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Zacks Small-Cap Research

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Semler Scientific (SMLR-OTCQB)

SMLR: Q3: Revenue Up 55%, Cash Flow Continues To Churn, Balance Sheet Cleaned, Moving PT to $35/share

SMLR generated ~$5.0M of cash through the first nine months and we estimate $7.0M for the full year, 2018. The Gordon Growth Model implies a 40x cash flow multiple, which values SMLR at $35/share today.

Current Price (10/29/18)	$31.50
Valuation	**$35.00**

OUTLOOK

Each of the last several consecutive quarters' financial results has incrementally bolstered the likely long-term viability of Semler's business model and sustainability of growth of revenue/earnings/cash flow-generation. Q3, which as management mentioned on the call was the best in company history (at least from a financial standpoint), provides additional support to that theme. Given Q3's strong numbers, including robust cash flow, we think there is now more risk of incorporating a cash flow multiple-based valuation methodology too late than in introducing it too soon. As such, we are moving from a DCF to a Gordon Growth Model-derived cash flow multiple to value SMLR's equity. SMLR generated ~$5.0M of cash through the first nine months and we estimate $7.0M for the full-year 2018. We expect cash flow to increase into 2019 but also model some offset from additional increase in share count – we estimate our $35/share target to be valid over the next ~6 months and look for potential upside towards a mid-2019 timeframe. 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.

SUMMARY DATA

52-Week High	**$39.35**
52-Week Low	**$5.75**
One-Year Return (%)	**424.83**
Beta	**0.68**
Average Daily Volume (sh)	**52,879**
Shares Outstanding (mil)	**6**
Market Capitalization ($mil)	**$198**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**2**
Insider Ownership (%)	**14**
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 2018 Estimate	**47.7**
P/E using 2019 Estimate	**38.9**
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)
2017	2055 A	2578 A	3607 A	4213 A	12453 A
2018	4463 A	5484 A	5579 A	6088 E	21614 E
2019					27805 E
2020					33948 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	$0.19 A	$0.18 E	$0.66 E
2019					$0.81 E
2020					$0.89 E

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

Q3 2018 Results: *Revenue up 55%, cash flow continues to churn, balance sheet cleaned, moving PT to $35/share…*

While revenue in Q3 was meaningfully below our estimate, it was nonetheless a new record high, up 55% yoy and 2% better than Q2. Revenue is expected to continue to climb from what we think is a new base level. Meanwhile EPS was largely inline with our estimate and, at $0.19, tied with the record set in Q2 of this year. Net income and EPS through the first nine months of the year was $3.6M and $0.48, compared to a $1.8M net loss and ($0.33) EPS in the comparable prior year period. But, perhaps the most significant highlight (given that we subscribe to 'cash is king') is operating cash flow – which was ~$1.9M in Q3 and $5.0M through the first nine months of the year.

Each of the last several consecutive quarters' financial results has incrementally bolstered the likely long-term viability of Semler's business model and sustainability of growth of revenue/earnings/cash flow-generation. Q3, which as management mentioned on the call was the best in company history (at least from a financial standpoint), provides additional support to that theme. And with cash flow churning higher, cash balance growing and the balance sheet continuing to clean up, our comfort level with 'cash flow multiple' as an appropriate valuation methodology has similarly been bolstered.

Cash flow multiple values SMLR at $35/share…

Given Q3's strong numbers, including robust cash flow, we think there is now more risk of incorporating a cash flow multiple-based valuation methodology too late than in introducing it too soon. As such, we are moving from a DCF to a Gordon Growth Model-derived cash flow multiple to value SMLR's equity. SMLR generated ~$5.0M of cash through the first nine months and we estimate $7.0M for the full-year 2018. We expect cash flow to increase into 2019 but also model some offset from additional increase in share count – we estimate our $35/share target to be valid over the next ~6 months and look for potential upside towards a mid-2019 timeframe. 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.

NASDAQ uplisting is in view…

The strong income growth, balance sheet cleansing and rapid increase in shareholders equity gets SMLR closer to meeting NASDAQ eligibility requirements. Stockholders' equity increased by nearly $2.1M in Q3 to $2.3M and, subsequent to quarter-end, $350k worth of warrants were exercised for the purchase of 1.03M common shares. We think SMLR could meet the $5M minimum stockholder's equity requirement for uplisting to NASDAQ by the time they report Q4/full-year results (March 2019), or shortly thereafter (they will also need to bring on at least another three independent directors in order to meet that related mandate).

Growth story remains intact…

The story and our outlook remain largely intact. So, we reiterate our comments following Q2 results… 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 Q3 and throughout 2018 as a whole. 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 – and we think Q3 numbers add further and substantive support to that theory.

Management continues to guide for revenue to grow faster than expenses and for profitability and positive cash flow to persist. As Q4 has historically been SMLR's strongest period in terms of revenue and, coupled with expectations that operating (including cost of revenue) remains largely flattish, we think Semler will finish the year strong. We now look for full-year revenue, net income and EPS of $21.6M, $5.3M and $0.66, compared to $12.5M, ($1.5M) and ($0.27) in the prior year. We also ballpark cash flow from operations of approximately $2.0M in Q4 and $7.0M for the full year.

