Zacks Small-Cap Research

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

PBSV: P.R. Weak But U.S., Lab Segments Stabilizing

Based on our model we look for EPS to grow at a 5-year CAGR of about 14% through 2020. We use an industry PE/G ratio of 1.9x to value PBSV. We look for 2019 EPS of $0.08 which values the company at approximately $2.00/share. The stock currently trades at about $0.72, indicating the shares are trading cheaper than fair value.

Current Price (03/22/17)	$0.72
Valuation	**$2.00**

OUTLOOK

While the significant slide in P.R. revenue which began about 18 months ago has taken a toll, we think there are other reasons to remain positive of PBSV returning to profitability. This includes stabilization of revenue in certain of the other major consulting segments, the company's ability to rapidly trim operating expenses, potential revenue upside from new business segments (such as the Calibrations division and Pharma-Brazil) and the possibility of favorable tax reform and FDA regulatory changes from the Trump administration. And while the effects of possible (likely, perhaps) healthcare reform in the U.S. on PBSV's business remain a complete unknown at this point, there is certainly a chance that it could result in positive outcomes for the company. And even in periods with relatively weak revenue, such as the most recent quarter, PBSV burns very little cash. The company used just $251k in cash for operations (ex-changes in working capital) in fiscal Q1 '17 which, aside from Q4 '16, was the greatest amount of cash burned for operations in any given quarter for at least the last six years (and quite possibly longer as we only looked back six years). Stock trades well below book value.

SUMMARY DATA

52-Week High	**$1.00**
52-Week Low	**$0.55**
One-Year Return (%)	**-5.01**
Beta	**-0.10**
Average Daily Volume (sh)	**1,443**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$17**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**51**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
One-Year Return (%)	**-5.01**
Beta	**-0.10**
Average Daily Volume (sh)	**1,443**
Shares Outstanding (mil)	**23**
P/E using TTM EPS	**N/A**
P/E using 2017 Estimate	**N/A**
P/E using 2018 Estimate	**21.8**
Zacks Rank	**N/A**

Risk Level	**Above Avg.,**
Type of Stock	**Small-Value**
Industry	**Consulting**

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	$4.1 A	$4.3 E	$4.3 E	$4.6 E	$17.3 E
2018					$19.3 E
2019					$22.5 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	-$0.02 A	-$0.01 E	-$0.01 E	-$0.00 E	-$0.04 E
2018					$0.04 E
2019					$0.08 E

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

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Fiscal Q1 2017 Results:

PBSV reported financial results for their fiscal first quarter 2017, ending January 31, 2017**. Revenue was relatively weak**, falling by double-digit percentages on both a sequential and year-over-year basis and coming in at what appears to be the lowest level since fiscal Q1 2011 (ending January 31, 2011).

The vast majority of the total top-line contraction from both fiscal Q1 '16 (i.e. yoy) and Q4 '16 (i.e. sequential) **is a result of a decrease in Puerto Rico consulting-related revenue**. Since this segment accounts for approximately 70% of total revenue, any volatility in its sales can have a disproportionate effect on total revenue. P.R. consulting revenue was $2.8M in Q1 '17, down 22% yoy and almost 19% sequentially and represented approximately 89% and 107% of the yoy and sequential total revenue decreases. While not specifically disclosed, we think a reasonable assumption for the relative softness in P.R. consulting revenue relates to the significant fiscal issues that the U.S. territory has been wrangling with for some time now.

But despite the significant drop in P.R. revenue and the six-year low in total revenue, **the quarter was far from all bad news.** In fact both U.S. consulting and lab revenue, which combined account for about 25% of total revenue, grew on a sequential basis and U.S. consulting also barely eked out positive yoy growth. In addition, revenue from both of these segments have been fairly stable over the last three consecutive quarters.

While the significant slide in P.R. revenue which began about 18 months ago has taken a toll, **we think there are other reasons to remain positive of PBSV returning to profitability**. This includes stabilization of revenue in certain of the other major consulting segments, the company's ability to rapidly trim operating expenses, potential revenue upside from new business segments (such as the Calibrations division and Pharma-Brazil) and the possibility of favorable tax reform and FDA regulatory changes from the Trump administration. And while the effects of possible (likely, perhaps) healthcare reform in the U.S. on PBSV's business remain a complete unknown at this point, there is certainly a chance that it could result in positive outcomes for the company.

And even in periods with relatively weak revenue, such as the most recent quarter, **PBSV burns very little cash**. The company used just $251k in cash for operations (ex-changes in working capital) in fiscal Q1 '17 which, aside from Q4 '16, was the greatest amount of cash burned for operations in any given quarter for at least the last six years (and quite possibly longer as we only looked back six years).

