Zacks Small-Cap Research

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Brian Marckx, CFA
bmarckx@zacks.com
Ph (312) 265-9474

scr.zacks.com

10 S. Riverside Plaza, Chicago, IL 60606

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

PBSV: CF Positive and Trading Below Book Value

Based on our model we look for EPS to grow at a 5-year CAGR of about 18% through 2020. We use an industry PE/G ratio of 1.9x to value PBSV. We look for 2018 EPS of $0.05 which values the company at approximately $2.00/share. The stock currently trades at about $0.87, indicating the shares are trading cheaper than fair value.

Current Price (02/02/17)	$0.87
Valuation	**$2.00**

OUTLOOK

While revenue has not been a highlight as of late, the company's highly variable cost structure allows it to easily weather these temporary downturns. Despite recent relative weakness in revenue growth, the company continues to generate positive cash flow. PBSV continues to opportunistically allocate resources where they see the greatest potential for growth. Recently this has included additional investments to expand their lab facilities in Puerto Rico (i.e. the only major segment posting revenue growth in 2016), opening of a lab facility in Spain and formation of a new Calibrations division ("Metrologix") in Puerto Rico. Investments such as these, as well as in human capital, are expected to benefit sales in future periods. We also point to several potential catalysts, the possible benefits of which we yet to fully incorporate in our model including political and regulatory changes, particularly related to the U.S. but also how these may have a global influence. Shares currently trade below where we calculate fair value. Also now trade below book value, which should provide a downside floor.

SUMMARY DATA

52-Week High	**$1.00**
52-Week Low	**$0.65**
One-Year Return (%)	**6.10**
Beta	**-0.05**
Average Daily Volume (sh)	**277**
Shares Outstanding (mil)	**23**
Market Capitalization ($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 (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2017 Estimate	**N/A**
P/E using 2018 Estimate	**17.4**
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)
2016	$4.9 A	$5.1 A	$4.9 A	$4.6 A	$19.5 A
2017	$4.6 E	$4.9 E	$5.0 E	$4.9 E	$19.4 E
2018					$22.3 E
2019					$25.2 E

Earnings per Share

	Q1 (Jan)	Q2 (Apr)	Q3 (Jul)	Q4 (Oct)	Year (Oct)
2016	$0.02 A	$0.00 A	-$0.01 A	-$0.02 A	$0.01 A
2017	-$0.01 E	-$0.00 E	-$0.00 E	-$0.00 E	-$0.02 E
2018					$0.05 E
2019					$0.09 E

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

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Fiscal Q4 2016 Results:

PBSV reported financial results for the fiscal fourth quarter ending October 31, 2016. Q4 capped off a tough year for the company with revenue falling 21% and marking the 12th straight quarter of yoy top-line contraction. For the full-year, revenue was down almost 17%, reflecting double-digit percentage decreases in three of the company's top four revenue reporting categories. Revenue from; Puerto Rico, which accounts for ~75% of total sales, fell 17%, U.S. (~8% of total sales) fell 46% and Europe (~4% of total sales) fell 25%. The sole revenue-related highlight was the lab segment, which accounts for approximately 12% of total sales and posted 22% yoy growth in 2016.

The major contributor to overall top-line weakness has been Puerto Rico. The $2.9M contraction in revenue from Puerto Rico ($17.5M in 2015 to $14.6M in 2016) accounted for 75% of the $3.8M decrease in total revenue ($23.4M in 2015 to $19.6M in 2016). And of the $2.9M slide, $1.3M relates to projects in Latin America that were managed from Puerto Rico. Another potential contributing factor could be the continued economic volatility and debt crisis in Puerto Rico.

But while revenue has not been a highlight as of late, as we have noted in our ongoing coverage of PBSV, the company benefits from a highly variable cost structure due in large part to the use of time-and-materials based contracts. While this means scalability is somewhat limited in times of revenue growth, it similarly limits the downside during less prosperous times. So despite the ~17% contraction in revenue in 2016, PBSV still managed to generate $186k in cash from operations (ex-changes in working capital). And had it not been for additional investments of ~$300k in 2016 related to new business development positions, cash flow would likely have been even slightly better.

