Zacks Small-Cap Research

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Pharma-Bio Serv (PBSV-OTC)

PBSV: Solid EPS, Cash Flow Despite Revenue Miss. New Revenue Catalysts in the Pipeline

Current Recommendation	**Buy**
Prior Recommendation	N/A
Date of Last Change	09/15/2013
Current Price (06/16/15)	$1.05
Target Price	**$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. 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	**$1.80**
52-Week Low	**$1.00**
One-Year Return (%)	**-34.38**
Beta	**-0.44**
Average Daily Volume (sh)	**1,645**
Shares Outstanding (mil)	**23**
Market Capitalization ($mil)	**$24**
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 (%)	**27.0**
Earnings Per Share (%)	**50.1**
Dividend (%)	**N/A**
P/E using TTM EPS	**10.5**
P/E using 2015 Estimate	**15.0**
P/E using 2016 Estimate	**9.6**
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	$5.4 A	$5.7 E	$6.3 E	$23.3 E
2016					$25.6 E
2017					$28.0 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 A	$0.02 E	$0.02 E	$0.07 E
2016					$0.11 E
2017					$0.16 E

Zacks Projected EPS Growth Rate - Next 4 Years % **18**

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Fiscal Q2 2015 Results: *Cost-cutting, healthy GM mutes miss on revenue. Several revenue catalysts could come into play…*

PBSV reported financial results for the fiscal second quarter ending April 30, 2015. Revenue continues to slide with Q2 marking the sixth consecutive period of yoy sales contraction. But despite softness in the top-line, which has mostly been the result of relative weakness of the U.S. consulting business, PBSV continues to generate positive net income and cash flow as the variable operating expense base affords the company an inherent built-in margin. So while revenue in the most recent quarter missed our estimate by about 12%, net income and EPS were inline with our numbers as a result of the company's continued diligence on trimming expenses and fitting the cost base to revenue.

We think the Puerto Rico division, which turned in solid growth through the first six months of fiscal 2015, may continue to demonstrate relative strength (mostly from projects in Latin America which are managed from P.R.) throughout the remainder of the current year. However, we have again trimmed our revenue estimates for the other major geographic divisions as we think the hangover from macro-economic weakness which resulted in delayed or cancelled projects may persist for longer than previously anticipated. But we have also made downward revisions to OpEx estimates given the company's aggressiveness in slashing expenses. The net result is only a modest adverse impact to forecasted net income and EPS.

And there are other potential catalysts and contributors to revenue that we have yet to model - those being the possibility of near-term acquisitions (in December PBSV engaged a firm to explore M&A opportunities), the recently formed Calibrations division (expected to be partially operational by October 2015) and Pharma-Brazil, a newly registered wholly-owned subsidiary which will provide consulting services to the Brazilian market. 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.

Q2 revenue was $5.4 million down 17% yoy, down 7% sequentially and below our $6.2 million estimate. As has been the case for the past several quarters, the majority of the contraction in the most recent period was led by weakness in U.S. sales, which fell 70% yoy and were down 24% from Q1. U.S. sales were the lowest in at least four years. U.S. sales had only recently accounted for about 30% of total revenue but through the first six months of fiscal 2015 accounted for less than 13% - which highlights the impact that this has had on contraction in company-wide sales. The European business has also been highly lackluster as of late, although the impact to the top-line is more muted than has been the case with the U.S. division given the latter's greater historical contribution. European sales, which have accounted for about 10% of total revenue in the past, slipped 46% yoy and 30% sequentially to $255k, representing 5% of total revenue in the most recent quarter. The weakness in Europe relates mostly to reduced activity with a major customer in Ireland.

The only recent highlight as it relates to revenue has been, which continued to be the case in Q2, Puerto Rico which saw sales increase 18% yoy (although contracting slightly sequentially). Puerto Rico related revenue, which fell almost 2% for the full fiscal year 2014, increased better than 15% (+18% in consulting revenue) through the first six months of 2015 - which, as noted, is mostly being fueled by projects in Latin America but managed in P.R.

Puerto Rico now accounts for approximately 82% of total sales, which is up from 59% through the first six months of fiscal 2014. As we noted in a recent update, this is meaningfully beneficial to net income as revenue generated in that territory 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 is highlighted in the aggregate income tax rate, which fell from 20.6% in the first six months of 2014 (when P.R. and U.S. revenue accounted for 59% and 32% of total sales) to just 9.9% in the first six months of the current year (when P.R. and U.S. revenue accounted for 82% and 13% of total sales). So, the shift in geographic revenue mix essentially added almost $77k, or about 13% more to net income (so far) in the current year.