Minimal cash burn, coupled with the company's sizeable cash balance which stood at $13.7M at quarter-end, means PBSV can weather even lengthy periods of less-than-favorable industry dynamics. And it is important to point out to investors that PBSV's light cash needs is not coming at the expense of significant stock compensation (a crutch often employed by companies to reduce cash burn when times get tough) – in fact PBSV's outstanding share count has consistently incrementally decreased shortly following the June 2014 implementation of a program to repurchase up to two million shares.

Some of the major reasons behind the minimal use of cash are largely fundamentally unique to PBSV. One is their **variable cost business model** and use of time-and-material contracts. While this means scalability is somewhat limited in times of revenue growth, it similarly limits the downside and cash burn during less prosperous times. Another is their **favorable income tax treatment**. Revenue generated in Puerto Rico is taxed at just 4% (as a result of the company's beneficial P.R. tax status), compared to a maximum regular federal income tax rate of 35% for U.S. operations. This benefit is highlighted in the amount of cash paid for income taxes, which fell from $535k in fiscal 2014 (when P.R. and U.S. revenue accounted for 57% and 28% of total sales, respectively) to just $152k in 2015 (when P.R. and U.S. revenue accounted for 75% and 12% of total sales, respectively).

In terms of additional opportunities, PBSV continues to 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 and which also had strong sequential growth in Q1 '17), opening of a lab facility in Spain and formation of a new Calibrations division ("Metrologix") in Puerto Rico. The Calibrations division, per the Q1 10-Q, contributed an increase of approximately $100k of revenue in the most recent quarter. Investments such as these, as well as recent 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 noted in their 2016 10-K that Brazil consulting revenue increased by ~$200k in 2016. Given the historical 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, in December 2016 PBSV 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, since December 2016 the company closed its (leased) offices in Pennsylvania and California which will reduce future lease costs beginning in fiscal Q2 ’17 (i.e. this quarter).

Financials: Puerto Rico Weakens, Other Segments Either Stable or Incrementally Growing
Q1 revenue was $4.1M, down 17% yoy, down 13% sequentially and 13% lower than our $4.6M estimate. As noted earlier, Puerto Rico revenue which accounts for approximately 70% of the total top-line and which slid 22% yoy and 19% sequentially, was responsible for the vast majority of the fall in total company revenue.

The other major segments performed much better. U.S. consulting revenue accounts for about 9% of total sales and was $347k, up less than 1% yoy but 11% higher than Q4 ’16. Lab revenue (~16% of total revenue) was $642k, while down 18% yoy, this is the highest level since Q2 ’16 and up almost 9% sequentially. Meanwhile, Europe, which accounts for about 5% of total revenue saw sales fall 10% yoy and 24% from Q4 ’16.

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 17%. As Puerto Rico accounts for about 70% of total company sales, weakness in this territory has been the majority contributor to the recent slide in PBSV’s top-line – accounting for approximately 89% and 107% of the yoy and sequential total revenue decreases in Q1 ’17. 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.

On a brighter note, U.S. consulting revenue has remained fairly stable as of late as has lab revenue. We think possible significant favorable changes to the FDA regulatory environment as well as to corporate tax rates due to the Trump administration’s policy agenda (as well as Republicans controlling both chambers of Congress) could benefit PBSV’s U.S. operations.

A more significant resurgence from the lab segment could provide meaningful upside to our estimates. That has been and continues to be a difficult line item to forecast. As noted, it was the only major segment that posted positive growth in 2016. But while it exhibited positive sequential growth in Q1, it still underperformed our estimate. Nonetheless, the recent stabilization has certainly been a positive trend.

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. 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 typically 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.

Meanwhile, European consulting revenue has been quite 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 at least stabilize.

Relative to **gross margin**, this has similarly contracted - falling from an average of 32% in 2015 to 29.6% in 2016. While gross margin ticked up to 25.5% in Q1 '17 from 23.2% in Q4 '16, it remains well below its historical average. The recent narrowing is attributable to both the lab and consulting segments. Relative to the lab segment, while this offers more scalability and thus, higher margins in times of greater activity, the recent lab expansion has introduced additional costs including personnel and depreciation on equipment related to the recent lab expansion. Consulting margins have been impacted by some less favorable project margins as well as temporary closure of some customer facilities in P.R.

OpEx was $1.4M, or 35% of revenue, in Q1. On an aggregate basis, this is in-line with historical levels although on a percentage of revenue basis it is relatively high (it was 30% in 2016). PBSV also notes that additional business development positions are reflected in the OpEx number.

Q1 net income and EPS were ($382)k and ($0.02), compared to our ($280)k and ($0.01) estimates.

