Zacks Small-Cap Research

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Semler Scientific (SMLR-OTC)

SMLR: Revenue Jumps 25% Q-o-Q. Could Reach Profitability This Year

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $7.50/share. This equates to a price/sales (2017) multiple of about 4x which we think is a fair given the company's high revenue growth rate, beefy margins, scalability of operations and lower-risk business model (i.e. - licensing, outsourced manufacturing and R&D).

Current Price (08/07/17)	$3.50
Valuation	**$7.50**

OUTLOOK

Revenue is on a tear, posting yoy and sequential growth of 58% and 25%, respectively, through the most recent quarter. Vascular testing-related revenue not only set a new record in Q2, it beat the prior high by more than 11%. This is even more noteworthy given that the previous best was set in Q4 2016 and the final quarter of the year is typically the best in terms of the topline. Given that revenue in the 1H '17 is ahead of any prior six-month period and this should only accelerate in the back half of this year, 2017 will almost undoubtedly be the best year ever in terms of the top line. Recent investments have increased total expenses. But the good news is how these investments have benefitted revenue growth – specifically that growth in revenue outpaced that of expenses from Q1 to Q2 (25% vs 12%) as well as from 1H 2016 to 1H 2017 (48% vs 20%), resulting in improvement in operating loss in both periods. Even better news is that this trend is expected to persist and result in continued improvement in operating loss and cash burn. In fact, management's goal is to reach operating profitability and a level of positive operating cash flow sometime this year.

SUMMARY DATA

52-Week High	**$3.97**
52-Week Low	**$2.77**
One-Year Return (%)	**60.00**
Beta	**0.20**
Average Daily Volume (sh)	**1,951**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$19**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**26**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**51.8**
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	**N/A**
Zacks Rank	**N/A**

Risk Level	**Above Avg.,**
Type of Stock	**N/A**
Industry	**Med Instruments**

ZACKS ESTIMATES

Revenue
(in '000s of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2016	1501 A	1636 A	1982 A	2316 A	7435 A
2017	2055 A	2578 A	2924 E	3263 E	10820 E
2018					14347 E
2019					17475 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2016	-$0.20 A	-$0.19 A	-$0.07 A	-$0.04 A	-$0.50 A
2017	-$0.17 A	-$0.16 A	-$0.09 E	-$0.05 E	-$0.47 E
2018					-$0.02 E
2019					$0.19 E

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

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WHAT'S NEW…

Q2 2017 Results: *Revenue Jumps 25% Q-o-Q, Closing In On Profitability, Positive Cash Flow…*

Semler reported financial results for their second quarter ending June 30th. While the quarter was not a particular highlight from a (GAAP) profitability standpoint, it certainly was from both a revenue and growth perspective. And, more importantly, based on management's comments on the call, revenue, profitability and cash flow should continue to rapidly improve as recent investments aimed at accelerating customer acquisitions are already bearing fruit.

Revenue is on a tear, posting yoy and sequential growth of 58% and 25%, respectively, through the most recent quarter. Vascular testing-related revenue not only set a new record in Q2, it beat the prior high by more than 11%. This is even more noteworthy given that the previous best was set in Q4 2016 and the final quarter of the year is typically the best in terms of the topline.

And while revenue likely benefitted from orders that were received late in Q1 but not booked until Q2 (per comments on the Q1 call in May), management indicated on the Q2 call that a similar occurrence should benefit Q3 sales. SMLR has been making preparations to satisfy the accelerating demand including increasing their manufacturing capacity and inventory levels.

Almost all of the recent revenue growth has come from the (traditional) licensing channel with the HRA segment still in somewhat of an initial momentum-building phase. That appears to have begun to evolve, however, with management mentioning that Q2 saw a significant number of QuantaFlo installations at both licensing and HRA customer sites. These HRA installations represent future (potentially very near future) revenue given that this revenue model mostly hinges on per-test fees – as such, the recent ramp in installations should be a harbinger to initial meaningful contribution from this second customer channel.

Management noted that they believe they are on their way to their best year ever. Given that revenue in the 1H '17 is ahead of any prior six-month period and this should only accelerate in the back half of this year, 2017 will almost undoubtedly be the best in terms of the top line.

Revenue Growing Faster Than Expenses, Expected To Continue and Drive Profitability, Cash Flow

SMLR has recently made investments related to product upgrades, such as enhancing cybersecurity features, and certain software and integration customization work - all aimed at facilitating the customer onboarding process as well as the overall customer experience and level of service. This has resulted in an increase in expenses but, based on management's comments, has been responsible for much of the recent revenue growth.

To meet the increase in demand SMLR has also beefed up manufacturing capacity and incrementally expanded support-related capabilities. These additional expenses have shown up in higher R&D expense and, to a lesser degree, in incremental cost of services. While we had anticipated that R&D expense would taper from the near-record level in Q1 ($439k), that didn't happen as these investment-type expenses actually ticked higher into Q2 and were solely responsible for the miss to operating loss relative to our number.

