May 1, 2019

# Zacks Small-Cap Research

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

*Sponsored – Impartial - Comprehensive*

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

## Semler Scientific (SMLR-OTCQB)

**No Slowing Down Into 2019. Record Revenue, EPS. Cash Flow Churning. Moving PT to $50/share.**

We estimate SMLR will generate ~$10.5M in cash in 2019. Based on the Gordon Growth Model, we calculate fair value at approximately $50/share.

| | |
|---|---|
| Current Price (05/01/19) | $44.75 |
| **Valuation** | **$50.00** |

## OUTLOOK

Q1 revenue was about 2% better than our estimate, up nearly 52% from the prior year and +13% from Q4'18 and a record high. Revenue has now increased on a sequential basis for the eighth consecutive quarter. Gross margin, at 86.7%, while not a record high was nonetheless relatively healthy and 250 basis points wider than the comparable prior year period (although down 150 bps from Q4'18 and lower than our 88.4% estimate). Meanwhile, operating expenses were at an all-time high but inline with our $4.0M estimate.

The net result was record highs on net income and EPS. Net income, of $1.85M, was nearly 2.5x that of Q1'18 ($706k), 34% higher than Q4'18 ($1.39M) and 26% higher than the prior best ($1.47M in Q3'18). EPS of $0.23 in Q1'19 compares to $0.10 in Q1'18, $0.17 in Q4'18 and a prior best of $0.19 (Q2 and Q3 2018).

Perhaps just as important as the new records that were set on the top and bottom lines was that significant cash generation continues. While management indicated that operating expenses could increase with further infrastructure-related investments (largely related to personnel additions), these are driven by continued growth in anticipated demand. SMLR's goal remains to grow the topline faster than that of expenses. Our PT has moved from $45 to $50/share.

## SUMMARY DATA

| | |
|---|---|
| **52-Week High** | **$49.00** |
| **52-Week Low** | **$9.06** |
| **One-Year Return (%)** | **404.85** |
| **Beta** | **0.39** |
| **Average Daily Volume (sh)** | **15,813** |
| **Shares Outstanding (mil)** | **6** |
| **Market Capitalization ($mil)** | **$283** |
| **Short Interest Ratio (days)** | **N/A** |
| **Institutional Ownership (%)** | **21** |
| **Insider Ownership (%)** | **47** |
| **Annual Cash Dividend** | **$0.00** |
| **Dividend Yield (%)** | **0.00** |
| **5-Yr. Historical Growth Rates** | |
| **Sales (%)** | **52.2** |
| **Earnings Per Share (%)** | **N/A** |
| **Dividend (%)** | **N/A** |
| **P/E using TTM EPS** | **N/A** |
| **P/E using 2019 Estimate** | **48.6** |
| **P/E using 2020 Estimate** | **42.2** |
| **Zacks Rank** | **N/A** |

| | |
|---|---|
| **Risk Level** | **Average,** |
| **Type of Stock** | **Small-Growth** |
| **Industry** | **Med Instruments** |

## ZACKS ESTIMATES

**Revenue**
(in '000s of $)

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2018 | 4463 A | 5484 A | 5579 A | 5964 A | 21490 A |
| 2019 | 6761 A | 6719 E | 7269 E | 7763 E | 28512 E |
| 2020 | | | | | 35684 E |
| 2021 | | | | | 43789 E |

**Earnings per Share**

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2018 | $0.10 A | $0.19 A | $0.19 A | $0.17 A | $0.66 A |
| 2019 | $0.23 A | $0.20 E | $0.24 E | $0.26 E | $0.92 E |
| 2020 | | | | | $1.06 E |
| 2021 | | | | | $1.36 E |

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

© Copyright 2019, Zacks Investment Research. All Rights Reserved.

**Q1 2019 Results:** *Record Revenue, EPS. Cash Flow Increasing. Infrastructure Investments Based on Demand…*

Semler reported financial results for their first quarter ending March 31, 2019. Revenue was about 2% better than our estimate, up nearly 52% from the prior year and +13% from Q4'18 and a record high. Revenue has now increased on a sequential basis for eight consecutive quarters. Gross margin, at 86.7%, while not a record high was nonetheless relatively healthy and 250 basis points wider than the comparable prior-year period (although down 150 bps from Q4'18 and lower than our 88.4% estimate). Meanwhile, operating expenses (not including cost of revenue) were at an all-time high but inline with our $4.0M estimate and a record low on a percentage of sales basis.