OpEx was $1.3 million, meaningfully below our $1.4 million estimate although slightly higher on a percentage of sales basis (23.8% A vs. 23% E). As noted, the inherent variability in the expense base has afforded the ability to trim costs in times of declining revenue. Total OpEx has been trending lower, coming down the last four quarters from $1.7 million in Q2 2014. Q2 net income and EPS were $359k and $0.02, in-line with our $380k and $0.02 estimates.

Despite the contraction in revenue over the last six consecutive quarters PBSV continues to generate both positive net income and cash flow. Cash flow from operations (ex-changes in working capital) was $2.9 million in

fiscal 2014 and $918k (including $517k in Q2) in the first six months of the current year. The company exited Q2 with $14.5 million in cash and securities.

Model Updates…
We have made some updates to our model following Q2 results including further trimming our forecasted U.S. and European related revenue for the remainder of 2015, which also carries through on an aggregate revenue basis through our out-years. However, we have also made downward revisions to our operating expense estimates given the continued progress with trimming the expense base with variability in revenue.

PBSV notes in the Q2 10-Q that they are "downsizing" their Integratek business (IT services and consulting based in P.R.) and indicating that this is being done in order to save costs. This division was mostly insignificant from a revenue standpoint so a reduction or shuttering of its operations should have no meaningful impact to sales but has the potential to trim the total expense base even further.

And with the revenue mix moving even further towards P.R. and away from the U.S. we have again downwardly revised our estimated income tax rate. The net result to the changes to our model have moved our forecasted 2015 net income and EPS from $1.9 million and $0.08 to $1.6 million and $0.07. Our out-year in our model (2018) has moved from $4.6 million of net income and $0.22/share to $4.0 million and $0.19.

And recently three potential new catalysts emerged, none of which we currently model and all of which could provide upside to our estimates. One relates to the relationship with T.R. Winston which was announced in early December. 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 Technical Iberica, a Spain-based company specializing in calibrations, validation, HVAC and clean room qualification services. Iberica will assist the company in establishing a calibrations division that will provide calibration and related services in Puerto Rico. This, per the Q2 10-Q, is expected to be partially operational by the end of the current fiscal year (i.e. – October 31, 2015).

And the third and most recent addition is the formation of Pharma-Brazil, which was registered as a wholly-owned subsidiary of the company in April 2015. Pharma-Brazil will provide consulting services to that market - no timelines were offered on expectations of when this division will commence activity. The relative strength in revenue coming from Latin American markets may be a harbinger of the potential that Brazil may hold. This will be something to keep an eye on.

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.

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 less than 1% of PBSV's total revenue. The company recently noted that they will downsize this business in order to cut costs.

> 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**
> **Validation Courses**
> **Safety**
> **cGMPs**
> **Microbiology**
> **Quality Systems**
> **Other Seminars**
> **Lean Six Sigma / Process Excellence and Continuous Improvement Series**

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 (April 30, 2015) cash balance stood at $14.5 million. 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 63% 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.

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 through the first six months of 2015. And on top of that, the company has consistently generated positive cash flow – including $3 million worth in relatively disappointing 2014 as well as $918k in the first six months of 2015.

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 through the remainder of the current year. 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 going into 2016.

And recently three potential new catalysts emerged, none of which we currently model and all of which could provide upside to our estimates. One relates to the relationship with T.R. Winston which was announced in early December. 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 18% through 2018. We use an industry PE/G ratio of 1.6x to value PBSV. We look for 2015 EPS of $0.07 (down from $0.08 since our prior update) which values the company at approximately $2.00/share (down from $2.65/share since our last update). The stock currently trades at about $1.05, indicating the shares are trading cheaper than fair value.

We also note that book value (as of April 30, 2015) is $20.1 million or about 87% 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 $2.00/share price target. We are maintaining our Outperform rating.

