Zacks Small-Cap Research

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Pharma-Bio Serv (PBSV-OTC)

PBSV: Q4 Revenue In-Line, Beat on EPS.

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/15/2013
Current Price (02/02/15)	$1.30
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 fueled significant revenue growth and consistent history of profitability. While revenue fell in 2014 we attribute this mostly to macro economic weakness and think PBSV returns to growth over the short-term. And despite revenue falling in 2014, cash flow generation remained robust and the company remained 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.

SUMMARY DATA

52-Week High	**$2.12**
52-Week Low	**$0.80**
One-Year Return (%)	**-31.37**
Beta	**-0.71**
Average Daily Volume (sh)	**7,663**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$32**
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	**11.7**
P/E using 2015 Estimate	**10.0**
P/E using 2016 Estimate	**7.2**
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)
2014	$7.0 A	$6.6 A	$6.8 A	$7.1 A	$27.6 A
2015	$6.2 E	$6.3 E	$6.7 E	$7.4 E	$26.6 E
2016					$29.6 E
2017					$32.7 E

Earnings per Share

	Q1 (Jan)	Q2 (Apr)	Q3 (Jul)	Q4 (Oct)	Year (Oct)
2014	$0.03 A	$0.01 A	$0.03 A	$0.03 A	$0.10 A
2015	$0.03 E	$0.03 E	$0.03 E	$0.04 E	$0.13 E
2016					$0.18 E
2017					$0.23 E

Zacks Projected EPS Growth Rate - Next 4 Years % **25**

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Fiscal Q4 2014 Results: *Revenue In-Line, Beat on EPS From Cost Control*

PBSV reported financial results for the fiscal fourth quarter ending October 31st. Revenue came in just about dead-on with our estimate, although certain of the components of revenue were meaningfully different then our numbers. As expected revenue for the full year came down about 17%, mostly due to slower activities with consulting projects in the U.S. and Europe. While earlier in the year we had expected to see some additional business coming from these territories, the prolonged weakness in the economy has resulted in a slower than initially anticipated rebound in PBSV's consulting businesses.

But despite the soft revenue throughout fiscal 2014, management did a nice job controlling expenses. The result was continued generation of positive net income, EPS and over $3 million of free cash flow. Cost control was particularly evident in the final quarter of the year – we estimated OpEx of almost $1.6 million while actual came in at barely over $1.4 million. The net result of in-line revenue and gross margin and lower OpEx was a $0.01 beat on EPS.

Q4 has historically been the strongest quarter – which has been the case every year since at least far back as 2011. And while that was also true in fiscal 2014, it was just barely so as a result of prolonged revenue softness in Europe and the U.S. Q4 revenue of $7.4 million was in-line with our $7.1 estimate and was down 19% yoy but up 4.4% from Q3. While revenue from Puerto Rico was relatively strong – $4.6 million, up 4% yoy and well ahead of our $3.7 million estimate, the opposite was the case for both Europe and the U.S. Revenue in Europe ($486k) and the U.S. ($1.6M) fell 51% and 46% and were well below our $2.2 million and $614k estimates.

Q4 net income and EPS were $811k and $0.03, compared to our $577k and $0.02 estimates. The difference coming from the aforementioned lower than estimated OpEx and also from a lower tax rate. As a reminder, while PBSV's is taxed at the maximum regular federal income tax rate of 35% for U.S. operations, they are subject to a very low (4%) tax rate for Puerto Rico operations. As such the higher than estimated Puerto Rico revenue and lower than estimated U.S. revenue resulted in the actual effective tax rate (11.7%) coming in much lower than our 19.5% estimate.

Cash balance at the end of fiscal 2014 was $15.2 million, up from $12.1 million at the end of fiscal 2013. The company continues to generate significant amounts of cash and brought in $3.2 million of free cash flow in 2014. The balance in general remains in very solid shape with a relatively huge cash balance and no debt.

2014 was a disappointing year in terms of revenue, falling 17% with no quarter doing better than an 8% yoy decrease. But "disappointing" should be put in context – PBSV grew revenue 76% in 2011, 47% in 2012 and 13% in 2013. And on top of that the company has been profitable every quarter since at least Q1 2011 – including every quarter in the relatively disappointing year of 2014. And on top of that, the company has consistently generated positive cash flow – including $3 million worth during 2014.

