Zacks Small-Cap Research

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Pharma-Bio Serv (PBSV-OTC)

PBSV: Still Generating Major Cash Despite Slip in Revenue

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/15/2013
Current Price (03/18/15)	$1.10
Target Price	**$2.65**

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 has slipped recently we attribute this mostly to macro-economic weakness and think PBSV returns to growth over the short-term. 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.

SUMMARY DATA

52-Week High	**$1.95**
52-Week Low	**$0.80**
One-Year Return (%)	**-31.37**
Beta	**-0.71**
Average Daily Volume (sh)	**4,594**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$25**
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	**11.0**
P/E using 2015 Estimate	**13.8**
P/E using 2016 Estimate	**7.9**
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	$5.9 A	$6.2 E	$6.7 E	$7.1 E	$25.9 E
2016					$28.5 E
2017					$31.2 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	$0.01 A	$0.02 E	$0.02 E	$0.03 E	$0.08 E
2016					$0.14 E
2017					$0.20 E

Zacks Projected EPS Growth Rate - Next 4 Years % **22**

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Fiscal Q1 2015 Results: *Variable Cost Base & "Built-In" Margin Keeps PBSV Profitable, Cash Flow Positive…*

PBSV reported financial results for the fiscal first quarter ending January 31, 2015. The numbers missed our estimates on all of the major line items including revenue, gross margin and operating expenses. And while Q1 results disappointed compared to our forecast, it was far from all doom-and-gloom as PBSV still managed to turn in another period of positive net income, generated a very healthy $401k in cash flow and exited the quarter $15.1 million in cash and equivalents.

We also note that while OpEx as a percentage of revenue was higher than what we modeled and increased from the prior two quarters, that in aggregate operating expenses have been coming down every period since fiscal Q2 2014. This continues to reflect management's diligence on cost control and their efforts to right-size the expense base as determined by revenue levels. It also highlights the significance of the variable expense cost-base inherent in their consulting-centric operating model. This has meant that in periods of declining revenues, profitability and cash flow has not suffered to the extent that would be the case with a heavy fixed cost base and has resulted in the company's long streak of generating positive net income and cash flow.

Q1 revenue was $5.9 million, down 16% yoy and below our $6.2 million estimate. The softness in revenue in Q1 was mostly the result of relatively very weak U.S. sales, which were at the lowest level in at least four years. U.S. sales have been slipping since the end of fiscal 2013 (10/31/2013) and while we had modeled continued contraction throughout the current fiscal year, Q1 surprised fairly significantly on the downside. And with U.S. sales recently representing almost 30% of total revenue, the 65% decline in Q1 was the major reason total revenue came down by 16%. European revenue, which represents ~6% of total sales, has also been on the decline over the past five quarters as a result of reduced activity with a major customer in Ireland. Sales in Europe contracted by 47% in Q1. The highlight in Q1 was Puerto Rico which saw sales increase 18% (+20% in consulting revenue) – most of the increase is related to projects in Latin America that are managed from Puerto Rico.

The relative weakness in European and U.S. sales and strength in Puerto Rico revenue pushed the percentage of revenue coming from Puerto Rico up to 80% - which is an increase from 57% in Q1 2014 and looks to be the highest in at least five years. This is meaningful from more than just a revenue standpoint given the company's beneficial tax status for revenue generated in Puerto Rico – which is taxed at just 4%, compared to a maximum regular federal income tax rate of 35% for U.S. operations. Q1 income tax rate was just 9.4%, down from 13.8% in Q1 2014 and 14.8% average for the full-year 2014.

OpEx was $1.4 million, which was in-line with our number on an aggregate basis but at 23.4% of sales, higher than our related 22.6% estimate. But, as noted earlier, total OpEx has been trending lower, coming down the last three quarters from $1.7 million in Q2 2014. Q1 net income and EPS were $288k and $0.01 compared to our $616k and $0.03 estimates.

PBSV continues to generate meaningful levels of cash, bringing in $401k (ex-changes in working capital) in Q1. Cash balance stood at $15.1 million at Q1 quarter-end, basically flat from fiscal 2014 year-end. PBSV did use $87k during the quarter to repurchase stock. As a reminder, in June 2014 PBSV implemented a stock repurchase program to buyback up to two million shares. Through January 31, 2015 the company had repurchased a total of 86k shares.

As we explained in our prior update in early February, while we think a contributing factor to the revenue slide since fiscal Q1 2014 (ending January 31, 2014) has been the heavy reliance on just a small handful of customers contributing the bulk of business, more macro factors almost certainly have also been playing 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 throughout the current fiscal year which is reflected in our financial estimates. 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 somewhat 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 recently two potential new catalysts emerged. One relates to the relationship with T.R. Winston, announced in early December, 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 (only noting this is aimed mostly at the U.S. consulting business) 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 catalyst is PBSV's Puerto Rican Calibrations Services Division. In October 2014 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. This, per the Q1 10-Q, is expected to be partially operational by the end of the current fiscal year (i.e. – October 31, 2015).

We continue to think the shares trade much cheaper than warranted. We are reiterating our Outperform rating.