The net result was record highs on net income and EPS. Net income, of $1.85M, was nearly 2.5x that of Q1'18 ($706k), 34% higher than Q4'18 ($1.39M) and 26% higher than the prior best ($1.47M in Q3'18). EPS of $0.23 in Q1'19 compares to $0.10 in Q1'18, $0.17 in Q4'18 and a prior best of $0.19 (Q2 and Q3 2018).

Perhaps just as important as the new records that were set on the top and bottom lines was that significant cash generation continues (Q1 cash flow statement will be available when the 10-Q is filed). Semler generated positive cash flow from operations in every quarter in 2018. For the full year, cash flow from operations was $4.7M (or $6.6M, ex-changes in working capital) in 2018, compared to $621k (or $440k, ex-changes in working capital) in 2017. The balance sheet also remains very healthy, following the cleansing of remaining debt during the latter portion of 2018.

**While management indicated that operating expenses could increase** with further infrastructure-related investments (largely related to personnel additions), these are driven by continued growth in anticipated demand. And while SMLR also noted larger orders could result in short-term volatility (i.e. 'spurts') in revenue, that their goal remains to grow the topline faster than that of expenses – the net result of which should be a continuance in growth of EPS and cash flow.

**As we have noted in the past, management already has a history of turning these types of 'investments' into revenue and profitability growth in short order.** Our updated model (following reporting of Q1 results) shows SMLR generating revenue and EPS of $28.5M and $0.92 in 2019 (adjusted from $28.4M and $0.91), which implies respective growth of 33% and 39%. If our model proves reasonably accurate, we think operating cash flow could be in the range of $10.0M - $11.0M, and possibly even higher. As it is now, we model cash flow of approximately $10.5M in 2019.

***Growth story remains intact…***
The story and our outlook have remained largely intact for the last several quarters – including through Q1'19. As such, we continue to reiterate our comments from our recent earnings updates… the consistency and regularity of revenue growth and flatness of expenses lend credence to the validity of the company's business model and strategy. Much of that hinges on the supposition that insurers have an economic interest in paying for their capitation-based insured to be tested for PAD. And with these insured tested annually, these are very sticky revenue units (somewhat analogous to an installed base but with much higher margins). Growth comes from adding new customers and additional testing from existing customers – which was the case in throughout 2018 and through the first quarter of 2019. And with SMLR's customers (i.e. insurers) consisting of some of the largest Medicare Advantage plans and SMLR's market penetration still in the low single-digits, this further validation of the company's business model and insurers' economic interests as it relates to PAD testing should signal ever-increasing confidence that revenue and profitability will continue to grow. The last several quarters have further bolstered our confidence in that regard.