But, back to the drop in revenue in 2014….while we think part of the difficulty has been the heavy reliance on just a small handful of customers contributing the bulk of business, more macro factors also played a big part. PBSV experienced a lag from the dive in the economy over the last few years with pharma clients either cancelling or delaying certain projects. We think there may be a continuing hangover in fiscal 2015 from this and have adjusted our estimates accordingly. But, with cost-control and gross margins holding up nicely, coupled with the fact that lower U.S. contribution benefits the average effective tax rate, we think the impact to the bottom line will be quite muted. And with the economic picture looking much brighter over the past few quarters, we expect the lag that PBSV felt following the downturn will result in a similar but opposite effect towards the back end of fiscal 2015 and be particularly evident in 2016.

And now there's two potential new catalysts. One relates to the recently announced relationship with T.R. Winston which could result in another avenue of growth for the company but which is not yet reflected in our financial model and therefore could provide additional upside. The company has not talked specifics but the fact that the balance sheet is frothing with cash, which continues to grow, and PBSV has entered into a relationship with a strategy and investment banking company leads us to believe that they are looking to reinvest their cash in growth opportunities. We have no insight into what types of opportunities that they may be exploring or potential timing but the possibility of an acquisition or partnership adds further to the potential that revenue turns back positive in the mid-term.

The other new potential new catalyst is PBSV's Puerto Rican Calibrations Services Division. In October the company signed a collaboration agreement with Quality Technicasl Iberica, a Spain-based company specializing

calibrations in calibrations to assist the company in establishing a calibrations division that will provide calibration and related services in Puerto Rico.

We continue to think the shares trade much cheaper than warranted. We are reiterating our Outperform rating $3.00/share price target.

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 91% 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 6% 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 91% 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 6% 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 1% of PBSV's total revenue.

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

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**
> **Lean Six Sigma / Process Excellence and Continuous Improvement Series**
> **Validation Courses**
> **Safety**
> **cGMPs**
> **Microbiology**
> **Quality Systems**
> **Other Seminars**

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 (October 31, 2014) cash balance stood at $15.2 million, up from $12.1 million in the year-earlier period. 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 65% 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 $3.3 in 2014. The business is also not very capital intensive, with CapEx of just $123k in 2011, $169k in 2012, $205k in 2013 and $208k in 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 contracted in 2014, PBSV continues to generate positive cash flow and maintains an ultra-healthy balance sheet.

2014 was a disappointing year in terms of revenue, falling 17% and no quarter doing better than an 8% yoy decrease. But "disappointing" should be put in context – PBSV grew revenue 76% in 2011, 47% in 2012 and 13% in 2013. And on top of that the company has been profitable every quarter since at least Q1 2011 – including every quarter in the relatively disappointing year of 2014. And on top of that, the company has consistently generated positive cash flow – including $3 million worth in relatively disappointing 2014.

But, back to the drop in revenue in 2014….while we think part of the difficulty has been the heavy reliance on just a small handful of customers contributing the bulk of business, more macro factors also played a big part. PBSV experienced a lag from the dive in the economy over the last few years with pharma clients either cancelling or delaying certain projects. We think there may be a continuing hangover in fiscal 2015 from this and have adjusted our estimates accordingly. But, with cost-control and gross margins holding up nicely, coupled with the fact that lower U.S. contribution benefits the average effective tax rate, we think the impact to the bottom line will be quite muted. And with the economic picture looking much brighter over the past few quarters, we expect the lag that PBSV felt following the downturn will result in a similar but opposite effect towards the back end of fiscal 2015 and be particularly evident in 2016.

And now there's two potential new catalysts. One relates to the recently announced relationship with T.R. Winston which could result in another avenue of growth for the company but which is not yet reflected in our financial model and therefore could provide additional upside. The company has not talked specifics but the fact that the balance sheet is frothing with cash, which continues to grow, and PBSV has entered into a relationship with a strategy and investment banking company leads us to believe that they are looking to reinvest their cash in growth opportunities. We have no insight into what types of opportunities that they may be exploring or potential timing but the possibility of an acquisition or partnership adds further to the potential that revenue turns back positive in the mid-term.

