Zacks Small-Cap Research

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Pharma-Bio Serv (PBSV-OTC)

PBSV: Revenue Soft But Cash Flow Positive. New Investments Could Spark Growth. Trading Below Book Value

Current Recommendation	**Buy**
Prior Recommendation	N/A
Date of Last Change	09/15/2013
Current Price (02/01/16)	$0.83
Target Price	**$2.00**

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.. While revenue has slipped recently we attribute this mostly to macro-economic weakness and think PBSV returns to growth over the short-term, facilitated by investments in infrastructure, personnel and entry into new markets.. And despite revenue falling recently, cash flow generation has remained robust and the company remains highly profitable. Company has a stellar balance sheet with tons of cash which they are now looking to reinvest in the business. New catalysts emerging which could pay dividends in short-order. Trading below book value offers opportune time to buy the stock.

SUMMARY DATA

52-Week High	**$1.40**
52-Week Low	**$0.83**
One-Year Return (%)	**-36.15**
Beta	**-0.15**
Average Daily Volume (sh)	**8,750**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$19**
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 (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**11.9**
P/E using 2016 Estimate	**41.5**
P/E using 2017 Estimate	**13.8**
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)
2015	$5.9 A	$5.4 A	$6.2 A	$5.9 A	$23.4 A
2016	$5.9 E	$6.0 E	$6.2 E	$6.4 E	$24.3 E
2017					$27.4 E
2018					$30.7 E

Earnings per Share

	Q1 (Jan)	Q2 (Apr)	Q3 (Jul)	Q4 (Oct)	Year (Oct)
2015	$0.01 A	$0.02 A	$0.02 A	$0.02 A	$0.07 A
2016	$0.01 E	$0.00 E	$0.00 E	$0.00 E	$0.02 E
2017					$0.06 E
2018					$0.11 E

Zacks Projected EPS Growth Rate - Next 4 Years % **18**

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Fiscal Q4 2015 Results: *Revenue Underwhelming But EPS Inline and Still Churning Positive Cash. Near-Term Investments Expected to Reignite Top-Line Growth…*

PBSV reported financial results for the fourth fiscal quarter ending October 31, 2015. Revenue was underwhelming, falling on both a yoy and sequential basis, coming in below our estimate and marking the eighth straight quarter of yoy contraction. All major itemized revenue segments exhibited a contraction aside from lab (microbiological and chemical testing). Both the U.S. and European consulting segments, which turned in sequential growth from Q2 to Q3 and which we had hoped marked a positive turning point, saw revenue fall more than 60% in Q4 and more than 50% for the full year. Meanwhile, Puerto Rico has been much more resilient, while down 4% in the quarter, that territory turned in 12% growth for the full year which was facilitated by projects in Latin America which are managed from Puerto Rico.

PBSV is looking to restart revenue growth and expects to put some of their $14.9M cash balance to work, noting in the 10-K that, "We are constantly realigning our business strategies to grow our business. As such, the Company management understands that planned infrastructure investments on human capital, new markets, and Lab facilities and equipment during fiscal year 2016 will provide sustainable growth to the Company in future years. For the year ended October 31, 2016, the Company intends to invest approximately (i) $1.7 million on new business development positions on consulting targeted new markets, and (ii) $2.0 million for the expansion of our Puerto Rico Lab facilities, openings of a Lab facility in Spain and the Calibrations division facility in Puerto Rico. The Company's working capital will be used to fund these investments"

As a reminder PBSV recently formed a new PR-based Calibrations division called Metrologix – while the company had previously expected this to be operational by October 2015, based on the language above, it appears this timeline may have slipped. And in April 2015 PBSV formed Pharma-Brazil, a wholly-owned subsidiary which will provide consulting services to the Brazilian market. Pharma-Brazil still remains in the development stage but offers another potential opportunity to contribute to revenue in future periods. Given the recent strength in Latin America-related project demand and revenue, this area of the world, including Brazil, could offer meaningful growth opportunity for PBSV.

And despite the recent consistent yoy contraction in revenue, including a 15% dip for the full fiscal year 2015, PBSV continues to remain in the black. Q4 and full year 2015 net income and EPS were $524k / $0.02 and $1.6M / $0.07 – which was inline with our estimates. And the company continues to generate positive cash flow including $372k in 2015 - or almost $2.1M excluding changes in working capital. The positive cash flow helped push book value up from $20.5M at the close of fiscal 2014 to $22M at fiscal 2015 year end.