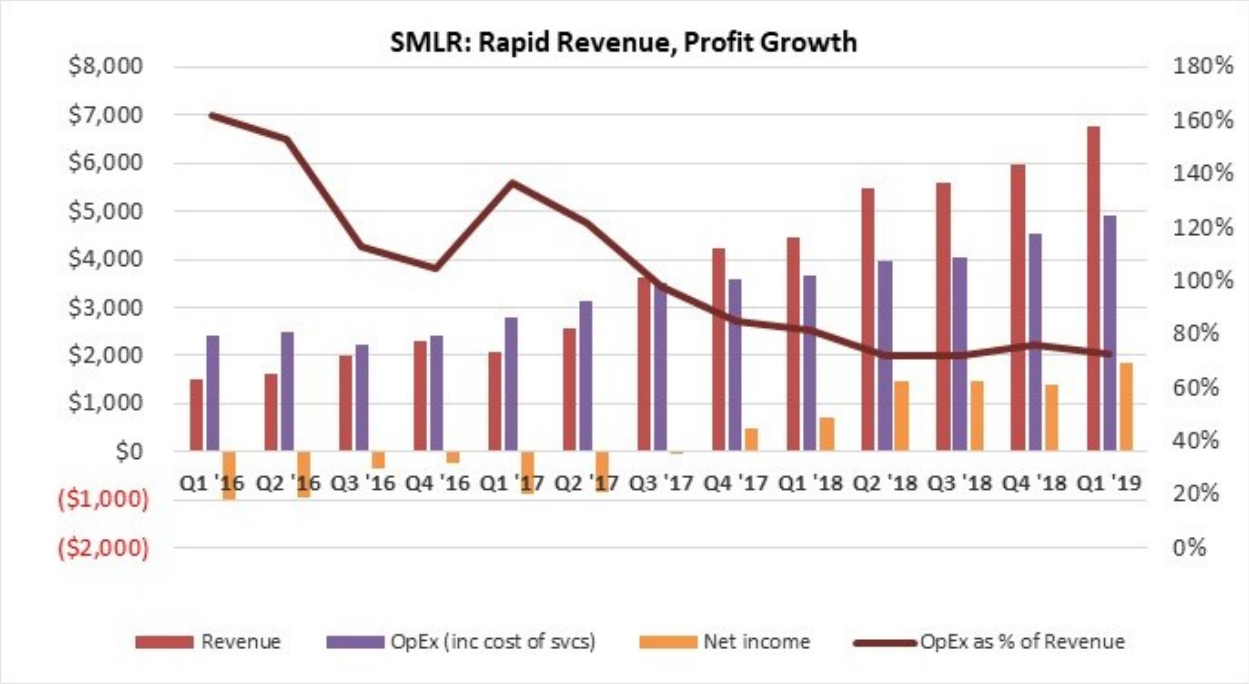
**NASDAQ uplisting is likely on the horizon**, which would increase visibility of SMLR and could bolster the 'investibility' of the shares, particularly as it relates to institutional interest and ownership. As we had forecasted, as of the close of Q1'19 Semler met the minimum required stockholder's equity for NASDAQ uplisting. While management was non-committal on the Q1 call in regards to potential plans to uplist, we think it is almost certainly a near-term goal. SMLR will still need to increase the number of independent directors in order to satisfy NASDAQ listing requirements.

**Q1 numbers**
Revenue was $6.8M, up 52% (+$2.3M) yoy, up 13% (+797k) sequentially and about 2% (+$158k) higher than our $6.6M estimate. It was also a new record high. As a reminder, with the reporting Q4'18 results (late-February)

SMLR announced that, based on a trend of both fixed and variable-type licenses which resulted in less meaningful distinction between their previously-reported revenue categories of licensing (i.e. implied 'fixed') and usage (i.e. 'variable') fees, they would no longer break these out.

**Q1 operating expenses** (including cost of revenue) was $4.9M, or 72.6% of revenue – this is nearly a record low on a percentage of revenue basis (only Q2 and Q3 2018, both at 72%, were lower). This compares to $3.7M (81.8%) in Q1'18 and $3.8M (75.7%) in Q4'18. For the full-year 2018, operating expenses averaged 75.2% of revenue, down from 107% in 2017. We currently forecast operating expenses (including cost of revenue) to average 71.5% of revenue throughout 2019.

As we noted in the past, OpEx as a percentage of revenue was a key metric to keep an eye on and the consistent improvement is a testament to management's efforts to keep costs in-check. It is also, in our opinion, further validation of the long-term viability of SMLR's business model. The combination of ramping revenue and relatively flat growth in operating expenses has resulted in rapid improvement in operating income/loss.




**Q1 net income was a record $1.9M –** increases of 163% and 34% from Q1'18 and Q4'18, respectively, and 26% greater than the previous high ($1.5M in Q3'18). As the chart above illustrates, the improvement is reflective of both revenue growth and relatively flattish OpEx. The dramatic improvement in all three metrics (i.e. increasing revenue, flattish opex and growing income) is captured in the 'OpEx as a % of revenue" line (lower is better).

As a reminder, when operating expenses were rapidly climbing during the early part of 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 several quarters' results** and the rapid pace of absorption of incremental expenses. It is also bolstered by management continuing to guide for the cost base to remain flattish despite continued anticipated revenue growth.