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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% (which increased to 39% in fiscal 2014) to what was an effective rate of 5.5% in fiscal 2011, 5.4% in 2012 and 4% in 2013 and 2014 (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, 2013 and 2014 were 18.6%, 19.3% and 16.2% 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). And so while the recent softness in U.S. revenue has been a disappointment, as U.S. revenue falls as a % of total revenue, the company's overall effective tax rate will also fall which mutes the impact of sliding revenue to the bottom line.

Valuation / Recommendation

Based on our model we look for EPS to grow at a CAGR of about 26% through 2017. We use an industry PE/G ratio of 2.2x (up from 2.0x since our last update) to value PBSV. We look for 2015 EPS of $0.13 which values the company at approximately $3.00/share (unchanged since our last update). The stock currently trades at about $1.30, 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

	2014 A	Q1E	Q2E	Q3E	Q4E	2015 E	2016 E	2017 E	2018 E
Puerto Rico Consulting	$15,586.3	$3,605.7	$3,662.7	$4,123.8	$4,771.9	$16,164.1	$17,376.4	$18,610.2	$19,633.7
YOY Growth	*-1.6%*	*2.4%*	*4.4%*	*3.8%*	*4.1%*	*3.7%*	*7.5%*	*7.1%*	*5.5%*
% of total sales	56.6%	58.1%	58.1%	61.3%	64.6%	60.7%	58.8%	56.9%	56.6%
U.S. Consulting	$7,760.9	$1,578.5	$1,570.2	$1,529.2	$1,574.0	$6,251.8	$7,433.4	$8,734.3	$9,267.1
YOY Growth	*-31.5%*	*-32.0%*	*-22.0%*	*-16.0%*	*-2.0%*	*-19.4%*	*18.9%*	*17.5%*	*6.1%*
% of total sales	28.2%	25.4%	24.9%	22.7%	21.3%	23.5%	25.1%	26.7%	26.7%
Europe Consulting	$2,185.0	$512.5	$490.5	$551.3	$515.6	$2,069.9	$2,260.3	$2,481.8	$2,581.1
YOY Growth	*-39.2%*	*-25.0%*	*4.9%*	*0.5%*	*6.2%*	*-5.3%*	*9.2%*	*9.8%*	*4.0%*
% of total sales	7.9%	8.3%	7.8%	8.2%	7.0%	7.8%	7.6%	7.6%	7.4%
Lab (microbiological & chemical testing)	$1,718.7	$458.0	$455.6	$416.5	$465.3	$1,795.5	$2,081.0	$2,382.8	$2,647.3
YOY Growth	*-7.9%*	*1.1%*	*3.5%*	*12.4%*	*2.3%*	*4.5%*	*15.9%*	*14.5%*	*11.1%*
% of total sales	6.2%	7.4%	7.2%	6.2%	6.3%	6.7%	7.0%	7.3%	7.6%
Other segments	$304.0	$51.7	$125.3	$104.0	$57.9	$338.9	$416.5	$493.5	$552.7
YOY Growth	*-29.5%*	*80.0%*	*-14.0%*	*-16.0%*	*897.0%*	*11.5%*	*22.9%*	*18.5%*	*12.0%*
% of total sales	1.1%	0.8%	2.0%	1.5%	0.8%	1.3%	1.4%	1.5%	1.6%
Total Revenues	$27,555.0	$6,206.5	$6,304.4	$6,724.8	$7,384.7	$26,620.3	$29,567.7	$32,702.6	$34,681.9
YOY Growth	*-16.7%*	*-11.4%*	*-4.1%*	*-1.6%*	*3.5%*	*-3.4%*	*11.1%*	*10.6%*	*6.1%*
Cost of Services	$18,581.9	$4,102.5	$4,287.0	$4,566.1	$4,940.4	$17,895.9	$19,071.2	$20,635.3	$21,849.6
Gross Income	$8,973.1	$2,104.0	$2,017.4	$2,158.6	$2,444.3	$8,724.4	$10,496.5	$12,067.3	$12,832.3
Gross Margin	*32.6%*	*33.9%*	*32.0%*	*32.1%*	*33.1%*	*32.8%*	*35.5%*	*36.9%*	*37.0%*
SG&A	$6,109.1	$1,402.7	$1,260.9	$1,324.8	$1,447.4	$5,435.7	$5,677.0	$5,886.5	$6,034.7
% SG&A	*22.2%*	*22.6%*	*20.0%*	*19.7%*	*19.6%*	*20.4%*	*19.2%*	*18.0%*	*17.4%*
Operating Income	$2,864.1	$701.3	$756.5	$833.9	$996.9	$3,288.7	$4,819.5	$6,180.8	$6,797.7
Operating Margin	*10.4%*	*11.3%*	*12.0%*	*12.4%*	*13.5%*	*12.4%*	*16.3%*	*18.9%*	*19.6%*
Total Other Income (Expense)	($1.8)	$0.0	$0.0	$0.0	$0.0	$0.0	$6.0	$8.0	$22.0
Pre-Tax Income	$2,862.3	$701.3	$756.5	$833.9	$996.9	$3,288.7	$4,825.5	$6,188.8	$6,819.7
Tax expense (benefit)	$464.5	$85.6	$91.5	$95.9	$111.7	$384.7	$858.9	$1,299.6	$1,500.3
Tax Rate	*16.2%*	*12.2%*	*12.1%*	*11.5%*	*11.2%*	*11.7%*	*17.8%*	*21.0%*	*22.0%*
Net Income	$2,397.7	$615.8	$665.0	$738.0	$885.3	$2,904.0	$3,966.6	$4,889.1	$5,319.3
YOY Growth	*-51.1%*	*-7.0%*	*102.9%*	*23.6%*	*9.2%*	*21.1%*	*36.6%*	*23.3%*	*8.8%*
Net Margin	*8.7%*	*9.9%*	*10.5%*	*11.0%*	*12.0%*	*10.9%*	*13.4%*	*15.0%*	*15.3%*
EPS	$0.10	$0.03	$0.03	$0.03	$0.04	$0.13	$0.18	$0.23	$0.25
YOY Growth	*-51.2%*	*-6.1%*	*107.6%*	*26.3%*	*14.3%*	*24.2%*	*39.7%*	*29.6%*	*9.3%*
Diluted Shares O/S	23,695	23,507	23,244	23,105	22,600	23,114	22,600	21,500	21,400

