Zacks Small-Cap Research

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Semler Scientific (SMLR-OTC)

SMLR: Record Revenue Expected to Continue. Modeling Positive Net Income in Q4

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $9/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 (10/31/17)	$6.59
Valuation	**$9.00**

OUTLOOK

Q3 results were extraordinarily strong, with revenue jumping 40% from the prior quarter to $3.6M and crushing the previous all-time high by 23%. And other major milestones were achieved in Q3 – operating expenses as a percentage of revenue were a record low and this was the first quarter that SMLR has generated positive operating income. Net loss, at just $41k, was also an all-time low – a $179k improvement from the prior best ($220k net loss in Q4 2016). Aside from the updated financial results, SMLR's story has remained largely the same since our update following Q2 results. Given that the story is regular continued improvement in financial results, no change to the plot is obviously positive. While expenses have increased, the rate of growth has been outpaced by that of revenue, resulting in regular improvement in operating loss/income throughout 2017. This trend is expected to continue and result in not only sustainable and growing operating income, but also reaching a point of positive cash flow in the near-term. Updates to our forecasted revenue has had a meaningful effect on operating leverage, operating income and resultant calculated cash-flow generation. It has also moved our DCF-generated price target to $9/share.

SUMMARY DATA

52-Week High	**$7.00**
52-Week Low	**$1.28**
One-Year Return (%)	**283.44**
Beta	**0.20**
Average Daily Volume (sh)	**4,632**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$36**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**9**
Insider Ownership (%)	**47**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**49.3**
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	3607 A	4016 E	12256 E
2018					16252 E
2019					19794 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	-$0.01 A	$0.01 E	-$0.32 E
2018					$0.06 E
2019					$0.24 E

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

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WHAT'S NEW…

Q3 2017 Results: *Record Revenue, Operating Income. OpEx at All-Time Low. Modeling Net Income in Q4…*

Semler reported financial results for their third quarter ending September 30th. Results were extraordinarily strong, with revenue jumping 40% from the prior quarter to $3.6M and crushing the previous all-time high by 23%. Even more impressive is that the prior best ($2.9M in Q4 2015) included significant Wellchec related revenue. And other major milestones were achieved in Q3 – operating expenses as a percentage of revenue were a record low and this was the first quarter that SMLR has generated positive operating income. Net loss, at just $41k, was also an all-time low and a $179k improvement from the prior best ($220k net loss in Q4 2016).

As a reminder, management recently noted that they expected 2017 to be a record year in terms of revenue – this has now been achieved through just the first nine months of the year. They had also has guided for q-o-q revenue growth to outpace growth of operating expenses and result in operating profitability during 2017 (also now achieved). We clearly erred when we more conservatively modeled a lower rate of near-term revenue growth and achievement of initial operating income not happening until next year.

With a significant number of installations happening late in Q3, billings for which are expected to benefit revenue in Q4, sequential revenue growth is forecasted to continue through the final quarter of 2017. These recent installations – which in addition to Q3, included a relatively large number in Q1 and Q2 – should not only benefit revenue in the remainder of the current year, but also subsequent periods as utilization increases. We have (again, following the reporting of quarterly results) made upward adjustments to our modeled revenue, which has also benefitted our operating and net income lines. We now model net income of approximately $400k in 2018 – adjusted up from a net loss of $139k. Stay tuned, however, as even these adjusted numbers could prove conservative given favorable utilization trends and the recent very high rate of sequential revenue growth and incrementally growing operating leverage.

We think it is noteworthy that while most of the recent revenue growth has come from the (traditional) licensing channel, it appears that the home risk assessment (HRA) segment has now started to become a more substantial contributor. While Semler does not disclose the break-out of revenue by source, comments on recent earnings calls suggest that the HRA business has continued to gain additional traction. That includes a mention on the Q2 call (August 2nd) that during that period there were a significant number of QuantaFlo installations at both licensing and HRA-related customer sites. On the Q3 call (October 31st) management provided some additional context surrounding growth of the HRA business, noting that while licensing fees were 11x that of usage fees (i.e. HRA-related revenue) in Q2 of this year, that narrowed to approximately 5x in Q3. And while we do not know what to expect in terms of continued growth of the HRA segment, we view the recent trends as encouraging.