So while top-line growth has stalled there are reasons to remain interested in PBSV – including reinvestments and new segments expected to come online which are expected to reignite sales growth, ongoing positive cash flow generation and increasing book value. In fact the stock currently trades at a discount to book value – which, based on the company's history of generating positive cash flow and increasing its book value, presentswhat we believe is a particularly opportune time to buy the shares. And PBSV had previously noted the possibility of an acquisition (in December 2014 PBSV engaged a firm to explore M&A opportunities) – if it were to happen, this could be another catalyst for growth.

Q4 revenue was $5.9 million, down 18% yoy, down 5% sequentially and 7% lower than our $6.3 million estimate. As has been the case for the past several quarters, U.S. and European sales remained tepid. U.S. consulting revenue fell on a yoy basis by 67% and 65% in Q4 and the full year, respectively, while European consulting revenue fell 63% and 51% over the same periods. U.S. had accounted for 28% of total revenue in fiscal 2014 – this fell to just 12% in 2015 – which represents the bulk of the contraction in total company revenue over that period. And while Europe has been similarly soft, although not nearly as important a territory as the U.S. (Europe accounts for just 5% of total revenue), this could represent an area of growth as PBSV expects to open a lab facility in Spain. As a reminder, the bulk of European revenue has related to just one customer in Ireland – so a new lab facility in Spain has the potential to significantly benefit revenue in this segment. Puerto Rico (most notably projects in Latin America managed in PR) has been one of the only bright spots - with revenue growing 12% for the year and now accounting for 75% of total revenue – up from 57% in 2014. With PBSV investing more capital in the build-out of their PR facilities, we model this segment's growth rate to steepen further.

And as we have noted in the past, a higher percentage of revenue from PR has tax benefits as revenue generated in that territory is taxed at just 4% (as a result of the company's beneficial PR tax status), compared to a maximum regular federal income tax rate of 35% for U.S. operations. This is highlighted in the aggregate

income tax rate, which fell from 16% in 2014 (when PR and U.S. revenue accounted for 57% and 28% of total sales, respectively) to just 9% in 2015 (when PR and U.S. revenue accounted for 75% and 12% of total sales, respectively). So, the shift in geographic revenue mix essentially added almost $119k, or about 8% more to net income in 2015.

Gross margin was another highlight in Q4. At 34.8% it was the highest since Q4 2013, well ahead of the 31% average posted through the first three quarters of 2015 and better than our 32.1% estimate. We continue to look for widening of gross margin with growth in revenue. OpEx was $1.4M and dead-on with our estimate. PBSV has been diligent on trimming costs where there are opportunities which has resulted in declining OpEx over the last few quarters. For the full year OpEx was $5.7M, down from $6.1M in 2014. PBSV is guiding for $1.7M in additional expense during 2016 related to the build-out of new business development positions related to new markets. While we expect revenue to benefit incrementally from these investments during 2016, we model a more substantive contribution in 2017 and beyond when we expect the additional operating expenses to be more fully absorbed.

Q4 net income and EPS were $524k and $0.02, largely inline with our $503k and $0.02 estimates. Despite the yoy contraction in revenue over the last eight consecutive quarters PBSV continues to generate both positive net income and cash flow. Cash flow from operations was $372k in 2015 - or almost $2.1M excluding changes in working capital. The company exited the year with $14.9 million in cash and securities. .

Model Updates…

We have made some updates to our model following Q4 results. The planned investments add meaningfully to our OpEx and the lingering softness in revenue has adjusted our near-term 2016 quarters lower. But, we think these investments in infrastructure, personnel and entry into new territories – assuming PBSV can successfully replicate their business model – should result in steepening of the revenue growth curve. We incorporate a greater rate of sequential revenue growth in the second half of 2016 related to this as well as the recent strength in Latin markets. We model mid-single digit revenue growth for the full year. 2017 and beyond should fully benefit from these investments which is reflected in the higher rate of growth.

Valuation / Recommendation

Based on our model we look for EPS to grow at a 4-year CAGR of about 23% through 2019. We use an industry PE/G ratio of 1.5x to value PBSV. We look for 2017 EPS of $0.06 which values the company at approximately $2.00/share. The stock currently trades at about $0.83, indicating the shares are trading cheaper than fair value.

We also note that book value (as of October 31, 2015) is $22 million or only about 115% of current market value – which should provide a fairly solid floor on the stock price. And given PBSV's long history of cash flow generation, which has continued during the recent slide in revenue, we think it is reasonable to expect book value to continue to grow, raising this floor and further reducing any downside risk. We recommend accumulating up to our $2.00/share price target. We are maintaining our Buy rating.

