Zacks Small-Cap Research

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July 29, 2016

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Semler Scientific (SMLR-NASDAQ)

SMLR: Another Step Closer To Profitability

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $6.50/share. This equates to a price/sales (2016) multiple of about 4x which we think is a fair given the company's high revenue growth rate, 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.

Current Price (07/29/16)	$2.06
Valuation	**$6.50**

OUTLOOK

Highly experienced mgmt team has had early success with strategic marketing plan that leverages recent changes in healthcare reimbursement from pay for service to pay for performance. QuantFlo use benefits providers, patients and insurers which has catalyzed demand for the device.

WellChec, SMLR's wellness testing service launched in Spring 2015 and has shown early promise. WellChec continues to score add'l contracts and is adding new tests to its menu of offerings. Further revenue growth in the vascular business should come from QuantaFlo's growing installed base, additional Medicare Advantage plan customers and higher avg revenue per customer.

Management has delivered on goal of keeping expenses in check which, coupled with top-line growth, has improved operating loss and moved SMLR closer to profitability.

SUMMARY DATA

52-Week High	**$3.70**
52-Week Low	**$1.12**
One-Year Return (%)	**-41.46**
Beta	**-0.72**
Average Daily Volume (sh)	**43,009**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$10**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**15**
Insider Ownership (%)	**22**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2016 Estimate	**N/A**
P/E using 2017 Estimate	**N/A**
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)
2015	1202 A	1303 A	1562 A	2934 A	7001 A
2016	1501 A	1636 A	1842 E	3170 E	8149 E
2017					11742 E
2018					15210 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	-$0.29 A	-$0.27 A	-$0.32 A	-$0.84 A	-$1.73 A
2016	-$0.20 A	-$0.19 A	-$0.17 E	-$0.15 E	-$0.70 E
2017					-$0.48 E
2018					-$0.24 E

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

WHAT'S NEW…

Q2 2016 Results: Revenue Below Estimate Due to Timing. Expect Rebound in Q3. Operating Loss Continues to Improve..

Semler reported financial results for the second quarter ending June 30. Revenue, which consisted of only contribution from the vascular testing business (i.e. WellChec remains offline as was the case in Q1), was flat from Q1 (excluding a $162k offset in Q1 related to WellChec) of this year and about 11% lower than our estimate, although it did show double-digit growth compared to Q2 2015. But, based on management's comments on the call, it appears the sequentially flat growth is more of a timing issue than anything related to fundamental stagnation in the business. We expect revenue to return to q-o-q growth in Q3 and benefit from some late-Q2 QuantaFlo shipments that will hit the income statement in the current quarter.

Importantly, not only was SMLR able to keep operating expenses just better than flat from Q1 (as management had guided on the Q1 call), but they came in below our forecast by about 11%. The net result of lower revenue and operating expenses as compared to our model, was EPS coming in largely inline (-0.17 E vs. -$0.19 A).

And while we continue to see several catalysts to push revenue higher, contribution from one of these will be delayed at least one more quarter. Management had previously expected that WellChec, the company's multi wellness testing service, would come back online in Q3 of this year - this has now been pushed back to Q4 as they continue to work to finalize details of the contract. Nonetheless, ongoing migrations from FloChec to the higher priced next-gen QuantaFlo instrument, onboarding of new vascular testing customers, further penetration of the Medicare Advantage market and the eventual restart of WellChec are expected to fuel revenue growth going forward.

As we noted in our previous update, we had expected to see consistent improvement in profitability on growth in revenue and leverage of the cost base. SMLR delivered as much, with operating loss improving from $1.3M in Q2 2015 and $932k in Q1 2016 to $870k in Q2 2016. If SMLR can continue to grow the top-line, maintain their focus on cost-control and continue to keep operating expenses roughly flat, profitability should continue to improve.

Q2 numbers…

Vascular testing revenue of $1.64M represented growth of approximately 31% on a yoy basis (from ~$1.25M in Q2 2015) but a 1% contraction (from $1.66M) compared to Q1 2016. As a reminder, SMLR's total revenue in Q1 2016 included $1.66M in vascular testing revenue which was offset by a $162k reduction related to prior period invoicing corrections related to WellChec.

