Zacks Small-Cap Research

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Semler Scientific (SMLR-OTC)

SMLR: Revenue On A Tear With No Signs Of Letting Up

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 (05/16/17)	$3.10
Valuation	**$7.50**

OUTLOOK

Revenue remains relatively very strong. Despite Q1 typically being the company's lightest in terms of vascular testing related revenue, sales in the most recent quarter were the second highest in company history – and only bested by Q4 2016. Also encouraging were management's comments on the call noting that additional orders were received late in Q1 for delivery in Q2 and that order flow may be accelerating. In order to meet this expected increase in demand Semler has made certain preparations aimed at increasing manufacturing capacity. They also purchased an additional $399k worth of equipment (i.e. vascular testing assets) in Q1 for lease – another sign that demand is on the rise And while we think the HRA channel likely contributed little in Q1 given the influence from insurance policy-related nuances which typical benefit later periods, this should be more meaningful in the second half of the year. So while vascular testing revenue was up 37% yoy, 11% better than our estimate and at the second highest level ever, fundamentals suggest that Q1 could prove to be relatively weak as compared to the remaining three quarters of 2017.

SUMMARY DATA

52-Week High	**$3.25**
52-Week Low	**$1.28**
One-Year Return (%)	**66.67**
Beta	**0.16**
Average Daily Volume (sh)	**11,609**
Shares Outstanding (mil)	**5**
Market Capitalization ($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 (%)	**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	**157.5**
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	2055 A	2232 E	2588 E	2879 E	9754 E
2018					12624 E
2019					15376 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	-$0.11 E	-$0.06 E	-$0.02 E	-$0.35 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…

Q1 2017 Results: Revenue Jumps 37% YoY. Investments, Order Book Implies Strong Growth Will Continue…..

Semler reported financial results for their first quarter ending March 31st. Revenue remains relatively very strong. Despite Q1 typically being the company's lightest in terms of revenue, vascular testing related sales in the most recent quarter were the second highest in company history – and only bested by Q4 2016. And since the final quarter of the year has typically been the best in terms of revenue, the Q4 to Q1 sequential comparison is innately difficult.

Also encouraging were management's comments on the call noting that additional orders were received late in Q1 for delivery in Q2 and that order flow may be accelerating. In order to meet this expected increase in demand Semler has made certain preparations aimed at increasing manufacturing capacity. They also purchased an additional $399k worth of equipment (i.e. vascular testing assets) in Q1 for lease – another sign that demand is on the rise And while we think the HRA channel likely contributed little in Q1 given the influence from insurance policy-related nuances which typical benefit later periods, this should be more meaningful in the second half of the year. So while vascular testing revenue was up 37% yoy, 11% better than our estimate and at the second highest level ever, fundamentals suggest that Q1 could prove to be relatively weak as compared to the remaining three quarters of 2017.

But while revenue was certainly a highlight, the financial snapshot in Q1 also included a sizeable increase in operating expenses and lower than estimated gross margin. Much of the incremental OpEx and at least some of the gross margin "miss" (to be clear GM, at 73.7%, was still very healthy) appears to be associated with product-related (cyber) security upgrades. Those costs, while expensed, are effectively product improvements (i.e. competitive enhancements) and are also not expected to persist over the long term. And the decision to update the cybersecurity features seems almost prescient given the recent "WannaCry" ransomware attack which caused major problems including the shutdown of some hospitals. Management also noted that additional expense related to the increase in (third-party) manufacturing capacity showed up in Q1. So while the increase in OpEx offset much of the revenue growth in Q1, presumably all of this incremental expense/investment will be recouped by growth in (near-term) future sales.

But while the increase in OpEx pushed operating loss higher than Q3 and Q4 2016, at $750k it is still improved compared to both of the first two quarters of last year. Reaching profitability remains one of management's near-term goals and, at least on a yoy basis, Q1 took another positive step in that direction.

	Q1	Q2	Q3	Q4	2016	Q1 '17
Total Revenues	$1,501.0	$1,636.0	$1,982.0	$2,316.0	$7,435.0	$2,055.0
YOY Growth	*24.9%*	*25.6%*	*26.9%*	*-21.1%*	*6.2%*	*36.9%*
Cost of Revenues	$417.0	$533.0	$398.0	$525.0	$1,873.0	$540.0
Gross Income	$1,084.0	$1,103.0	$1,584.0	$1,791.0	$5,562.0	$1,515.0
Gross Margin	*72.2%*	*67.4%*	*79.9%*	*77.3%*	*74.8%*	*73.7%*
R&D	$270.0	$182.0	$183.0	$232.0	$867.0	$439.0
% R&D	*18.0%*	*11.1%*	*9.2%*	*10.0%*	*11.7%*	*21.4%*
Selling & Mktg	$974.0	$1,028.0	$950.0	$875.0	$3,827.0	$988.0
% Sell&Mktg	*64.9%*	*62.8%*	*47.9%*	*37.8%*	*51.5%*	*48.1%*
G&A	$772.0	$763.0	$706.0	$787.0	$3,028.0	$838.0
% G&A	*51.4%*	*46.6%*	*35.6%*	*34.0%*	*40.7%*	*40.8%*
Operating Income	($932.0)	($870.0)	($255.0)	($103.0)	($2,160.0)	($750.0)
Operating Margin	*-62.1%*	*-53.2%*	*-12.9%*	*-4.4%*	*-29.1%*	*-36.5%*