FINANCIAL MODEL

Pharma-Bio Serv, Inc

	2015 E	Q1E	Q2E	Q3E	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$23,384.9	$5,877.0	$5,898.6	$6,186.2	$6,375.4	$24,337.2	$27,441.5	$30,692.4	$33,936.6
YOY Growth	*-15.1%*	*-0.1%*	*8.4%*	*0.1%*	*8.5%*	*4.1%*	*12.8%*	*11.8%*	*10.6%*
Cost of Services	$15,900.4	$3,996.3	$4,011.1	$4,206.6	$4,335.3	$16,549.3	$18,440.7	$20,226.3	$22,058.8
Gross Income	$7,484.5	$1,880.6	$1,887.6	$1,979.6	$2,040.1	$7,787.9	$9,000.8	$10,466.1	$11,877.8
Gross Margin	*32.0%*	*32.0%*	*32.0%*	*32.0%*	*32.0%*	*32.0%*	*32.8%*	*34.1%*	*35.0%*
SG&A	$5,703.1	$1,674.9	$1,828.6	$1,917.7	$1,976.4	$7,397.6	$7,546.4	$7,703.8	$7,975.1
% SG&A	*24.4%*	*28.5%*	*31.0%*	*31.0%*	*31.0%*	*30.4%*	*27.5%*	*25.1%*	*23.5%*
Operating Income	$1,781.3	$205.7	$59.0	$61.9	$63.8	$390.3	$1,454.4	$2,762.3	$3,902.7
Operating Margin	*7.6%*	*3.5%*	*1.0%*	*1.0%*	*1.0%*	*1.6%*	*5.3%*	*9.0%*	*11.5%*
Total Other Income (Expense)	$11.5	$4.0	$3.0	$2.0	$1.0	$10.0	$8.0	$22.0	$22.0
Pre-Tax Income	$1,792.8	$209.7	$62.0	$63.9	$64.8	$400.3	$1,462.4	$2,784.3	$3,924.7
Tax expense (benefit)	$168.0	$19.9	$5.9	$6.1	$6.2	$38.0	$166.7	$345.3	$494.5
Tax Rate	*9.4%*	*9.5%*	*9.5%*	*9.5%*	*9.5%*	*9.5%*	*11.4%*	*12.4%*	*12.6%*
Net Income	$1,624.8	$189.8	$56.1	$57.8	$58.6	$362.3	$1,295.7	$2,439.1	$3,430.2
YOY Growth	*-32.2%*	*-34.2%*	*-84.4%*	*-87.3%*	*-88.8%*	*-77.7%*	*257.7%*	*88.2%*	*40.6%*
Net Margin	*6.9%*	*3.2%*	*1.0%*	*0.9%*	*0.9%*	*1.5%*	*4.7%*	*7.9%*	*10.1%*
EPS	$0.07	$0.01	$0.00	$0.00	$0.00	$0.02	$0.06	$0.11	$0.16
YOY Growth	*-31.4%*	*-33.3%*	*-84.2%*	*-87.1%*	*-88.6%*	*-77.4%*	*275.1%*	*92.6%*	*42.6%*
Diluted Shares O/S	23,400	23,150	23,100	23,050	23,000	23,075	22,000	21,500	21,200

