Zacks Small-Cap Research

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

PBSV: Q2 Inline. Positive Net Income, Cash Flow Continues

Based on our model we look for EPS to grow at a 4-year CAGR of about 21% through 2019. We use an industry PE/G ratio of 1.4x to value PBSV. We look for 2017 EPS of $0.07 which values the company at approximately $2.00/share.

Current Price (06/14/16)	$0.90
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 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	**$1.20**
52-Week Low	**$0.65**
One-Year Return (%)	**-14.29**
Beta	**0.12**
Average Daily Volume (sh)	**3,946**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$21**
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 (%)	**6.1**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**12.9**
P/E using 2016 Estimate	**30.0**
P/E using 2017 Estimate	**12.9**
Zacks Rank	**N/A**

Risk Level	**Above Avg.,**
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	$5.5 E	$5.7 E	$21.2 E
2017					$24.4 E
2018					$27.5 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 E	$0.00 E	$0.03 E
2017					$0.07 E
2018					$0.11 E

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

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Fiscal Q2 2016 Results: *Inline With Estimates. Continue to Generate Positive Cash Flow, Net Income…*

PBSV reported financial results for their second fiscal quarter ending April 30, 2016. While results on the top-line remain on the tepid side with revenue in three of the four most significant geographic territories contracting on a year-over-year basis, the company continues to generate positive net income as well as positive cash flow. And while revenue in certain of the geographically itemized territories differed from our estimates, more importantly, total revenue and net income came in largely in-line with our expectations. While gross margin was softer than we were looking for, that was mostly offset by lower than modeled operating expenses.

Overall, we think PBSV continues to weather the ongoing economic weakness 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. Despite revenue falling (y-o-y) for ten straight quarters, PBSV continues to generate positive cash flow and grow their cash balance.

Revenue declined from $33M in fiscal 2013 (October 2013) to $28M (-17%) in 2014 to $23M (-15%) in 2015 and fell 9% (from $11.3M to $10.3M) in the first half of the current year. Despite that, cash balance increased from $12M at the end of 2013 to $14.5M at the end of Q2 2016. And not only did PBSV not raise any capital over that period of time, but to the contrary, they made over $1.1M in capital purchases (i.e. – reinvestments in the business) and repurchased $224k worth of common stock – both of which are aimed at increasing shareholder value for the long-term. These are 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 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 has 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, PBSV continues to remain in the black. But 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 about a 10% discount to book value – which, based on the company's history of generating positive cash flow and increasing its book value, 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.

Q2 revenue was $5.1 million, down 6% yoy, up 5% sequentially and 2% lower than our $5.2 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 36%, while European consulting revenue fell 25%. U.S. had accounted for 28% of total revenue in fiscal 2014 – this fell to 12% in 2015 and just 7% in the first six 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) has been one of the only bright spots in the consulting segment - with revenue growing 12% in 2015, although slipping about 11% through the first half of fiscal 2016. Puerto Rico consulting now accounts for over 70% of total revenue, up from 57% in 2014. But the most significant recent

highlight has been with the Lab testing segment, which is currently all based in Puerto Rico. Lab testing revenue grew 17% in 2015 and almost 60% in 1H 2016. This represents perhaps the most significant near-term growth opportunity as PBSV expects to pump ~$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 a relatively strong 36% on Q1 of this year but fell to 30% in the most recent quarter. The sequential narrowing is attributed to recent 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 $1.4M and below our $1.6M estimate – the difference due to our expectation that some of the aforementioned investments in human capital would show up in the quarter.

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.

Q2 net income and EPS were $37k and $0.00, compared to our $143k and $0.01 estimates. Despite the yoy contraction in revenue over the last ten consecutive quarters PBSV continues to generate both positive net income and cash flow. Cash flow from operations was $130k in Q2 ($202k in 1H 2016) and was $193k ($640k in 1H 2016) excluding changes in working capital. The company exited the quarter with $14.4 million in cash and securities.

Valuation

Based on our model we look for EPS to grow at a 4-year CAGR of about 21% through 2019. We use an industry PE/G ratio of 1.4x to value PBSV. We look for 2017 EPS of $0.07 which values the company at approximately $2.00/share. The stock currently trades at about $0.90, indicating the shares are trading cheaper than fair value.

