Zacks Small-Cap Research

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Pharma-Bio Serv, Inc. (PBSV-OTC)

PBSV: Lab Segment Remains Robust, Reflecting Opportunistic Investments

Based on our model we look for EPS to grow at a 4-year CAGR of about 19% through 2019. We use an industry PE/G ratio of 1.6x to value PBSV. We look for 2017 EPS of $0.06 which values the company at approximately $2.00/share.

Current Price (12/15/16)	$0.87
Valuation	**$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 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 at book value offers opportune time to buy the stock.

SUMMARY DATA

52-Week High	**$1.02**
52-Week Low	**$0.55**
One-Year Return (%)	**0.71**
Beta	**-0.05**
Average Daily Volume (sh)	**3,082**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$20**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**51**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**-2.8**
Earnings Per Share (%)	**-27.0**
Dividend (%)	**N/A**
P/E using TTM EPS	**13.6**
P/E using 2016 Estimate	**95.0**
P/E using 2017 Estimate	**15.8**
Zacks Rank	**N/A**

Risk Level	**High,**
Type of Stock	**Small-Value**
Industry	**Consulting**
Zacks Rank in Industry	**N/A**

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	$4.9 A	$5.1 A	$4.9 A	$5.1 E	$20.0 E
2017					$22.7 E
2018					$25.3 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	$0.02 A	$0.00 A	-$0.01 A	-$0.00 E	$0.01 E
2017					$0.06 E
2018					$0.10 E

Zacks Projected EPS Growth Rate - Next 5 Years % **N/A**

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Fiscal Q3 2016 Results: *Lab Segment Remains Robust, Reflecting PBSV's Opportunistic Investments …*

PBSV reported financial results for their third quarter ending July 31, 2016. While results on the top-line remain on the tepid side with revenue contracting on a year-over-year basis for 11 straight quarters, the company continues to generate positive operating cash flow. And this is despite PBSV making incremental investments in headcount (as well as capital investments in lab facilities).

But, this has been a challenging year for the company, which is highlighted by revenue falling in each of the company's largest geographic territories. This includes contractions of 15%, 47% and 36% in consulting-related revenue from Puerto Rico, the U.S. and Europe, respectively, through the first nine months of fiscal 2016. The only real meaningful highlight as it relates to revenue has been the lab segment, which turned in 23% growth in Q3 and 47% through the first nine months.

The company's business model allows for significant flexibility, however, and we expect PBSV to continue to be opportunistic and dedicate a greater portion of resources where they see the most opportunity for growth. The lab segment clearly appears to be one of those areas. Lab-related revenue now accounts for 12.5% of total sales, up from just 7.5% through the first nine months of 2015, and this could expand further. As a reminder, PBSV previously announced an expected aggregate investment of approximately $2M to expand its lab facilities - $1.1M has already been invested and, per the current 10-Q footnotes, the remaining ~$900k is expected to be allocated by fiscal year-end (i.e. October 31st).

Overall, we think PBSV continues to weather the ongoing economic weakness (including the recent P.R. government fiscal problems) and adversity caused by industry consolidation about as good as could be expected. The company has benefited from its highly variable cost structure, affording it the ability to continue to generate positive cash flow even in times of declining revenues.

Revenue declined from $33M in fiscal 2013 (October 2013) to $28M (-17%) in 2014 to $23M (-15%) in 2015 and fell 15% (from $17.5M to $14.9M) through the first nine months of the current year. Despite that, cash balance increased from $12M at the end of 2013 to $14M at the end of Q3 2016. And not only did PBSV not raise any capital over that period of time, but to the contrary, they made over $1.5M in capital purchases (i.e. – reinvestments in the business) and repurchased $231k worth of common stock – both of which are aimed at increasing shareholder value for the long-term. These are some of the reasons for investor to be interested in PBSV.

And the company is looking to restart revenue growth by putting some of their cash balance to work, noting in the last several quarterly SEC filings that, “We are constantly realigning our business strategies to grow our business. As such, the Company's 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."

This includes $2.0 million allocated for "the expansion of our Puerto Rico Lab facilities, openings of a Lab facility in Spain and the Calibrations division facility in Puerto Rico." As noted, approximately $900k has already be invested in this program. The company had previously expected to spend up to another $1.7M "on new business development positions on consulting targeted new markets" during fiscal 2016 but recently trimmed this down to an expected $500k - $200k of which has been spent through the first nine months of fiscal 2016.

