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Zacks Small-Cap Research

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Semler Scientific (SMLR-OTCQB)

Q2 Beats Big. Thesis Continues To Play Out. Upward Revision to CF Estimate Moves PT to $55

We estimate SMLR will generate ~$11.0M in cash in 2019. Based on the Gordon Growth Model, we calculate fair value at approximately $55/share.

Current Price (08/08/19)	$50.00
Valuation	**$55.00**

OUTLOOK

The entire income statement was a highlight in Q2. Revenue set a new record high (exceeding the prior record by 18%) and was 18% ahead of our estimate. Q2 marks the 9th consecutive quarter of sequential revenue growth and 8th consecutive quarter of revenue setting a new record high. Meanwhile, gross margin was nearly a record best and opex a record low (on a % of revenue basis). The net result of record high revenue, gross margin of almost 90% and record low opex was net income and EPS of $2.6M and $0.32 – ahead of their respective prior highs by 41% and 39%. Q2 extended the streak to six consecutive quarters with positive cash flow. Cash flow was $1.7M ($2.1M ex-changes in working capital) in Q1'19 and $2.7M ($3.0M ex-changes in w/c) in Q2'19. SMLR generated $5.0M and $4.3M of cash from operations and free cash flow, respectively, representing respective growth of 69% and 53% from 1H 2018. Particularly noteworthy is that these cash flow growth rates are well ahead of that of revenue, which increased by 48% over the same period – which reflects scaling of the business and leveraging the operating base. We had been forecasting CF of $10.5M in 2019. Given the big beat (vs our numbers) in Q2, the fact that SMLR is already nearly halfway to our projected FY cash flow estimate (i.e. $5.0M through 1H) and expectations of continued sequential revenue growth, we now expect FY CF of $11.0-$11.5M (despite expectations of continued growth-related investments and incremental expenses), which has moved our PT from $50 to $55/share.

SUMMARY DATA

52-Week High	**$54.50**
52-Week Low	**$21.10**
One-Year Return (%)	**107.47**
Beta	**0.86**
Average Daily Volume (sh)	**14,912**
Shares Outstanding (mil)	**6**
Market Capitalization ($mil)	**$317**
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 (%)	**56.7**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**54.9**
P/E using 2019 Estimate	**44.2**
P/E using 2020 Estimate	**38.8**
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	7953 A	8092 E	8418 E	31224 E
2020					39498 E
2021					48967 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	$0.32 A	$0.29 E	$0.29 E	$1.13 E
2020					$1.29 E
2021					$1.54 E

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

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Q2 2019 Results: Huge Beat to Our Numbers. Record Revenue, Income, EPS and Cash Flow. Moving PT to $55…

Semler reported financial results for their second quarter ending June 30th. The company did not hold an earnings call as CEO Doug Murphy-Chutorian continues to recover from the mild stroke he suffered approximately six weeks prior. As a reminder, per SMLR's press release announcing the event, Doug remained (and remains) at the helm of the organization and involved in day-to-day operations. Encouragingly, the Q2 earnings release notes that Doug continues to make strong progress, that SMLR will host a Q3 earnings call and that additional executives will join him on the call.

As it relates to Q2 results, pretty much the whole income statement was a highlight. Revenue remains very strong, set a new record high (exceeding the prior record of $6.8M set in Q1'19 by 18%) and was 18% ahead of our estimate. Q2'19 marks the ninth consecutive quarter of sequential revenue growth and the eighth consecutive quarter of revenue setting a new record high.

Meanwhile, gross margin was nearly a record best and operating expenses were a record low (on a percentage of revenue basis). The net result of record high revenue, gross margin of almost 90% and record low opex was net income and EPS of $2.6M and $0.32 – which are ahead of their respective prior highs (both from Q1'19) by 41% and 39%.

Cash generation also continues to churn higher and Q2 extended the streak to six consecutive quarters with positive cash flow. 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. Cash flow was $1.7M ($2.1M ex-changes in working capital) in Q1'19 and $2.7M ($3.0M ex-changes in w/c) in Q2'19. SMLR generated $5.0M and $4.3M of cash from operations and free cash flow, respectively, representing respective growth of 69% and 53% from 1H 2018. Particularly noteworthy is that these cash flow growth rates are well ahead of that of revenue, which increased by 48% over the same period – which reflects scaling of the business and leveraging the operating base.

As we noted in our Q1 update in May, we were forecasting FY2019 cash flow of approximately $10.5M. Given the big beat (vs our numbers) in Q2, the fact that SMLR is already nearly halfway to our projected FY cash flow estimate (i.e. $5.0M through 1H) and expectations of continued sequential revenue growth (if history is an accurate guide, revenue should grow sequentially through Q4), we think our prior forecast may be too conservative. Updates to our model following Q2 earnings announcement resulted in an increase of projected cash flow from $10.5M to between $11M and $11.5M (despite expectations of continued growth-related investments and incremental expenses).

