Zacks Small-Cap Research

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Semler Scientific (SMLR-OTC)

SMLR: Impressive Turnaround in 2016, Modeling Operating Profitability in 2017

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 (03/15/17)	$3.15
Valuation	**$7.50**

OUTLOOK

We commend management for the quick and decisive action to shutter WellChec. The HRA channel (as a secondary vendor) should be much less resource (i.e. capital, time, personnel and expertise) intensive than WellChec and will contribute significantly more at the margin. It also almost certainly minimizes execution and capital risk given that vascular testing is SMLR's wheelhouse and the per-test revenue model mitigates margin risks inherent of lump-sum contracts.

We also expect to see a continuance of scalability in operations as revenue grows and benefits are realized from the WellChec reorganization including much higher overall gross margins and less resource drain. If 2016 was a harbinger of further improvements to come, we think 2017 could be a milestone year for the company. In fact we now model SMLR generating positive operating income in Q4 of this year.

SUMMARY DATA

52-Week High	**$3.15**
52-Week Low	**$1.28**
One-Year Return (%)	**96.88**
Beta	**0.14**
Average Daily Volume (sh)	**3,340**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$16**
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 (%)	**56.0**
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	**65.3**
Zacks Rank	**N/A**

Risk Level	**High,**
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	1852 E	2232 E	2649 E	2957 E	9690 E
2018					12541 E
2019					15275 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	-$0.13 E	-$0.07 E	-$0.04 E	-$0.00 E	-$0.24 E
2018					$0.08 E
2019					$0.22 E

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

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WHAT'S NEW…

Q4 2016 Results: Q4 Caps Year of Progressive Financial Improvement. Modeling Operating Profitability This Year…...

Semler reported financial results for the fourth quarter ending December 31st. Revenue remains robust, setting a new record high in Q4 from the vascular testing business. And revenue was just of one several highlights – others included relatively elevated gross margin and continued cost-control in OpEx. The result was operating loss in Q4 coming in at the lowest level in history.

Importantly, and what contributes to our thesis that SMLR could reach operating profitability in the near term, is that the Q4 numbers fit a trend of progressive improvement throughout 2016. This included sequential revenue growth and improvement in operating loss in every quarter throughout the year. And while that step-by-step improvement may not continue in such a regular fashion going forward, we do not expect a reintroduction of the level of volatility that was associated with the WellChec business (which was essentially discontinued in late 2015).

	Q1A	Q2A	Q3A	Q4A	2016 A
Total Revenues	$1,501.0	$1,636.0	$1,982.0	$2,316.0	$7,435.0
YOY Growth	*24.9%*	*25.6%*	*26.9%*	*-21.1%*	*6.2%*
Cost of Revenues	$417.0	$533.0	$398.0	$525.0	$1,873.0
Gross Income	$1,084.0	$1,103.0	$1,584.0	$1,791.0	$5,562.0
Gross Margin	*72.2%*	*67.4%*	*79.9%*	*77.3%*	*74.8%*
R&D	$270.0	$182.0	$183.0	$232.0	$867.0
%R&D	*18.0%*	*11.1%*	*9.2%*	*10.0%*	*11.7%*
Selling & Mktg	$974.0	$1,028.0	$950.0	$875.0	$3,827.0
%Sell&Mktg	*64.9%*	*62.8%*	*47.9%*	*37.8%*	*51.5%*
G&A	$772.0	$763.0	$706.0	$787.0	$3,028.0
% G&A	*51.4%*	*46.6%*	*35.6%*	*34.0%*	*40.7%*
Operating Income	($932.0)	($870.0)	($255.0)	($103.0)	($2,160.0)
Operating Margin	*-62.1%*	*-53.2%*	*-12.9%*	*-4.4%*	*-29.1%*

Semler quickly shelved WellChec when it became obvious that the business was too resource-intensive and did not fit with their near-term goal of reaching cash flow break-even. While management had viewed the multi wellness testing service as a complement to their core instruments (i.e. QuantaFlo / FloChec), the viability, or proof-of-concept, of that business had yet to be fully established. WellChec had contributed significantly to revenue in late 2015 but that was compromised by the even more significant resources and related expense consumed in support of getting the business up and running and maintaining its operations. And with gross margins which we estimated in the low double digits (i.e. 10% - 20%) and which paled in comparison to the instruments business (i.e.70% - 80%), it seemed WellChec's days were numbered unless it could demonstrate the potential to significantly steepen its revenue curve and begin to establish scalability.