Q1 numbers…

Revenue was $2.06M, up 37% yoy, down 11% sequentially and about 11% higher than our estimate. As a reminder, as Well-Chec was decommissioned at the end of 2015 that year, all current revenue relates to vascular testing. We continue to model sequential revenue growth throughout the remainder of the year and view SMLR's recent capacity and equipment-related investments as well as management's comments related to growth in order-flow as positive indications in that regard.

SMLR recently began targeting home risk assessment organizations (HRA) with its vascular testing offering. The HRA channel is essentially an extension of the company's base business (i.e. vascular testing largely targeting Medicare Advantage plans) 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. While SMLR does not break out the source of vascular testing revenue (i.e. HRA vs insurance customers), management did indicate on the call that the HRA channel was not a significant contributor in Q1. We do expect this to grow in the latter part of the year, however.

Gross margin of 73.7% was up from 72.2% in Q1 2016, although down from 77.3% in Q4 2016 and below our 76.0% estimate. As noted, some of the incremental development-related expense ran through cost of services which contributed to the sequential tightening. While we think GM may continue to move around a little bit, we think it still has room trend incrementally higher. Management has indicated that margins from the HRA customer segment will be at least as high as that from insurers. In addition, the potential for some IT-related customization work as well as incremental contribution from sensor sales could offer additional margin enhancement.

OpEx was $2.27M, up from $2.02M in Q1 2016 and $1.89M in Q4 2016. As explained earlier, most of the increase relates to R&D expense which should not persist over the long term.

In terms of cash, SMLR used $505k ($516k ex-changes in working capital) in cash for operations in Q1. They used another $399k for the (capital) purchase of additional vascular testing equipment – which is expected to be immediately put to use to generate additional revenue. For comparison, SMLR purchased $591k in equipment in all of 2016. Cash balance at Q1 quarter-end was $159k. While SMLR raised $475k in Q1 via the sale of 190k shares (to major existing shareholders) through stock purchase agreements, the company has largely financed operations through debt. We expect the company will continue to also 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 continue to think SMLR could be 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 gross margin in 2017, although there is potential for incremental widening with 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	Q1A	Q2E	Q3E	Q4E	2017 E	2018 E	2019 E
Total Revenues	$7,001.0	$7,435.0	$2,055.0	$2,232.0	$2,588.0	$2,879.0	$9,754.0	$12,623.6	$15,375.6
YOY Growth	*92.6%*	*6.2%*	*36.9%*	*36.4%*	*30.6%*	*24.3%*	*36.5%*	*29.4%*	*21.8%*
Cost of Revenues	$2,809.0	$1,873.0	$540.0	$524.5	$582.3	$633.4	$2,280.2	$2,840.3	$3,382.6
Gross Income	$4,192.0	$5,562.0	$1,515.0	$1,707.5	$2,005.7	$2,245.6	$7,473.8	$9,783.3	$11,993.0
Gross Margin	*59.9%*	*74.8%*	*73.7%*	*76.5%*	*77.5%*	*78.0%*	*76.6%*	*77.5%*	*78.0%*
R&D	$1,436.0	$867.0	$439.0	$388.0	$256.0	$231.0	$1,314.0	$1,012.0	$1,045.5
% R&D	*20.5%*	*11.7%*	*21.4%*	*17.4%*	*9.9%*	*8.0%*	*13.5%*	*8.0%*	*6.8%*
Selling & Mktg	$6,304.0	$3,827.0	$988.0	$991.0	$1,124.0	$1,167.0	$4,270.0	$4,812.0	$5,489.1
% Sell&Mktg	*90.0%*	*51.5%*	*48.1%*	*44.4%*	*43.4%*	*40.5%*	*43.8%*	*38.1%*	*35.7%*
G&A	$4,871.0	$3,028.0	$838.0	$810.0	$805.0	$830.0	$3,283.0	$3,461.0	$3,859.3
% G&A	*69.6%*	*40.7%*	*40.8%*	*36.3%*	*31.1%*	*28.8%*	*33.7%*	*27.4%*	*25.1%*
Operating Income	($8,419.0)	($2,160.0)	($750.0)	($481.5)	($179.3)	$17.6	($1,393.2)	$498.3	$1,599.1
Operating Margin	*-120.3%*	*-29.1%*	*-36.5%*	*-21.6%*	*-6.9%*	*0.6%*	*-14.3%*	*3.9%*	*10.4%*
Other Expense total	$82.0	$394.0	$121.0	$124.0	$126.0	$130.0	$501.0	$370.0	$145.0
Pre-Tax Income	($8,501.0)	($2,554.0)	($871.0)	($605.5)	($305.3)	($112.4)	($1,894.2)	$128.3	$1,454.1
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)	($605.5)	($305.3)	($112.4)	($1,894.2)	$128.3	$1,454.1
YOY Growth	*-88.3%*	*70.0%*	*13.4%*	*37.3%*	*15.7%*	*48.9%*	*25.8%*	*106.8%*	*-1033.2%*
Net Margin	*-121.4%*	*-34.4%*	*-42.4%*	*-27.1%*	*-11.8%*	*-3.9%*	*-19.4%*	*1.0%*	*9.5%*
EPS	($1.73)	($0.50)	($0.17)	($0.11)	($0.06)	($0.02)	($0.35)	$0.02	$0.19
YOY Growth	*-56.3%*	*71.1%*	*15.2%*	*39.4%*	*20.0%*	*52.4%*	*29.1%*	*105.3%*	*-927.5%*
Diluted Shares O/S	4,928	5,124	5,231	5,300	5,400	5,500	5,358	6,800	7,500