***Cash flow churning and debt-free…***

Cash flow from operating activities and free cash flow also continue to improve. For some context…

- FY 2017: for the full-year 2017, excluding changes in working capital (i.e. eliminating any noise), SMLR generated $440k in cash from operations – an improvement of more than $1.7M as compared to the

$1.3M of cash used during 2016. Free cash flow, which accounts for capex, was negative $528k in 2017, compared to negative $2.5M in 2016.

- Q4 2017: in Q4 2017, excluding changes in working capital, cash flow from operations was positive $909k. Subtracting 25% of full-year capex, free cash flow was positive $667k in Q4 2017. This compares to Q4 2016 which had $142k in positive operating cash flow (ex-changes in w/c) and $3k of positive free cash flow.
- Q1 2018: excluding changes in working capital, cash flow from operations was positive $1.170M. Free cash flow was $1.078M
- Q2 2018: excluding changes in working capital, cash flow from operations was positive $1.847M. Free cash flow was $1.696M
- Q3 2018: excluding changes in working capital, cash flow from operations was positive $1.87M. Free cash flow was $1.667M
- Q4 2018: excluding changes in working capital, cash flow from operations was positive $1.735M. Free cash flow was $1.345M
- FY2018: excluding changes in working capital, cash flow from operations was $6.617M. Free cash flow was $5.774M

***Profitability, ROI Ramping…***

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. These investments have benefitted revenue growth and improved profitability. Results through Q1'19 indicate that the return on these investments is not only still growing, but it is significantly accelerating. 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 and gross income will grow even faster which should result in continued improvement in net income and cash burn.

**Outlook**

It is rare to see a micro-cap company perform so well. While SMLR's results over the last ~2.5 years represent what an ideal financial model and growth curve would look like, they rarely play out like this. Given our experiences covering micro-cap med-tech, we had been hesitant to fully embrace the idea that that management could scale the business without significantly greater spend - but, given the consistently, significantly and rapidly improving financial results (in revenue, profitability and cash flow), we are quickly warming up to the idea that SMLR is the needle-in the-haystack that we had hoped it could be when we initiated coverage of the company back in early 2015.

That said, we feel it is prudent to maintain some level of skepticism (perhaps, 'caution' is a better word) that recent performance (financially as well as operationally) is a valid yardstick to gauge how the future may play out. Our hesitance (and what remains of our skepticism), however, will almost certainly continue to erode with every upcoming quarter that further validates SMLR's business model, the competitive advantages of QuantaFlo and macro demand for PAD testing.

Management deserves much credit for the company's success to-date – that includes keeping expenses at-bay and, of course, driving revenue. But, it also includes deftly recognizing the market opportunity for PAD testing and the unmet need for a faster, easier-to-use, less-costly and more accurate option than what has long been considered standard of care (i.e. Doppler). And it also includes recognizing and leveraging the 'right' commercialization strategy.

What makes SMLR even more compelling as an investment, in our opinion, is that it appears the company may be in the right spot and the right time. That is because the prevalence of PAD is on the rise and, despite that, overall awareness of the disease and its associated risks has, until recently, been relatively low. Historically, ~5% of Americans over the age of 65 were affected by PAD, today it is about 25% (much of the increase can be attributed to increasing rates of diabetes). But, an estimated 75% of the people that should be tested for PAD, are not.

And while awareness has been low, that has recently changed with efforts aimed at educating the public, healthcare providers and insurers of what has been called 'a public health crisis'. That has culminated in the availability to more resources supporting testing and treatment – which included a recent (2017) National Coverage Determination by CMS (Medicare) to cover supervised exercise therapy for the treatment of symptomatic peripheral artery disease.

And while SMLR does not benefit directly from this coverage decision or necessarily directly from the awareness efforts, they almost certainly benefit indirectly as it means more people will get tested for PAD. Management estimates that their market penetration is in the low single digits – with the impact of these recent market-oriented catalysts likely to grow over time, competitive advantages of QuantaFlo, management's proven ability to ramp revenue, profitability and cash flow, and SMLR's commercialization strategy that benefits their customers (as well as the company), we think SMLR could be a needle-in-the-haystack type of investment.

**Model Updates / Valuation**

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. Increasing awareness and recently implemented reimbursement should bode well for increasing testing.

