

Equity Research

INC Research Holdings, Inc.

INCR: Q4 2014 Earnings Full Analysis

Outperform / V

Sector: Pharmaceutical Services

Overweight

Earnings Estimates Revised Up

EPS	2014A	2015E		2016E	
		Curr.	Prior	Curr.	Prior
Q1 (Mar.)	\$0.11	\$0.28	NC	\$0.35	
Q2 (June)	0.26	0.29	0.28	0.36	
Q3 (Sep.)	0.27	0.31	NC	0.38	
Q4 (Dec.)	0.25	0.33	0.32	0.40	
FY	\$0.89	\$1.22	1.20	\$1.50	
CY	\$0.89	\$1.22		\$1.50	
FY P/EPS	31.4x	22.9x		18.6x	
Rev.(MM)	\$810	\$891		\$1,000	

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 intangibles and non-recurring items.

• **What to do from here.** INCR has strong momentum following its first quarter as a public company. Revenue, EPS, and bookings all beat consensus, and the company issued 2015 guidance with a mid-point slightly above our prior estimate on EPS and in-line with our prior estimate on revenue, despite substantial FX revenue headwinds (the FX impact on operating income is neutral due to a large cost base in GBP). With a conservative coverage ratio (89%), the outlook for continued double-digit revenue growth and 20%+ EPS growth seems realistic, which we believe makes the current valuation look reasonable, if not attractive. We are raising our valuation range to \$32-34 from \$29-30 and increasing our 2015E EPS to \$1.22 from \$1.20. Establishing our 2016E EPS of \$1.50.

• **Thoughts on Astellas.** We believe some investors are concerned about the company's relationship with Astellas, which provided 12% of revenue in 2014. The original relationship was an FSP contract with a renewal date in Q2 2015, which INCR believes could be renewed under a full service model. The company indicates negotiations are going well but that some of the conservatism built into guidance is due to risk-adjusting of Astellas. We think Astellas will indeed be renewed, but we also appreciate the company's more conservative guidance, and we think a renewal of the contract could create upside potential to our current estimates.

• **Financial highlights.** Revenue of \$214MM beat consensus of \$208MM and our estimate of \$209MM. EPS of \$0.25 (including stock comp) beat our estimate of \$0.21 (recall that we include stock comp, which the company excludes from its own non-GAAP number, making consensus EPS somewhat unreliable due to a mixed basis). Book-to-bill of 1.48x beat our estimate of 1.20x. Besides the revenue beat, a strong operating margin (15.9% versus our 15.3% estimate) helped drive the EPS beat. FX played a large factor in the margin beat as the company has more costs in GBP than revenue.

• **Guidance highlights.** The company issued 2015 EPS guidance of \$1.19-1.29 on revenue of \$870-900MM. EPS guidance excludes about \$0.04 of stock-based comp, so on an apples-to-apples basis with our methodology, the EPS guidance would be \$1.15-1.25. The revenue guidance assumes an FX headwind of about 400 bps, although FX should be neutral on operating income. Management indicates the current backlog covers 89% of 2015 revenue guidance, which compares favorably to other companies that give this metric.

Valuation Range: \$32.00 to \$34.00 from \$29.00 to \$30.00

Our valuation range is DCF-based (WACC = 8.5%; terminal NOPLAT growth = 2%) and represents 22x our 2016 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) limited track record in public equity markets; and (5) controlled company status.

Investment Thesis:

We believe INCR should be able to grow revenue and EPS at a CAGR of about 10% and 20%, respectively, over the next few years. While we also expect higher-than-average bookings volatility, we believe the strong growth potential tilts the risk/reward profile in a favorable direction.

Please see page 4 for rating definitions, important disclosures and required analyst certifications

All estimates/forecasts are as of 02/24/15 unless otherwise stated.

