August 3, 2018

Zacks Small-Cap Research

Sponsored – Impartial - Comprehensive

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

scr.zacks.com

10 S. Riverside Plaza, Chicago, IL 60606

Semler Scientific (SMLR-OTC)

SMLR: Q2: Huge Beat to Our #s. Huge Upward Revisions to Our Model and Price Target…

We have, again, made meaningful upward revisions to our forecasted revenue and EPS in every period in our model. Our 10-yr DCF model now values SMLR at approximately $25/share. This equates to a price/sales (2019) multiple of about 4.5x and 2019 P/E multiple of 26x - both of which we think are very reasonable (and arguably conservative).

Current Price (08/03/18)	$22.00
Valuation	**$25.00**

OUTLOOK

The consistency and regularity of revenue growth and flatness of expenses lend credence to the validity of the company's business model and strategy. 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 growth curve would look like, they rarely play out like this. We are quickly warming up to the idea that SMLR is the needle-in the-haystack type of investment that we had hoped it could be. Management deserves much credit for the company's success to-date, including 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 a long-term holding is that it appears the company may be in the right spot at the right time as awareness of PAD is increasing and helping to drive an increase in testing. Our DCF now values the company at $25/share, which equates to 4.5x P/S (2019) and 26x P/E. Given their growth rate, profitability and cash flow generation, we may still end up too conservative.

SUMMARY DATA

52-Week High	**$22.00**
52-Week Low	**$3.20**
One-Year Return (%)	**587.50**
Beta	**0.63**
Average Daily Volume (sh)	**25,596**
Shares Outstanding (mil)	**6**
Market Capitalization ($mil)	**$131**
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 (%)	**49.7**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**68.8**
P/E using 2018 Estimate	**30.6**
P/E using 2019 Estimate	**23.9**
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	4463 A	5484 A	5882 E	6214 E	22042 E
2019					28372 E
2020					34629 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	$0.10 A	$0.19 A	$0.20 E	$0.22 E	$0.72 E
2019					$0.96 E
2020					$1.06 E

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

<u>Q2 2018 Results:</u> *Huge Beat to Our #s. Huge Upward Revisions to Our Model and Price Target…*

Semler's results in each of the last few quarters have indicated that the company could be one of those **needle-in-a-haystack type of investments**. Q2 2018 provided the most validation as it relates to that theme with revenue, net income, EPS and cash flow all crushing prior bests – most impressive was EPS of $0.19 (and that's a clean $0.19). Results have been on a tear with revenue increasing at an average of more than 16% per quarter since Q2 '16 – with only one of the eight quarters (Q1 '17) experiencing a contraction (and that is explained by typical seasonal softness in Q1). And expenses have all but flatlined – over the same period, operating expenses (including cost of revenue) grew an average of just over 3%.

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 Q2 as well. 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. Q2 may have been somewhat of a milestone period in that regard.

Management continues to guide for revenue to grow faster than expenses and is aiming for 2018 to be the first full year of profitability. With $2.2M of net income already generated through the first half of the year, full-year profitability seems like almost a given (for context, FY2017 net loss was $1.5M: Q1 -$871k, Q2 -$850k, Q3 -$41k, Q4 +$254k) – that certainly fits with management's recent conservativeness in terms of guidance. Following Q2 results we have made significant upward revisions to our forecasted revenue. Given SMLR has continued to keep expense growth at a minimum, we feel comfortable in that trend continuing. The updates to our model have also benefited our price target ($25).