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) recently prompted an extension of the runway in our model until revenue turns back towards consistent growth. We now model continued yoy contraction in the top-line through approximately Q3 of this fiscal year and then relatively flat revenue in the final quarter. We now show a return to sustained top-line expansion to begin early next 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, as well as the potential effects from healthcare reform, 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 14% through 2020. We use an industry PE/G ratio of 1.9x to value PBSV. We look for 2019 EPS of $0.08 which values the company at approximately $2.00/share. The stock currently trades at about $0.72, 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 January 31, 2017) is ~$21.4 million or $0.93/share. Cash balance currently sits at a hefty $13.7M, or ~$0.59/share. We think book value should provide a floor on the stock. PBSV has a long history of cash flow generation. And even recently, when revenue has been at the lowest level in six years, the company used just $251k in cash for operations. So we think it is reasonable to expect book value to continue to grow with even a moderate increase in total revenue from current levels.

FINANCIAL MODEL

Pharma-Bio Serv, Inc

	2016 A	Q1A	Q2E	Q3E	Q4E	2017 E	2018 E	2019 E	2020 E
Total Revenues	$19,536.7	$4,046.3	$4,291.9	$4,311.7	$4,625.1	$17,275.0	$19,883.3	$22,506.7	$25,079.4
YOY Growth	*-16.5%*	*-17.4%*	*-16.3%*	*-11.4%*	*-0.3%*	*-11.6%*	*15.1%*	*13.2%*	*11.4%*
Cost of Services	$13,753.5	$3,013.9	$3,133.1	$3,074.3	$3,260.7	$12,482.0	$13,381.4	$14,944.5	$16,050.8
Gross Income	$5,783.3	$1,032.3	$1,158.8	$1,237.5	$1,364.4	$4,793.0	$6,501.8	$7,562.3	$9,028.6
Gross Margin	*29.6%*	*25.5%*	*27.0%*	*28.7%*	*29.5%*	*27.7%*	*32.7%*	*33.6%*	*36.0%*
SG&A	$5,875.0	$1,416.3	$1,382.0	$1,379.8	$1,415.3	$5,593.4	$5,567.3	$5,694.2	$5,868.6
% SG&A	*30.1%*	*35.0%*	*32.2%*	*32.0%*	*30.6%*	*32.4%*	*28.0%*	*25.3%*	*23.4%*
Operating Income	($91.8)	($384.0)	($223.2)	($142.3)	($50.9)	($800.3)	$934.5	$1,868.1	$3,160.0
Operating Margin	*-0.5%*	*-9.5%*	*-5.2%*	*-3.3%*	*-1.1%*	*-4.6%*	*4.7%*	*8.3%*	*12.6%*
Total Other Income (Expense)	($112.0)	$3.6	$2.5	$4.0	$3.0	$13.1	$14.0	$18.0	$25.0
Pre-Tax Income	($203.7)	($380.4)	($220.7)	($138.3)	($47.9)	($787.2)	$948.5	$1,886.1	$3,185.0
Tax expense (benefit)	$52.8	$1.8	$18.3	$8.3	$2.1	$30.5	$85.4	$237.6	$401.3
Tax Rate	*-25.9%*	*-0.5%*	*-8.3%*	*-6.0%*	*-4.4%*	*-3.9%*	*9.0%*	*12.6%*	*12.6%*
Net Income	($256.5)	($382.1)	($239.0)	($146.6)	($50.0)	($817.7)	$863.1	$1,648.4	$2,783.7
YOY Growth	*-115.8%*	*-209.2%*	*-742.4%*	*12.3%*	*-90.3%*	*218.7%*	*-205.6%*	*91.0%*	*68.9%*
Net Margin	*-1.3%*	*-9.4%*	*-5.6%*	*-3.4%*	*-1.1%*	*-4.7%*	*4.3%*	*7.3%*	*11.1%*
EPS	($0.01)	($0.02)	($0.01)	($0.01)	($0.00)	($0.04)	$0.04	$0.08	$0.14
YOY Growth	*-115.9%*	*-210.2%*	*-746.4%*	*13.0%*	*-90.2%*	*220.8%*	*-215.0%*	*91.0%*	*74.2%*
Diluted Shares O/S	23,186	23,051	23,100	23,000	23,000	23,038	21,150	21,150	20,500

Brian Marckx, CFA

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BALANCE SHEET

	January 31, 2017	October 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,671	$ 13,774
Marketable Securities	22	20
Accounts Receivable	6,015	6,853
Other	808	981
Total current assets	20,515	21,628
Property and equipment, net	2,505	2,334
Other assets	36	36
Total assets	$ 23,056	$ 23,998
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 21	$ 23
Accounts payable and accrued expenses	1,511	2,091
Income taxes payable	46	45
Total current liabilities		2,159
Obligations under capital leases	25	29
Total liabilites	1,603	2,188
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,253	1,231
Retained earnings	20,593	20,975
Accumulated other comprehensive loss	(161)	(166)
Total stockholders' equity	21,454	21,810
Total liabilities and stockholders' equity	$ 23,056	$ 23,998