Q3 numbers…

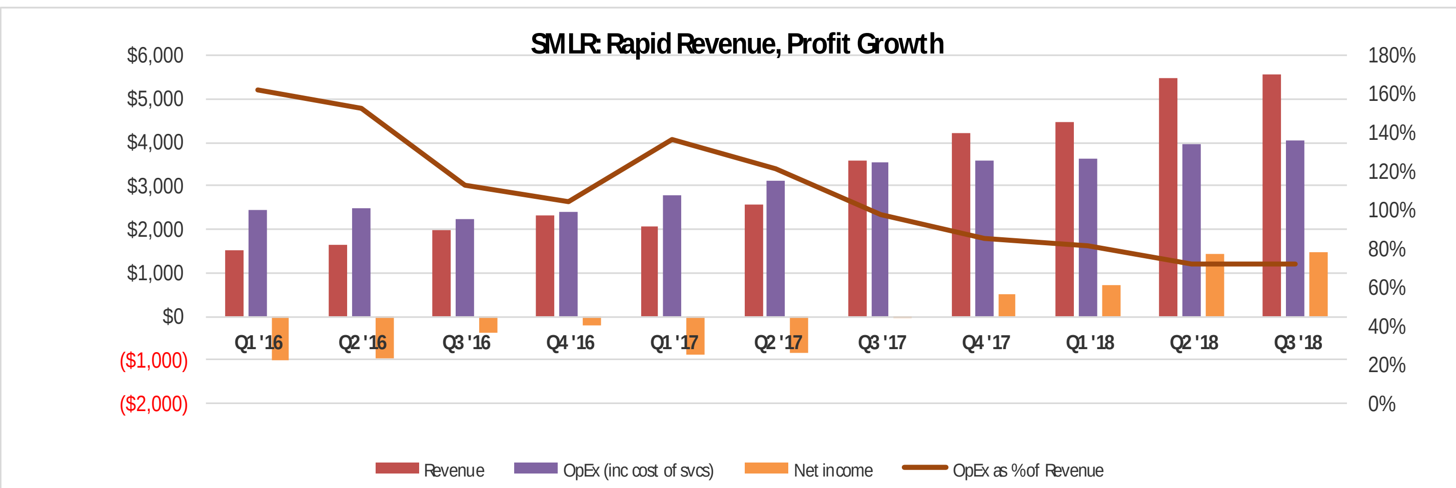
Revenue was $5.6M, up 55% (+$2.0M) yoy, up 2% (+$95k) sequentially and about 5% (~$300k) lower than our $5.9M estimate. It was also a new record high. Usage and other fees (from the HRA channel) were approximately $1.4M – roughly flat from Q2 but nearly double the $772k from Q3 2017. We had anticipated usage fees to grow sequentially – as they had for the previous ~10 quarters, which explains ~2/3 of the miss on total revenue in Q3.

Importantly, comments on the call suggest that the pattern of usage (and other) fees growing sequentially from Q1 through Q4 each year is likely to repeat itself in 2019 (and beyond). Meanwhile, licensing revenue continues to charge higher, albeit slightly less so than we had forecast for Q3. Licensing revenue was approximately $4.2M in Q3, up ~46% yoy (+$1.3M), up ~4% sequentially (+$148k) and about 2% shy of our $4.3M estimate.

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 has quickly become a meaningful contributor to revenue – usage fees were approximately $467k in 2016, accounting for just 6% of total revenue in that year, then grew to almost $2.1M in 2017, or 17% of total revenue. Usage fees accounted for 26% and 24% of total revenue in the most recent three and nine-month periods, respectively.

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.

Q3 operating expenses (including cost of revenue) were $4.0M, or 72%, which ties the record low set in Q2 and compares to $3.5M, or 98% of total revenue, in the prior-year period. Through the first nine months of 2018, operating expenses were $11.6M, equal to 75% of revenue, compared to $9.5M and 115% in the prior year. 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.



Q3 net income was $1.5M – roughly flat from Q2 but more than double the $706k in Q1 and compares to a $41k net loss in Q3 2017. 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 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 / 9-months 2018: we don't have all the details as the 10-Q will be filed later this week. But, using the information from the earnings release and on the conference call, it appears cash flow from operations (excluding working capital) was approximately $1.9M in Q3. That would put YTD cash flow from operations at almost $5.0M and YTD free cash flow (which accounts for ~$450k in capex) at around $4.5M

SMLR has also rapidly cleaned up their balance sheet. Including cash payments made during, and subsequent to, Q3, Semler retired $2.2M in debt principal and related interest and is now effectively debt-free. Given expectations of continued strong cash generation, the cash position should rapidly increase.

Profitability, ROI Ramping…

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. The last two quarters have 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 expense increased just 7% through the first nine months of the current year and, despite record high R&D spend in the last two quarters, has substantially fallen on a percentage-of-revenue basis.

