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Zacks Small-Cap Research

Brian Marckx, CFA
bmarckx@zacks.com
Ph (312) 265-9474

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scr.zacks.com
10 S. Riverside Plaza, Chicago, IL 60606

Semler Scientific (SMLR-OTC)

SMLR: Reaches Positive Net Income and Cash Flow With No Slowing Down in 2018!

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, now values SMLR at approximately $10.75/share. This equates to a price/sales (2018) 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).

Current Price (03/01/18)	$8.10
Valuation	**$11.00**

OUTLOOK

Results were, again, extraordinarily strong, including revenue which set another new record high, beating the prior best by a healthy 17%. The final three months of 2017 marked the first quarter in company history with net income and EPS in the black – and that's despite taking a sizeable (non-cash, one-time) charge. Most importantly, operating cash flow was positive in Q4 – which marked the second consecutive quarter of generating cash from operations. Management has delivered on their prior guidance, which we think provides credence in their ability to meet their current forecasts, which includes continued growth in revenue, profitability and cash flow. 2018 is expected to mark the first full year of positive net income and positive operating cash flow. Importantly, management does not expect to need to raise additional capital.

We have made significant upward revisions to our forecasted revenue and EPS in every period in our model. Our updates have moved our DCF-generated price target to $11.00/share (up from $9.00), which equates to forward P/S of ~4x.

SUMMARY DATA

52-Week High	**$8.50**
52-Week Low	**$1.81**
One-Year Return (%)	**207.41**
Beta	**0.35**
Average Daily Volume (sh)	**8,063**
Shares Outstanding (mil)	**7**
Market Capitalization ($mil)	**$53**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**28**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**48.5**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2018 Estimate	**32.4**
P/E using 2019 Estimate	**19.3**
Zacks Rank	**N/A**

Risk Level	**Average,**
Type of Stock	**N/A**
Industry	**Med Instruments**

ZACKS ESTIMATES

Revenue
(in '000s of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2017	2055 A	2578 A	3607 A	4213 A	12453 A
2018	4043 E	4422 E	4828 E	5143 E	18436 E
2019					23307 E
2020					27647 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2017	-$0.17 A	-$0.16 A	-$0.01 A	$0.04 A	-$0.27 A
2018	$0.02 E	$0.05 E	$0.07 E	$0.11 E	$0.25 E
2019					$0.42 E
2020					$0.51 E

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

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WHAT'S NEW…

Q4 2017 Results: *Management Delivers on Guidance, Expects Growth in Revenue, EPS, Cash to Continue…*

Semler reported financial results for their fourth quarter and full year ending December 31st. Results were, again, extraordinarily strong, including revenue which set another new record high, beating the prior best by a healthy 17%. The impressive top-line strength was far from the only highlight, however. The final three months of 2017 marked the first quarter in company history with net income and EPS in the black – and that's despite taking a sizeable (non-cash, one-time) charge related to write-down of WellChec assets. Most importantly, operating cash flow was positive in Q4 – which marked the second consecutive quarter of generating cash from operations.

Management has delivered on their prior guidance, which we think provides credence in their ability to meet their current forecasts. As a reminder, early in 2017 management said that they expected to set new revenue records during the year. Not only was full year revenue at a new high, but three of the four quarters (Q2, Q3, Q4) set new consecutive records in vascular testing (i.e. comparables exclude discontinued operations) revenue. Management also said that they expected growth in revenue to outpace that of operating expenses – that also happened and resulted in consecutive quarterly improvement in profitability. And finally, they predicted reaching cash flow positive - which happened by Q3 (and also in Q4).

Per their comments on the Q4 call (Feb 1st), management believes growth in QuantFlo installations, higher pricing, growth in the HRA-related segment (i.e. usage fees) and leverage from their recurring revenue model will continue to push the top line higher. And, coupled with the ability to maintain a relatively flat operating cost structure, SMLR expects profitability will also increase. Improved profitability means cash flow generation should also increase which, coupled with cash on-hand, should be sufficient to meet operational needs and debt obligations. 2018 is expected to mark the first full year of positive net income and positive operating cash flow. Importantly, management does not expect to need to raise additional capital.

While the rapid (and expected continued) improvement in revenue, profitability and cash flow are the major highlights as it relates to strength of the business, this is complemented by recent increased diversification and balance of the revenue sources via growth in the HRA segment. 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 has not always disclosed the break-out of revenue by source, comments on recent earnings calls suggest that the HRA business has continued to gain additional traction. Usage fees (i.e. HRA-related revenue) grew from approximately $215k in Q2 2017 (~8% of total revenue), to ~$550k in Q3 (~15% of total revenue) and to ~$800k in Q4 (~19% of total revenue). And while usage fee revenue may be somewhat more variable in nature (based on HRA contracts with insurers) as compared to SMLR's licensing-related revenue, the expectation is that this segment will continue to grow over the long-term.