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 92% 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 92% 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 7% 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 (January 31, 2015) cash balance stood at $15.1 million, up from $12.1 million at the end of fiscal 2013 (October 31, 2013). The company has zero debt, zero preferred stock, and about 23 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 66% 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. 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 recently two potential new catalysts emerged. One relates to the relationship with T.R. Winston, announced in early December, 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 (only noting this is aimed mostly at the U.S. consulting business) 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 4-year CAGR of about 22% through 2018. We use an industry PE/G ratio of 1.5x to value PBSV. We look for 2015 EPS of $0.08 (down from $0.13 since our prior update) which values the company at approximately $2.65/share (down from $3.00/share since our last update). The stock currently trades at about $1.10, indicating the shares are trading cheaper than fair value.

We also note that book value (as of Jan 31, 2015) is $20.7 million or about 83% 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 $2.65 price target. We are maintaining our Outperform rating.

FINANCIAL MODEL

Pharma-Bio Serv, Inc

	2014 A	Q1A	Q2E	Q3E	Q4E	2015 E	2016 E	2017 E	2018 E
Total Revenues	$27,555.0	$5,882.2	$6,183.9	$6,733.1	$7,067.7	$25,867.0	$28,465.9	$31,200.9	$33,083.6
YOY Growth	*-16.7%*	*-16.1%*	*-5.9%*	*-1.5%*	*-1.0%*	*-6.1%*	*10.0%*	*9.6%*	*6.0%*
Cost of Services	$18,581.9	$4,176.9	$4,328.8	$4,706.5	$4,869.7	$18,081.8	$18,929.8	$20,311.8	$21,504.3
Gross Income	$8,973.1	$1,705.3	$1,855.2	$2,026.7	$2,198.1	$7,785.2	$9,536.1	$10,889.1	$11,579.2
Gross Margin	*32.6%*	*29.0%*	*30.0%*	*30.1%*	*31.1%*	*30.1%*	*33.5%*	*34.9%*	*35.0%*
SG&A	$6,109.1	$1,376.9	$1,422.3	$1,454.4	$1,385.3	$5,638.8	$5,807.0	$5,990.6	$6,186.6
% SG&A	*22.2%*	*23.4%*	*23.0%*	*21.6%*	*19.6%*	*21.8%*	*20.4%*	*19.2%*	*18.7%*
Operating Income	$2,864.1	$328.4	$432.9	$572.3	$812.8	$2,146.4	$3,729.0	$4,898.5	$5,392.6
Operating Margin	*10.4%*	*5.6%*	*7.0%*	*8.5%*	*11.5%*	*8.3%*	*13.1%*	*15.7%*	*16.3%*
Total Other Income (Expense)	($1.8)	($1.2)	($1.0)	($1.0)	($1.0)	($4.2)	$6.0	$8.0	$22.0
Pre-Tax Income	$2,862.3	$327.2	$431.9	$571.3	$811.8	$2,142.2	$3,735.0	$4,906.5	$5,414.6
Tax expense (benefit)	$464.5	$38.8	$52.3	$65.7	$90.9	$247.7	$481.8	$706.5	$812.2
Tax Rate	*16.2%*	*11.9%*	*12.1%*	*11.5%*	*11.2%*	*11.6%*	*12.9%*	*14.4%*	*15.0%*
Net Income	$2,397.7	$288.4	$379.6	$505.6	$720.9	$1,894.5	$3,253.2	$4,200.0	$4,602.4
YOY Growth	*-51.1%*	*-56.4%*	*15.8%*	*-15.3%*	*-11.1%*	*-21.0%*	*71.7%*	*29.1%*	*9.6%*
Net Margin	*8.7%*	*4.9%*	*6.1%*	*7.5%*	*10.2%*	*7.3%*	*11.4%*	*13.5%*	*13.9%*
EPS	$0.10	$0.01	$0.02	$0.02	$0.03	$0.08	$0.14	$0.20	$0.22
YOY Growth	*-51.2%*	*-55.9%*	*19.5%*	*-13.1%*	*-8.0%*	*-18.9%*	*75.4%*	*35.7%*	*10.1%*
Diluted Shares O/S	23,695	23,464	23,050	23,000	22,850	23,091	22,600	21,500	21,400

Brian Marckx, CFA

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BALANCE SHEET

	Janurary 31, 2015	October 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$ 15,046	$ 15,088
Marketable Securities	66	68
Accounts Receivable	6,286	6,386
Other	721	783
Total current assets	22,189	22,325
Property and equipment, net	812	869
Other assets	17	17
Total assets	$ 23,211	$ 23,211
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 22	$ 22
Accounts payable and accrued expenses	1,887	2,355
Income taxes payable	285	249
Total current liabilities	2,194	2,626
Obligations under capital leases	69	75
Total liabilites	2,263	2,700
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,076	1,055
Retained earnings	19,895	19,607
Accumulated other comprehensive loss	(184)	(136)
Total stockholders' equity	20,685	20,511
Total liabilities and stockholders' equity	$ 22,948	$ 23,211

