William Blair

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INC Research Holdings, Inc.

Post-Call Model Changes; A Promising Sign of Strong Momentum Continuing in the Clinical CRO Market

- **Conclusion.** INC reported strong first-quarter results on Monday morning, April 27, that exceeded our expectations in terms of revenues (slightly) and gross margin (substantially). The company also increased EPS guidance by 22 cents at the midpoint to $1.46 (up 56%) following a 16 cent beat in the quarter. We note that guidance does not include any incremental interest expense from the $100 million revolver that will be used to repurchase $150 million of shares. Management also stated that renewal discussions with Astellas were progressing nicely, with the hope that it will transition from a functional service provider structure to a full-service relationship. Over the short term we do not expect much upside, but we are encouraged to see the reduction of this key renewal risk.

  Given INC's therapeutic expertise in fast-growing categories like oncology and CNS, coupled with a healthy mix of both large and small clients, we believe the company is well positioned to outperform the broader CRO market in the near to intermediate term in terms of earnings growth. With a $150 million share-repurchase plan in place, along with a very healthy backlog coverage ratio of nearly 90% for this year, we believe management's current 2015 guidance appears reasonable if not conservative. We are increasing our full year 2015 EPS estimate by 26 cents, to $1.50 (up 60%), and maintain our Outperform rating on the stock despite its premium valuation versus its peers.

- **Demand Trends Remain Elevated.** Continuing the trend of strong bookings across the clinical CRO sector, INC reported a respectable 1.2-times net book-to-bill ratio in the first quarter. Given extremely strong biotech funding, along with increased R&D spending from large pharma, we believe INC is well positioned to generate midteens organic revenue growth in 2015. With this strong macro backdrop, we would not be surprised to see pricing and/or mix improve for the clinical CROs, which should bode well for further margin upside. We look to ICON (ICLR $70.21; Outperform), Quintiles (Q $68.90; Outperform), and Parexel (PRXL $70.13; Outperform) later this week to confirm the clinical group's demand trends.

- **Updated Guidance May Be Conservative.** Following a roughly in-line revenue quarter, management increased top-line guidance from 10.6% to 11.5% at the midpoint. While foreign-exchange rates are expected to negatively affected revenue by roughly 4.5% in 2015, we believe underlying constant-currency growth targets may prove conservative. Over the last five quarters, constant-currency growth has averaged 23.2%, with the most recent quarter increasing 19.4%. While we acknowledge that tougher comparisons exist going forward, constant-currency revenue guidance implies growth of 12.5% over the next three quarters. We view this as a conservative estimate of future growth, especially since backlog burn rates have remained above 12% since first quarter 2014.

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

Symbol:	INCR (NASDAQ)
Price:	$35.31 (52-Wk.: $20-$35)
Market Value (mil.):	$1,859
Fiscal Year End:	December
Long-Term EPS Growth Rate:	20%
Dividend/Yield:	None

		2014A	2015E	2016E
Estimates				
EPS	Q1	$0.12	A$0.42	NA
	Q2	$0.27	$0.33	NA
	Q3	$0.28	$0.36	NA
	Q4	$0.26	$0.38	NA
	FY	$0.93	$1.50	$1.75
	CY		$1.50	$1.75
Valuation				
FY P/E		38.0x	23.5x	20.2x
CY P/E			23.5x	20.2x

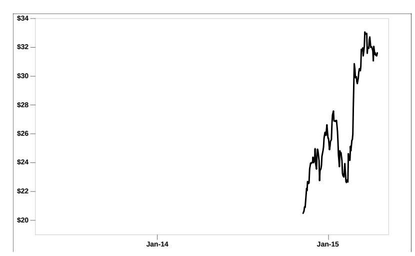
Trading Data (FactSet)

Shares Outstanding (mil.)	58
Float (mil.)	25
Average Daily Volume	131,937

Financial Data (FactSet)

Long-Term Debt/Total Capital (MRQ)	0.0
Book Value Per Share (MRQ)	6.4
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.

