

INC Research Holdings, Inc.

INCR: A Game of Expectations

We reiterate our Sector Weight on INC Research Holdings, Inc. with the shares trading at a ~25% premium to the other CROs. Since February, mgmt has raised its 2015 EBITDA guidance by a total of ~22% due, in large part, to internally generated margin efficiencies and the timing of backlog conversion. Our concern is the market may now be *anticipating* guidance increases, which could potentially result in share price downside even if INCR meets its stated financial targets. This could account for as much as ~\$10 of the stock, in our view.

Key Investment Points

We are materially increasing our EPS estimates to **\$1.80 in 2015 (from \$1.52)** and to **\$2.14 in 2016 (from \$1.77)**. The increased outlook reflects the strong 2Q15 book-to-bill (1.3x) and margin performance (+630bps YOY EBITDA margin). Also, the quality of INCR's top line has improved with only 34% of its revenues from its top 5 clients (down from 38% YOY) and 68% of its backlog aligned with faster growing, therapeutic areas such as CNS and oncology. Finally, INCR successfully converted its functional relationship with *Astellas Pharma* (~10% revenue client) into a 3-year project-based arrangement.

Over the past 6 months, **mgmt has increased its 2015 adj EBITDA guidance by 22% at the midpoint** from **\$159M-\$169M (midpoint: \$164M)** in February to **\$195M-\$205M (\$200M)** currently. It appears most of the upside has come from margins and backlog conversion. Notably, INCR has already passed its previously given "long-term" EBITDA margin target of ~20% (albeit with ~100bps of unforeseen FX benefit). Mgmt has also raised its adj EPS guidance by ~40% from **\$1.19-\$1.29 (midpoint: \$1.24)** to **\$1.69-\$1.80 (\$1.75)** driven by the aforementioned factors as well as an opportunistic financing and share repurchase in May.

Is the 2015 guidance still too low? Our base case 2015 estimate of \$1.80 is at the very top end of guidance. Specifically, mgmt's 2015 guidance assumes only a 20.0% adj EBITDA margin in 2H15 -- down from 23.8% in 1H15. This ~380bps 1H15-2H15 margin decline equates to ~\$18M of adj EBITDA, or ~\$0.18 of potential EPS. Mgmt is asking the market to expect this margin decline because of the acceleration of project revenues into 2Q15 (~60bps of margin), public company costs (~80bps), higher bad debt (~50bps), and hiring. *We suspect mgmt is also allowing itself room to potentially provide another guidance increase in 3Q15.*

As an aside, **INCR filed an S-1 today for an 8M share secondary offering**. Currently, INCR's 2 primary shareholders own ~67% of the Company, after selling 8M shares in May.

Estimates

FY ends 12/31	F2014A	1Q15A	2Q15A	3Q15E	4Q15E	F2015E	F2016E
EPS (Net)	0.83	0.42	0.47	0.41	0.50	1.80	2.14
Cons. EPS	--	\$0.42	\$0.47	\$0.43	\$0.44	\$1.74	\$2.05
Previous	--	--	0.31	0.38	0.41	1.52	1.77
Valuation							
P/E	60.3x	--	--	--	--	27.8x	23.4x

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

For analyst certification and important disclosures, please refer to the Disclosure Appendix.

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NASDAQ: INCR

Rating: **Sector Weight**
Price Target: **NA**
Price: **\$50.08**



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

Company Data

52-week range	\$20 - \$50
Market Cap. (M)	\$3,064.9
Shares Out. (M)	61.20
Enterprise Value (M)	\$3,358.4
Avg. Daily Volume (30D)	311,297.0
SI as % of Float	1.8%
SI % Chg. from Last Per.	39.9%
Book Value/Share	\$7.32

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

Valuation

INCR current trading price implies a 23.4x multiple of our 2016 adjusted EPS estimate of \$2.14, which is ~20%+ premium to the CRO group average of 19.4x. In our opinion, this premium multiple is appropriate given INCR's strong bookings momentum in recent quarters and alignment with fast-growing therapeutic categories such as central nervous system disorders and oncology. INCR currently trades at ~25x consensus 2016 adjusted EPS of \$2.05.