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, language in recent public filings suggests this has yet launch. And in April 2015 PBSV formed Pharma-Brazil, a wholly-owned subsidiary which will provide consulting services to the Brazilian market. Pharma-Brazil also still remains in the development stage but offers another potential opportunity to contribute to revenue in future periods. Given the strength (until recently) 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, PBSV continues to remain in the black, generating $257k of net income through the first nine months of 2016. And there are other 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

book value – which, based on the company's history of generating positive cash flow, presents what we believe to be 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.

Q3 revenue was $4.9 million, down 21% yoy, down 5% sequentially and 11% lower than our $5.5 million estimate. As has been the case for the past several quarters, Puerto Rico, U.S. and European sales remained tepid. U.S. consulting revenue fell on a yoy basis by 45%, while European consulting revenue fell 35%. U.S. had accounted for 28% of total revenue in fiscal 2014 – this fell to 12% in 2015 and just 8% in the first nine months of 2016 – which represents the bulk of the contraction in total company revenue over those periods. Europe has been similarly soft, although not as important a territory as the U.S. (Europe accounts for just 4% - 5% of total revenue). As a reminder, the bulk of European revenue has related to just one customer in Ireland and declining European revenue relates to loss of project headcount related to this customer.

Puerto Rico consulting (most notably projects in Latin America managed in PR) had been one of the only bright spots in the consulting segment - with revenue growing 12% in 2015, although it slipped about 15% through the first nine months of fiscal 2016. Although not specifically mentioned by the company, the significant government fiscal turmoil in Puerto Rico may be a factor to the recent relative weakness in revenue from that territory.

But while consulting-related revenue has been on a consistent downward trend, the opposite is true for the Lab segment, which is currently all based in Puerto Rico. Lab testing revenue grew 17% in 2015 and almost 47% in the first three quarters of 2016. This represents perhaps the most significant near-term growth opportunity as PBSV expects to pump a total of ~$2M into expansion of the P.R. lab, opening of a lab in Spain and starting the Calibrations division (in P.R.). The other benefit that could come with increasing Lab-related revenue is this segment carries higher margins than that of the consulting business.

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 also been somewhat softer - falling from an average of 32% in 2015 to 31.6% through the first nine months of the current year, which includes 29.3% in Q3. The recent narrowing is attributed to closing of some higher margin consulting projects. However, we continue to model incremental widening of GM as Lab services grows as a percentage of total revenue. OpEx was $1.6M and inline with our estimate.

PBSV is guiding for the remaining ~$900k allocated towards lab-related build out and ~$200k related to new business development positions to be invested by the end of October. While we think the remainder of the current year could see some incremental benefit from these investments, we model a more substantive contribution in 2017.

Net income and EPS in the three and nine month periods ending July 31, 2016 were ($131)k / ($0.01) and $257k / $0.01. Despite the yoy contraction in revenue over the last 11 consecutive quarters PBSV continues to generate both positive net income and cash flow. Cash flow from operations was $44k in Q3 and $246k through the first nine months of the year. The company exited the quarter with $14 million in cash and securities.

Valuation

Based on our model we look for EPS to grow at a 4-year CAGR of about 19% through 2019. We use an industry PE/G ratio of 1.6x 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 $0.95, indicating the shares are trading cheaper than fair value.

We also note that book value (as of July 31, 2016) is ~$22 million or almost exactly where the market is valuing the equity. We think book value should provide a floor on the stock. PBSV has a long history of cash flow generation, which has continued during the recent slide in revenue. So we think it is reasonable to expect book value to continue to grow, raising this floor and further reducing any downside risk.