We model 10-year revenue CAGR of ~32%. We show flattish gross margin from the very healthy current level (87% - 88%) and, coupled with expectations of continued improvement in operating leverage from stabilizing R&D and efficiencies in SG&A, has us modeling SMLR to generate significant net income into the foreseeable future. We model 2019 revenue, net income and EPS of $28.5M, $7.7M and $0.92 (slightly upwardly revised from $28.4M, $7.6M and $0.91).

EPS in our out-years is $1.06 in 2020 and $1.36 in 2021 (both unchanged since our prior update).

**Cash flow multiple puts fair value at $50/share**

Given our comfort level with the likelihood of SMLR continuing to generate positive cash flow, we recently moved our valuation methodology from DCF to a Gordon Growth Model-derived cash flow multiple.

SMLR generated ~$7M of cash in 2018 and we estimate ~$10.5M in 2019. Assuming a long-term sustainable cash flow growth rate of 8.5%, at a 11% discount rate (based on CAPM), the Gordon Growth Model implies a ((1/(0.11 – 0.085) = ) 40x cash flow multiple. This values SMLR at ~$50/share today on a fully-diluted basis. Our price target is based on SMLR generating $10.5M of cash in 2019 – if this proves conservative (liberal), we would expect upside (downside) to our price target to materialize. We also note that NASDAQ uplisting, if and when it happens, would likely meaningfully improve liquidity and potentially facilitate accelerated realization of our price target.

## FINANCIAL MODEL

Semler Scientific, Inc

| | 2017 A | 2018 A | Q1A | Q2E | Q3E | Q4E | 2019 E | 2020 E | 2021 E |
|---|---|---|---|---|---|---|---|---|---|
| Total Revenues | $12,453.0 | $21,490.0 | $6,761.0 | $6,719.3 | $7,269.3 | $7,762.7 | $28,512.4 | $35,683.6 | $43,789.1 |
| YOY Growth | 67.5% | 72.6% | 51.5% | 22.5% | 30.3% | 30.2% | 32.7% | 25.2% | 22.7% |
| Cost of Revenues | $2,554.0 | $2,703.0 | $896.0 | $766.0 | $814.2 | $853.9 | $3,330.1 | $3,925.2 | $4,816.8 |
| Gross Income | $9,899.0 | $18,787.0 | $5,865.0 | $5,953.3 | $6,455.1 | $6,908.8 | $25,182.3 | $31,758.4 | $38,972.3 |
| Gross Margin | 79.5% | 87.4% | 86.7% | 88.6% | 88.8% | 89.0% | 88.5% | 89.0% | 89.0% |
| R&D | $1,831.0 | $2,086.0 | $569.0 | $611.0 | $715.0 | $731.0 | $2,626.0 | $3,211.5 | $3,853.4 |
| % R&D | 14.7% | 9.7% | 8.4% | 9.1% | 9.8% | 9.4% | 9.2% | 9.0% | 8.8% |
| Selling & Mktg | $5,077.0 | $7,201.0 | $2,070.0 | $2,109.9 | $2,195.3 | $2,328.8 | $8,704.0 | $10,598.0 | $12,348.5 |
| % Sell&Mktg | 40.8% | 33.5% | 30.6% | 31.4% | 30.2% | 30.0% | 32.0% | 29.7% | 28.2% |
| G&A | $3,843.0 | $4,159.0 | $1,372.0 | $1,404.3 | $1,417.5 | $1,544.8 | $5,738.6 | $6,637.1 | $7,969.6 |
| % G&A | 30.9% | 19.4% | 20.3% | 20.9% | 19.5% | 19.9% | 20.1% | 18.6% | 18.2% |
| Operating Income | ($852.0) | $5,341.0 | $1,854.0 | $1,828.1 | $2,127.3 | $2,304.2 | $8,113.6 | $11,311.7 | $14,800.7 |
| Operating Margin | -6.8% | 24.9% | 27.4% | 27.2% | 29.3% | 29.7% | 28.5% | 31.7% | 33.8% |
| Other Expense total | $656.0 | $301.0 | $0.0 | ($8.8) | ($10.1) | ($11.0) | ($29.9) | ($66.2) | ($98.7) |
| Pre-Tax Income | ($1,508.0) | $5,040.0 | $1,854.0 | $1,836.9 | $2,137.4 | $2,315.2 | $8,143.5 | $11,377.9 | $14,899.4 |
| Taxes | $0.0 | $26.0 | $0.0 | $141.4 | $164.6 | $185.2 | $491.2 | $2,503.1 | $3,277.9 |
| Tax Rate | 0.0% | 0.5% | 0.0% | 7.7% | 7.7% | 8.0% | 11.0% | 22.0% | 22.0% |
| Net Income | ($1,508.0) | $5,014.0 | $1,854.0 | $1,695.5 | $1,972.8 | $2,130.0 | $7,652.3 | $8,874.8 | $11,621.5 |
| YOY Growth | 41.0% | -432.5% | 162.6% | 16.7% | 34.4% | 53.6% | 52.6% | 16.0% | -31.0% |
| Net Margin | -12.1% | 23.3% | 27.4% | 25.2% | 27.1% | 27.4% | 26.8% | 24.9% | 26.5% |
| EPS | ($0.27) | $0.66 | $0.23 | $0.20 | $0.24 | $0.26 | $0.92 | $1.06 | $1.36 |
| YOY Growth | 46.7% | -347.2% | 134.0% | 5.6% | 27.6% | 49.3% | 40.3% | 14.6% | 28.7% |
| Diluted Shares O/S | 5,672 | 7,630 | 8,170 | 8,325 | 8,350 | 8,350 | 8,299 | 8,400 | 8,550 |