While SMLR does not break out vascular testing revenue by instrument much of the yoy growth appears to be coming from migrating customers from the legacy FloChec over to the premium-priced QuantaFlo instrument which launched in Q3 2015 and has additional functionality. While the pace of customers switching to the new instruments has been brisk, with ~85% of the installed base still using FloChec, significant migration-related growth remains ahead. Management continues to note that customer feedback of QuantaFlo's performance has been excellent. Additional onboarding of customers is also contributing to growth of this segment.

WellChec, as expected, did not generate any revenue in the quarter. As a reminder, management had previously announced that they expected to limit WellChec business until later in 2016 in order to lessen OpEx and conserve cash. The timeout from this business has allowed the company to make preparations to meet what is expected to be greater demand for its WellChec services. While management had previously guided for this business to come back online in Q3, that has since been pushed back to Q4. The delay relates to preparations for another multi-test testing program for a large repeat customer that generated $1.4M in revenue for SMLR in Q4 of last year. Management indicated that this upcoming program could be even larger.

Gross margin of 67.4% was almost 500 basis points lower than Q1 2016 and well below our 73.8% estimate. Management noted on the call that an increase in depreciation related to FloChec instruments returned (any remaining carrying value is fully depreciated when returned) to the company (and swapped for QuantaFlo) along with some incremental additions to headcount is reflected in the lower gross margin. We have since made adjustments to our modeled vascular segment GMs going forward. And as a reminder, we continue to expect aggregate gross margins to meaningfully contract once WellChec comes back online, given that businesses' relatively narrow margins (~20% - 30%).

Management has delivered on its goal of slashing operating expenses, which ballooned in late 2015. As a reminder, Q4 2015 saw OpEx jump 90% ($2.7M to $5.2M) from the previous quarter. Much of that increase related to stock compensation as well as initial start up costs related to WellChec. Since then SMLR has tightened the belt, resulting in OpEx falling to $2.0M in both Q1 and Q2 of this year. While we expect some incremental spend when WellChec returns, our model continues to reflect expectations of ongoing cost-control with OpEx growth trailing that of revenue. This, coupled with expectations of consistent top-line growth, has us modeling significant improvement in profitability. And despite some expected contraction in gross margin, we think net loss improves from $8.5M in 2015 to $3.8M in 2016.

SMLR exited Q2 with $1.0M in cash. Management believes the current cash balance will be sufficient to get them to a point of profitability and positive cash flow generation.

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 and increasing order sizes. QuantaFlo appears to be a winner and one we think has the potential to steepen the revenue curve even further. Migration of customers from FloChec to QuantaFlo, which commands as much as 50% or more in premium pricing, has been a catalyst to vascular testing revenue as has onboarding of new customers. And with gross margins of ~70%, instruments should be a strong driver of operating leverage.

The WellChec business has shown early promise – at least from a revenue perspective. This segment is much more difficult to model given that contracts can be fairly short term and there is little visibility on length and size of contracts or what may be in the customer pipeline. However, management's comments indicate that they have had a positive reception from customers and view WellChec as having significant potential in not only top-line growth but now with learning-curve related wrinkles being ironed out, in positively contributing to profitability. When WellChec comes back online - which is now expected to be Q4 of this year, it may provide another glimpse and gauge of the viability of this segment.

Importantly SMLR is just scratching the surface of the potential for WellChec. They are currently only concentrating on existing customer accounts, which alone have significant revenue upside potential – possibly to the tune of tens of millions of dollars. SMLR will focus on delivering quality and value-added testing services, making sure that existing accounts are well taken care of before expanding outwards.

We have revenue growing in the mid teens% in 2016, accelerating to ~30% in 2017 and 2018 reflecting full years' contribution from WellChec and then graduating down to the mid-teens in the out-year (2019) in our model. We think this is reasonable, or perhaps conservative, given the recurring revenue streams of the instruments business and the very strong revenue growth that WellChec could produce. Our revenue estimates, like all of our inputs, are subject to change.

We also expect to see much more scalability in operations as revenue grows and "learning-curve" expenses related to WellChec begin to temper. 1H 2016 was very solid in the operating expense category – if SMLR can maintain this level going forward as they believe they can, profitability should improve very rapidly. Q4, when WellChec is expected to come back online should be revealing in terms of SMLR's ability to control expense growth. We expect operating leverage to improve in 2016 and beyond.