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.

FINANCIAL MODELS

Figure 1: Projected Income Statement

INCR -- GAAP Income Statements (in millions)	2013A	Fiscal Year End, December 2014					Fiscal Year End, December 2015					Fiscal Year End, December 2016				
		1QA	2QA	3QA	4QA	2014A	1QA	2QA	3QE	4QE	2015E	1QE	2QE	3QE	4QE	2016E
Net Service Revenue	\$652.4	\$184.7	\$203.5	\$207.8	\$213.7	\$809.7	\$211.5	\$227.4	\$232.7	\$238.3	\$909.9	\$243.2	\$250.1	\$258.3	\$262.1	\$1,013.8
Year-Over-Year Growth, % (Services)	12.7%	23.3%	27.9%	22.9%	22.6%	24.1%	14.5%	11.7%	12.0%	11.5%	12.4%	15.0%	10.0%	11.0%	10.0%	11.4%
Less: Direct Costs	(432.3)	(120.8)	(130.8)	(129.6)	(134.0)	(515.1)	(125.4)	(138.0)	(144.3)	(147.7)	(555.5)	(150.3)	(154.6)	(159.6)	(162.0)	(626.5)
Gross Income	\$220.2	\$63.9	\$72.8	\$78.2	\$79.8	\$294.7	\$86.1	\$89.4	\$88.4	\$90.6	\$354.4	\$92.9	\$95.5	\$98.7	\$100.1	\$387.3
Gross Margin, % (Services)	33.7%	34.6%	35.7%	37.6%	37.3%	36.4%	40.7%	39.3%	38.0%	38.0%	39.0%	38.2%	38.2%	38.2%	38.2%	38.2%
less: Selling, General, and Admin	(117.9)	(32.2)	(34.0)	(38.2)	(40.8)	(145.1)	(35.8)	(37.1)	(38.4)	(39.3)	(150.6)	(39.1)	(40.2)	(41.5)	(42.1)	(162.8)
less: Depreciation	(19.2)	(6.9)	(5.0)	(4.7)	(5.0)	(21.6)	(4.8)	(4.4)	(4.5)	(4.6)	(18.3)	(4.7)	(4.9)	(5.0)	(5.1)	(19.7)
less: Amortization	(39.3)	(7.5)	(6.2)	(9.6)	(9.6)	(32.9)	(9.5)	(9.5)	(9.4)	(9.4)	(37.8)	(9.4)	(9.4)	(9.4)	(9.4)	(37.6)
less: Other	(12.3)	(2.8)	(19.7)	(3.0)	(5.9)	(31.3)	(3.6)	(2.4)	-	-	(6.0)	-	-	-	-	-
Operating Income	\$31.5	\$14.6	\$7.9	\$22.7	\$18.5	\$63.6	\$32.4	\$35.9	\$36.1	\$37.2	\$141.6	\$39.7	\$41.1	\$42.8	\$43.6	\$167.2
Operating Margin % (Services)	4.8%	7.9%	3.9%	10.9%	8.6%	7.9%	15.3%	15.8%	15.5%	15.6%	15.6%	16.3%	16.4%	16.6%	16.6%	16.5%
plus: Interest Income	0.3	0.2	0.0	0.0	0.0	0.2	0.1	0.0	0.1	0.1	0.3	0.1	0.1	0.1	0.2	0.5
less: Interest Expense	(60.8)	(16.1)	(12.8)	(12.9)	(11.2)	(53.0)	(5.4)	(4.2)	(4.5)	(4.3)	(18.5)	(4.3)	(4.2)	(4.2)	(4.1)	(16.8)