These investments have benefitted revenue growth and improved profitability. 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 nine months of 2018 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 now model 10-year revenue CAGR of 35%. We show flattish gross margin from the very healthy current level (89%) 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 through the remainder of 2018 and into the foreseeable future. We model 2018 net income and EPS of $5.2M and $0.66, revised from $5.4M and $0.72. Our downward revisions relate to the topline miss in Q3 and, mostly, to a higher than anticipated outstanding share count, respectively. We look for 2018 revenue of $21.6M (revised from $22.0M).

EPS in our out-years is now 2019 $0.81 (from $0.96) and 2020 $0.89 (from $1.06) – the revisions relate mostly to the updated share count.

Cash flow multiple puts fair value at $35/share

In August, when we published following Q2 results, we noted that we thought SMLR's cash flow generating position could warrant use of a cash flow multiple to value the shares. But, given cash flow multiple inherently requires assumed consistent cash flow in all future periods, we also indicated that we wanted to see more evidence of the company's ability to continue to generate cash before incorporating that methodology. Given Q3's strong numbers, including robust cash flow, we think there is now more risk of incorporating it too late than in introducing it too soon. As such, we are moving from a DCF to a Gordon Growth Model-derived cash flow multiple to value SMLR's equity.

SMLR generated ~$5.0M of cash through the first nine months and we estimate $7.0M for the full year, 2018. Assuming a (perhaps, very conservative) long-term sustainable cash flow growth rate of 7.5%, at a 10% discount rate, the Gordon Growth Model implies a (1/0.10 – 0.075 =) 40x cash flow multiple. Which values SMLR at

$35/share today on a fully-diluted basis. We expect cash flow to increase into 2019 but also model some offset from additional increase in share count – we estimate our $35/share target to be valid over the next ~6 months and look for potential upside towards a mid-2019 timeframe. 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

	2016 A	2017 A	Q1A	Q2A	Q3A	Q4E	2018 E	2019 E	2020 E
Total Revenues	$7,435.0	$12,453.0	$4,463.0	$5,484.0	$5,579.0	$6,088.1	$21,614.1	$27,804.8	$33,948.3
YOY Growth	6.2%	67.5%	117.2%	112.7%	54.7%	44.5%	73.6%	28.6%	22.1%
Cost of Revenues	$1,873.0	$2,554.0	$704.0	$680.0	$615.0	$669.7	$2,668.7	$3,197.6	$3,904.1
Gross Income	$5,562.0	$9,899.0	$3,759.0	$4,804.0	$4,964.0	$5,418.4	$18,945.4	$24,607.3	$30,044.2
Gross Margin	74.8%	79.5%	84.2%	87.6%	89.0%	89.0%	87.7%	88.5%	88.5%
R&D	$867.0	$1,831.0	$367.0	$489.0	$587.0	$518.0	$1,961.0	$2,384.0	$2,851.7
% R&D	11.7%	14.7%	8.2%	8.9%	10.5%	8.5%	9.1%	8.6%	8.4%
Selling & Mktg	$3,827.0	$5,077.0	$1,705.0	$1,779.0	$1,798.0	$2,076.0	$7,358.0	$8,897.5	$10,693.7
% Sell&Mktg	51.5%	40.8%	38.2%	32.4%	32.2%	34.1%	34.0%	32.0%	31.5%
G&A	$3,028.0	$3,843.0	$874.0	$1,001.0	$1,033.0	$1,126.3	$4,034.3	$4,671.2	$5,499.6
% G&A	40.7%	30.9%	19.6%	18.3%	18.5%	18.5%	18.7%	16.8%	16.2%
Operating Income	($2,160.0)	($852.0)	$813.0	$1,535.0	$1,546.0	$1,698.1	$5,592.1	$8,654.5	$10,999.2
Operating Margin	-29.1%	-6.8%	18.2%	28.0%	27.7%	27.9%	25.9%	31.1%	32.4%
Other Expense total	$394.0	$656.0	$107.0	$82.0	$78.0	$64.0	$331.0	$110.0	$0.0
Pre-Tax Income	($2,554.0)	($1,508.0)	$706.0	$1,453.0	$1,468.0	$1,634.1	$5,261.1	$8,544.5	$10,999.2
Taxes	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$939.9	$2,419.8
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	$1,468.0	$1,634.1	$5,261.1	$7,604.6	$8,579.4
YOY Growth	70.0%	41.0%	181.1%	270.9%	3680.5%	-543.3%	448.9%	-44.5%	-12.8%
Net Margin	-34.4%	-12.1%	15.8%	26.5%	26.3%	26.8%	24.3%	27.3%	25.3%
EPS	($0.50)	($0.27)	$0.10	$0.19	$0.19	$0.18	$0.66	$0.81	$0.89
YOY Growth	71.1%	46.7%	158.2%	221.2%	2567.6%	-380.3%	350.1%	-21.7%	
Diluted Shares O/S	5,124	5,672	7,280	7,535	7,928	8,911	7,914	9,400	9,650

Brian Marckx, CFA

HISTORICAL STOCK PRICE

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