As shown in exhibit 1, after accounting for INC's new credit agreement, a stronger U.S. dollar, and a 16 cent first-quarter beat, management is targeting only a 5 cent benefit from continued operations for the rest of the year. We note that 1 cent is due to a slight increase to as-reported revenue (assuming a 17% EBITA margin). Furthermore, if we account for the recent $150 million share repurchase, funded by $100 million of additional credit and $50 million of cash on hand, we estimate an incremental 4 cent EPS benefit not included in guidance.

Exhibit 1. Components of Updated 2015 Guidance for INC Research

		2015E
Previous WB Estimate	**$**	**1.24**
1Q15 beat		0.16
Revenue guidane increase		0.01
Implied margin benefit		0.04
FX		(0.02)
Interest expense		0.03
Updated Guidance (midpoint)	**$**	**1.46**
Revolver ($100m)		(0.02)
Share repurchase		0.06
New WB Estimate	**$**	**1.50**

Sources: Company reports and William Blair estimates

- **Model Changes.** We now assume 2015 revenue for INC of $892 million, up 10.2% from 2014 and up $6 million from our previous model despite a stiffer foreign-exchange headwind. We now model a headwind of 500 basis points, up from 410 basis points previously. On a constant-currency basis, we now expect revenue growth of 15.2%, up from 13.4% previously. We expect adjusted EBITDA margin of 19.9%, up from 18.3% previously, because of the strong first-quarter level of 24.2% (23.9% including stock comp), which included 290 basis points of one-time benefits. Over the balance of the year, we expect adjusted EBITDA margin of 19.0% (18.7% including stock comp), which essentially matches our prior model. Below the operating line, we now model interest expense of $16.7 million, down from $19.1 million previously, as favorable refinancing rates are offset by incremental borrowing related to the share buyback, which was also announced Monday.

  Regarding the buyback, we project the repurchases to be completed by the end of the second quarter, allowing the company to realize the full benefit of the lower share count by the third quarter. We now expect 61 million shares outstanding for full year 2015 (59.1 million in the third quarter), compared with our previous expectation of 64 million in both the third quarter and for the full year. We estimate the accretive impact of the share buyback to be roughly 4 cents including the incremental interest expense and we note that this is not reflected in guidance. Netting these items, on the bottom line we now expect EPS of $1.50 excluding stock compensation expense (compared with $1.24 previously). We continue to model stock option expense of 4 cents.

- **Valuation and stock thoughts.** Following these positive results, INC trades at 23.6 times our revised 2015 EPS estimate of $1.50 (up 60%). The clinical CRO peer group trades at 21.4 times (ICLR at 19.8 times, Q at 22.4 times, PRA [PRAH $27.27; Outperform] at 20.0 times, and PRXL at 23.2 times). Given INC's leading organic growth profile, we view the premium relative to the group as reasonable. We remain constructive on the CRO group and maintain our Outperform rating on INCR.

Exhibit 2, showing our updated model summary, is included on the following page.