plus: Other Income (expense)	(1.6)	1.4	(0.3)	5.1	(45.2)	(39.1)	3.5	(8.1)	(5.0)	-	(9.7)	-	-	-	-	-
Pretax Income	(\$30.7)	\$0.1	(\$5.3)	\$15.0	(\$37.9)	(\$28.2)	\$30.5	\$23.6	\$26.7	\$32.9	\$113.8	\$35.5	\$37.0	\$38.8	\$39.6	\$151.0
less: Provision for Income Taxes	(10.8)	(1.6)	20.6	(2.4)	(11.8)	4.7	(5.3)	(0.3)	(5.3)	(6.6)	(17.5)	(12.4)	(13.0)	(13.6)	(13.9)	(52.8)
Net Earnings	(\$41.5)	(\$1.6)	\$15.3	\$12.6	(\$49.8)	(\$23.5)	\$25.3	\$23.3	\$21.3	\$26.3	\$96.3	\$23.1	\$24.1	\$25.2	\$25.8	\$98.1
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	\$23.3	\$21.3	\$26.3	\$96.3	\$23.1	\$24.1	\$25.2	\$25.8	\$98.1
Diluted EPS (GAAP)	(\$0.81)	(\$0.03)	\$0.29	\$0.24	(\$0.92)	(\$0.51)	\$0.40	\$0.39	\$0.37	\$0.45	\$1.60	\$0.40	\$0.41	\$0.43	\$0.44	\$1.68
Diluted Share Count	52.0	51.9	52.2	52.5	57.5	53.5	63.1	60.5	58.4	58.4	60.1	58.4	58.4	58.4	58.4	58.4
Non-GAAP Metrics																
Net Services Revenue	\$652.4	\$184.7	\$203.5	\$207.8	\$213.7	\$809.7	\$211.5	\$227.4	\$232.7	\$238.3	\$909.9	\$243.2	\$250.1	\$258.3	\$262.1	\$1,013.8
Year-Over-Year Growth, % (Period)	12.7%	23.3%	27.9%	22.9%	22.6%	24.1%	14.5%	11.7%	12.0%	11.5%	12.4%	15.0%	10.0%	11.0%	10.0%	11.4%
Year-Over-Year Growth, % (R4Q)	12.7%	17.0%	21.0%	22.2%	24.1%	24.1%	21.7%	17.6%	14.9%	12.4%	12.4%	12.6%	12.1%	11.8%	11.4%	11.4%
Adjusted EBITDA	\$105.5	\$32.6	\$35.5	\$36.8	\$40.3	\$145.3	\$51.2	\$53.3	\$46.0	\$52.3	\$202.7	\$54.9	\$56.5	\$58.3	\$59.2	\$228.9
Adjusted EBITDA Margin %	16.2%	17.6%	17.5%	17.7%	18.9%	17.9%	24.2%	23.4%	19.8%	21.9%	22.3%	22.6%	22.6%	22.6%	22.6%	22.6%
Year-Over-Year Growth, % (Period)	25.1%	80.8%	43.5%	11.9%	35.2%	37.7%	57.1%	49.9%	25.0%	29.6%	39.6%	7.3%	6.0%	26.7%	13.2%	12.9%
Adjusted EPS	\$0.30	\$0.14	\$0.18	\$0.26	\$0.26	\$0.83	\$0.42	\$0.47	\$0.41	\$0.50	\$1.80	\$0.51	\$0.53	\$0.55	\$0.56	\$2.14
Year-Over-Year Growth, % (Period)	460.6%	-591.4%	182.2%	62.3%	159.0%	181.6%	207.1%	166.2%	58.8%	92.2%	116.3%	22.2%	11.4%	32.3%	11.6%	18.7%

Source: Company reports and KeyBanc Capital Markets

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.