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Ticker	INCR
Price (02/24/2015)	\$27.91
52-Week Range:	\$19-29
Shares Outstanding: (MM)	61.3
Market Cap.: (MM)	\$1,710.9
S&P 500:	2,113.79
Avg. Daily Vol.:	106,661
Dividend/Yield:	\$0.00/0.0%
LT Debt: (MM)	\$420.0
LT Debt/Total Cap.:	52.0%
ROE:	34.0%
3-5 Yr. Est. Growth Rate:	21.0%
CY 2015 Est. P/EPS-to-Growth:	1.1x
Last Reporting Date:	02/24/2015

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

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Together we'll go far



Exhibit 1. Variance Table

FY ending December In millions except EPS	Actual		Est	Actual	Cons	Yr / Yr change	Seq change
	Q4 2013	Q3 2014					
Total revenues	\$ 174	\$ 208	\$ 209	\$ 214	\$ 208	22.6%	2.9%
Cost of revenues	112	130	134	134		19.5%	3.4%
Gross profit	62	78	75	80		28.1%	2.0%
Selling, general & administrative	34	38	38	41		19.9%	8.0%
Depreciation	5	5	5	5		(4.8%)	5.4%
Operating income	23	36	32	34		47.6%	(4.8%)
Interest expense and other, net	16	13	12	11		(30.8%)	(13.5%)
Pretax income	7	23	20	23		231.0%	0.2%
Provision for income taxes	3	8	8	8		232.6%	0.1%
Income before equity in affiliates	4	14	\$ 13	\$ 14		230.1%	0.2%
Non-GAAP EPS	0.08	\$ 0.27	\$ 0.21	\$ 0.25		192.0%	(10.5%)
Non-GAAP EPS (company method)	0.10	\$ 0.28	\$ 0.22	\$ 0.26		152.7%	(8.8%)
Diluted shares outstanding	52	53	61	59			
EBITDA	\$ 28	\$ 40	\$ 37	\$ 39		37.9%	(3.6%)
MARGIN ANALYSIS							
Cost of revenue	64.3%	62.4%	64.2%	62.7%		(160) bps	30 bps
Gross margin	35.7%	37.6%	35.8%	37.3%		160 bps	(30) bps
SG&A / revenue	19.5%	18.2%	18.1%	19.1%		(40) bps	90 bps
Depreciation / revenue	3.0%	2.3%	2.4%	2.3%		(70) bps	10 bps
Operating margin	13.2%	17.2%	15.3%	15.9%		270 bps	(130) bps
Tax rate	36.8%	37.0%	37.0%	36.9%		20 bps	0 bps
Net margin	2.5%	6.9%	6.2%	6.7%		420 bps	(20) bps
EBITDA margin	16.2%	19.5%	17.7%	18.2%		200 bps	(120) bps
REVENUE ANALYSIS							
Total revenues	\$ 174	\$ 208	\$ 209	\$ 214			
Growth: core	14.0%	22.7%	21.5%	24.9%			
Growth: FX	0.6%	(0.2%)	(2.3%)	(2.7%)			
Growth: acquisitions	0.0%	0.4%	0.4%	0.4%			
Growth: total	14.6%	22.9%	19.6%	22.6%			
Beginning backlog	\$ 1,373	\$ 1,493	\$ 1,506	\$ 1,506			
Revenue	(174)	(208)	(209)	(214)			
Net bookings	285	249	250	316	260	10.9%	26.9%
Other adjustments	7	(28)	(7)	(20)			
Ending backlog	\$ 1,491	\$ 1,506	\$ 1,541	1589	1,550		
Net book-to-bill	1.64	1.20	1.20	1.48			
Backlog burn rate	12.7%	13.9%	13.9%	14.2%			