Opportunistically Invest in Areas of Growth, Reduce Costs in Others…
Another significant benefit of the company's business model is that it allows for significant flexibility and agility in regards to where, when and how they put their assets to work. The company continues to opportunistically allocate resources where they see the greatest potential for growth. Recently this has included additional investments to expand their lab facilities in Puerto Rico (i.e. the only major segment posting revenue growth in 2016), opening of a lab facility in Spain and formation of a new Calibrations division ("Metrologix") in Puerto Rico. Investments such as these, as well as the aforementioned investments in human capital, are expected to benefit sales in future periods.

Other potential growth-related opportunities include Pharma-Brazil and, possibly, entry into Cuba. Pharma-Brazil is a wholly-owned subsidiary which PBSV registered in 2015 in order to provide consulting services to the Brazilian market – PBSV notes in the 2016 10-K that Brazil consulting revenue increased by ~$200k in 2016. 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.

Relative to Cuba, PBSV notes in their 10-K that in December 2016 they obtained a license from the U.S. Dept of Treasury Office of Foreign Assets Control (OFAC) authorizing the company to perform certain services and transactions with a Cuban state-run organization. While too early for us to hypothesize the significance of this, the OFAC license may provide PBSV with (at least) foot-in-the-door opportunity to a country that has been largely off-limits to most American companies (with some exceptions). And the recently restored (at least formally restored) diplomatic relations between the U.S. and Cuba and potential that sanctions are reduced in the future may mean that this foot-in-the-door could eventually result in even greater opportunity for PBSV.

But PBSV has also shown a willingness to deprioritize or reduce assets and activity in areas which hold less, or waning, promise for growth or otherwise afford an opportunity to reduce costs. As an example, in December 2016 the company closed its (leased) office in Pennsylvania (although they will maintain a U.S. sales force) which will reduce future lease costs.

Financials: Consulting Revenue Remains Soft, Lab Continues Growth. Still CF Positive
Q4 revenue was $4.6M, down 21% yoy, down 5% sequentially and 10% lower than our $5.1M 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 42%, while European consulting revenue fell 32%. U.S. had accounted for 28% of total revenue in fiscal 2014 – this fell to 12% in 2015 and just 7% in 2016 – the decline in U.S. revenue

represented the bulk of the contraction in total company revenue from 2014 to 2015 (while the slide in Puerto Rico sales was the largest contributor to total revenue decline from 2015 to 2016).

European consulting revenue has been similarly soft, although since it accounts for just 4% - 5% of total sales, its impact to company-wide revenue has not been as substantial as has other territories. 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. But while European consulting revenue has slid fairly regularly since the end of 2013, we remain hopeful that this segment can return to growth.

In fact Europe was one of the sole bright spots in Q4 2016 and the only geographic territory that posted positive consulting revenue growth in the quarter (+32% yoy, +31% sequentially). Improving worldwide economies, development of lab facilities in Spain and the potential for reduced pharmaceutical-related regulations in the U.S. (which could have global benefits) all could play a role in spurring additional activity in PBSV's European operations.

Puerto Rico consulting had been very strong in the recent past - with revenue growing 12% in 2015. However, 2016 was a different story with revenue dropping 22% in Q4 and 17% for the full year. As Puerto Rico accounts for almost 75% of total company sales, weakness in this territory has been the majority contributor to the slide in PBSV's top-line throughout 2016 – accounting for 79% of the yoy decrease in Q4 revenue and 75% for the full year. The company notes that $1.3M (or ~45%) of the $2.9M slide in Puerto Rico revenue in 2016 relates to projects in Latin America managed in P.R. Although not specifically mentioned by the company, the significant government fiscal turmoil in Puerto Rico may also be a factor to the recent relative weakness in revenue from that territory. But on a brighter note, Brazil consulting revenue increased $200k in 2016.