But the good news is how these investments have benefitted revenue growth – specifically that growth in revenue outpaced that of expenses from Q1 to Q2 (25% vs 12%) as well as from 1H 2016 to 1H 2017 (48% vs 20%), resulting in improvement in operating loss in both the three and six month periods ending June 30, 2017. The even better news is that this trend is expected to continue. So while management is guiding for operating expenses to continue to climb, the positive ROI from these investments means that revenue will grow even faster. The net result should be continued improvement in operating loss and cash burn. Management's goal is to reach operating profitability and a level of positive operating cash flow sometime this year.

	Q1	Q2	Q3	Q4	2016	Q1 '17	Q2A
Total Revenues	$1,501.0	$1,636.0	$1,982.0	$2,316.0	$7,435.0	$2,055.0	$2,578.0
YOY Growth	*24.9%*	*25.6%*	*26.9%*	*-21.1%*	*6.2%*	*36.9%*	*57.6%*
Cost of Revenues	$417.0	$533.0	$398.0	$525.0	$1,873.0	$540.0	$592.0
Gross Income	$1,084.0	$1,103.0	$1,584.0	$1,791.0	$5,562.0	$1,515.0	$1,986.0
Gross Margin	*72.2%*	*67.4%*	*79.9%*	*77.3%*	*74.8%*	*73.7%*	*77.0%*
R&D	$270.0	$182.0	$183.0	$232.0	$867.0	$439.0	$474.0
% R&D	*18.0%*	*11.1%*	*9.2%*	*10.0%*	*11.7%*	*21.4%*	*18.4%*
Selling & Mktg	$974.0	$1,028.0	$950.0	$875.0	$3,827.0	$988.0	$1,164.0
% Sell&Mktg	*64.9%*	*62.8%*	*47.9%*	*37.8%*	*51.5%*	*48.1%*	*45.2%*
G&A	$772.0	$763.0	$706.0	$787.0	$3,028.0	$838.0	$902.0
% G&A	*51.4%*	*46.6%*	*35.6%*	*34.0%*	*40.7%*	*40.8%*	*35.0%*
Operating Income	($932.0)	($870.0)	($255.0)	($103.0)	($2,160.0)	($750.0)	($554.0)

Q2 numbers…

Revenue was $2.58M, up 58% yoy, up 25% sequentially and about 16% better than our $2.23M estimate. This was also an all-time high of vascular testing related revenue. Management indicated that while there was some incremental contribution from equipment sales via the HRA channel, that the vast majority of the $523k sequential increase in revenue relates to new QuantaFlo installations at licensing-related accounts. As a reminder, SMLR begins generating revenue immediately upon consummation of new licensing agreements. Growth from this licensing channel is expected to remain robust and will likely account for the majority of growth, at least over the near-term.

The recent increase in QuantaFlo placements at home risk assessment customer sites means this segment, which we estimate has so far contributed little to revenue, could also soon make a more meaningful impact to Semler's financials. As a reminder of the HRA-related revenue model, Semler charges these customers on a per-test basis. And as the HRA customer takes possession of the asset, the equipment is immediately expensed. This differs from the annual/monthly licensing revenue model and asset depreciation (SMLR maintains ownership of the asset) that they employ with the likes of Medicare Advantage plans.

While this was the second consecutive quarter of revenue beating our estimate (by a combined average of 13%), it was also the second consecutive quarter of operating expenses (including cost of services) coming in higher than what we expected (by a combined average of 16%). Operating loss improved in the three and six months ending June 30, 2017 from the prior year comparable periods, although as a result of the aforementioned recent investments, the rate of the operating loss improvement has slightly lagged our expectations.

A bloated and growing expense base could be of potentially significant concern, particularly if the sole goal is to chase revenue growth or market share at the expense of mounting operating losses. But, given what we believe was sound explanation by management of the reason for the recent jump in expenses and what already appears to be a direct return in the form of even faster topline expansion (and improvement in operating loss), we see no indications which would warrant such concerns.

Total operating expenses (including cost of revenue) were $3.13M in Q2. While this is 12% higher than the $2.81M from Q1, as a result of revenue growing at the much faster rate of 25%, operating expenses fell to 121% of revenue in Q2 – down from 137% in Q1 of this year. This metric (i.e. OpEx as percentage of revenue) will be the key one to watch and, given management's prediction that revenue will grow at a rate faster than that of operating expenses, we should continue to see this fall. Positive operating income will occur when this is under 100% which, again, SMLR has indicated could happen by current year-end (we more conservatively model initial positive operating income in 2018).

Valuation
The recurring revenue model means that already established instruments customers should provide a fairly stable base of business. Additional growth will come from expanding the number of customers, increasing order sizes and extension of the vascular testing business via the HRA channel. And with gross margins of ~75%+, instruments should be a strong driver of operating leverage.

Indications are that the HRA channel has just recently grown out of its infancy. These HRA installations represent future (potentially very near future) revenue given that this revenue model mostly hinges on per-test fees – as such, the recent ramp in installations should be a harbinger to initial meaningful contribution from this second customer channel.

