Zacks Small-Cap Research

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Pharma-Bio Serv (PBSV-OTC)

PBSV: Maintaining Outperform Rating

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/15/2013
Current Price (12/08/14)	$1.21
Target Price	**$3.00**

OUTLOOK

Regularly recognized as one of the top validation companies in Puerto Rico, PBSV is principally engaged in providing compliance consulting to the pharmaceutical industry. Serving customers in the U.S., Europe, and Puerto Rico, PBSV counts many of the pharma "majors" as clients. The company's small size, high levels of expertise in various disciplines and reputation as an eminent life sciences consulting firm has allowed it to adapt to and capitalize on the changing regulatory landscape. This has helped push revenue up 75% in 2011, 47% in 2012 and 13% in 2013. The industry remains ripe for continued growth and PBSV is sitting in the cat-bird's seat ready to take advantage of it. PBSV is generating net profits, significant cash flow, has a stellar balance sheet, and trades cheap. Despite all their success, mgmt has remained focused on running the business and running it the right way.

SUMMARY DATA

52-Week High	**$2.09**
52-Week Low	**$1.00**
One-Year Return (%)	**-36.32**
Beta	**-0.70**
Average Daily Volume (sh)	**11,076**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$28**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**43**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**33.0**
Earnings Per Share (%)	**80.1**
Dividend (%)	**N/A**
P/E using TTM EPS	**5.7**
P/E using 2014 Estimate	**13.3**
P/E using 2015 Estimate	**6.3**
Zacks Rank	**N/A**

Risk Level	**High,**
Type of Stock	**Small-Value**
Industry	**Consulting**

ZACKS ESTIMATES

Revenue
(in millions)

	Q1 (Jan)	Q2 (Apr)	Q3 (Jul)	Q4 (Oct)	Year (Oct)
2013	$7.7 A	$8.3 A	$8.4 A	$8.8 A	$33.1 A
2014	$7.0 A	$6.6 A	$6.8 A	$7.1 E	$27.5 E
2015					$30.9 E
2016					$34.6 E

Earnings per Share

	Q1 (Jan)	Q2 (Apr)	Q3 (Jul)	Q4 (Oct)	Year (Oct)
2013	$0.05 A	$0.06 A	$0.05 A	$0.05 A	$0.21 A
2014	$0.03 A	$0.01 A	$0.03 A	$0.02 E	$0.09 E
2015					$0.14 E
2016					$0.19 E

Zacks Projected EPS Growth Rate - Next 4 Years % **8**

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PBSV Remains Undervalued

We are reiterating our Outperform rating and $3.00/share price target on PBSV. We continue to think the shares remain undervalued and with the sell-off in the stock since early 2014, resulting in the price falling from over $2.00 to the current $1.21, this presents an attractive opportunity to own PBSV at a cheap valuation. We also note that the recently announced relationship with T.R. Winston could result in another avenue of growth for the company which is not yet reflected in our financial model and therefore could provide additional upside.

Fiscal Q3 2014 Results: *Revenue Softness Continues But Still Generating Tons of Cash…*

PBSV reported financial results for the fiscal third quarter ending July 31st. While revenue missed our number by about 7%, net income and EPS were a hair better than our estimates as a result of cost control in SG&A. We have made no material adjustments to our model following reporting of Q3 results, which is in contrast to prior recent periods where both revenue and earnings handily missed our numbers, which prompted downward adjustments to our forecasted financials. Importantly, despite the lingering softness in revenue the company continues to generate significant cash flow.

Revenue has remained soft over the last several quarters, falling almost 16% through the first nine months of fiscal 2014. Per management the culprit continues to be worldwide economic weakness and certain challenges (Obamacare, Puerto Rico Act 154) which are effecting their pharmaceutical industry and thus, PBSV's revenue. The company's outlook also remains largely unchanged from that offered since earlier this fiscal year - that being that these issues are expected to continue to persist for at least the near-term but that PBSV will continue to invest in the business in anticipation that these headwinds will subside and return the company to positive revenue growth. We continue to model revenue to fall (on a yoy basis) through the remainder of fiscal 2014 but to turn back to positive growth the following year.