And while as we have noted in the past, some expected variability in revenue, coupled with periodic additions to personnel and infrastructure aimed at meeting growth in demand, may result in some inconsistent cash flow generation, our confidence of long-term cash flow growth is further bolstered by every passing quarter. And, importantly, the balance sheet remains very healthy with zero debt and cash of $4.2M as of the close of Q2.

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. We may have underestimated just how quickly that they can make that happen. Fairly significant updates to our model (following reporting of Q2 results) shows SMLR generating revenue and EPS of $31.2M and $1.13 in 2019 (adjusted from $28.5M and $0.92), which implies respective growth of 45% and 72%. If our model proves reasonably accurate, we now think operating cash flow could be in the range of $11.0M - $11.5M, and possibly even higher. As it is now, we model cash flow of approximately $11.0M in 2019.

Growth story remains intact…

The story and our outlook have remained largely intact for the last several quarters – including through Q2'19. 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

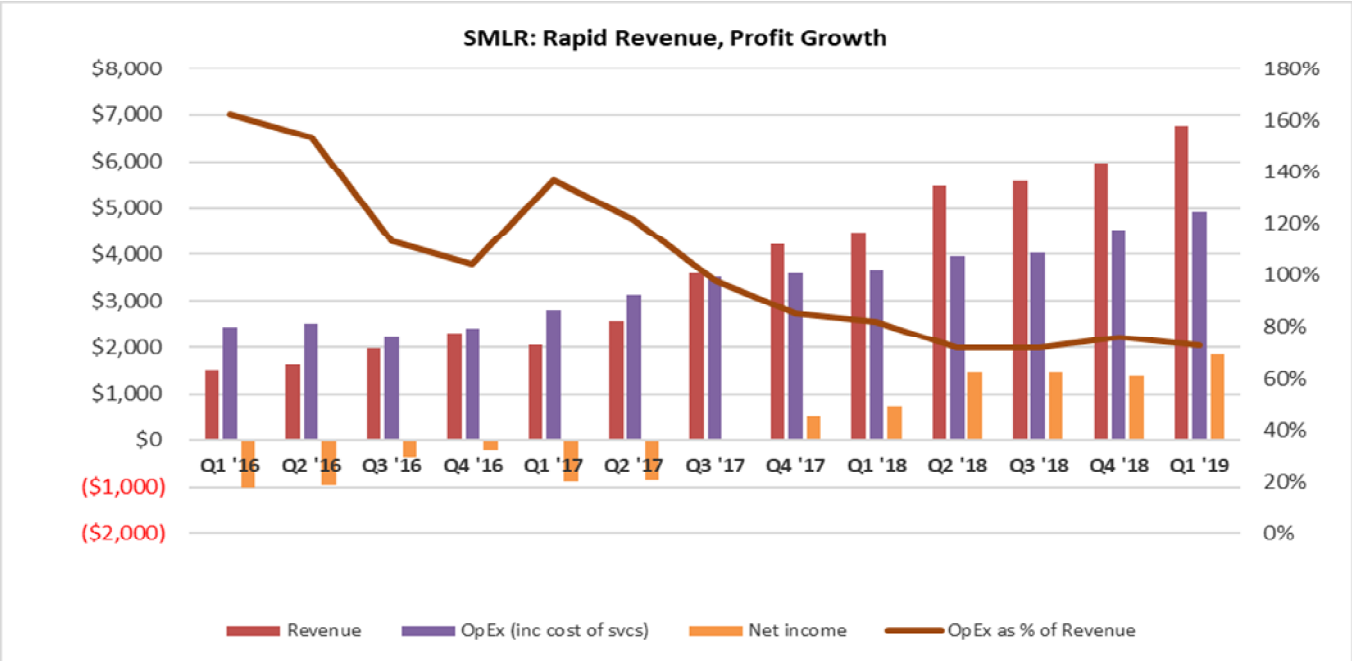
strategy. Much of that hinges on the supposition that insurers have an economic interest in paying for their capitation-based insured to be tested for PAD. And with these insured tested annually, these are very sticky revenue units (somewhat analogous to an installed base but with much higher margins). Growth comes from adding new customers and additional testing from existing customers – which was the case in throughout 2018 and through the first half 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. Semler has met the minimum required stockholder's equity for NASDAQ uplisting. While management has been non-committal 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.

Q2 numbers
Revenue was $8.0M, up 45% (+$2.5M) yoy, up 18% (+1.2M) sequentially and about 18% (+$1.2M) higher than our $6.7M estimate. It was also a new record high. SMLR previously noted (at the time that they reported Q4'18 results in late-February) 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. However, the Q2'19 earnings release did disclose that approximately $5.4M (or ~68%) of total revenue relates to license fees and ~$2.3M to variable revenue (i.e. 29% of total). The remaining $306k is from equipment (and/or supplies and accessories) sales.