Source: FactSet; Company data; Wells Fargo Securities, LLC estimates

Exhibit 3. Earnings Model

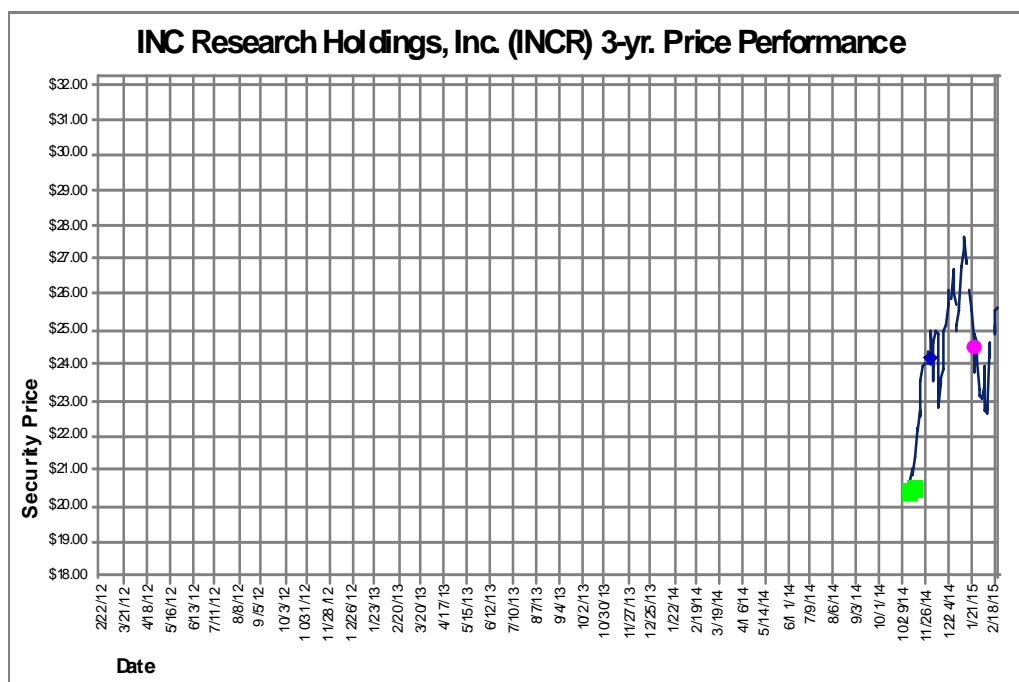
In millions, except per share

	2011	2012	2013	Q1	Q2	Q3	Q4	2014	Q1E	Q2E	Q3E	Q4E	2015E	2016E	2017E
INCOME STATEMENT															
Total revenues	\$ 437	\$ 579	\$ 652	\$ 185	\$ 204	\$ 208	\$ 214	\$ 810	\$ 214	\$ 220	\$ 226	\$ 232	\$ 891	\$ 1,000	\$ 1,106
Cost of revenues	280	389	432	121	131	130	134	515	137	141	144	148	570	640	705
Gross profit	157	190	220	64	73	78	80	295	77	79	82	84	321	361	402
Selling, general & administrative	95	110	117	32	34	38	41	144	38	39	40	41	159	175	191
Depreciation	16	20	19	7	5	5	5	22	5	5	5	5	21	23	27
Operating income	47	60	84	25	34	36	34	129	33	35	36	37	142	163	183
Interest expense and other, net	54	57	60	16	13	13	11	53	5	5	5	5	20	17	13
Pretax income	(7)	3	23	9	21	23	23	76	28	29	31	33	121	146	170
Provision for income taxes	(3)	1	9	3	8	8	8	28	10	11	11	12	44	50	54
Net income	\$ (4)	\$ 2	\$ 15	\$ 6	\$ 13	\$ 14	\$ 14	\$ 48	\$ 18	\$ 19	\$ 20	\$ 21	\$ 78	\$ 97	\$ 116
Non-GAAP EPS	\$ (0.10)	\$ 0.04	\$ 0.28	\$ 0.11	\$ 0.26	\$ 0.27	\$ 0.25	\$ 0.89	\$ 0.28	\$ 0.29	\$ 0.31	\$ 0.33	\$ 1.22	\$ 1.50	\$ 1.77
Non-GAAP EPS (company method)	\$ (0.08)	\$ 0.05	\$ 0.31	\$ 0.12	\$ 0.27	\$ 0.28	\$ 0.26	\$ 0.93	\$ 0.29	\$ 0.30	\$ 0.32	\$ 0.34	\$ 1.26	\$ 1.54	\$ 1.81
Diluted shares outstanding	43.9	52.2	52.0	51.9	52.2	52.5	58.8	53.9	63.7	63.7	63.8	63.8	63.8	64.3	65.1
EBITDA	\$ 63	\$ 80	\$ 103	\$ 32	\$ 39	\$ 40	\$ 39	\$ 151	\$ 38	\$ 40	\$ 42	\$ 43	\$ 162	\$ 186	\$ 210
MARGIN ANALYSIS															
Cost of revenue	64.0%	67.2%	66.3%	65.4%	64.3%	62.4%	62.7%	63.6%	64.1%	64.1%	63.8%	63.8%	63.9%	63.9%	63.7%
Gross margin	36.0%	32.8%	33.7%	34.6%	35.7%	37.6%	37.3%	36.4%	35.9%	35.9%	36.2%	36.2%	36.1%	36.1%	36.3%
SG&A / revenue	21.6%	18.9%	17.9%	17.3%	16.5%	18.2%	19.1%	17.8%	18.0%	17.9%	17.8%	17.7%	17.8%	17.5%	17.3%
Depreciation / revenue	3.6%	3.4%	2.9%	3.7%	2.5%	2.3%	2.3%	2.7%	2.3%	2.3%	2.3%	2.4%	2.3%	2.3%	2.4%
Operating margin	10.7%	10.4%	12.9%	13.6%	16.8%	17.2%	15.9%	15.9%	15.6%	15.7%	16.1%	16.1%	15.9%	16.3%	16.6%
Tax rate	37.0%	37.5%	36.9%	36.9%	37.0%	37.0%	36.9%	37.0%	36.0%	36.0%	36.0%	36.0%	36.0%	34.0%	32.0%
Net margin	(1.0%)	0.3%	2.3%	3.2%	6.6%	6.9%	6.7%	5.9%	8.4%	8.5%	8.9%	9.0%	8.7%	9.7%	10.5%
EBITDA margin	14.3%	13.9%	15.8%	17.4%	19.2%	19.5%	18.2%	18.6%	17.9%	18.0%	18.4%	18.5%	18.2%	18.6%	19.0%
CHANGE ANALYSIS YR / YR															
Total revenues		32.5%	12.7%	23.3%	27.9%	22.9%	22.6%	24.1%	15.7%	8.0%	8.7%	8.5%	10.1%	12.2%	10.6%
Gross profit		20.9%	15.8%	42.2%	38.0%	29.9%	28.1%	33.8%	20.0%	8.5%	4.5%	5.3%	9.1%	12.2%	11.3%
SG&A		16.0%	6.7%	16.8%	18.7%	37.7%	19.9%	23.1%	20.6%	17.1%	6.5%	0.7%	10.4%	9.9%	9.5%
Depreciation		26.8%	(3.7%)	54.5%	5.6%	0.1%	(4.8%)	12.7%	(30.0%)	0.5%	11.2%	9.3%	(4.8%)	9.7%	19.7%