Brian Marckx, CFA

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BALANCE SHEET

	October 31, 2014	October 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 15,088	$ 12,046
Marketable Securities	68	71
Accounts Receivable	6,386	7,404
Other	783	768
Total current assets	22,325	20,289
Property and equipment, net	869	976
Other assets	17	17
Total assets	$ 23,211	$ 21,282
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 22	$ 32
Accounts payable and accrued expenses	2,355	2,826
Income taxes payable	249	323
Total current liabilities	2,626	3,180
Obligations under capital leases	75	52
Total liabilites	2,700	3,232
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,055	931
Retained earnings	19,607	17,193
Accumulated other comprehensive loss	(136)	(77)
Total stockholders' equity	20,511	18,050
Total liabilities and stockholders' equity	$ 23,211	$ 21,282

CASH FLOW STATEMENT

	Twelve months October 31, 2014	2013
Cash flows from operating activities:		
Net income	$ 2,414	$ 4,906
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	(16)	(1)
Stock-based compensation	94	53
Depreciation and amortization	377	345
Changes in operating assets and liabilities:		
Accounts receivable	1,051	428
Other assets	(17)	(384)
Liabilities	(573)	280
Net cash provided by operating activities	3,331	5,627
Cash flows from investing activities:		
Acquisition of P&E	(208)	(219)
Proceeds from disposition of P&E	39	14
Net cash used in investing activities	(169)	(205)
Cash flows from financing activities:		
Proceeds from common stock issuance	0	110
Repurchase of common stock	(18)	0
Payments on obligations under capital lease	(73)	(39)
Net cash provided by (used in) financing activities	(91)	70
Effect of exchange rate changes on cash	(29)	16
Net increase (decrease) in cash and cash equivalents	3,042	5,508
Cash and cash equivalents, beginning of period	12,046	6,538
Cash and cash equivalents, end of period	$ 15,088	$ 12,046