FINANCIAL MODEL

Pharma-Bio Serv, Inc

	2014 A	Q1A	Q2A	Q3E	Q4E	2015 E	2016 E	2017 E	2018 E
Total Revenues	$27,555.0	$5,882.2	$5,442.7	$5,682.4	$6,335.3	$23,342.6	$25,630.1	$28,033.9	$29,720.8
YOY Growth	*-16.7%*	*-16.1%*	*-17.2%*	*-16.9%*	*-11.2%*	*-15.3%*	*9.8%*	*9.4%*	*6.0%*
Cost of Services	$18,581.9	$4,176.9	$3,756.6	$3,920.9	$4,365.0	$16,219.4	$17,402.8	$18,474.4	$19,467.1
Gross Income	$8,973.1	$1,705.3	$1,686.0	$1,761.6	$1,970.3	$7,123.2	$8,227.3	$9,559.6	$10,253.7
Gross Margin	*32.6%*	*29.0%*	*31.0%*	*31.0%*	*31.1%*	*30.5%*	*32.1%*	*34.1%*	*34.5%*
SG&A	$6,109.1	$1,376.9	$1,294.0	$1,301.3	$1,387.4	$5,359.6	$5,484.8	$5,578.8	$5,617.2
% SG&A	*22.2%*	*23.4%*	*23.8%*	*22.9%*	*21.9%*	*23.0%*	*21.4%*	*19.9%*	*18.9%*
Operating Income	$2,864.1	$328.4	$392.0	$460.3	$582.8	$1,763.6	$2,742.4	$3,980.8	$4,636.4
Operating Margin	*10.4%*	*5.6%*	*7.2%*	*8.1%*	*9.2%*	*7.6%*	*10.7%*	*14.2%*	*15.6%*
Total Other Income (Expense)	($1.8)	($1.2)	($0.8)	($1.0)	($1.0)	($4.0)	$6.0	$8.0	$22.0
Pre-Tax Income	$2,862.3	$327.2	$391.2	$459.3	$581.8	$1,759.6	$2,748.4	$3,988.8	$4,658.4
Tax expense (benefit)	$464.5	$38.8	$32.2	$50.5	$63.4	$185.0	$324.3	$510.6	$628.9
Tax Rate	*16.2%*	*11.9%*	*8.2%*	*11.0%*	*10.9%*	*10.5%*	*11.8%*	*12.8%*	*13.5%*
Net Income	$2,397.7	$288.4	$359.0	$408.8	$518.4	$1,574.6	$2,424.1	$3,478.2	$4,029.6
YOY Growth	*-51.1%*	*-56.4%*	*9.5%*	*-31.5%*	*-36.1%*	*-34.3%*	*54.0%*	*43.5%*	*15.8%*
Net Margin	*8.7%*	*4.9%*	*6.6%*	*7.2%*	*8.2%*	*6.7%*	*9.5%*	*12.4%*	*13.6%*
EPS	$0.10	$0.01	$0.02	$0.02	$0.02	$0.07	$0.11	$0.16	$0.19
YOY Growth	*-51.2%*	*-55.9%*	*11.2%*	*-29.7%*	*-33.8%*	*-32.9%*	*57.9%*	*50.8%*	*16.4%*
Diluted Shares O/S	23,695	23,464	23,428	23,000	22,850	23,186	22,600	21,500	21,400

Brian Marckx, CFA

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BALANCE SHEET

	April 30, 2015	October 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,405	$ 15,088
Marketable Securities	48	68
Accounts Receivable	7,108	6,386
Other	759	783
Total current assets	22,320	22,325
Property and equipment, net	754	869
Other assets	19	17
Total assets	$ 23,093	$ 23,211
LIABILITIES		
Current liabilities:		
Current portion-obligations under capital lease	$ 22	$ 22
Accounts payable and accrued expenses	1,732	2,355
Income taxes payable	221	249
Total current liabilities	1,975	2,626
Obligations under capital leases	64	75
Total liabilites	2,038	2,700
STOCKHOLDERS' EQUITY		
Preferred Stock	-	-
Common stock	2	2
Additional paid-in capital	1,142	1,055
Retained earnings	20,254	19,607
Accumulated other comprehensive loss	(207)	(136)
Total stockholders' equity	21,055	20,511
Total liabilities and stockholders' equity	$ 23,093	$ 23,211

CASH FLOW STATEMENT

	Twelve months April 30, 2015	2014
Cash flows from operating activities:		
Net income	$ 359	328
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on disposition of P&E	-	-
Stock-based compensation	65	17
Depreciation and amortization	92	96
Changes in operating assets and liabilities:		
Accounts receivable	(879)	(1,325)
Other assets	(43)	(53)
Liabilities	(162)	55
Net cash provided by operating activities	568	(882)
Cash flows from investing activities:		
Acquisition of P&E	(34)	(66)
Proceeds from disposition of P&E	-	-
Net cash used in investing activities	(34)	(66)
Cash flows from financing activities:		
Proceeds from common stock issuance	-	-
Repurchase of common stock	(31)	-
Payments on obligations under capital lease	(5)	(10)
Net cash provided by (used in) financing activities	(37)	(10)
Effect of exchange rate changes on cash	(2)	4
Net increase (decrease) in cash and cash equivalents	(641)	(954)
Cash and cash equivalents, beginning of period	15,146	13,783
Cash and cash equivalents, end of period	$ 14,405	12,829