Operating income		28.9%	38.8%	90.5%	73.8%	27.3%	47.6%	53.7%	32.8%	1.2%	1.6%	10.2%	9.9%	15.2%	12.2%
Net income		NA	654.1%	NA	337.7%	71.9%	230.1%	224.9%	207.6%	39.5%	39.0%	45.1%	61.5%	24.5%	19.6%
EPS		NA	657.1%	NA	336.8%	70.3%	192.0%	213.9%	150.9%	14.2%	14.5%	33.6%	36.4%	23.4%	18.1%
Diluted shares outstanding		19.1%	(0.4%)	(0.1%)	0.2%	0.9%	13.0%	3.5%	22.6%	22.1%	21.5%	8.6%	18.4%	0.9%	1.2%
EBITDA		28.4%	28.3%	81.4%	60.5%	23.4%	37.9%	46.1%	19.4%	1.1%	2.7%	10.0%	7.7%	14.5%	13.1%
REVENUE ANALYSIS															
Total revenue	\$ 437	\$ 579	\$ 652	\$ 185	\$ 204	\$ 208	\$ 214	\$ 810	\$ 214	\$ 220	\$ 226	\$ 232	\$ 891	\$ 1,000	\$ 1,106
Growth: core		4.3%	12.3%	22.6%	26.2%	22.7%	24.9%	24.1%	20.2%	12.8%	12.7%	10.8%	13.9%	12.2%	10.6%
Growth: FX		(2.2%)	0.4%	0.6%	1.2%	(0.2%)	(2.7%)	(0.4%)	(4.8%)	(4.8%)	(4.0%)	(2.3%)	(3.9%)	0.0%	0.0%
Growth: acquisitions		30.4%	0.0%	0.1%	0.4%	0.4%	0.4%	0.4%	0.3%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%
Growth: total		32.5%	12.7%	23.3%	27.9%	22.9%	22.6%	24.1%	15.7%	8.0%	8.7%	8.5%	10.1%	12.2%	10.6%
Beginning backlog		\$ 1,222	\$ 1,321	\$ 1,491	\$ 1,594	\$ 1,493	\$ 1,506	\$ 1,491	\$ 1,589	\$ 1,617	\$ 1,661	\$ 1,706	\$ 1,589	\$ 1,752	\$ 1,952
Revenue		(579)	(652)	(185)	(204)	(208)	(214)	(810)	(214)	(220)	(226)	(232)	(891)	(1,000)	(1,106)
Net bookings		676	814	281	103	249	316	950	256	264	271	278	1,070	1,200	1,327
Other adjustments		2	9	7	(1)	(28)	(20)	(42)	(15)	-	-	-	(15)	-	-
Ending backlog	\$ 1,222	\$ 1,321	\$ 1,491	\$ 1,594	\$ 1,493	\$ 1,506	\$ 1,589	\$ 1,589	\$ 1,617	\$ 1,661	\$ 1,706	\$ 1,752	\$ 1,752	\$ 1,952	\$ 2,173
Net book-to-bill		1.17	1.25	1.52	0.51	1.20	1.48	1.17	1.20	1.20	1.20	1.20	1.20	1.20	1.20
Backlog burn rate		47.4%	49.4%	12.4%	12.8%	13.9%	14.2%	54.3%	13.5%	13.6%	13.6%	13.6%	56.1%	57.1%	56.7%
OTHER															
Cash and equivalents		\$ 81	\$ 97	\$ 114	\$ 156	\$ 186	\$ 126	\$ 126	\$ 119	\$ 128	\$ 150	\$ 136	\$ 136	\$ 185	\$ 280
Total debt		594	594	590	589	588	420	420	420	401	381	362	362	284	258
Net cash (debt)		\$ (513)	\$ (498)	\$ (475)	\$ (433)	\$ (403)	\$ (294)	\$ (294)	\$ (301)	\$ (273)	\$ (232)	\$ (226)	\$ (226)	\$ (99)	\$ 22
Debt to TTM EBITDA		0.0x	4.8x	4.0x	3.3x	2.9x	1.3x	1.9x	1.9x	1.7x	1.5x	1.4x	1.4x	0.5x	-0.1x
Cash flow from operations		\$ 43	\$ 37	\$ 31	\$ 49	\$ 37	\$ 14	\$ 131	\$ (0)	\$ 35	\$ 49	\$ 13	\$ 98	\$ 158	\$ 152
Capital expenditures		(10)	(18)	(5)	(8)	(5)	(8)	(26)	(7)	(7)	(7)	(7)	(28)	(29)	(30)
Free cash flow		\$ 33	\$ 20	\$ 27	\$ 41	\$ 32	\$ 6	\$ 106	\$ (7)	\$ 28	\$ 42	\$ 6	\$ 70	\$ 129	\$ 122
Headcount (actual)		4,890	4,850			5,500	5,600	5,600	5,725	5,850	5,975	6,100	6,100	6,600	7,100
Book value per share		\$ 6	\$ 5	\$ 5	\$ 6	\$ 6	\$ 7	\$ 7	\$ 6	\$ 7	\$ 7	\$ 7	\$ 7	\$ 9	\$ 10
Tangible book value per share		\$ (10)	\$ (10)	\$ (10)	\$ (9)	\$ (9)	\$ (6)	\$ (7)	\$ (5)	\$ (5)	\$ (4)	\$ (4)	\$ (4)	\$ (2)	\$ 0