Brian Marckx, CFA

© Copyright 2019, Zacks Investment Research. All Rights Reserved.

## HISTORICAL STOCK PRICE




© Copyright 2019, Zacks Investment Research. All Rights Reserved.

# DISCLOSURES

The following disclosures relate to relationships between Zacks Small-Cap Research ("Zacks SCR"), a division of Zacks Investment Research ("ZIR"), and the issuers covered by the Zacks SCR Analysts in the Small-Cap Universe.

ANALYST DISCLOSURES

I, Brian Marckx, CFA, hereby certify that the view expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the recommendations or views expressed in this research report. I believe the information used for the creation of this report has been obtained from sources I considered to be reliable, but I can neither guarantee nor represent the completeness or accuracy of the information herewith. Such information and the opinions expressed are subject to change without notice.

INVESTMENT BANKING AND FEES FOR SERVICES

Zacks SCR does not provide investment banking services nor has it received compensation for investment banking services from the issuers of the securities covered in this report or article.
Zacks SCR has received compensation from the issuer directly or from an investor relations consulting firm engaged by the issuer for providing non-investment banking services to this issuer and expects to receive additional compensation for such non-investment banking services provided to this issuer. The non-investment banking services provided to the issuer includes the preparation of this report, investor relations services, investment software, financial database analysis, organization of non-deal road shows, and attendance fees for conferences sponsored or co-sponsored by Zacks SCR. The fees for these services vary on a per-client basis and are subject to the number and types of services contracted. Fees typically range between ten thousand and fifty thousand dollars per annum. Details of fees paid by this issuer are available upon request.

POLICY DISCLOSURES

This report provides an objective valuation of the issuer today and expected valuations of the issuer at various future dates based on applying standard investment valuation methodologies to the revenue and EPS forecasts made by the SCR Analyst of the issuer's business.
SCR Analysts are restricted from holding or trading securities in the issuers that they cover. ZIR and Zacks SCR do not make a market in any security followed by SCR nor do they act as dealers in these securities. Each Zacks SCR Analyst has full discretion over the valuation of the issuer included in this report based on his or her own due diligence. SCR Analysts are paid based on the number of companies they cover. SCR Analyst compensation is not, was not, nor will be, directly or indirectly, related to the specific valuations or views expressed in any report or article.

ADDITIONAL INFORMATION

Additional information is available upon request. Zacks SCR reports and articles are based on data obtained from sources that it believes to be reliable, but are not guaranteed to be accurate nor do they purport to be complete. Because of individual financial or investment objectives and/or financial circumstances, this report or article should not be construed as advice designed to meet the particular investment needs of any investor. Investing involves risk. Any opinions expressed by Zacks SCR Analysts are subject to change without notice. Reports or articles or tweets are not to be construed as an offer or solicitation of an offer to buy or sell the securities herein mentioned.