We also note that book value (as of April 30, 2016) is ~$22 million or about 1.1x that of current market value. 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	Q3E	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$23,384.9	$4,900.5	$5,129.8	$5,461.0	$5,725.4	$21,216.7	$24,388.4	$27,464.7	$30,571.0
YOY Growth	*-15.1%*	*-16.7%*	*-5.7%*	*-11.7%*	*-2.6%*	*-9.3%*	*14.9%*	*12.6%*	*11.3%*
Cost of Services	$15,900.4	$3,142.1	$3,605.6	$3,713.5	$3,893.3	$14,354.5	$16,389.0	$18,071.7	$19,871.1
Gross Income	$7,484.5	$1,758.4	$1,524.2	$1,747.5	$1,832.1	$6,862.2	$7,999.4	$9,392.9	$10,699.8
Gross Margin	*32.0%*	*35.9%*	*29.7%*	*32.0%*	*32.0%*	*32.3%*	*32.8%*	*34.2%*	*35.0%*
SG&A	$5,703.1	$1,374.2	$1,429.5	$1,583.7	$1,717.6	$6,105.1	$6,462.9	$6,893.6	$7,184.2
% SG&A	*24.4%*	*28.0%*	*27.9%*	*29.0%*	*30.0%*	*28.8%*	*26.5%*	*25.1%*	*23.5%*
Operating Income	$1,781.3	$384.1	$94.6	$163.8	$114.5	$757.1	$1,536.5	$2,499.3	$3,515.7
Operating Margin	*7.6%*	*7.8%*	*1.8%*	*3.0%*	*2.0%*	*3.6%*	*6.3%*	*9.1%*	*11.5%*
Total Other Income (Expense)	$11.5	($2.7)	($49.9)	($1.2)	$1.0	($52.8)	$8.0	$22.0	$22.0
Pre-Tax Income	$1,792.8	$381.4	$44.8	$162.6	$115.5	$704.3	$1,544.5	$2,521.3	$3,537.7
Tax expense (benefit)	$168.0	$31.4	$7.6	$13.5	$9.6	$62.1	$162.2	$277.3	$445.7
Tax Rate	*9.4%*	*8.2%*	*16.9%*	*8.3%*	*8.3%*	*8.8%*	*10.5%*	*11.0%*	*12.6%*
Net Income	$1,624.8	$350.0	$37.2	$149.1	$105.9	$642.3	$1,382.3	$2,243.9	$3,091.9
YOY Growth	*-32.2%*	*21.4%*	*-89.6%*	*-67.1%*	*-79.8%*	*-60.5%*	*115.2%*	*62.3%*	*37.8%*
Net Margin	*6.9%*	*7.1%*	*0.7%*	*2.7%*	*1.9%*	*3.0%*	*5.7%*	*8.2%*	*10.1%*
EPS	$0.07	$0.02	$0.00	$0.01	$0.00	$0.03	$0.07	$0.11	$0.15
YOY Growth	*-31.4%*	*22.4%*	*-89.6%*	*-66.7%*	*-79.5%*	*-60.0%*	*135.4%*	*62.3%*	*37.8%*
Diluted Shares O/S	23,400	23,258	23,244	23,016	23,010	23,132	21,150	21,150	21,150

Brian Marckx, CFA

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BALANCE SHEET

	April 30, 2016	October 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,427	$ 14,898
Marketable Securities	22	33
Accounts Receivable	7,705	7,448
Other	703	892
Total current assets	22,857	23,267
Property and equipment, net	1,322	854
Other assets	33	18
Total assets	$ 24,212	$ 24,139
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 23	$ 23
Accounts payable and accrued expenses	1,682	2,062
Income taxes payable	47	39
Total current liabilities	1,753	2,124
Obligations under capital leases	40	52
Total liabilites	1,793	2,176
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,187	1,143
Retained earnings	21,619	21,232
Accumulated other comprehensive loss	(163)	(227)
Total stockholders' equity	22,421	21,963
Total liabilities and stockholders' equity	$ 24,213	$ 24,139

CASH FLOW STATEMENT

	Three months April 30, 2016	2015
Cash flows from operating activities:		
Net income	$ 37	359
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	-	-
Stock-based compensation	22	65
Depreciation and amortization	79	92
Impairment of avail-for-sale securities	55	-
Changes in operating assets and liabilities:		
Accounts receivable	(333)	(879)
Other assets	17	(43)
Liabilities	253	(162)
Net cash provided by operating activities	130	568
Cash flows from investing activities:		
Acquisition of P&E	(207)	(34)
Proceeds from disposition of P&E	-	-
Net cash used in investing activities	(207)	(34)
Cash flows from financing activities:		
Proceeds from common stock issuance	-	-
Repurchase of common stock	(8)	(31)
Payments on obligations under capital lease	(6)	(5)
Net cash provided by (used in) financing activities	(14)	(37)
Effect of exchange rate changes on cash	4	(2)
Net increase (decrease) in cash and cash equivalents	(88)	(641)
Cash and cash equivalents, beginning of period	14,516	15,146
Cash and cash equivalents, end of period	14,428	14,405

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