We also look for EPS to increase from 2014 to 2015 - from $0.09 to $0.14, with the growth catalyzed by the increase in the top-line, some slightly greater leverage in opex and a smaller outstanding share count (the latter the result of the recently announced share buyback program for up to two million shares). And with almost $14M in cash, the company can easily fund the buyback program.

Q3 revenue of $6.8M was down 18% yoy but ticked up 4% from Q2 2014. Revenue was just over $500k lower than our $7.4M estimate. Similar to the first six months of the year, U.S. and European consulting revenue (which were catalysts in driving the 13% top-line growth in 2013), were the biggest laggards in the most recent quarter - falling 34% and 39% respectively.

Q3 net income and EPS were $597k and $0.03, compared to our $551k and $0.02 estimates with the majority of the difference a result of $222k lower than modeled operating expenses ($1.5M A vs $1.7M E). Notably, opex came down meaningfully from the first two quarters of the year where it averaged $1.6M per quarter. As noted, PBSV has been increasing spending on business development and operational activities to support anticipated increased demand in the U.S. and Puerto Rican markets. We continue to expect increasing demand for the company’s services to result in revenue growth within the next several quarters and expect resultant further improvement in operating leverage, operating margin and EPS.

Cash balance and the balance sheet in general remain in very solid shape. Cash flow from operations was an inflow of $1.1M in Q3 and $2.0M through the first nine months of fiscal 2014. Excluding changes in working capital, cash flow from operations was an inflow of $710k and $1.9M over the same periods. PBSV exited Q3 with $13.8M in cash (up from $12.0M at the end of Q2) and no debt.

SERVICES

PBSV's core business is FDA and international agencies regulatory compliance and related services, although they also offer other integrated services that affords them the ability to be a full-service solution provider.

The vast majority of the company's services are provided through time and materials contracts where clients are charged for the time, materials and expenses incurred on a particular project or service. Time and material

contracts, which account for approximately 94% of the company's revenue, have somewhat of a built-in margin to PBSV.

Laboratory testing, which is usually completed and certified within days of sample receipt, represents about 5% of total revenue.

Compliance Consulting
PBSV has over 20 years of compliance consulting experience. Their consulting business caters to some of the largest life sciences organizations in the world including eight of the top ten pharmaceutical companies and seven of the top ten medical technology companies. The company believes their competitive advantages relative to compliance consulting include their two decades of experience, ability to offer a wide range and depth of services with very high levels of expertise, accomplished track record of exceptional performance that consistently meets or exceeds client's expectations, and being able to provide their services at a significantly lower cost. PBSV also puts considerable effort into maintaining close and trusting relationships with their client companies, which provides clear benefits in terms of repeat business. Compliance consulting services accounts for approximately 93% of the company's total revenue.

PBSV's compliance consulting spans a large menu of services under a variety categories.

Scienza Labs
Per the company's website and company filings, Scienza Labs is a state of the art microbiological testing facility with the latest equipment and technology and test methodologies available, harmonized with the current pharmacopeias. The labs are designed to exceed customers' expectations with an excellent organization, on time delivery, and shorter testing cycle times. The lab provides services to the company's core industry (life sciences) as well as to the cosmetic and food industries. Microbiology and chemical testing services accounts for approximately 5% of the company's total revenue.

> State of the Art New Facilities with fully Validated Equipment
> FDA Registered and compliant with current regulations. Inspected by SJ District Office with zero observations
> ISO 9001:2008 Certified
> Certified Minority Controlled Company
> Excellent Organization
> On-Site Pick-up 24 hours a day / 7 days a week
> On time delivery



SOURCE: pharmabioserv.com

Integratek
Per the company's website and company filings, Integratek, their Puerto Rico based information technology services and consulting division, provides a variety of information technology services such as web pages and portals development, digital art design, intranets, extranets, software development including database integration, Windows and web applications development, software technical training and learning management systems, technology project management, and compliance consulting services, among others. Integratek is a Microsoft Certified Partner and a reseller for technology products from leading vendors in the market. IT services and the company's Pharma Serv Academy (technical training) account for approximately 2% of PBSV's total revenue.