The recent investments related to product upgrades, certain software and integration customization work and infrastructure/capacity enhancement has already increased revenue growth but we think will provide even greater leverage going into the back half of 2017 and beyond. With management guiding for revenue to continue to outpace growth of expenses and (per the Q2 call) they are "not satisfied with [25% sequential revenue growth]", we think positive operating income could materialize in the very near term.

We use a 10-year DCF model to value SMLR. We model 10-year revenue CAGR of 19%, which we think is reasonable if not conservative given the historical much higher rate of growth along with the recurring revenue model. We show incremental widening of gross margin in 2017, although greater contribution from the HRA channel has the potential to push this even higher. This, coupled with expectations of continued improvement in operating leverage from stabilizing R&D and efficiencies in SG&A has us modeling initial positive net income in 2018. We reiterate, however, that this is more conservative than management's expectations of positive operating income by the end of 2017 and, as such – and coupled with the difficulty in accurately estimating revenue growth – it is not unlikely that our forecast could prove too conservative.

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $7.50/share. This equates to a price/sales (2017) multiple of about 4x which we think is fair given the company's high revenue growth rate, beefy gross margins, scalability of operations and lower-risk business model (i.e. - licensing, outsourced manufacturing and R&D). We also assign real value to the quality of management.

FINANCIAL MODEL

Semler Scientific, Inc

	2015 A	2016 A	Q1A	Q2A	Q3E	Q4E	2017 E	2018 E	2019 E
Total Revenues	$7,001.0	$7,435.0	$2,055.0	$2,578.0	$2,924.0	$3,263.0	$10,820.0	$14,347.3	$17,475.0
YOY Growth	*92.6%*	*6.2%*	*36.9%*	*57.6%*	*47.5%*	*40.9%*	*45.5%*	*32.6%*	*21.8%*
Cost of Revenues	$2,809.0	$1,873.0	$540.0	$592.0	$672.5	$717.9	$2,522.4	$3,084.7	$3,669.8
Gross Income	$4,192.0	$5,562.0	$1,515.0	$1,986.0	$2,251.5	$2,545.1	$8,297.6	$11,262.6	$13,805.3
Gross Margin	*59.9%*	*74.8%*	*73.7%*	*77.0%*	*77.0%*	*78.0%*	*76.7%*	*78.5%*	*79.0%*
R&D	$1,436.0	$867.0	$439.0	$474.0	$451.0	$469.0	$1,833.0	$1,916.0	$2,022.0
% R&D	*20.5%*	*11.7%*	*21.4%*	*18.4%*	*15.4%*	*14.4%*	*16.9%*	*13.4%*	*11.6%*
Selling & Mktg	$6,304.0	$3,827.0	$988.0	$1,164.0	$1,258.0	$1,328.0	$4,738.0	$5,406.0	$6,011.4
% Sell&Mktg	*90.0%*	*51.5%*	*48.1%*	*45.2%*	*43.0%*	*40.7%*	*43.8%*	*37.7%*	*34.4%*
G&A	$4,871.0	$3,028.0	$838.0	$902.0	$921.0	$916.0	$3,577.0	$3,710.0	$4,176.5
% G&A	*69.6%*	*40.7%*	*40.8%*	*35.0%*	*31.5%*	*28.1%*	*33.1%*	*25.9%*	*23.9%*
Operating Income	($8,419.0)	($2,160.0)	($750.0)	($554.0)	($378.5)	($167.9)	($1,850.4)	$230.6	$1,595.3
Operating Margin	*-120.3%*	*-29.1%*	*-36.5%*	*-21.5%*	*-12.9%*	*-5.1%*	*-17.1%*	*1.6%*	*9.1%*
Other Expense total	$82.0	$394.0	$121.0	$296.0	$126.0	$130.0	$673.0	$370.0	$145.0
Pre-Tax Income	($8,501.0)	($2,554.0)	($871.0)	($850.0)	($504.5)	($297.9)	($2,523.4)	($139.4)	$1,450.3
Taxes	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Tax Rate	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Net Income	($8,501.0)	($2,554.0)	($871.0)	($850.0)	($504.5)	($297.9)	($2,523.4)	($139.4)	$1,450.3
YOY Growth	*-88.3%*	*70.0%*	*13.4%*	*12.0%*	*-39.4%*	*-35.4%*	*1.2%*	*94.5%*	*1140.8%*
Net Margin	*-121.4%*	*-34.4%*	*-42.4%*	*-33.0%*	*-17.3%*	*-9.1%*	*-23.3%*	*-1.0%*	*8.3%*
EPS	($1.73)	($0.50)	($0.17)	($0.16)	($0.09)	($0.05)	($0.47)	($0.02)	$0.19
YOY Growth	*-56.3%*	*71.1%*	*15.2%*	*15.6%*	*-32.2%*	*-26.1%*	*5.7%*	*95.6%*	*1043.6%*
Diluted Shares O/S	4,928	5,124	5,231	5,340	5,400	5,500	5,368	6,800	7,500

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