But while consulting-related revenue has been on a consistent downward trend, the lab segment, which is currently all based in Puerto Rico, has performed much better. Lab testing revenue grew 17% in 2015 and 22% in 2016. And while the $590k in Q4 2016 revenue from this segment is down 21% yoy, the decrease reflects a difficult and lumpy prior-year comp and is in-line with the $600k quarterly average during the most current year. We continue to think that the lab segment represents perhaps the most significant near-term growth opportunity given PBSV's recent investments towards expansion of the P.R. lab and opening of a lab facility in Spain. During 2016 the company spent $1.5M ($200k toward Spain lab, $1.3M toward P.R. lab) related to these facilities (up to $2M is budgeted in total for these as well as the new Calibrations division) – as $1.1M of this is still construction-in-progress, we could begin to see the fruits of these investments in the fairly near-term. The other benefit that could come with increasing lab-related revenue is this segment carries higher margins than that of the consulting business.

A resurgence in revenue from Puerto Rico would have other benefits as well, including a reduction to the company's overall income tax exposure. Revenue generated in Puerto Rico 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).

Gross margin was also been somewhat softer - falling from an average of 32% in 2015 to 29.6% in 2016, which includes 23.2% in Q4. The recent narrowing is mostly 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 $5.9M, or 30.1% of revenue, in 2016. This is up from $5.7M, or 24.4%, in 2015. We attribute most of the recent increase in OpEx to the aforementioned opportunistic investments in personnel and other resources in areas which hold significant opportunity for growth.

Net income and EPS in the three and twelve month periods ending October 31, 2016 were ($513)k / ($0.02) and ($257)k / ($0.01). Despite the net loss, PBSV still managed to generate $710k (or $186k ex-changes in working capital) of positive cash flow from operations in 2016.

Valuation:
The somewhat longer than previously anticipated continued softness in consulting revenue, particularly as it relates to Puerto Rico, as well as more drawn-out timelines (relative to our forecast) for completion and opening of the additional lab facilities in Puerto Rico and Spain has prompted an extension of the runway in our model until revenue turns back towards consistent growth. We now model relatively flat revenue growth through the first half of fiscal 2017 and a return to sustained top-line expansion to begin later in the year. We note, however, that the benefits of PBSV's business model, including the ability to rapidly adapt to opportunities, means that our model is highly subject to updating over short periods.

We also point to several potential catalysts, the possible benefits of which we yet to fully incorporate in our model. These include the possibility of outsized returns from recently added revenue centers, such as Pharma-Brazil or the calibrations division. Political and regulatory changes, particularly related to the U.S. but also how these may have a global influence, are somewhat of a wildcard at this point. But, given President Trump's stated position on reducing regulatory barriers, including those related to the pharmaceutical industry, we will be closely watching any related developments and how this may potentially benefit PBSV and their client customers.

Based on our model we look for EPS to grow at a 5-year CAGR of about 18% through 2020. We use an industry PE/G ratio of 1.9x to value PBSV. We look for 2018 EPS of $0.05 which values the company at approximately $2.00/share. The stock currently trades at about $0.87, indicating the shares are trading cheaper than fair value.

We also note that the shares are currently trading below book value. Book value (as of October 31, 2016) is ~$21.8 million or $0.95/share. 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