Q2 operating expenses (including cost of revenue) was $5.3M, or 66% of revenue – which crushes the prior record low (Q2 and Q3 2018 were both at 72%) by about 600 basis points and is significantly improved from 73% in Q1'19. This metric averaged 69% through the first six months of 2019, compared to 76% in the comparable prior year period and 75% for the full year 2018 (which was a dramatic improvement from 107% in 2017). While we had previously forecasted operating expenses (including cost of revenue) to average 71.5% of revenue throughout 2019, the updates to our model following Q2 results have us now forecasting this at 69.0% (which is flat from 1H'19 and could prove conservative).

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.



Q2 net income was a record $2.6M – increasing by 80% and 41% from Q2'18 (the previous best) and Q1'19, respectively. 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
- Q1 2019: excluding changes in working capital, cash flow from operations was $2.135M. Free cash flow was $1.679M
- Q2 2019: excluding changes in working capital, cash flow from operations was $2.9587M. Free cash flow was $2.572M

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 1H'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 ~3 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 ~33%. 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 $31.2M, $9.7M and $1.13, which are all substantially increased from the $28.5M, $7.7M and $0.92 that we had been forecasting prior to the reporting of Q2 results.

EPS in our out-years is $1.29 and $1.54 in 2020 and 2021, similarly reflecting large upward revisions (from $1.06 and $1.36).

Cash flow multiple puts fair value at $55/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 ~$11.0M 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 ~$55/share today on a fully-diluted basis. Our price target is based on SMLR generating $11.0M 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	Q2A	Q3E	Q4E	2019 E	2020 E	2021 E
Total Revenues	$12,453.0	$21,490.0	$6,761.0	$7,953.0	$8,091.9	$8,418.0	$31,223.9	$39,497.6	$48,966.7
YOY Growth	67.5%	72.6%	51.5%	45.0%	45.0%	41.1%	45.3%	26.5%	24.0%
Cost of Revenues	$2,554.0	$2,703.0	$896.0	$885.0	$906.3	$926.0	$3,613.3	$4,344.7	$5,386.3
Gross Income	$9,899.0	$18,787.0	$5,865.0	$7,068.0	$7,185.6	$7,492.0	$27,610.6	$35,152.8	$43,580.4
Gross Margin	79.5%	87.4%	86.7%	88.9%	88.8%	89.0%	88.4%	89.0%	89.0%
R&D	$1,831.0	$2,086.0	$569.0	$591.0	$702.0	$731.0	$2,593.0	$3,357.3	$4,211.1
% R&D	14.7%	9.7%	8.4%	7.4%	8.7%	8.7%	8.3%	8.5%	8.6%
Selling & Mktg	$5,077.0	$7,201.0	$2,070.0	$2,212.0	$2,322.4	$2,432.8	$9,037.2	$10,901.3	$13,416.9
% Sell&Mktg	40.8%	33.5%	30.6%	27.8%	28.7%	28.9%	28.9%	27.6%	27.4%
G&A	$3,843.0	$4,159.0	$1,372.0	$1,570.0	$1,626.5	$1,717.3	$6,285.7	$7,781.0	$9,548.5
% G&A	30.9%	19.4%	20.3%	19.7%	20.1%	20.4%	20.1%	19.7%	19.5%
Operating Income	($852.0)	$5,341.0	$1,854.0	$2,695.0	$2,534.8	$2,611.0	$9,694.7	$13,113.2	$16,403.9
Operating Margin	-6.8%	24.9%	27.4%	33.9%	31.3%	31.0%	31.0%	33.2%	33.5%
Other Expense total	$656.0	$301.0	$0.0	($1.0)	($2.8)	($4.7)	($8.5)	($47.1)	($77.6)
Pre-Tax Income	($1,508.0)	$5,040.0	$1,854.0	$2,696.0	$2,537.6	$2,615.7	$9,703.2	$13,160.3	$16,481.5
Taxes	$0.0	$26.0	$0.0	$77.0	$182.7	$211.9	$471.6	$2,461.0	$3,461.1
Tax Rate	0.0%	0.5%	0.0%	2.9%	7.2%	8.1%	4.9%	18.7%	21.0%
Net Income	($1,508.0)	$5,014.0	$1,854.0	$2,619.0	$2,354.9	$2,403.8	$9,231.6	$10,699.3	$13,020.3
YOY Growth	41.0%	-432.5%	162.6%	80.2%	60.4%	73.3%	84.1%	15.9%	-21.7%
Net Margin	-12.1%	23.3%	27.4%	32.9%	29.1%	28.6%	29.6%	27.1%	26.6%
EPS	($0.27)	$0.66	$0.23	$0.32	$0.29	$0.29	$1.13	$1.29	$1.54
YOY Growth	46.7%	-347.2%	134.0%	68.0%	55.6%	71.6%	72.2%	13.9%	19.5%
Diluted Shares O/S	5,672	7,630	8,170	8,086	8,172	8,200	8,157	8,300	8,450

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HISTORICAL STOCK PRICE



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