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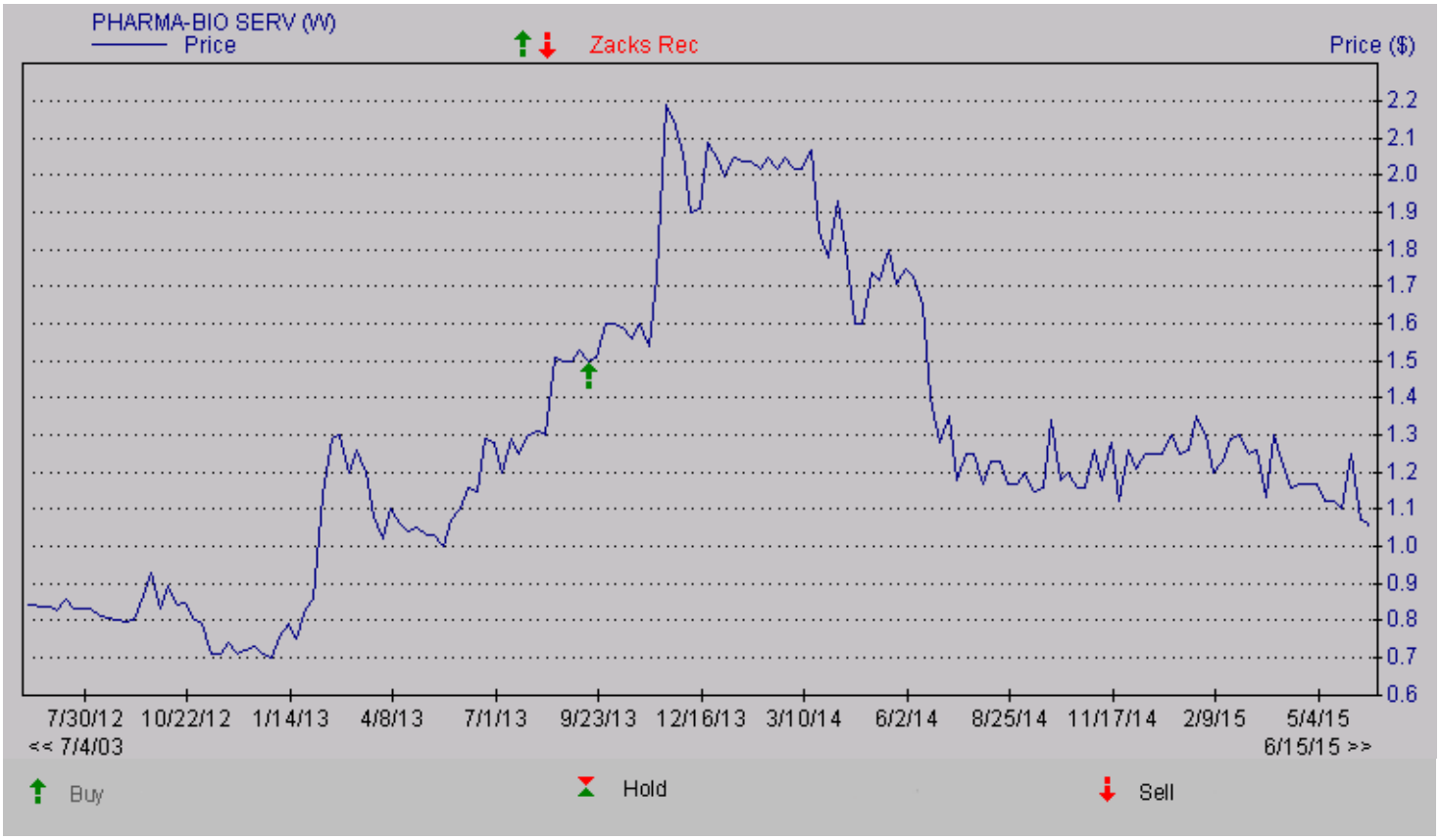
HISTORICAL ZACKS RECOMMENDATIONS



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The current distribution is as follows: Buy/Outperform- 22.7%, Hold/Neutral- 61.4%, Sell/Underperform – 13.0%. Data is as of midnight on the business day immediately prior to this publication.