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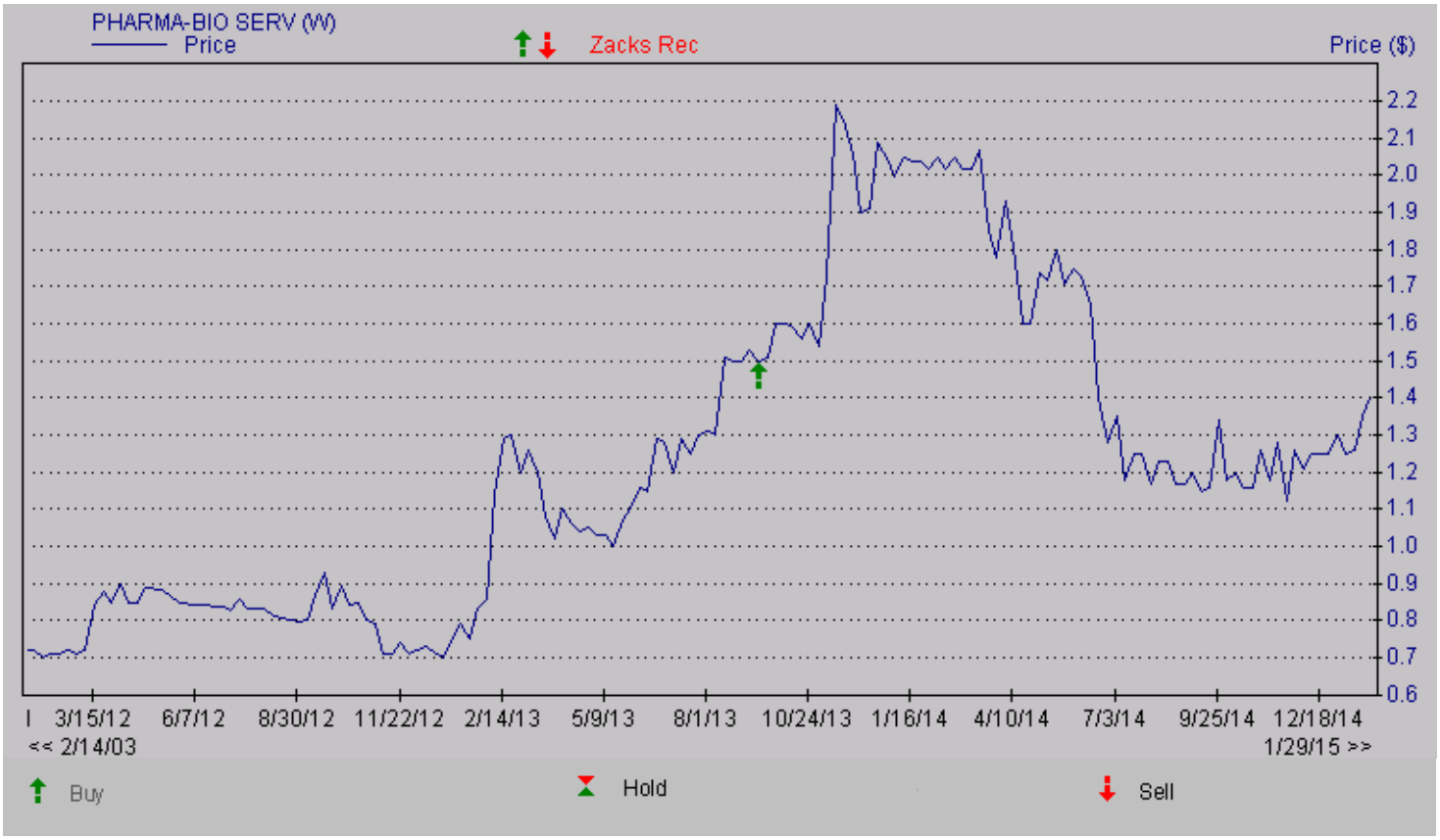
HISTORICAL ZACKS RECOMMENDATIONS



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