Importantly, management indicated that there is no expectation of the licensing business slowing down. In fact, comments on the Q4 call included expectation for sequential growth in licensing revenue through at least the first two quarters of 2018. We also continue to think market fundamentals favor long-term growth for Semler. PAD afflicts an estimated 20M Americans, yet has been diagnosed in only 25%. Insurers have a financial interest in diagnosing PAD as the potential consequences, including heart attack and stroke, are relatively extremely costly to treat. Physicians are also incentivized to use QuantaFlo as it offers an easier-to-use and (per clinical data) more accurate diagnosis than competing technologies (such as Doppler). The relative operating simplicity of QuantaFlo means a relatively low-level (and low cost) medical aide can administer the test – which frees up physicians and improves profitability.

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 recent updates. 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. An additional near-term upgrade is to provide system compatibility with iOS (in addition to current capability with Android and Windows).

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. The initial related increase in R&D expense happened from Q4 2016 ($232k) to Q1 2017 ($439k) and ticked up to $486k in Q4 2017.

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%) and Q3 to Q4 (17% vs 3%, ex-one time charge) as well as yoy for the full year 2017 (68% vs 36%). The net result has been regular and significant improvement in profitability and cash flow. The even better news is that these trends are 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 net income and cash burn.

	Q1A	Q2A	Q3A	Q4A	2016 A	Q1A	Q2A	Q3A	Q4A	2017 A
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	$4,213.0	$12,453.0
YOY Growth	*24.9%*	*25.6%*	*26.9%*	*-21.1%*	*6.2%*	*36.9%*	*57.6%*	*82.0%*	*81.9%*	*67.5%*
Cost of Revenues	$417.0	$533.0	$398.0	$525.0	$1,873.0	$540.0	$592.0	$724.0	$698.0	$2,554.0
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	$3,515.0	$9,899.0
Gross Margin	*72.2%*	*67.4%*	*79.9%*	*77.3%*	*74.8%*	*73.7%*	*77.0%*	*79.9%*	*83.4%*	*79.5%*
R&D	$270.0	$182.0	$183.0	$232.0	$867.0	$439.0	$474.0	$432.0	$486.0	$1,831.0
%R&D	*18.0%*	*11.1%*	*9.2%*	*10.0%*	*11.7%*	*21.4%*	*18.4%*	*12.0%*	*11.5%*	*14.7%*
Selling & Mktg	$974.0	$1,028.0	$950.0	$875.0	$3,827.0	$988.0	$1,164.0	$1,350.0	$1,575.0	$5,077.0
%Sell&Mktg	*64.9%*	*62.8%*	*47.9%*	*37.8%*	*51.5%*	*48.1%*	*45.2%*	*37.4%*	*37.4%*	*40.8%*
G&A	$772.0	$763.0	$706.0	$787.0	$3,028.0	$838.0	$902.0	$1,025.0	$1,078.0	$3,843.0
%G&A	*51.4%*	*46.6%*	*35.6%*	*34.0%*	*40.7%*	*40.8%*	*35.0%*	*28.4%*	*25.6%*	*30.9%*
Operating Income	($932.0)	($870.0)	($255.0)	($103.0)	($2,160.0)	($750.0)	($554.0)	$76.0	$376.0	($852.0)
Operating Margin	*-62.1%*	*-53.2%*	*-12.9%*	*-4.4%*	*-29.1%*	*-36.5%*	*-21.5%*	*2.1%*	*8.9%*	*-6.8%*

Q4 numbers…

Revenue was $4.2M, up 82% (+$1.9M) yoy, up 17% (+$606k) sequentially and about 5% higher than our $4.0M 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 ~19% of total revenue in Q4).

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.

Q4 operating expenses (including cost of revenue) were $3.8M, or 91% of revenue, compared to our $3.9M, or 95% 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 the last few quarters' results and the rapid pace of absorption of incremental expenses.

Q4 operating income of $376k – but, excluding a non-cash charge for write-down of WellChec-related assets, operating income would have been $627k. This is just the second quarter in SMLR's history posting positive operating income (the other, in Q3 2017 was $76k) and the first time generating positive net income. Net income and EPS were $254k (or $505k ex-charge) and $0.04 (or $0.08 ex-charge).

We have made meaningful upward revisions to our forecasted revenue and EPS in every period in our model. We are modeling 2018 revenue and EPS of $18.4M (+48%) and $0.25 (vs. minus $0.27 in 2017).

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.