CASH FLOW STATEMENT

	Twelve months January 31, 2015	2014
Cash flows from operating activities:		
Net income	$ 288	662
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	-	-
Stock-based compensation	21	17
Depreciation and amortization	91	92
Changes in operating assets and liabilities:		
Accounts receivable	144	1,732
Other assets	63	109
Liabilities	(490)	(859)
Net cash provided by operating activities	118	1,752
Cash flows from investing activities:		
Acquisition of P&E	(35)	-
Proceeds from disposition of P&E	-	-
Net cash used in investing activities	(35)	-
Cash flows from financing activities:		
Proceeds from common stock issuance	-	-
Repurchase of common stock	(87)	
Payments on obligations under capital lease	(6)	(10)
Net cash provided by (used in) financing activities	(93)	(10)
Effect of exchange rate changes on cash	(31)	(4)
Net increase (decrease) in cash and cash equivalents	(42)	1,737
Cash and cash equivalents, beginning of period	15,088	12,046
Cash and cash equivalents, end of period	$ 15,046	13,783

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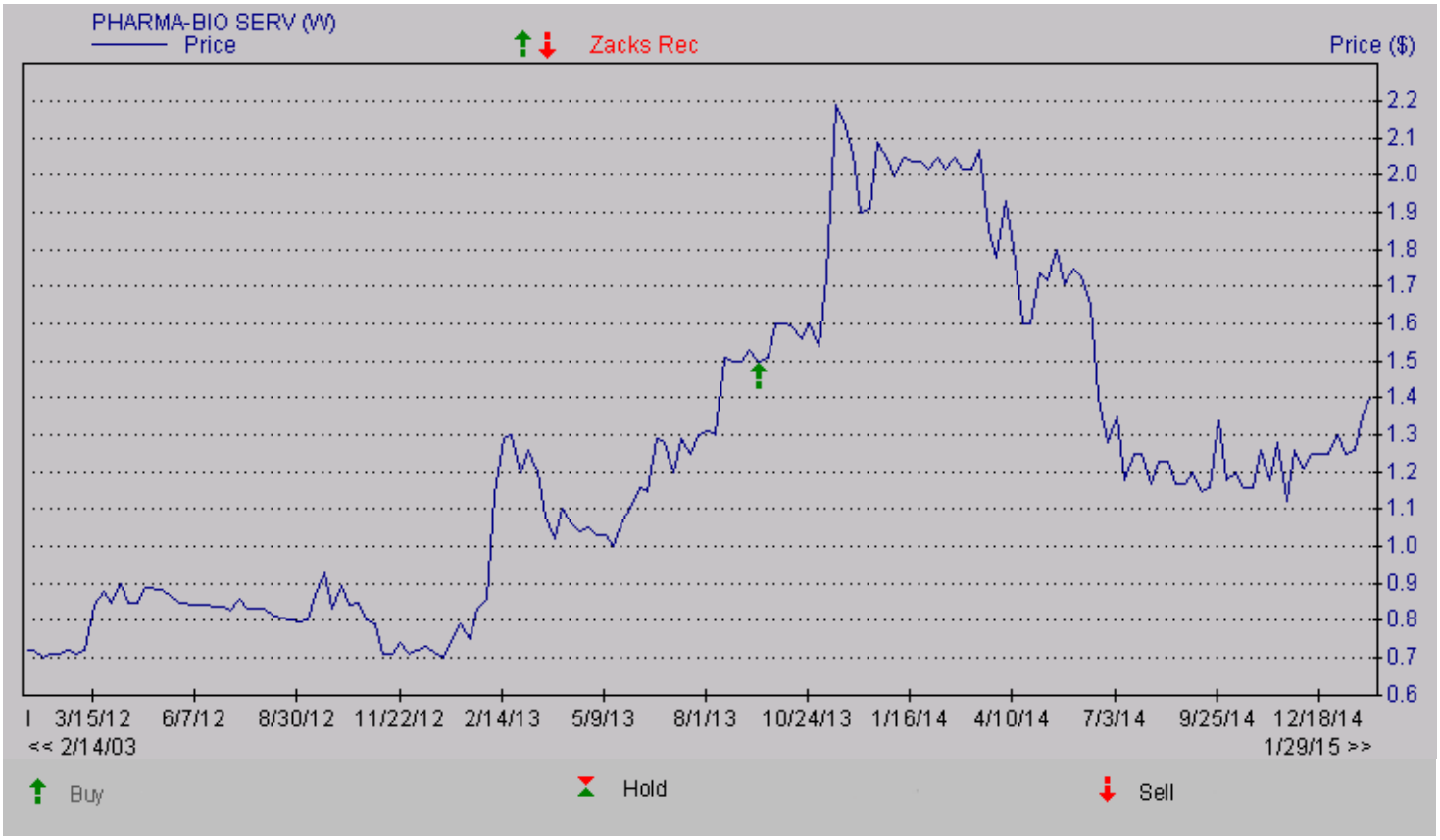
HISTORICAL ZACKS RECOMMENDATIONS



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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- 15.8%, Hold/Neutral- 77.2%, Sell/Underperform – 6.4%. Data is as of midnight on the business day immediately prior to this publication.