We use a 10-year DCF model to value SMLR. We model 10-year revenue CAGR of 25%, which again we think is reasonable if not conservative given the historical much higher rate of growth along with the recurring revenue model and strong start to WellChec. We show incremental widening of gross margin in 2016 benefitting from lower WellChec revenue as compared to the prior year but then remaining largely stable in our out years as QuantaFlo-driven growth in vascular margins are offset by lower margin WellChec contribution. This coupled with scaling operating expenses consistent with growing revenues and efficiencies in SG&A has us modeling initial positive net income in mid-to-late 2019. Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $6.50/share. This equates to a price/sales (2016) multiple of about 4x which we think is a fair given the company's high revenue growth rate, 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.

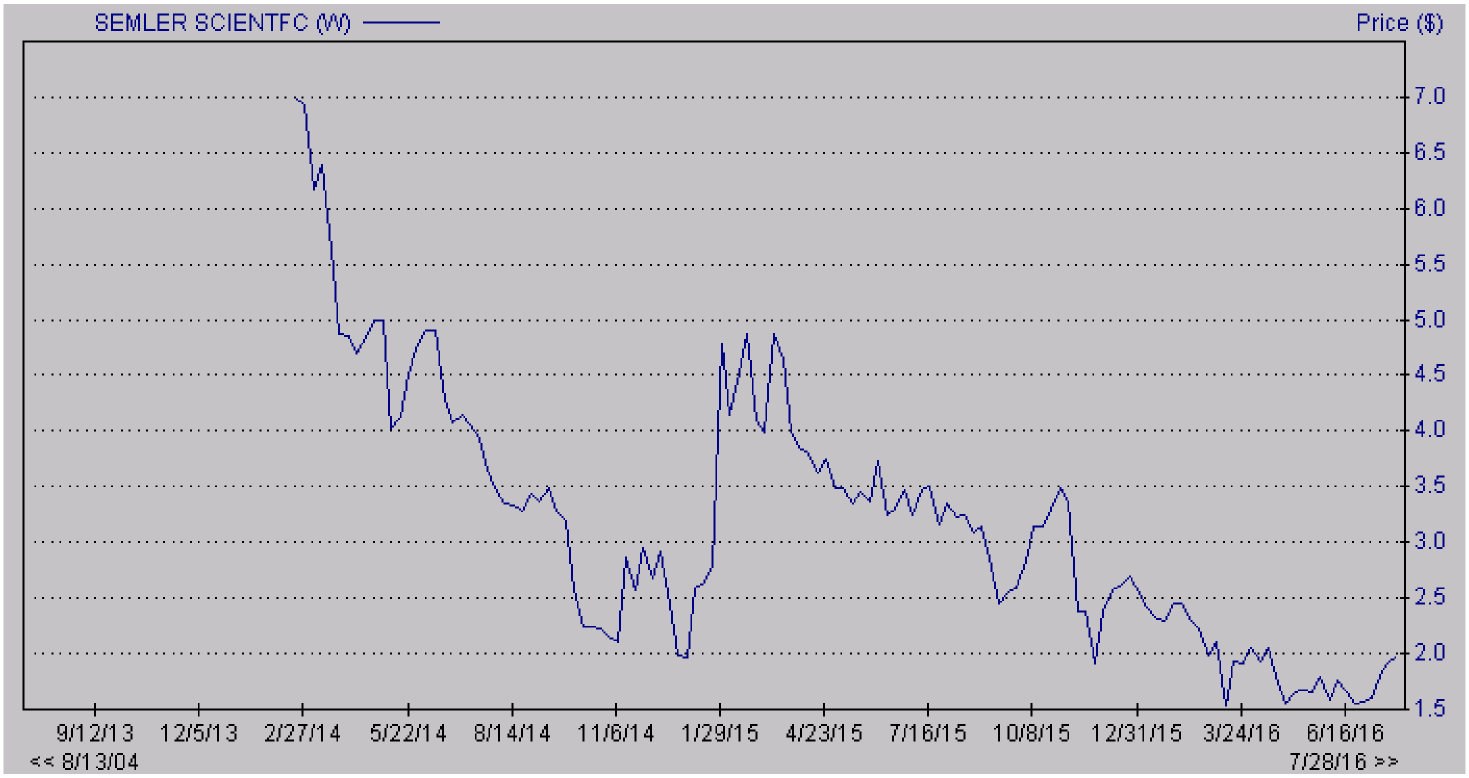
FINANCIAL MODEL

Semler Scientific, Inc

	2015 A	Q1A	Q2A	Q3E	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$7,001.0	$1,501.0	$1,636.0	$1,842.0	$3,170.0	$8,149.0	$11,742.4	$15,209.8	$18,533.2
YOY Growth	*92.6%*	*24.9%*	*25.6%*	*17.9%*	*8.0%*	*16.4%*	*31.5%*	*28.0%*	*16.5%*
Cost of Revenues	$2,809.0	$417.0	$533.0	$571.0	$1,556.5	$3,077.5	$4,456.9	$5,187.6	$6,330.0
Gross Income	$4,192.0	$1,084.0	$1,103.0	$1,271.0	$1,613.6	$5,071.5	$7,285.4	$10,022.3	$12,203.1
Gross Margin	*59.9%*	*72.2%*	*67.4%*	*69.0%*	*50.9%*	*62.2%*	*62.0%*	*65.9%*	*65.8%*