Management is guiding for revenue to set a new annual record in 2018 and for profitability and cash flow generation to also continue to improve. While we think total revenue may slightly contract sequentially from Q4 2017 to Q1 2018 as a result of potential seasonality in HRA-related revenue, regular growth in licensing revenue should result in another year of strong top line growth.

We think market fundamentals favor long-term growth for Semler. PAD afflicts an estimated 20M Americans, yet has been diagnosed in only 25%. Insurers have a financial interest in diagnosing PAD as the potential consequences, including heart attack and stroke, are relatively extremely costly to treat. Physicians are also incentivized to use QuantaFlo as it offers an easier-to-use and (per clinical data) more accurate diagnosis than competing technologies (such as Doppler). The relative operating simplicity of QuantaFlo means a relatively low-level (and low cost) medical aide can administer the test – which frees up physicians and improves profitability.

We use a 10-year DCF model to value SMLR. We now model 10-year revenue CAGR of 25%, 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 2018. This, coupled with expectations of continued improvement in operating leverage from stabilizing R&D and efficiencies in SG&A has us modeling consecutive growth in net income throughout 2018 and model $1.7M in net income and $0.25 EPS for the full-year 2018.

Updates to our forecasted revenue has also had a meaningful effect on the out-years in our model. We now look for revenue and EPS of $23.3M and $0.42 in 2019 (revised from $19.8M and $0.24) and $27.7M and $0.51 in 2020 (revised from $23.6M and $0.38).

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, now values SMLR at approximately $11/share. This equates to a price/sales (2018) 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

	2016 A	2017 A	Q1E	Q2E	Q3E	Q4E	2018 E	2019 E	2020 E
Total Revenues	$7,435.0	$12,453.0	$4,043.0	$4,422.0	$4,828.0	$5,143.0	$18,436.0	$23,307.3	$27,647.2
YOY Growth	6.2%	67.5%	96.7%	71.5%	33.9%	22.1%	48.0%	26.4%	18.6%
Cost of Revenues	$1,873.0	$2,554.0	$849.0	$884.4	$922.1	$925.7	$3,581.3	$4,428.4	$4,939.6
Gross Income	$5,562.0	$9,899.0	$3,194.0	$3,537.6	$3,905.9	$4,217.3	$14,854.7	$18,878.9	$22,707.6
Gross Margin	74.8%	79.5%	79.0%	80.0%	80.9%	82.0%	80.6%	81.0%	81.0%
R&D	$867.0	$1,831.0	$487.0	$512.0	$520.0	$531.0	$2,050.0	$2,412.0	$2,792.4
% R&D	11.7%	14.7%	12.0%	11.6%	10.8%	10.3%	11.1%	10.3%	10.1%
Selling & Mktg	$3,827.0	$5,077.0	$1,495.9	$1,600.8	$1,713.9	$1,800.1	$6,610.7	$8,017.7	$9,178.9
% Sell&Mktg	51.5%	40.8%	37.0%	36.2%	35.5%	35.0%	35.9%	34.4%	33.2%
G&A	$3,028.0	$3,843.0	$962.0	$1,016.0	$1,095.0	$1,072.0	$4,145.0	$5,034.4	$5,944.1
% G&A	40.7%	30.9%	23.8%	23.0%	22.7%	20.8%	22.5%	21.6%	21.5%
Operating Income	($2,160.0)	($852.0)	$249.1	$408.8	$576.9	$814.2	$2,049.0	$3,414.8	$4,792.2
Operating Margin	-29.1%	-6.8%	6.2%	9.2%	11.9%	15.8%	11.1%	14.7%	17.3%
Other Expense total	$394.0	$656.0	$117.0	$90.0	$82.0	$64.0	$353.0	$145.0	$0.0
Pre-Tax Income	($2,554.0)	($1,508.0)	$132.1	$318.8	$494.9	$750.2	$1,696.0	$3,269.8	$4,792.2
Taxes	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$718.8
Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	15.0%
Net Income	($2,554.0)	($1,508.0)	$132.1	$318.8	$494.9	$750.2	$1,696.0	$3,269.8	$4,073.4
YOY Growth	70.0%	41.0%	115.2%	137.5%	1307.1%	-195.4%	212.5%	-92.8%	-24.6%
Net Margin	-34.4%	-12.1%	3.3%	7.2%	10.3%	14.6%	9.2%	14.0%	14.7%
EPS	($0.50)	($0.27)	$0.02	$0.05	$0.07	$0.11	$0.25	$0.42	$0.51
YOY Growth	71.1%	46.7%	111.9%	129.5%	1042.2%	-178.7%	192.8%	-70.0%	
Diluted Shares O/S	5,124	5,672	6,660	6,800	7,000	7,050	6,878	7,800	8,000

Brian Marckx, CFA

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