> **Application Development / Systems Integration**
> **Art Design / Web Pages and Portals**
> **Document Digitalization / Process Automation**
> **Networking / Help Desk / Virtualization**
> **Computer System Validation**
> **Project Management**
> **Systems Integration**
> **Temporary Staffing Services**
> **E-Learning / Learning Mngmt Systems / Classroom & Webinar Courses**
> **Mobile Application Development**

Pharma Serv Academy
Pharma Serv Academy (per company filings and website), through a network of leading industry professional experts in their field, including those from PBSV, provides technical seminars/training that incorporate the latest regulatory trends and standards as well as other related areas. These services are provided in the markets that PBSV currently serves, as well as other industries.

> **Project Management**
> **Risk Management Program**
> **Regulatory Guidance Documents**
> **Regulatory Enforcement**
> **ICH Guidelines for Product Life Cycle**
> **Computer Systems**
> **Validation Courses**
> **Safety**
> **cGMPs**
> **Microbiology**
> **Quality Systems**
> **Other Seminars**
> **Lean Six Sigma / Process Excellence and Continuous Improvement Series**

FINANCIAL CONDITION / FINANCIAL PERFORMANCE

Solid, Spotless Balance Sheet and Significant Positive Cash Flow
PBSV maintains a stellar balance sheet, which is particularly impressive for a micro-cap company. At the most recent quarter-end (July 31, 2014) cash balance stood at $13.8 million, up from $12.0 million at the end of the prior quarter. The company has zero debt, zero preferred stock, and just under 24 million fully-diluted common shares outstanding. Quality of assets appears to be strong with an immaterial amount of intangibles, cash and securities accounting for about 63% of total assets, and no indication that all of A/R is anything other than collectible.

PBSV also has a history of positive cash flow generation. Cash flow from operating activities was $2.1 million in fiscal 2011, $2.5 million in fiscal 2012, $5.6 million in fiscal 2013 and $2.0 million through the first nine months of fiscal 2014. The business is also not very capital intensive, with CapEx of just $123k in 2011, $169k in 2012, $205k in 2013 and $172k through the first nine month of 2014.

Impressive Performance: Revenue Grows 76% in 2011, 47% in 2012, 13% in 2013 and Mid-Teen Net Margins
PBSV has grown revenues from $11.4 million in fiscal 2010 to $19.9 million (+76%) in 2011 to $29.2 million (+47%) in 2012 and to $33.0 million (+13%) in 2013. Almost all of this revenue growth is organic, with little contribution from any acquisitions over these periods.

The company points to a few factors that have attributed to this impressive revenue growth including some contraction in the pharmaceutical industry which has eliminated some competition as well as recent regulatory changes that have increased demand for their services. As we have indicated in our ingoing coverage of the company, PBSV's relatively small size coupled with their high levels of expertise in various disciplines allows them to quickly shift resources when opportunities present themselves and to capitalize on changes within the regulatory environment and the industry. This appears to have been a significant benefit to PBSV over the recent past.

The company has done an excellent job with not just growing revenue but also with keeping expenses in check. The combination has resulted in EPS growing from $0.02 in fiscal 2010 to $0.14 in 2011 to $0.20 in 2012 and $0.21 in 2013.

Recent Softness Not Expected To Be a Long-Term Trend. Cash Flow Continues…

While revenue and EPS have contracted through the first nine months of fiscal 2014, PBSV continues to generate positive cash flow and maintains an ultra-healthy balance sheet. Cash flow from operating activities during the first nine months of fiscal 2014 was an inflow of $2.0M ($1.9M ex-changes in working capital). This follows $5.6M ($5.3M ex-changes in working capital) of cash generated in fiscal 2013. The company exited Q3 with $13.8M in cash and securities. The balance sheet remains debt-free.