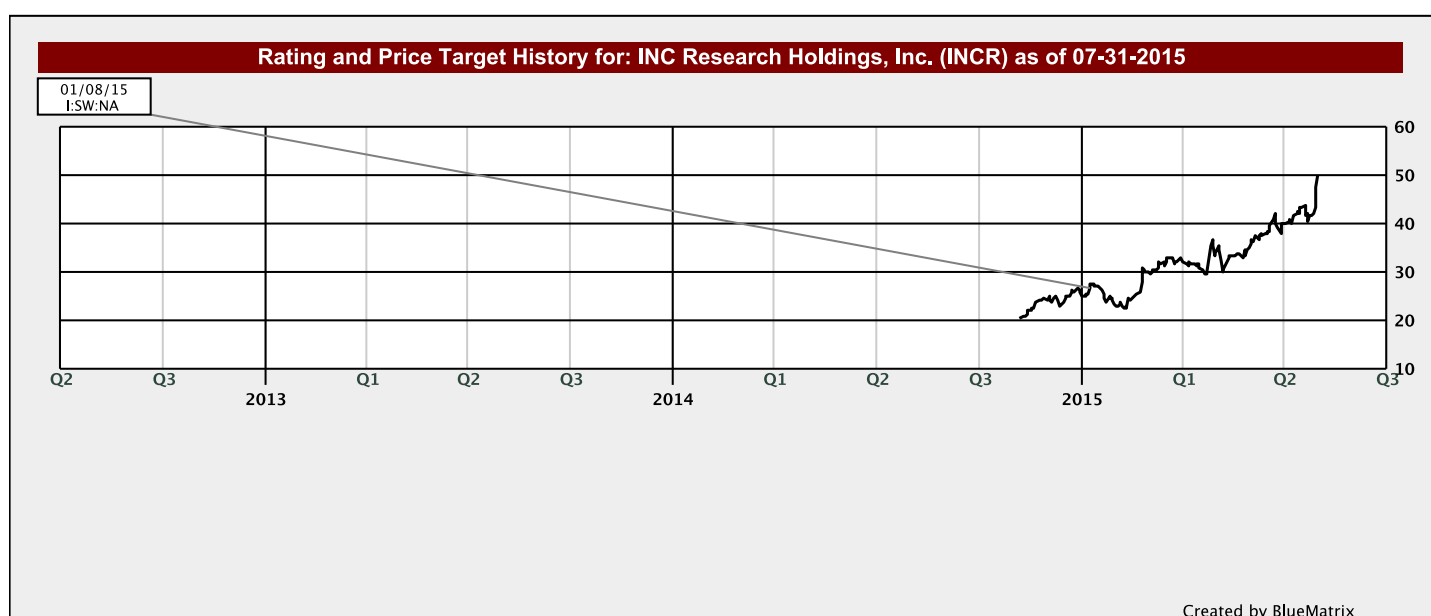
During the past 12 months, INC Research Holdings, Inc. has been a client of the firm or its affiliates for non-securities related services.

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

Reg A/C Certification

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Three-Year Rating and Price Target History



Rating Disclosures

Distribution of Ratings/IB Services Firmwide and by Sector									
KeyBanc Capital Markets					HEALTHCARE				
Rating	Count	Percent	IB Serv/Past 12 Mos.		Rating	Count	Percent	IB Serv/Past 12 Mos.	
			Count	Percent				Count	Percent
Overweight [OW]	355	45.63	84	23.66	Overweight [OW]	18	41.86	3	16.67
Sector Weight [SW]	407	52.31	66	16.22	Sector Weight [SW]	23	53.49	5	21.74
Underweight [UW]	16	2.06	0	0.00	Underweight [UW]	2	4.65	0	0.00

Disclosure Appendix (cont'd)

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.

Note: KeyBanc Capital Markets changed its rating system after market close on February 27, 2015. The previous ratings were Buy, Hold and Underweight. Additionally, Pacific Crest Securities changed its rating system to match KeyBanc Capital Markets' rating system after market close on April 10, 2015, in conjunction with the merger of the broker dealers. The previous ratings were Outperform, Sector Perform and Underperform.

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