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BALANCE SHEET

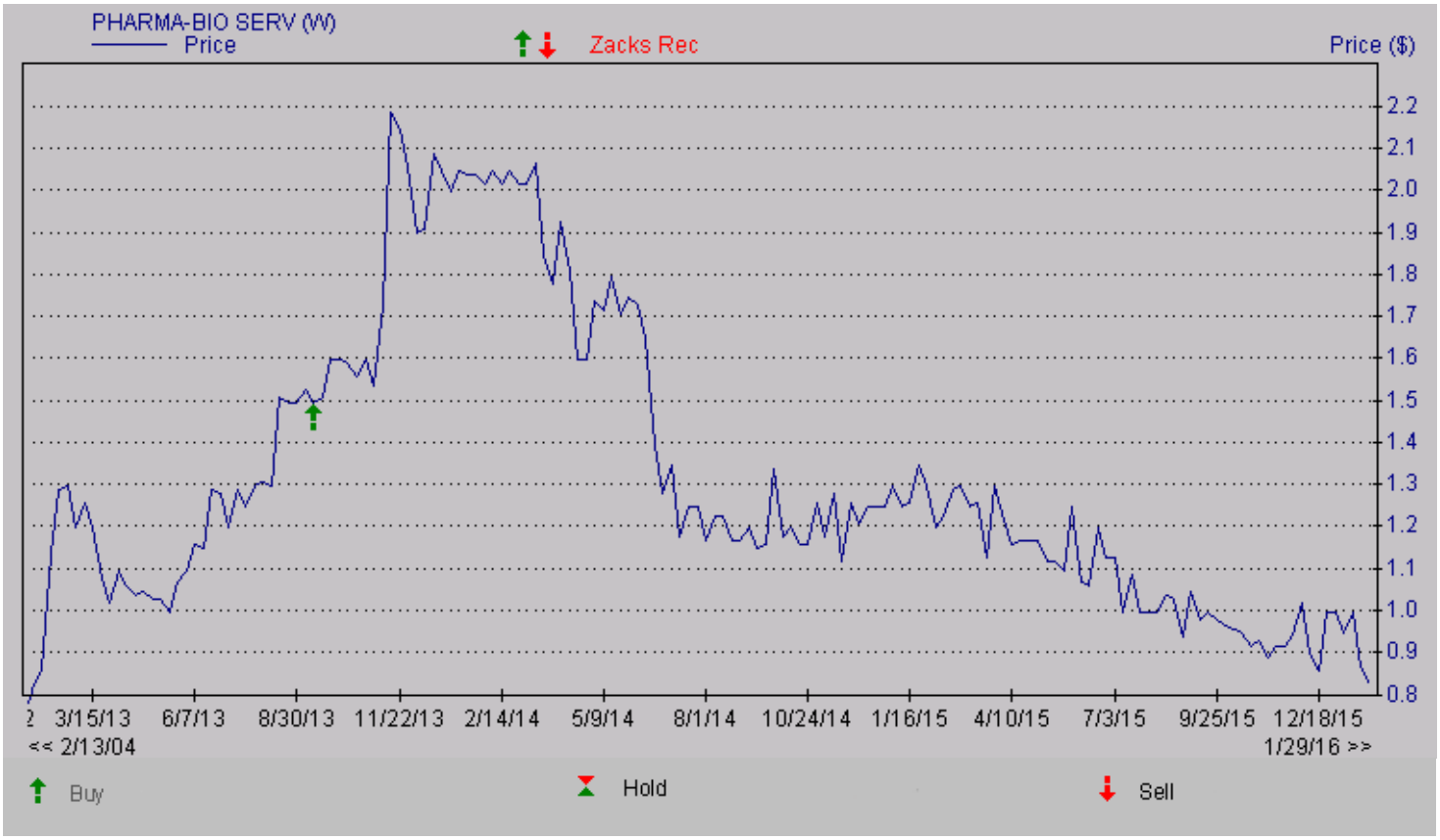
	October 31, 2015	October 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,898	$ 15,088
Marketable Securities	33	68
Accounts Receivable	7,448	6,386
Other	892	783
Total current assets	23,267	22,325
Property and equipment, net	854	869
Other assets	18	17
Total assets	$ 24,139	$ 23,211
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 23	$ 22
Accounts payable and accrued expenses	2,062	2,355
Income taxes payable	39	249
Total current liabilities	2,124	2,626
Obligations under capital leases	52	75
Total liabilites	2,176	2,700
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,143	1,055
Retained earnings	21,232	19,607
Accumulated other comprehensive loss	(227)	(136)
Total stockholders' equity	21,963	20,511
Total liabilities and stockholders' equity	$ 24,139	$ 23,211

CASH FLOW STATEMENT

	October 31, 2015	2014
Cash flows from operating activities:		
Net income	$ 1,625	$ 2,414
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	-	(16)
Stock-based compensation	87	94
Depreciation and amortization	357	377
Changes in operating assets and liabilities:		
Accounts receivable	(1,067)	1,051
Other assets	(116)	(17)
Liabilities	(513)	(573)
Net cash provided by operating activities	373	3,331
Cash flows from investing activities:		
Acquisition of P&E	(342)	(208)
Proceeds from disposition of P&E	-	39
Net cash used in investing activities	(342)	(169)
Cash flows from financing activities:		
Proceeds from common stock issuance		0
Repurchase of common stock	(169)	(18)
Payments on obligations under capital lease	(22)	(73)
Net cash provided by (used in) financing activities	(191)	(91)
Effect of exchange rate changes on cash	(34)	(29)
Net increase (decrease) in cash and cash equivalents	(195)	3,042
Cash and cash equivalents, beginning of period	15,088	12,046
Cash and cash equivalents, end of period	14,893 $	15,088

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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- 25.8%, Hold/Neutral- 51.7%, Sell/Underperform – 17.3%. Data is as of midnight on the business day immediately prior to this publication.