R&D	$1,436.0	$270.0	$182.0	$207.0	$247.0	$906.0	$1,016.0	$1,087.0	$1,112.0
% R&D	*20.5%*	*18.0%*	*11.1%*	*11.2%*	*7.8%*	*11.1%*	*8.7%*	*10.0%*	*6.0%*
Selling & Mktg	$6,304.0	$974.0	$1,028.0	$1,116.0	$1,266.0	$4,384.0	$5,577.0	$6,844.0	$7,580.1
% Sell&Mktg	*90.0%*	*64.9%*	*62.8%*	*60.6%*	*39.9%*	*53.8%*	*47.5%*	*47.2%*	*40.9%*
G&A	$4,871.0	$772.0	$763.0	$777.0	$841.0	$3,153.0	$3,489.0	$3,841.0	$4,299.7
% G&A	*69.6%*	*51.4%*	*46.6%*	*42.2%*	*26.5%*	*38.7%*	*29.7%*	*27.4%*	*23.2%*
Operating Income	($8,419.0)	($932.0)	($870.0)	($829.0)	($740.5)	($3,371.5)	($2,796.6)	($1,749.7)	($788.6)
Operating Margin	*-120.3%*	*-62.1%*	*-53.2%*	*-45.0%*	*-23.4%*	*-41.4%*	*-23.8%*	*-11.5%*	*-4.3%*
Interest expense (income)	$82.0	$74.0	$96.0	$117.0	$117.0	$404.0	$468.0	$38.0	$38.0
Other Expense total	$82.0	$74.0	$96.0	$117.0	$117.0	$404.0	$468.0	$38.0	$38.0
Pre-Tax Income	($8,501.0)	($1,006.0)	($966.0)	($946.0)	($857.5)	($3,775.5)	($3,264.6)	($1,787.7)	($826.6)
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)	($1,006.0)	($966.0)	($946.0)	($857.5)	($3,775.5)	($3,264.6)	($1,787.7)	($826.6)
YOY Growth	*-88.3%*	*26.7%*	*28.0%*	*40.1%*	*79.6%*	*55.6%*	*13.5%*	*45.2%*	*53.8%*
Net Margin	*-121.4%*	*-67.0%*	*-59.0%*	*-51.4%*	*-27.0%*	*-46.3%*	*-27.8%*	*-11.8%*	*-4.5%*
EPS	($1.73)	($0.20)	($0.19)	($0.17)	($0.15)	($0.70)	($0.48)	($0.24)	($0.11)
YOY Growth	*-56.3%*	*31.8%*	*30.0%*	*45.8%*	*82.2%*	*59.2%*	*31.8%*	*50.3%*	*55.0%*
Diluted Shares O/S	4,928	5,124	5,124	5,500	5,700	5,362	6,800	7,500	7,700

Brian Marckx, CFA

HISTORICAL ZACKS RECOMMENDATIONS



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