It was out with WellChec and in with providing home risk assessment organizations (HRA) with vascular testing capabilities. HRA appears to be a much simpler complement to the company's vascular testing business – in fact, it is essentially an extension of that business with just a slightly different revenue model. SMLR charges HRA customers on a per-test basis – which differs from the annual/monthly licensing revenue model that they employ with the likes of Medicare Advantage plans.

Given that QuantaFlo and vascular testing is where SMLR's expertise lies, there should be no 'reinventing-the-wheel' risk with HRA. And in addition to being much less resource-intensive than WellChec, HRA should be lower risk from a capital standpoint. The icing on the cake is that management believes margins from the HRA customer segment will be at least as high as that from insurers – the potential for some IT-related customization work as well as incremental contribution from sensor sales offer additional margin enhancement.

SMLR notes that revenue growth continues to be the product of increasing market penetration, growth of their installed base and their recurring revenue business model. With management continuing to guide for revenue growth, expense control and stable-to-improving gross margins (which are already at a beefy 75%+ level), we continue to think the company could be at a level of positive operating income and break-even cash flow by later this year.

While migration of customers from their legacy FloChec technology over to (the higher priced) QuantaFlo had also been a source of revenue, that will likely dissipate given that the majority of switching is likely now complete.

Q4 numbers…
Revenue was $2.32M, up 17% sequentially from Q3 ’16 ($1.92M). As a reminder, WellChec, which contributed $1.44M in revenue in Q4 ’15, was decommissioned at the end of that year. So on a comparable yoy basis, and excluding WellChec, revenue increased 55% from Q4 ’15 to Q4 ’16. Vascular testing revenue set an all-time record in Q4 ’16. While SMLR does not break out the source of vascular testing revenue (i.e. HRA vs insurance customers), management did indicate on the Q4 call that there was at least some contribution in the quarter from HRA customers.

For the full year 2016, revenue was $7.44M – which, excluding WellChec revenue (which contributed $1.86M in 2015), was up 45% ($2.29M) from 2015.

Gross margin of 77.3% in Q4 ’16 and 74.8% for the full year 2016 compared favorably to the 33.2% and 59.9% in the respective year-earlier periods. As noted, the HRA-related customer base is expected to generate this level or better margins going forward.

In terms of operating expenses, management continues to deliver on their goal of trimming fat. Operating expenses ballooned in late 2015 – Q4 ’15 OpEx was $5.2M, much of which related to stock compensation as well as some ongoing costs related to WellChec. Since then SMLR has tightened the belt, resulting in average quarterly OpEx falling to $1.9M throughout 2016 – that compares to a quarterly average of $3.2M in 2015. In Q4 ‘16, OpEx was $1.9M, equal to 82% of revenue - a record low and substantially improved from the previous best of 93% of revenue (Q3 ’16). This will be a key metric to watch going forward.

Similar to revenue growth, operating loss has shown consistent improvement over the course of 2016. Q4 ’16 operating loss was just $103k – also an all-time best. With management guiding for revenue to continue to grow faster than operating expenses, coupled with gross margins that should remain at least stable (and potentially widen), we think operating leverage should continue to benefit and break-even operating income is reasonably attainable in the near-term.

In terms of cash, SMLR exited 2016 with $622k in cash and equivalents. Management indicated that they expect the positive trends in revenue and progress towards profitability to continue and have a goal of reaching a point of positive cash flow generation during 2017. The company has largely financed operations through debt and has previously mentioned that in the event they need additional operating capital, that they will seek to secure non-dilutive funding from sources such as loans as they have done in the past.

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 ~70%+, instruments should be a strong driver of operating leverage.

The WellChec business had shown early promise in terms of revenue generation but was a significant drain on resources and cash and came with relatively very low margins. We estimate that WellChec contributed approximately $1.9M, or about 27%, of total revenue in 2015. Operating loss was a dismal $8.4M in that year.

We commend management for the quick and decisive action to shutter WellChec. The HRA channel (as a secondary vendor) should be much less resource (i.e. capital, time, personnel and expertise) intensive than WellChec and will contribute significantly more at the margin. It also almost certainly minimizes execution and capital risk given that vascular testing is SMLR's wheelhouse and the per-test revenue model mitigates margin risks inherent of lump-sum contracts.