Déjà Vu: Revenue Growing Faster Than Expenses, Driving Profitability, Cash Flow

Aside from the updated financial results, SMLR's story has remained largely the same since our last update in August (following Q2 results). Given that the story is regular and continued improvement in financial results, no change to the plot is obviously positive. While expenses have increased, the rate of growth has been outpaced by that of revenue – resulting in regular improvement in operating loss/income throughout 2017. This trend is expected to continue and result in not only sustainable and growing operating income, but also reaching a point of positive cash flow in the near-term.

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. As a reminder, R&D expense nearly doubled from Q4 2016 ($232k) to Q1 2017 ($439k) and ticked up even higher in Q2 ($474k) – resulting in relatively sizeable operating losses in both periods.

But the good news is how these investments have already benefitted revenue growth – specifically that growth in revenue has significantly outpaced that of expenses from Q1 to Q2 (25% vs 12%) and Q2 to Q3 (40% vs 13%) as

well as yoy through the first nine months of 2017 (61% vs 35%). The net result has been regular and significant improvement in operating loss. 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 which should result in continued improvement in operating income and cash burn. Management already reached their goal of operating profitability before current year-end, Q4 could see achievement of their goal of cash-flow break-even.

	Q1	Q2	Q3	Q4	2016	Q1 '17	Q2 '17	Q3 '17
Total Revenues	$1,501.0	$1,636.0	$1,982.0	$2,316.0	$7,435.0	$2,055.0	$2,578.0	$3,607.0
YOY Growth	*24.9%*	*25.6%*	*26.9%*	*-21.1%*	*6.2%*	*36.9%*	*57.6%*	*82.0%*
Cost of Revenues	$417.0	$533.0	$398.0	$525.0	$1,873.0	$540.0	$592.0	$724.0
Gross Income	$1,084.0	$1,103.0	$1,584.0	$1,791.0	$5,562.0	$1,515.0	$1,986.0	$2,883.0
Gross Margin	*72.2%*	*67.4%*	*79.9%*	*77.3%*	*74.8%*	*73.7%*	*77.0%*	*79.9%*
R&D	$270.0	$182.0	$183.0	$232.0	$867.0	$439.0	$474.0	$432.0
%R&D	*18.0%*	*11.1%*	*9.2%*	*10.0%*	*11.7%*	*21.4%*	*18.4%*	*12.0%*
Selling & Mktg	$974.0	$1,028.0	$950.0	$875.0	$3,827.0	$988.0	$1,164.0	$1,350.0
%Sell&Mktg	*64.9%*	*62.8%*	*47.9%*	*37.8%*	*51.5%*	*48.1%*	*45.2%*	*37.4%*
G&A	$772.0	$763.0	$706.0	$787.0	$3,028.0	$838.0	$902.0	$1,025.0
% G&A	*51.4%*	*46.6%*	*35.6%*	*34.0%*	*40.7%*	*40.8%*	*35.0%*	*28.4%*
Operating Income	($932.0)	($870.0)	($255.0)	($103.0)	($2,160.0)	($750.0)	($554.0)	$76.0
Operating Margin	*-62.1%*	*-53.2%*	*-12.9%*	*-4.4%*	*-29.1%*	*-36.5%*	*-21.5%*	*2.1%*

Q3 numbers…

Revenue was $3.6M, up 82% (+$1.6M) yoy, up 40% (+$1.0M) sequentially and about 23% higher than our $2.9M estimate. This was also a new record high. As noted, while the company does not publicly itemize revenue by customer channel, indications are that the HRA segment has recently become a more meaningful contributor (accounting for ~17% of total revenue in Q3, up from ~8% in Q2).

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 continue to account for the majority revenue, at least over the near-term.

The recent increase in QuantaFlo placements at HRA customer sites means this segment's proportional contribution to total revenue could continue to grow. 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.

Not only did revenue beat our respective estimate in Q3, so did operating expenses. Operating expenses (including cost of revenue) were $3.5M, or 98% of revenue, compared to our $3.3M, or 113% of revenue, estimate. 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.

When operating expenses were rapidly climbing earlier in 2017 we cautioned that a bloated and growing expense base could be of potentially significant concern, particularly if the sole goal was to chase revenue growth or market share at the expense of mounting operating losses. But, we also noted that we believed management's explanation for the recent jump in expenses was sound (i.e. related to revenue-generating investments) and, as such, saw no indications for significant concern. Importantly, our confidence is further bolstered by Q3 results and the rapid pace of absorption of incremental expenses.

Q3 saw operating income of $76k – this is the first time this line was in the black. Operating loss was $1.2M through the first nine months of 2017, improved from an operating loss of $2.1M in the comparable prior-year period. Positive net income could be right around the corner – in fact, we now model that to happen in Q4 of this year.