	2016 A	Q1E	Q2E	Q3E	Q4E	2017 E	2018 E	2019 E	2020 E
Total Revenues	$19,536.7	$4,632.7	$4,867.0	$4,998.6	$4,874.2	$19,372.6	$22,277.4	$25,191.0	$27,988.4
YOY Growth	*-16.5%*	*-5.5%*	*-5.1%*	*2.7%*	*5.0%*	*-0.8%*	*15.0%*	*13.1%*	*11.1%*
Cost of Services	$13,753.5	$3,469.9	$3,455.6	$3,529.0	$3,436.3	$13,890.8	$14,992.7	$16,726.9	$17,912.6
Gross Income	$5,783.3	$1,162.8	$1,411.4	$1,469.6	$1,437.9	$5,481.7	$7,284.7	$8,464.2	$10,075.8
Gross Margin	*29.6%*	*25.1%*	*29.0%*	*29.4%*	*29.5%*	*28.3%*	*32.7%*	*33.6%*	*36.0%*
SG&A	$5,875.0	$1,440.8	$1,499.0	$1,544.6	$1,501.3	$5,985.7	$6,237.7	$6,373.3	$6,549.3
% SG&A	*30.1%*	*31.1%*	*30.8%*	*30.9%*	*30.8%*	*30.9%*	*28.0%*	*25.3%*	*23.4%*
Operating Income	($91.8)	($278.0)	($87.6)	($75.0)	($63.4)	($503.9)	$1,047.0	$2,090.9	$3,526.5
Operating Margin	*-0.5%*	*-6.0%*	*-1.8%*	*-1.5%*	*-1.3%*	*-2.6%*	*4.7%*	*8.3%*	*12.6%*
Total Other Income (Expense)	($112.0)	$1.0	$1.0	$1.0	$1.0	$4.0	$14.0	$18.0	$25.0
Pre-Tax Income	($203.7)	($277.0)	($86.6)	($74.0)	($62.4)	($499.9)	$1,061.0	$2,108.9	$3,551.5
Tax expense (benefit)	$52.8	$3.0	$7.2	$4.4	$2.7	$17.4	$95.5	$265.7	$447.5
Tax Rate	*-25.9%*	*-1.1%*	*-8.3%*	*-6.0%*	*-4.4%*	*-3.5%*	*9.0%*	*12.6%*	*12.6%*
Net Income	($256.5)	($280.0)	($93.8)	($78.4)	($65.1)	($517.3)	$965.5	$1,843.1	$3,104.0
YOY Growth	*-115.8%*	*-180.0%*	*-352.1%*	*-39.9%*	*-87.3%*	*101.7%*	*-286.6%*	*90.9%*	*68.4%*
Net Margin	*-1.3%*	*-6.0%*	*-1.9%*	*-1.6%*	*-1.3%*	*-2.7%*	*4.3%*	*7.3%*	*11.1%*
EPS	($0.01)	($0.01)	($0.00)	($0.00)	($0.00)	($0.02)	$0.05	$0.09	$0.15
YOY Growth	*-115.9%*	*-180.7%*	*-354.8%*	*-39.4%*	*-87.2%*	*103.5%*	*-302.8%*	*90.9%*	*68.4%*
Diluted Shares O/S	23,186	23,055	23,000	22,950	22,900	22,976	21,150	21,150	21,150

Brian Marckx, CFA

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BALANCE SHEET

	October 31, 2016	October 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,774	$ 14,898
Marketable Securities	20	33
Accounts Receivable	6,853	7,448
Other	981	892
Total current assets	21,628	23,267
Property and equipment, net	2,334	854
Other assets	36	18
Total assets	$ 23,998	$ 24,139
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 23	$ 23
Accounts payable and accrued expenses	2,091	2,062
Income taxes payable	45	39
Total current liabilities	2,159	2,124
Obligations under capital leases	29	52
Total liabilites	2,188	2,176
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,231	1,143
Retained earnings	20,975	21,232
Accumulated other comprehensive loss	(166)	(227)
Total stockholders' equity	21,810	21,963
Total liabilities and stockholders' equity	$ 23,998	$ 24,139

CASH FLOW STATEMENT

	October 31, 2016	2015
Cash flows from operating activities:		
Net income	$ (257)	$ 1,625
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	(14)	-
Stock-based compensation	89	87
Depreciation and amortization	313	357
Impairment of avail-for-sale securities	55	
Changes in operating assets and liabilities:		
Accounts receivable	647	(1,067)
Other assets	(108)	(116)
Liabilities	(16)	(513)
Net cash provided by operating activities	710	373
Cash flows from investing activities:		
Acquisition of P&E	(1,809)	(342)
Proceeds from disposition of P&E	30	-
Net cash used in investing activities	(1,779)	(342)
Cash flows from financing activities:		
Proceeds from common stock issuance		
Repurchase of common stock	(46)	(169)
Payments on obligations under capital lease	(23)	(22)
Net cash provided by (used in) financing activities	(69)	(191)
Effect of exchange rate changes on cash	18	(34)
Net increase (decrease) in cash and cash equivalents	(1,120)	(195)
Cash and cash equivalents, beginning of period	14,893	15,088
Cash and cash equivalents, end of period	13,774	$ 14,893