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

Company Description:

Raleigh, North Carolina-based INC Research Holdings, Inc. (NASDAQ: INCR) is a mid-size clinical contract research organization. The company is a pure play in clinical (phase I-IV) development. The company is differentiated by its specialization in trials related to central nervous system therapies. It operates in one segment.

Required Disclosures

	Date	Publication Price (\$)	RatingCode	Val. Rng. Low	Val. Rng. High	Close Price(\$)
□	11/7/2014		IPO at \$18.50			
	12/2/2014		Evans			
◆	12/2/2014	24.00	1	27.00	28.00	24.20
●	1/22/2015	25.50	1	29.00	30.00	24.58

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- Valuation Range Change

- ◆ Initiation, Resumption, Drop or Suspend
- Analyst Change
- Split Adjustment

Rating Code Key

- | | |
|-----------------------|----------------|
| 1 Outperform/Buy | SR Suspended |
| 2 Market Perform/Hold | NR Not Rated |
| 3 Underperform/Sell | NE No Estimate |

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- Wells Fargo Securities, LLC or its affiliates intends to seek or expects to receive compensation for investment banking services in the next three months from an affiliate of INC Research Holdings, Inc.

INCR: 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) limited track record in public equity markets; and (5) controlled company status.

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1=Outperform: The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY

2=Market Perform: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD

3=Underperform: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING

O=Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

M=Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

U=Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

VOLATILITY RATING

V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: February 24, 2015

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Wells Fargo Securities, LLC has provided investment banking services for 30% of its Equity Research Market Perform-rated companies.

2% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Underperform.

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