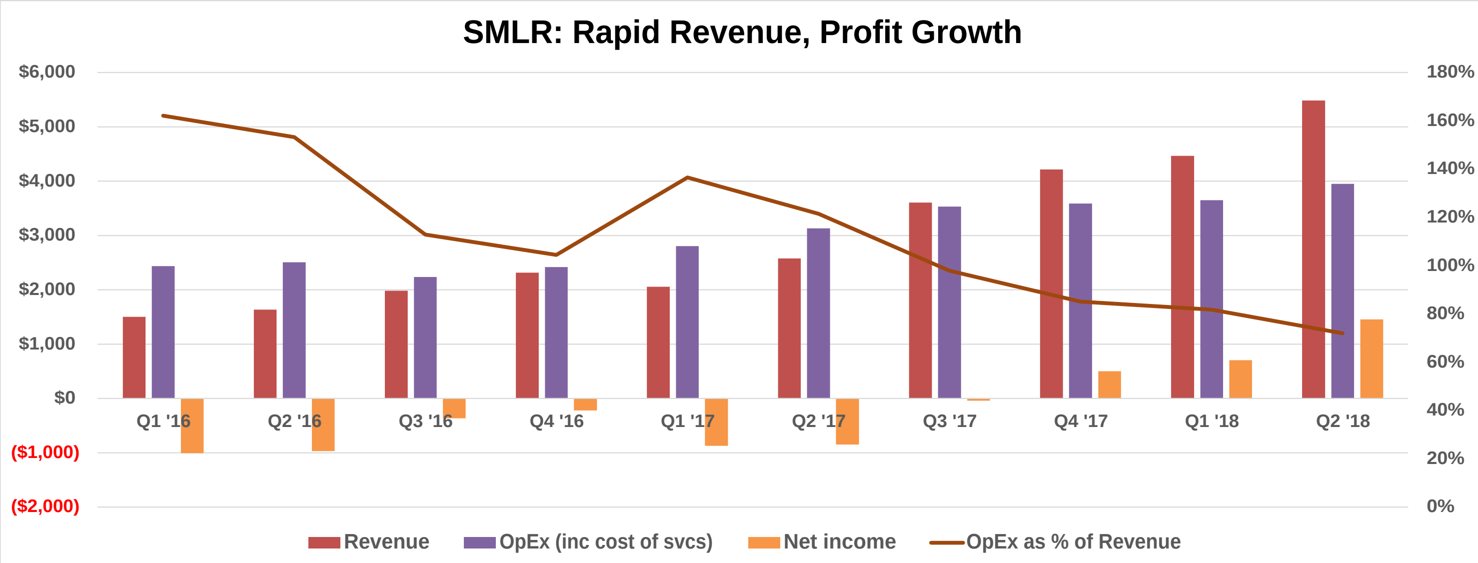
Q2 numbers…
Revenue was $5.5M, up 113% (+$2.9M) yoy, up 23% ($1.0M) sequentially and about 17% higher than our $4.7M estimate. It was also a new record high. Usage fees (from the HRA channel) were approximately $1.5M – roughly double the ~$750k generated in Q1 and nearly 5x from the prior year period ($309k). Usage fees increased sequentially every quarter during 2017 and we continue to forecast that pattern repeating through the remainder of 2018. Meanwhile, licensing revenue continues to charge higher. Licensing revenue was approximately $4.0M in Q2, up ~76% yoy (+$1.7M) and ~7% sequentially (+$287k).

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 HRA channel as quickly become a meaningful contributor to revenue – usage fees were approximately $467k in 2016, accounting for just 6% of total revenue in that year. Usage fees grew to almost $2.1M in 2017, or about 17% of total revenue and accounted for 22% ($2.2M) of total revenue through 1H 2018.

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.

Q2 operating expenses (including cost of revenue) were $4.0M, or 72%, which is a new record low. That compares to Q1's 82% and our 85% estimate. 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 $1.5M – more than double the $706k in Q1, which was the prior record high. 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).

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 few 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
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
- 1H 2018: excluding changes in working capital, cash flow from operations was positive $3.017M. Free cash flow was $2.774M

In addition, SMLR's loan balance fell by almost $200k. SMLR is also now at nearly a net-cash positive position, with cash balance at Q2 quarter end of $2.0M and total debt of $2.07M. Given expectations of continued strong cash generation, A/R collections and debt retirements, the net-cash position should rapidly increase.

Expect 2018 To Mark First Full-Year of Positive Net Income and Cash Flow
Aside from the updated financial results, SMLR's story has remained largely the same over the last several quarters. 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. That trend took hold in Q1 '17 and has yet to let up. We noted in our Q1 '18 update (May 3rd) that we believed SMLR had reached a point of sustainable cash flow and anticipated that 2018 would mark the first full year that the company not only generates positive income, but also positive operating cash flow. Q2's results provided greater confidence of the prescience of those predictions.

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. 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. Since then, R&D has flattened on a dollar basis and, despite record high R&D spend in Q2 '18 ($489k), has substantially fallen on a percentage-of-revenue basis.

These investments have benefitted revenue growth and improved profitability. So, while R&D expense has increased, as a percentage of revenue it has done the opposite. R&D expense increased by almost $1M from FY2016 to FY2017 but over the same period, revenue and gross income grew by $5.0M and $4.3M, respectively – implying incremental ROI of more than 300%. Results through the first half of 2018 indicate that the return on these investments is not only still growing, but it is significantly accelerating – in fact, it's not calculable as R&D expense fell (on both a 1H yoy basis and 1H annualized yoy basis) while incremental gross income grew $5.1M.

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, while we have made some fairly significant positive adjustments to our model following Q2 '18 results, 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 have underestimated revenue growth and improvement in profitability for the last three straight quarters. And while we have, again, made upward revisions to our model, we could still very possibly end up too conservative given that we assume q-to-q revenue grows at an average of just better than $350k through Q4 of this year – which compares to average q-to-q revenue growth of more than $600k over the last three quarters.

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.