	2011	2012	2013	2014	Q1'15	Q2'15E	Q3'15E	Q4'15E	2015E	2016E	2017E	2018E
Service revenue	**$ 437,005**	**$ 579,145**	**$ 652,418**	**$ 809,728**	**211,514**	**218,147**	**225,804**	**236,690**	**$ 892,156**	**$ 1,004,454**	**$ 1,104,899**	**$ 1,209,865**
Direct Costs	279,840	389,057	432,262	515,059	125,448	138,524	142,821	149,115	555,907	633,144	693,899	757,512
SG&A	92,891	106,970	117,055	143,763	35,579	39,048	40,871	43,314	158,812	172,264	187,833	202,047
Stock-based comp expense	(1,176)	(1,248)	(2,419)	(3,370)	(707)	(707)	(707)	(707)	(2,828)	(4,210)	(6,600)	(7,600)
Adjusted EBITDA	**65,450**	**84,366**	**105,520**	**154,276**	51,194	41,282	42,819	44,968	**180,264**	**203,256**	**229,767**	**257,905**
Depreciation	15,700	19,915	19,175	21,619	4,766	5,236	5,419	5,681	21,101	24,727	27,157	29,037
EBITA	**49,750**	**64,451**	**86,345**	**132,657**	**46,428**	**36,047**	**37,400**	**39,287**	**159,163**	**178,529**	**202,610**	**228,869**
Interest expense	(65,482)	(62,007)	(60,489)	(52,787)	(5,305)	(3,799)	(3,783)	(3,767)	(16,654)	(12,957)	(8,491)	(2,831)
Pre-tax income	**(15,732)**	**2,444**	**25,856**	**79,870**	**41,123**	**32,248**	**33,617**	**35,520**	**142,509**	**165,572**	**194,119**	**226,037**
Income tax (expense) benefit	2,157	(1,653)	(9,567)	(29,553)	(14,805)	(11,609)	(12,102)	(12,787)	(51,304)	(58,778)	(66,001)	(72,332)
Adjusted Net Income (excluding SBC)	**(13,575)**	**791**	**16,289**	**50,317**	26,318	20,639	21,515	22,733	**91,205**	**106,794**	**128,119**	**153,705**
As reported net Income	**$ (59,547)**	**$ (59,114)**	**$ (41,530)**	**$ (23,470)**	**$ 25,843**	**$ 20,701**	**$ 21,255**	**$ 22,016**	**$ 89,815**	**$ 94,607**	**$ 107,822**	**$ 127,194**
Adjusted EPS (excluding SBC)	$ (0.31)	$ 0.02	$ 0.31	$ 0.93	$ 0.42	$ 0.33	$ 0.36	$ 0.38	$ 1.50	$ 1.75	$ 2.09	$ 2.50
Adjusted Net Income (including SBC)	***$ (14,590)***	***$ (3,973)***	***$ 14,765***	***$ 48,194***	***$ 25,866***	***$ 20,186***	***$ 21,062***	***$ 22,281***	***$ 89,395***	***$ 104,078***	***$ 123,763***	***$ 148,537***
Adjusted EPS (including SBC)	**$ (0.33)**	**$ (0.08)**	**$ 0.28**	**$ 0.89**	***$ 0.41***	***$ 0.32***	***$ 0.36***	***$ 0.38***	**$ 1.46**	**$ 1.71**	**$ 2.02**	**$ 2.42**
As reported EPS	**$ (1.36)**	**$ (1.13)**	**$ (0.80)**	**$ (0.44)**	**$ 0.41**	**$ 0.33**	**$ 0.36**	**$ 0.37**	**$ 1.47**	**$ 1.55**	**$ 1.76**	**$ 2.07**
Diluted Class A common shares outstanding (in thousands)	*43,874*	*52,228*	*52,033*	*53,859*	*63,103*	*62,524*	*59,146*	*59,246*	*61,005*	*61,157*	*61,310*	*61,463*
Margin Analysis												
Gross margin	36.0%	32.8%	33.7%	36.4%	40.7%	*36.5%*	*36.8%*	*37.0%*	37.7%	37.0%	37.2%	37.4%
SG&A	21.3%	18.5%	17.9%	17.8%	16.8%	*17.9%*	*18.1%*	*18.3%*	17.8%	17.2%	17.0%	16.7%
Adjusted EBITDA (excluding sbc)	15.0%	14.6%	16.2%	19.1%	24.2%	18.9%	19.0%	19.0%	20.2%	20.2%	20.8%	21.3%
Adjusted EBITDA (including sbc)	**14.7%**	**14.4%**	**15.8%**	**18.6%**	**24.2%**	**18.6%**	**18.7%**	**18.7%**	**19.9%**	**19.8%**	**20.2%**	**20.7%**
Depreciation	3.6%	3.4%	2.9%	2.7%	2.3%	*2.4%*	*2.4%*	*2.4%*	2.4%	2.5%	2.5%	2.4%
EBITA	**11.4%**	**11.1%**	**13.2%**	**16.4%**	**22.0%**	**16.5%**	**16.6%**	**16.6%**	**17.8%**	**17.8%**	**18.3%**	**18.9%**
Tax rate	13.7%	67.6%	37.0%	37.0%	36.0%	*36.0%*	*36.0%*	*36.0%*	36.0%	35.5%	34.0%	32.0%
Net Income	**-3.1%**	**0.1%**	**2.5%**	**6.2%**	**12.4%**	**9.5%**	**9.5%**	**9.6%**	**10.2%**	**10.6%**	**11.6%**	**12.7%**
Growth metrics												
Total Revenue		**32.5%**	**12.7%**	**24.1%**	**14.5%**	**7.2%**	**8.7%**	**10.7%**	**10.2%**	**12.6%**	**10.0%**	**9.5%**
Constant currency growth		*34.7%*	*12.3%*	***24.2%***	*19.4%*	*13.3%*	*14.0%*	*14.0%*	***15.2%***			
Cost of goods sold		39.0%	11.1%	19.2%	3.9%	5.9%	10.2%	11.3%	7.9%	13.9%	9.6%	9.2%
Gross profit		20.9%	15.8%	33.8%	34.6%	9.4%	6.1%	9.8%	14.1%	10.4%	10.7%	10.1%
SG&A		15.2%	9.4%	22.8%	11.6%	16.2%	8.2%	7.0%	10.5%	8.5%	9.0%	7.6%
Adjusted EBITDA		**28.9%**	**25.1%**	**46.2%**	**57.1%**	**3.1%**	**3.6%**	**11.5%**	**16.8%**	**12.8%**	**13.0%**	**12.2%**
Depreciation		26.8%	-3.7%	12.7%	-30.6%	4.2%	14.5%	13.8%	-2.4%	17.2%	9.8%	6.9%
EBITA		29.5%	34.0%	53.6%	80.6%	3.0%	2.2%	11.1%	20.0%	12.2%	13.5%	13.0%
Net Income		-105.8%	1959.3%	208.9%	325.9%	47.7%	44.2%	49.2%	81.3%	17.1%	20.0%	20.0%
EPS		**-104.9%**	**1967.0%**	**198.4%**	**325.9%**	**47.7%**	**44.2%**	**49.2%**	**60.0%**	**16.8%**	**19.7%**	**19.7%**
Weighted average shares		19.0%	-0.4%	3.5%	21.5%	19.8%	12.6%	0.8%	13.3%	0.2%	0.3%	0.2%