CASH FLOW STATEMENT

	January 31, 2017	2016
Cash flows from operating activities:		
Net income	$ (382)	350
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E		-
Stock-based compensation	22	22
Depreciation and amortization	109	74
Impairment of avail-for-sale securities		
Changes in operating assets and liabilities:		
Accounts receivable	849	82
Other assets	178	171
Liabilities	(592)	(627)
Net cash provided by operating activities	185	72
Cash flows from investing activities:		
Acquisition of P&E	(281)	(414)
Proceeds from disposition of P&E	-	-
Net cash used in investing activities	(281)	(414)
Cash flows from financing activities:		
Proceeds from common stock issuance	-	-
Repurchase of common stock	(2)	(29)
Payments on obligations under capital lease	(6)	(6)
Net cash provided by (used in) financing activities	(8)	(35)
Effect of exchange rate changes on cash	0	(1)
Net increase (decrease) in cash and cash equivalents	(103)	(378)
Cash and cash equivalents, beginning of period	13,774	14,893
Cash and cash equivalents, end of period	13,671	14,516

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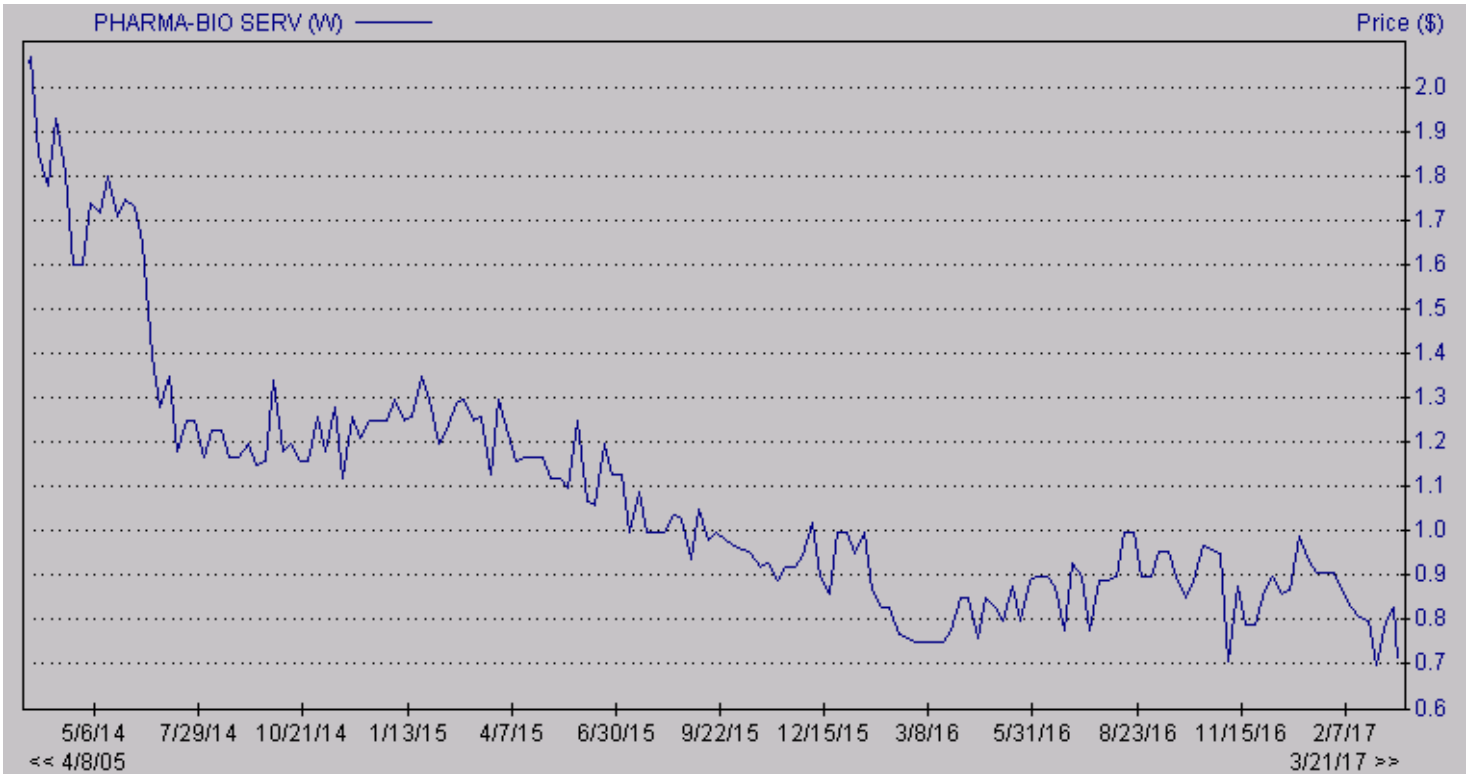
HISTORICAL STOCK PRICE



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