FINANCIAL MODEL

Pharma-Bio Serv, Inc

	2015 E	Q1A	Q2A	Q3A	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$23,384.9	$4,900.5	$5,129.8	$4,866.0	$5,131.8	$20,028.1	$22,723.6	$25,306.4	$28,105.4
YOY Growth	*-15.1%*	*-16.7%*	*-5.7%*	*-21.3%*	*-12.7%*	*-14.4%*	*13.5%*	*11.4%*	*11.1%*
Cost of Services	$15,900.4	$3,142.1	$3,605.6	$3,440.1	$3,597.4	$13,785.2	$15,270.2	$16,651.6	$18,268.5
Gross Income	$7,484.5	$1,758.4	$1,524.2	$1,425.9	$1,534.4	$6,242.9	$7,453.3	$8,654.8	$9,836.9
Gross Margin	*32.0%*	*35.9%*	*29.7%*	*29.3%*	*29.9%*	*31.2%*	*32.8%*	*34.2%*	*35.0%*
SG&A	$5,703.1	$1,374.2	$1,429.5	$1,546.7	$1,539.6	$5,890.0	$5,999.0	$6,301.3	$6,576.7
% SG&A	*24.4%*	*28.0%*	*27.9%*	*31.8%*	*30.0%*	*29.4%*	*26.4%*	*24.9%*	*23.4%*
Operating Income	$1,781.3	$384.1	$94.6	($120.8)	($5.1)	$352.9	$1,454.3	$2,353.5	$3,260.2
Operating Margin	*7.6%*	*7.8%*	*1.8%*	*-2.5%*	*-0.1%*	*1.8%*	*6.4%*	*9.3%*	*11.6%*
Total Other Income (Expense)	$11.5	($2.7)	($49.9)	$3.0	$2.0	($47.6)	$8.0	$22.0	$22.0
Pre-Tax Income	$1,792.8	$381.4	$44.8	($117.8)	($3.1)	$305.3	$1,462.3	$2,375.5	$3,282.2
Tax expense (benefit)	$168.0	$31.4	$7.6	$12.7	($0.3)	$51.4	$153.5	$261.3	$413.6
Tax Rate	*9.4%*	*8.2%*	*16.9%*	*-10.7%*	*8.3%*	*16.8%*	*10.5%*	*11.0%*	*12.6%*
Net Income	$1,624.8	$350.0	$37.2	($130.5)	($2.9)	$253.9	$1,308.8	$2,114.2	$2,868.7
YOY Growth	*-32.2%*	*21.4%*	*-89.6%*	*-128.7%*	*-100.5%*	*-84.4%*	*415.5%*	*61.5%*	*35.7%*
Net Margin	*6.9%*	*7.1%*	*0.7%*	*-2.7%*	*-0.1%*	*1.3%*	*5.8%*	*8.4%*	*10.2%*
EPS	$0.07	$0.02	$0.00	($0.01)	($0.00)	$0.01	$0.06	$0.10	$0.14
YOY Growth	*-31.4%*	*22.4%*	*-89.6%*	*-129.0%*	*-100.6%*	*-84.2%*	*464.5%*	*61.5%*	*35.7%*
Diluted Shares O/S	23,400	23,258	23,244	23,130	23,010	23,161	21,150	21,150	21,150