Our DCF model has significantly changed given SMLR's higher than previously expected revenue growth rate and much more rapid growth in cash flow and profitability. We use a 10-year DCF model to value SMLR. We now model 10-year revenue CAGR of 34%. 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 SMLR to generate significant net income through the remainder of 2018. While we had previously modeled 2018 net income and EPS of $2.6M and $0.36, we now estimate $5.4M and $0.72. We look for 2018 revenue of $22.0M (revised from $19.2M).

EPS in our out-years is now 2019 $0.96 (from $0.58) and 2020 $1.06 (from $0.58).

Our 10-yr DCF model, which uses an 10% discount and 2% terminal growth rate, **now values SMLR at approximately $25/share.** This equates to a price/sales (2019) multiple of about 4.5x and 2019 P/E multiple of 26x - both of which we think are very reasonable (and arguably conservative) given SMLR's outsized growth rate (in both revenue and income), cash generation, recent history of consistent and significant financial improvement, scalability of operations, competitive position in what looks like a quickly burgeoning space and proven abilities of management.

Cash flow multiple suggest SMLR could be worth $30+/share

While SMLR's cash-flow positive position is still too nascent for us to be comfortable using a cash-flow multiple to value the stock, we think including a brief discussion on the topic is worthwhile. SMLR generated $3.0M of cash in 1H '18, or $6M annualized. If we (perhaps very conservatively) assume a long-term sustainable cash flow growth rate of 7.5%, at a 10% discount rate, the Gordon Growth Model implies a 40x cash flow multiple. Which values SMLR at $31.5/share today. So, while we do not yet think it is an appropriate valuation methodology, a little more history may warrant use of it.

FINANCIAL MODEL

Semler Scientific, Inc

	2016 A	2017 A	Q1A	Q2A	Q3E	Q4E	2018 E	2019 E	2020 E
Total Revenues	$7,435.0	$12,453.0	$4,463.0	$5,484.0	$5,881.5	$6,213.5	$22,042.0	$28,371.8	$34,629.4
YOY Growth	6.2%	67.5%	117.2%	112.7%	63.1%	47.5%	77.0%	28.7%	22.1%
Cost of Revenues	$1,873.0	$2,554.0	$704.0	$680.0	$758.7	$776.7	$2,919.4	$3,404.6	$4,155.5
Gross Income	$5,562.0	$9,899.0	$3,759.0	$4,804.0	$5,122.8	$5,436.8	$19,122.6	$24,967.2	$30,473.9
Gross Margin	74.8%	79.5%	84.2%	87.6%	87.1%	87.5%	86.8%	88.0%	88.0%
R&D	$867.0	$1,831.0	$367.0	$489.0	$520.0	$554.0	$1,930.0	$2,366.0	$2,908.9
% R&D	11.7%	14.7%	8.2%	8.9%	8.8%	8.9%	8.8%	8.3%	8.4%
Selling & Mktg	$3,827.0	$5,077.0	$1,705.0	$1,779.0	$1,882.1	$1,988.3	$7,354.4	$9,079.0	$10,908.3
% Sell&Mktg	51.5%	40.8%	38.2%	32.4%	32.0%	32.0%	33.4%	32.0%	31.5%
G&A	$3,028.0	$3,843.0	$874.0	$1,001.0	$1,095.0	$1,126.0	$4,096.0	$5,021.8	$5,887.0
% G&A	40.7%	30.9%	19.6%	18.3%	18.6%	18.1%	18.6%	17.7%	17.0%
Operating Income	($2,160.0)	($852.0)	$813.0	$1,535.0	$1,625.7	$1,768.5	$5,742.2	$8,500.4	$10,769.7
Operating Margin	-29.1%	-6.8%	18.2%	28.0%	27.6%	28.5%	26.1%	30.0%	31.1%
Other Expense total	$394.0	$656.0	$107.0	$82.0	$72.0	$55.0	$316.0	$110.0	$0.0
Pre-Tax Income	($2,554.0)	($1,508.0)	$706.0	$1,453.0	$1,553.7	$1,713.5	$5,426.2	$8,390.4	$10,769.7
Taxes	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$922.9	$2,369.3
Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	11.0%	22.0%
Net Income	($2,554.0)	($1,508.0)	$706.0	$1,453.0	$1,553.7	$1,713.5	$5,426.2	$7,467.4	$8,400.4
YOY Growth	70.0%	41.0%	181.1%	270.9%	3889.5%	-574.6%	459.8%	-37.6%	-12.5%
Net Margin	-34.4%	-12.1%	15.8%	26.5%	26.4%	27.6%	24.6%	26.3%	24.3%
EPS	($0.50)	($0.27)	$0.10	$0.19	$0.20	$0.22	$0.72	$0.96	$1.06
YOY Growth	71.1%	46.7%	158.2%	221.2%	2824.2%	-486.7%	371.5%	-33.5%	
Diluted Shares O/S	5,124	5,672	7,280	7,535	7,600	7,650	7,516	7,750	7,950

Brian Marckx, CFA

HISTORICAL STOCK PRICE

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.