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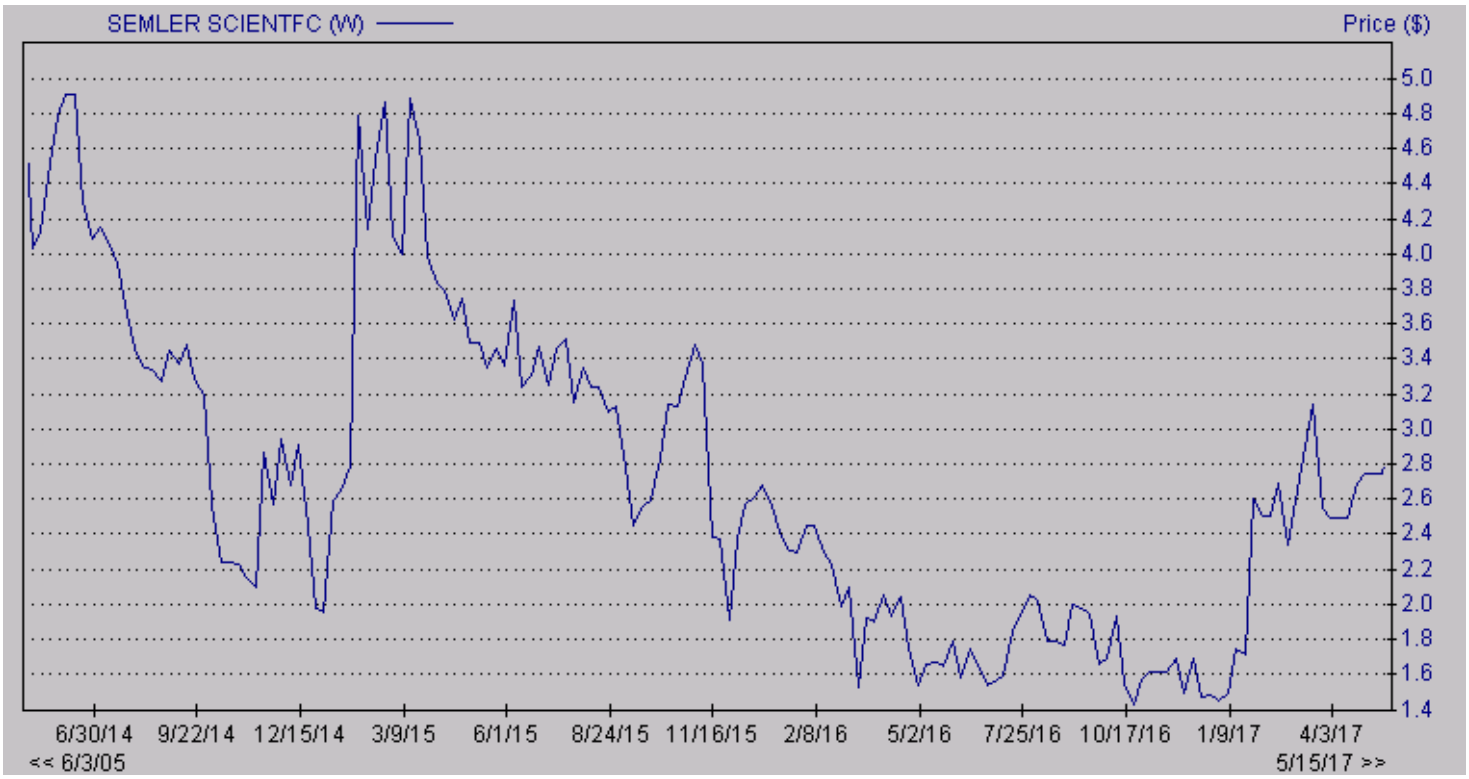

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