We also expect to see a continuance of scalability in operations as revenue grows and benefits are realized from the WellChec reorganization including higher overall gross margins and less resource drain. If 2016 was a harbinger of further improvements to come, we think 2017 could be a milestone year for the company. In fact we now model SMLR generating positive operating income in Q4 of this year.

We use a 10-year DCF model to value SMLR. We model 10-year revenue CAGR of 18%, which we think is reasonable if not conservative given the historical much higher rate of growth along with the recurring revenue model. We show stable to slight incremental widening of gross margin in 2017, benefitting from the addition of the HRA channel, including some customization work, as well as the larger QuantFlo installed base. This, coupled with scaling operating expenses consistent with growing revenues and efficiencies in SG&A has us modeling initial positive net income in Q4 '17 and for the full year in 2018.

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	Q1E	Q2E	Q3E	Q4E	2017 E	2018 E	2019 E
Total Revenues	$7,001.0	$7,435.0	$1,852.0	$2,232.0	$2,649.0	$2,957.0	$9,690.0	$12,540.8	$15,274.7
YOY Growth	*92.6%*	*6.2%*	*23.4%*	*36.4%*	*33.7%*	*27.7%*	*36.5%*	*29.4%*	*21.8%*
Cost of Revenues	$2,809.0	$1,873.0	$444.5	$508.9	$596.0	$650.5	$2,199.9	$2,821.7	$3,360.4
Gross Income	$4,192.0	$5,562.0	$1,407.5	$1,723.1	$2,053.0	$2,306.5	$7,490.1	$9,719.1	$11,914.3
Gross Margin	*59.9%*	*74.8%*	*76.0%*	*77.2%*	*77.5%*	*78.0%*	*77.3%*	*77.5%*	*78.0%*
R&D	$1,436.0	$867.0	$226.0	$220.0	$220.0	$231.0	$897.0	$922.0	$962.3
% R&D	*20.5%*	*11.7%*	*12.2%*	*9.9%*	*8.3%*	*7.8%*	*9.3%*	*7.4%*	*6.3%*
Selling & Mktg	$6,304.0	$3,827.0	$961.0	$966.0	$1,124.0	$1,167.0	$4,218.0	$4,812.0	$5,453.1
% Sell&Mktg	*90.0%*	*51.5%*	*51.9%*	*43.3%*	*42.4%*	*39.5%*	*43.5%*	*38.4%*	*35.7%*
G&A	$4,871.0	$3,028.0	$790.0	$770.0	$765.0	$790.0	$3,115.0	$3,218.0	$3,833.9
% G&A	*69.6%*	*40.7%*	*42.7%*	*34.5%*	*28.9%*	*26.7%*	*32.1%*	*25.7%*	*25.1%*
Operating Income	($8,419.0)	($2,160.0)	($569.5)	($232.9)	($56.0)	$118.5	($739.9)	$767.1	$1,664.9
Operating Margin	*-120.3%*	*-29.1%*	*-30.7%*	*-10.4%*	*-2.1%*	*4.0%*	*-7.6%*	*6.1%*	*10.9%*
Other Expense total	$82.0	$394.0	$119.0	$124.0	$126.0	$130.0	$499.0	$220.0	$65.0
Pre-Tax Income	($8,501.0)	($2,554.0)	($688.5)	($356.9)	($182.0)	($11.5)	($1,238.9)	$547.1	$1,599.9
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)	($688.5)	($356.9)	($182.0)	($11.5)	($1,238.9)	$547.1	$1,599.9
YOY Growth	*-88.3%*	*70.0%*	*31.6%*	*63.1%*	*49.7%*	*94.8%*	*51.5%*	*144.2%*	*-192.4%*
Net Margin	*-121.4%*	*-34.4%*	*-37.2%*	*-16.0%*	*-6.9%*	*-0.4%*	*-12.8%*	*4.4%*	*10.5%*
EPS	($1.73)	($0.50)	($0.13)	($0.07)	($0.04)	($0.00)	($0.24)	$0.08	$0.22
YOY Growth	*-56.3%*	*71.1%*	*31.6%*	*63.1%*	*49.7%*	*95.1%*	*52.4%*	*133.9%*	*-176.2%*
Diluted Shares O/S	4,928	5,124	5,124	5,124	5,124	5,500	5,218	6,800	7,200

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