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BALANCE SHEET

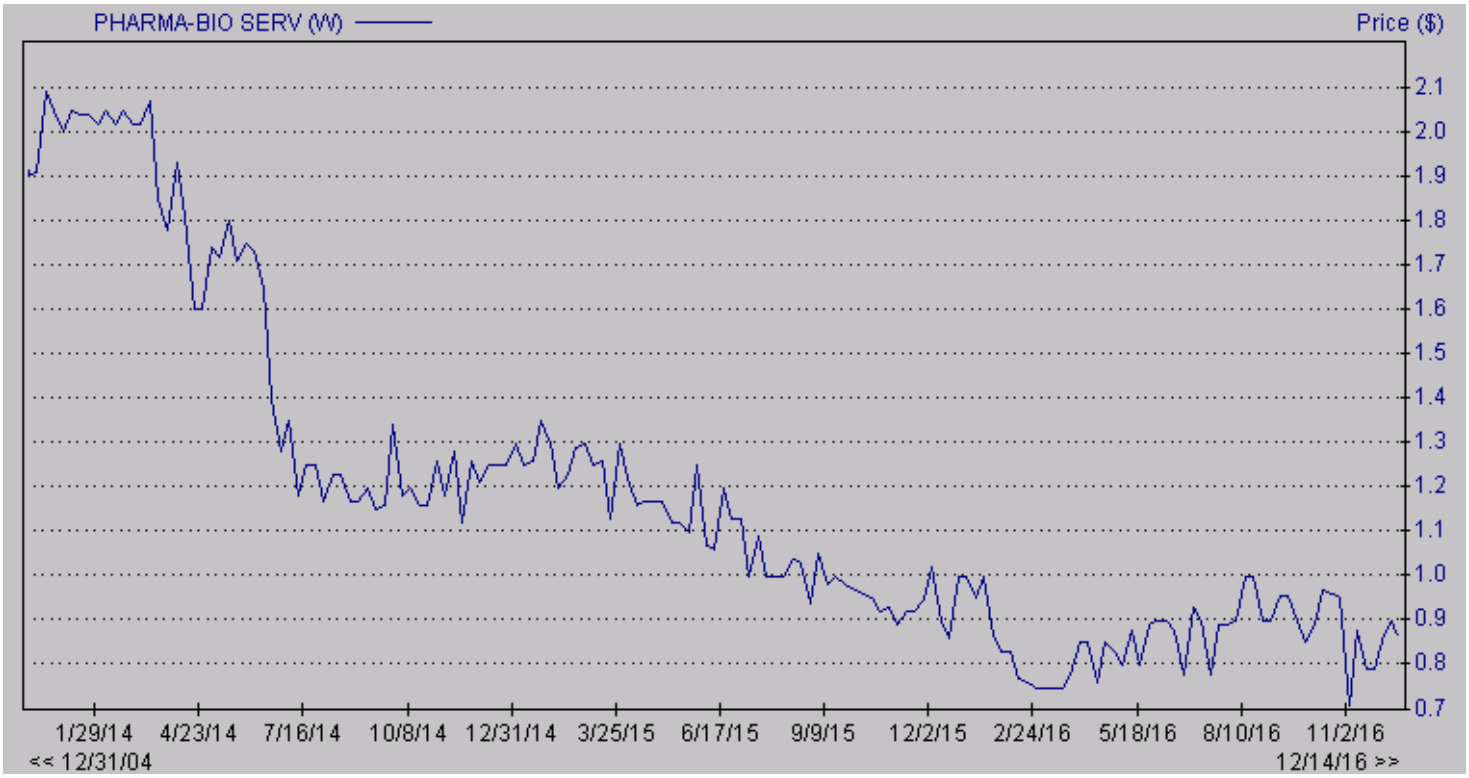
	July 31, 2016	October 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,008	$ 14,898
Marketable Securities	28	33
Accounts Receivable	7,377	7,448
Other	862	892
Total current assets	22,275	23,267
Property and equipment, net	1,709	854
Other assets	33	18
Total assets	$ 24,018	$ 24,139
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 24	$ 23
Accounts payable and accrued expenses	1,591	2,062
Income taxes payable	56	39
Total current liabilities	1,672	2,124
Obligations under capital leases	34	52
Total liabilites	1,706	2,176
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,209	1,143
Retained earnings	21,488	21,232
Accumulated other comprehensive loss	(156)	(227)
Total stockholders' equity	22,312	21,963
Total liabilities and stockholders' equity	$ 24,018	$ 24,139

CASH FLOW STATEMENT

	Three months July 31, 2016	2015
Cash flows from operating activities:		
Net income	$ (130)	454
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	-	-
Stock-based compensation	22	21
Depreciation and amortization	78	90
Impairment of avail-for-sale securities		
Changes in operating assets and liabilities:		
Accounts receivable	335	(579)
Other assets	(170)	(115)
Liabilities	(90)	(220)
Net cash provided by operating activities	44	(349)
Cash flows from investing activities:		
Acquisition of P&E	(465)	(33)
Proceeds from disposition of P&E	-	-
Net cash used in investing activities	(465)	(33)
Cash flows from financing activities:		
Proceeds from common stock issuance	-	-
Repurchase of common stock	(7)	(8)
Payments on obligations under capital lease	(6)	(5)
Net cash provided by (used in) financing activities	(13)	(14)
Effect of exchange rate changes on cash	14	(2)
Net increase (decrease) in cash and cash equivalents	(420)	(398)
Cash and cash equivalents, beginning of period	14,428	14,405
Cash and cash equivalents, end of period	14,008	14.007.856

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