But while we expect a return to meaningful and sustained revenue growth within the next 18 months, we think the relative softness throughout fiscal 2014 may be indicative of the roll-off of certain contracts that may also impact the next one to two quarters. PBSV has also noted that worldwide economic weakness and certain challenges (Obamacare, Puerto Rico Act 154) are effecting their pharmaceutical industry clients which have put downward pressure on the company's revenue. And while the language in the most recent 10-Q indicates that management expects these issues to continue to persist for at least the near-term, PBSV continues to invest in the business in anticipation that these headwinds will subside and return the company to positive revenue growth.

Important to remember is that most contracts are relatively short-term in nature, meaning short-term weakness is not indicative of future performance. PBSV has recently dedicated more resources towards investments in the business, a sign that indicates they expect resurgence in demand to materialize in the near-term. In addition, aside from the most recent three quarters, PBSV has not experienced a yoy decline in revenues – perhaps lending more support that the recent revenue weakness is more anomaly than trend.

Beneficial Income Tax Status…
One somewhat unique advantage that PBSV enjoys and helps maximize the amount of revenue that flows to the bottom line is that they are subject to a lower than normal statutory Puerto Rico income tax rate. In June 2011 the company obtained a Grant of Industrial Tax Exemption from the Puerto Rico Industrial Development Company. The grant was effective November 2009. The grant provides relief on various Puerto Rico taxes, including income tax, with certain limitations, for most of the activities carried on within Puerto Rico, including those that are for services to parties located outside of Puerto Rico. The grant, which is effective through 2024, significantly reduces PBSV's Puerto Rico income tax liability from what would have been a tax rate of 30% to what was an effective rate of 5.5% in fiscal 2011, 5.4% in 2012 and 4% in fiscal 2013 (and should remain at 4% until expiration).

This grant only covers operations in Puerto Rico. Operations carried out in the United States are taxed at a maximum regular federal income tax rate of 35%.

PBSV's total effective tax rate in 2012 and 2013 were 18.6% and 19.3% which is significantly favorable relative to the 35% U.S. federal statutory rate and PBSV's 2010 effective rate of 40.1% (which was prior to obtaining the grant).

OUTLOOK

The company is in the process of making a more deliberate effort to communicate with the investing public which we expect will provide more insight into the current status of operations and their near-term plans for continued growth. We also think it will confirm that management's lack of investor-awareness activities had everything to do with them spending their energies focused on running the company and running it in the right way, something that we think speaks highly of where their priorities lie and which should provide investors comfort.

Our current financial model, which is subject change, is largely based on recent trends along with some very general "guidance" that the company has publicly disclosed. This guidance includes that the bulk of PBSV's near-term growth opportunity lies with the U.S. market, that growth in Puerto Rico will likely be limited for the foreseeable future and that growth in Europe, while having meaningful potential over the longer-term, may be constrained for a period of time due to the widespread economic weakness.

Our modeled revenue growth (-17% 2014, +12% 2015, +12% 2016) is arguably conservative given PBSV's recent historical financial performance (revenue growth of 76% 2011, 47% 2012, 13% in 2013). We reiterate that our estimates are subject to change. The majority of our modeled revenue growth is driven by growth in the U.S., with Puerto Rico revenue growth in the mid-single digits and European revenue starting to pick up more meaningfully towards the 2015 - 2016 timeframe. We have incorporated only modest expansion in gross margin

from current levels - which is also potentially conservative. During 2013 the company intentionally dedicated more resources towards beefing up their U.S. related capabilities in order to meet the anticipated increase in demand, which resulted in SG&A spend materially increasing during the year. We now look for SG&A spend to increase by about 9% in the current year compared to 2013 but for the company to start to see some leverage from SG&A on a % of sales basis in 2015.

With U.S. revenue increasing as a % of total sales and Puerto Rico revenue growth more modest, the benefit from the low Puerto Rico income tax rate will be lessened. As a result, we model the effective tax rate to increase throughout our modeled periods.

Valuation / Recommendation

Based on our model we look for EPS to grow at a CAGR of about 11% through 2017. We use an industry PE/G ratio of 2.0x (which fell from 2.5x since our last update) to value PBSV. We look for 2015 EPS of $0.14 which values the company at approximately $3.00/share (unchanged since our last update). The stock currently trades at about $1.21, indicating the shares are trading cheaper than fair value. As such we recommend accumulating up to our $3.00 price target. We are maintaining our Outperform rating.

