
EPS		-104.9%	1967.0%	164.8%	325.9%	156.5%	180.2%	86.6%	134.0%	15.1%	19.5%	
Weighted average shares		19.0%	-0.4%	3.5%	21.5%	15.9%	11.9%	1.0%	12.2%	0.2%	0.1%	

Sources: Company reports and William Blair & Company, L.L.C. estimates

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DOW JONES: 17,779.52

S&P 500: 2,090.35

NASDAQ: 5,095.69



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