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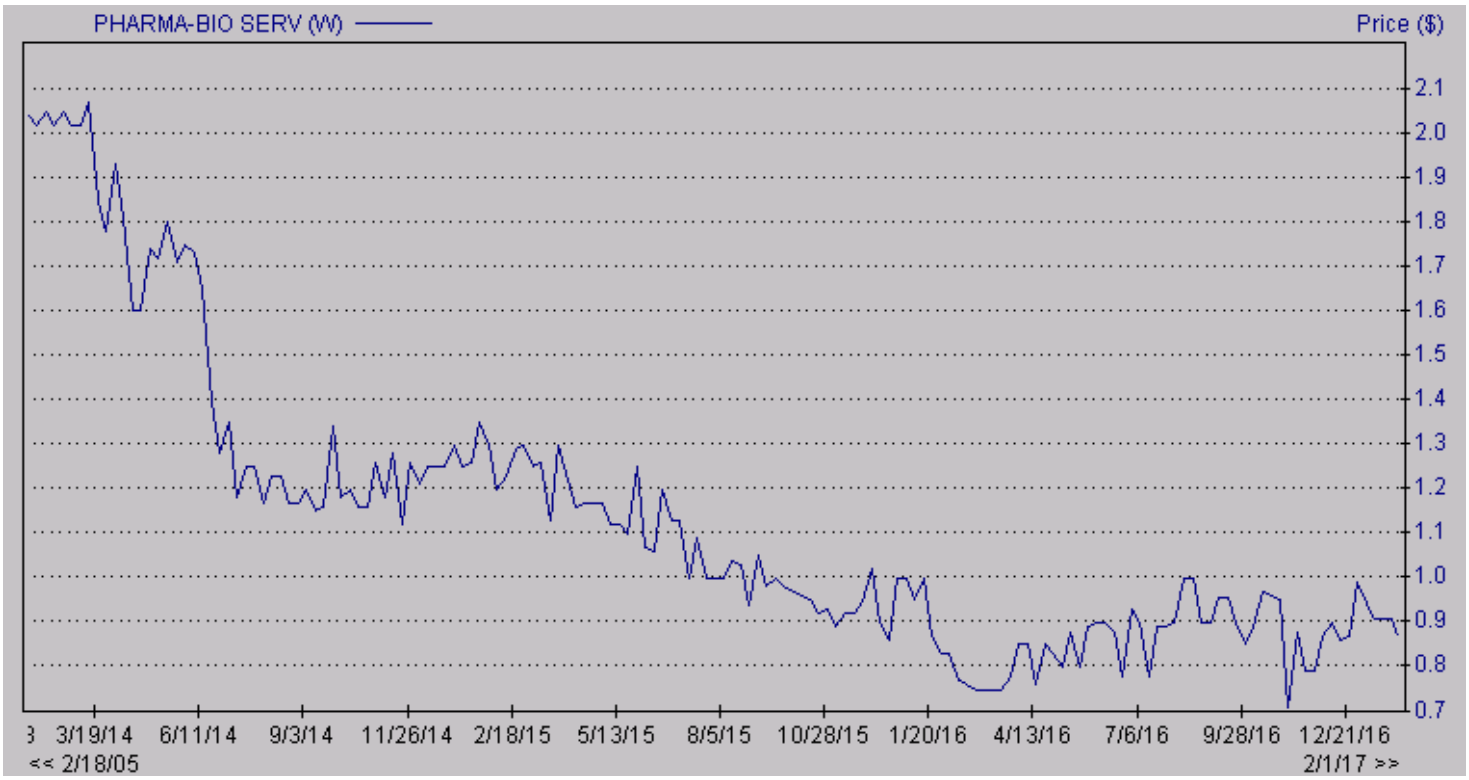

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