FINANCIAL MODEL

Pharma-Bio Serv, Inc

	2013 A	Q1A	Q2A	Q3A	Q4E	2014 E	2015 E	2016 E	2017 E
Puerto Rico Consulting	$15,833.2	$3,521.2	$3,508.4	$3,972.8	$3,729.3	$14,731.7	$15,689.2	$16,865.9	$18,063.4
YOY Growth	*4.1%*	*-0.7%*	*-7.6%*	*-2.9%*	*-15.2%*	*-7.0%*	*6.5%*	*7.5%*	*7.1%*
% of total sales	47.9%	50.2%	53.4%	58.1%	52.5%	53.5%	50.8%	48.7%	46.7%
U.S. Consulting	$11,334.1	$2,321.3	$2,013.1	$1,820.4	$2,230.8	$8,385.7	$10,222.1	$12,154.1	$14,281.1
YOY Growth	*23.7%*	*-15.6%*	*-29.7%*	*-33.8%*	*-25.0%*	*-26.0%*	*21.9%*	*18.9%*	*17.5%*
% of total sales	34.3%	33.1%	30.6%	26.6%	31.4%	30.5%	33.1%	35.1%	37.0%
Europe Consulting	$3,596.6	$683.3	$467.6	$548.5	$614.3	$2,313.8	$2,510.5	$2,741.4	$3,010.1
YOY Growth	*12.0%*	*-20.1%*	*-44.9%*	*-39.2%*	*-38.0%*	*-35.7%*	*8.5%*	*9.2%*	*9.8%*
% of total sales	10.9%	9.8%	7.1%	8.0%	8.7%	8.4%	8.1%	7.9%	7.8%
Lab (microbiological & chemical testing)	$1,866.9	$453.1	$440.2	$370.6	$427.1	$1,691.0	$1,970.0	$2,283.2	$2,614.3
YOY Growth	*117.6%*	*23.6%*	*-31.4%*	*-29.4%*	*28.0%*	*-9.4%*	*16.5%*	*15.9%*	*14.5%*
% of total sales	5.6%	6.5%	6.7%	5.4%	6.0%	6.1%	6.4%	6.6%	6.8%
Other segments	$431.1	$28.7	$145.7	$123.8	$98.0	$396.2	$463.6	$569.7	$675.1
YOY Growth	*-45.0%*	*-79.3%*	*38.4%*	*29.2%*	*7.1%*	*-8.1%*	*17.0%*	*22.9%*	*18.5%*
% of total sales	1.3%	0.4%	2.2%	1.8%	1.4%	1.4%	1.5%	1.6%	1.7%
Total Revenues	$33,062.0	$7,007.7	$6,575.0	$6,836.2	$7,099.5	$27,518.3	$30,855.4	$34,614.4	$38,644.0
YOY Growth	*13.1%*	*-8.4%*	*-20.4%*	*-18.3%*	*-19.2%*	*-16.8%*	*12.1%*	*12.2%*	*11.6%*
Cost of Services	$21,228.6	$4,635.5	$4,485.0	$4,657.9	$4,813.5	$18,591.9	$20,148.6	$22,326.3	$24,384.3
Gross Income	$11,833.5	$2,372.2	$2,089.9	$2,178.2	$2,286.1	$8,926.4	$10,706.8	$12,288.1	$14,259.6
Gross Margin	*35.8%*	*33.9%*	*31.8%*	*31.9%*	*32.2%*	*32.4%*	*34.7%*	*35.5%*	*36.9%*
SG&A	$5,761.7	$1,544.6	$1,670.7	$1,480.0	$1,569.0	$6,264.2	$6,633.9	$6,749.8	$6,955.9
% SG&A	*17.4%*	*22.0%*	*25.4%*	*21.6%*	*22.1%*	*22.8%*	*21.5%*	*19.5%*	*18.0%*
Operating Income	$6,071.7	$827.6	$419.3	$698.3	$717.1	$2,662.2	$4,072.9	$5,538.3	$7,303.7
Operating Margin	*18.4%*	*11.8%*	*6.4%*	*10.2%*	*10.1%*	*9.7%*	*13.2%*	*16.0%*	*18.9%*
Total Other Income (Expense)	$4.6	$0.0	($0.9)	($0.8)	$0.0	$0.0	$4.0	$6.0	$8.0
Pre-Tax Income	$6,076.3	$827.6	$418.4	$697.5	$717.1	$2,662.2	$4,076.9	$5,544.3	$7,311.7
Tax expense (benefit)	$1,169.8	$165.7	$90.6	$100.4	$139.8	$496.5	$913.2	$1,269.6	$1,696.3
Tax Rate	*19.3%*	*20.0%*	*21.7%*	*14.4%*	*19.5%*	*18.7%*	*22.4%*	*22.9%*	*23.2%*
Net Income	$4,906.5	$661.9	$327.8	$597.1	$577.2	$2,165.7	$3,163.7	$4,274.7	$5,615.4
YOY Growth	*4.7%*	*-37.2%*	*-76.4%*	*-52.1%*	*-52.7%*	*-55.9%*	*46.1%*	*35.1%*	*31.4%*
Net Margin	*14.8%*	*9.4%*	*5.0%*	*8.7%*	*8.1%*	*7.9%*	*10.3%*	*12.3%*	*14.5%*
EPS	$0.21	$0.03	$0.01	$0.03	$0.02	$0.09	$0.14	$0.19	$0.26
YOY Growth	*1.5%*	*-39.6%*	*-76.8%*	*-52.7%*	*-49.5%*	*-55.9%*	*51.6%*	*36.3%*	*36.2%*
Diluted Shares O/S	23,660	23,725	23,788	23,609	23,550	23,668	22,800	22,600	21,800