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 ~80%+, 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 potentially represent more significant contribution given that this revenue model mostly hinges on per-test fees.

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 over the near term. With management guiding for revenue to continue to outpace growth of expenses and sequential growth expected to continue, we could see positive net income materialize very soon – very possibly in Q4.

We use a 10-year DCF model to value SMLR. We model 10-year revenue CAGR of 21%, 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 and again in 2018, 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 Q4 2017 and regularly growing throughout 2018. We note, however, that we have underestimated the rate of revenue growth over the last few quarters and, while we have made upward revisions following Q3 results, our forecasts may still prove too conservative.

Updates to our forecasted revenue has also had a meaningful effect on operating leverage, operating income and resultant calculated cash-flow generation. For example, we now model operating income of approximately $770k and $2.0M in 2018 and 2019, revised from $231k and $1.6M, respectively. Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, now values SMLR at approximately $9.00/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	Q3A	Q4E	2017 E	2018 E	2019 E
Total Revenues	$7,001.0	$7,435.0	$2,055.0	$2,578.0	$3,607.0	$4,016.0	$12,256.0	$16,251.5	$19,794.3
YOY Growth	*92.6%*	*6.2%*	*36.9%*	*57.6%*	*82.0%*	*73.4%*	*64.8%*	*32.6%*	*21.8%*
Cost of Revenues	$2,809.0	$1,873.0	$540.0	$592.0	$724.0	$883.5	$2,739.5	$3,494.1	$4,156.8
Gross Income	$4,192.0	$5,562.0	$1,515.0	$1,986.0	$2,883.0	$3,132.5	$9,516.5	$12,757.4	$15,637.5
Gross Margin	*59.9%*	*74.8%*	*73.7%*	*77.0%*	*79.9%*	*78.0%*	*77.6%*	*78.5%*	*79.0%*
R&D	$1,436.0	$867.0	$439.0	$474.0	$432.0	$469.0	$1,814.0	$2,122.0	$2,208.0
% R&D	*20.5%*	*11.7%*	*21.4%*	*18.4%*	*12.0%*	*11.7%*	*14.8%*	*13.1%*	*11.2%*
Selling & Mktg	$6,304.0	$3,827.0	$988.0	$1,164.0	$1,350.0	$1,449.0	$4,951.0	$5,649.0	$6,730.1
% Sell&Mktg	*90.0%*	*51.5%*	*48.1%*	*45.2%*	*37.4%*	*36.1%*	*40.4%*	*34.8%*	*34.0%*
G&A	$4,871.0	$3,028.0	$838.0	$902.0	$1,025.0	$1,052.0	$3,817.0	$4,218.0	$4,730.8
% G&A	*69.6%*	*40.7%*	*40.8%*	*35.0%*	*28.4%*	*26.2%*	*31.1%*	*26.0%*	*23.9%*
Operating Income	($8,419.0)	($2,160.0)	($750.0)	($554.0)	$76.0	$162.5	($1,065.5)	$768.4	$1,968.6
Operating Margin	*-120.3%*	*-29.1%*	*-36.5%*	*-21.5%*	*2.1%*	*4.0%*	*-8.7%*	*4.7%*	*9.9%*
Other Expense total	$82.0	$394.0	$121.0	$296.0	$117.0	$130.0	$664.0	$370.0	$145.0
Pre-Tax Income	($8,501.0)	($2,554.0)	($871.0)	($850.0)	($41.0)	$32.5	($1,729.5)	$398.4	$1,823.6
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)	($41.0)	$32.5	($1,729.5)	$398.4	$1,823.6
YOY Growth	*-88.3%*	*70.0%*	*13.4%*	*12.0%*	*88.7%*	*114.8%*	*32.3%*	*123.0%*	*-357.7%*
Net Margin	*-121.4%*	*-34.4%*	*-42.4%*	*-33.0%*	*-1.1%*	*0.8%*	*-14.1%*	*2.5%*	*9.2%*
EPS	($1.73)	($0.50)	($0.17)	($0.16)	($0.01)	$0.01	($0.32)	$0.06	$0.24
YOY Growth	*-56.3%*	*71.1%*	*15.2%*	*15.6%*	*89.4%*	*113.8%*	*35.6%*	*118.2%*	*-315.0%*
Diluted Shares O/S	4,928	5,124	5,231	5,340	5,464	5,500	5,384	6,800	7,500

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