Sources: Company reports and William Blair & Company estimates

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William Blair or an affiliate expects to receive or intends to seek compensation for investment banking services from INC Research Holdings, Inc. within the next three months.

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Additional information is available upon request.

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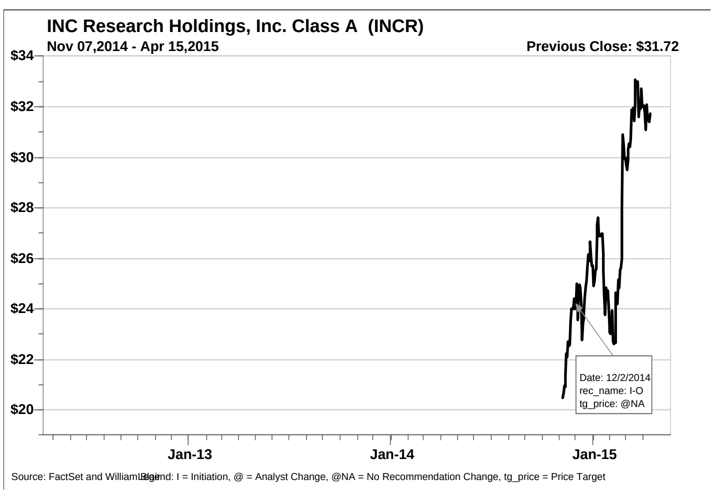
DOW JONES: 18,080.14
S&P 500: 2,117.69
NASDAQ: 5,092.09



Current Rating Distribution (as of 03/31/15)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	65	Outperform (Buy)	16
Market Perform (Hold)	33	Market Perform (Hold)	3
Underperform (Sell)	2	Underperform (Sell)	0

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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