Brian Marckx, CFA

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BALANCE SHEET

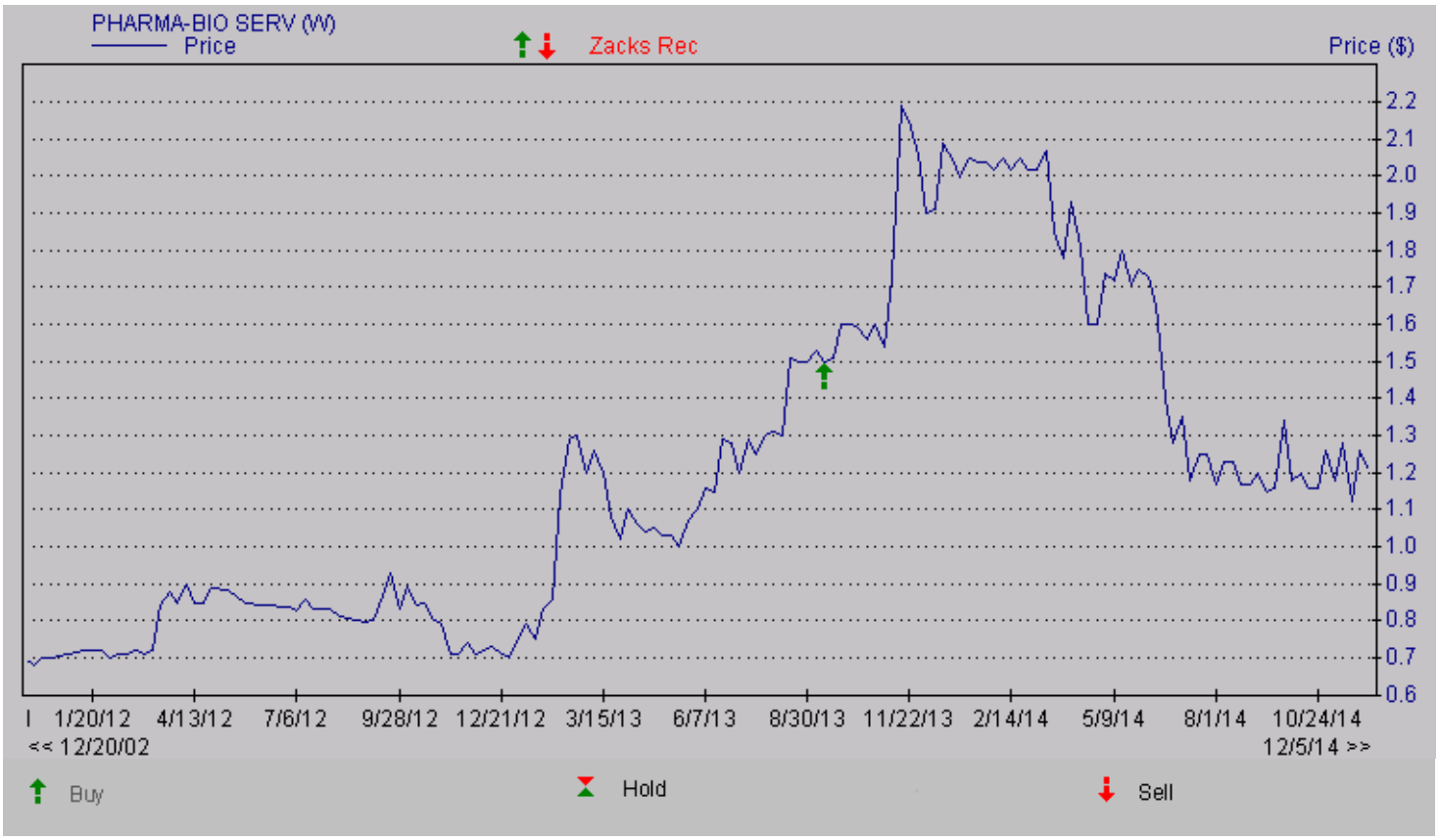
	July 31, 2014	January 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,797	$ 13,783
Marketable Securities	67	64
Accounts Receivable	6,386	5,671
Other	807	659
Total current assets	21,057	20,177
Property and equipment, net	953	884
Other assets	17	17
Total assets	$ 22,027	$ 21,078
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 38	$ 28
Accounts payable and accrued expenses	2,060	1,844
Income taxes payable	166	419
Total current liabilities	2,264	2,291
Obligations under capital leases	101	46
Total liabilites	2,364	2,337
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	982	978
Retained earnings	18,780	17,855
Accumulated other comprehensive loss	(100)	(94)
Total stockholders' equity	19,662	18,741
Total liabilities and stockholders' equity	$ 22,027	$ 21,078

CASH FLOW STATEMENT

	Three months July 31, 2014	2013
Cash flows from operating activities:		
Net income	$ 597	$ 1,247
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	-	-
Stock-based compensation	17	2
Depreciation and amortization	94	86
Changes in operating assets and liabilities:		
Accounts receivable	632	(391)
Other assets	(96)	(344)
Liabilities	(148)	91
Net cash provided by operating activities	1,096	691
Cash flows from investing activities:		
Acquisition of P&E	(106)	(76)
Proceeds from disposition of P&E	-	-
Net cash used in investing activities	(106)	(76)
Cash flows from financing activities:		
Proceeds from common stock issuance	-	-
Repurchase of common stock	(2)	0
Payments on obligations under capital lease	(10)	(10)
Net cash provided by (used in) financing activities	(13)	(10)
Effect of exchange rate changes on cash	(9)	1
Net increase (decrease) in cash and cash equivalents	968	607
Cash and cash equivalents, beginning of period	12,829	8,493
Cash and cash equivalents, end of period	$ 13,797	$ 9,100

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Buy/Outperform: The analyst expects that the subject company will outperform the broader U.S. equity market over the next one to two quarters.
Hold/Neutral: The analyst expects that the company will perform in line with the broader U.S. equity market over the next one to two quarters.
Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

The current distribution is as follows: Buy/Outperform- 16.3%, Hold/Neutral- 77.3%, Sell/Underperform – 6.2%. Data is as of midnight on the business day immediately prior to this publication.