February 28, 2019

Zacks Small-Cap Research

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Semler Scientific (SMLR-OTCQB)

Q4 Results: Revenue, Earnings & Cash Flow Continue to Climb. Cash Flow Forecast Implies $45/Share Fair Value

We estimate SMLR will generate ~$11M in cash in 2019. Based on the Gordon Growth Model, we calculate fair value at approximately $45/share.

Current Price (02/28/19)	$40.50
Valuation	**$45.00**

OUTLOOK

Despite a slight miss on Q4 earnings, we remain highly encouraged by the financial results, particularly as cash flow generation continues to be significant. Semler generated positive earnings and operating cash flow in every quarter during 2018, a trend that is expected to continue for the foreseeable future.

While the guidance includes the potential for some variability in the topline as associated with some 'bulky' order flow, the expectation remains that revenue will grow sequentially and continue to trend higher for the long-term. Gross margins ended 2018 at an average of better than 87% and could still have more room to widen. And while we may see some additional spend related to sales and support infrastructure as well as on areas aimed at enhancing the customer experience, management has demonstrated an ability to turn those 'investments' into revenue and profitability growth in short order. Our updated model shows SMLR generating revenue and EPS of $28.4M and $0.91 in 2019, which implies respective growth of 32% and 39%. If our model proves reasonably accurate, we think operating cash flow could be $11M (or possibly higher) in 2019. This implies SMLR is worth ~$45/share.

SUMMARY DATA

52-Week High	**$42.89**
52-Week Low	**$7.72**
One-Year Return (%)	**393.98**
Beta	**1.29**
Average Daily Volume (sh)	**17,685**
Shares Outstanding (mil)	**6**
Market Capitalization ($mil)	**$255**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**20**
Insider Ownership (%)	**46**
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	**44.5**
P/E using 2020 Estimate	**38.2**
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	6603 E	6719 E	7269 E	7763 E	28355 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	$0.22 E	$0.20 E	$0.24 E	$0.26 E	$0.91 E
2020					$1.06 E
2021					$1.36 E

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

Q4 2018 Results: *Revenue, Earnings & Cash Flow Continue to Climb. Cash Flow Forecast Implies $45/Share Fair Value…*

Semler reported financial results for the fourth quarter ending December 31, 2018. While revenue slightly missed our estimate, it nonetheless came in strong – up 42% yoy, 7% better than Q3 and a new record high. Gross margin, at 88.2%, also remains strong and continues to show an incremental upward trajectory. Meanwhile, operating expenses were higher than what had anticipated and at an all-time high. The net result was EPS of $0.17, a penny miss to our $0.18 estimate, up from $0.04 in the prior year period and down from $0.19 in Q3'18.

But, despite the small earnings miss, we remain highly encouraged by the financial results, particularly as cash flow generation continues to be significant. Semler generated positive earnings and operating cash flow in every quarter during 2018, a trend that is expected to continue for the foreseeable future. We estimate that cash flow from operations was approximately $2M and $7M in the three and twelve months ending 12/31/18 (we'll know the exact numbers when the 10-K is filed, likely next week). This compares to ~$900k and $440k in the respective prior-year periods. Net income and EPS for the full year were $5.0M and $0.66, compared to ($1.50M) and ($0.27) in 2017.

Management also made a priority of cleaning up their balance sheet and did so with their cash-generating proceeds. As of the close of fiscal 2017, SMLR was carrying more than $3.1M of debt and accrued interest. The was completely repaid by October 2018.

Cash flow estimate implies SMLR is worth $45/share…
As we noted in our Q3 update (Oct 29th *Q3:Revenue Up 55%, Cash Flow Continues To Churn, Balance Sheet Cleaned, Moving PT to $35/share*), given our comfort level with the likelihood of SMLR continuing to generate positive cash flow, we moved our valuation methodology from DCF to a cash flow multiple. Q4's results, coupled with management's 'guidance' of expected sequential revenue growth and sales outpacing that of operating expenses, further bolsters our confidence that our revised methodology is appropriate. Based on our 2019 cash flow estimate, fair value of SMLR is ~$45/share.

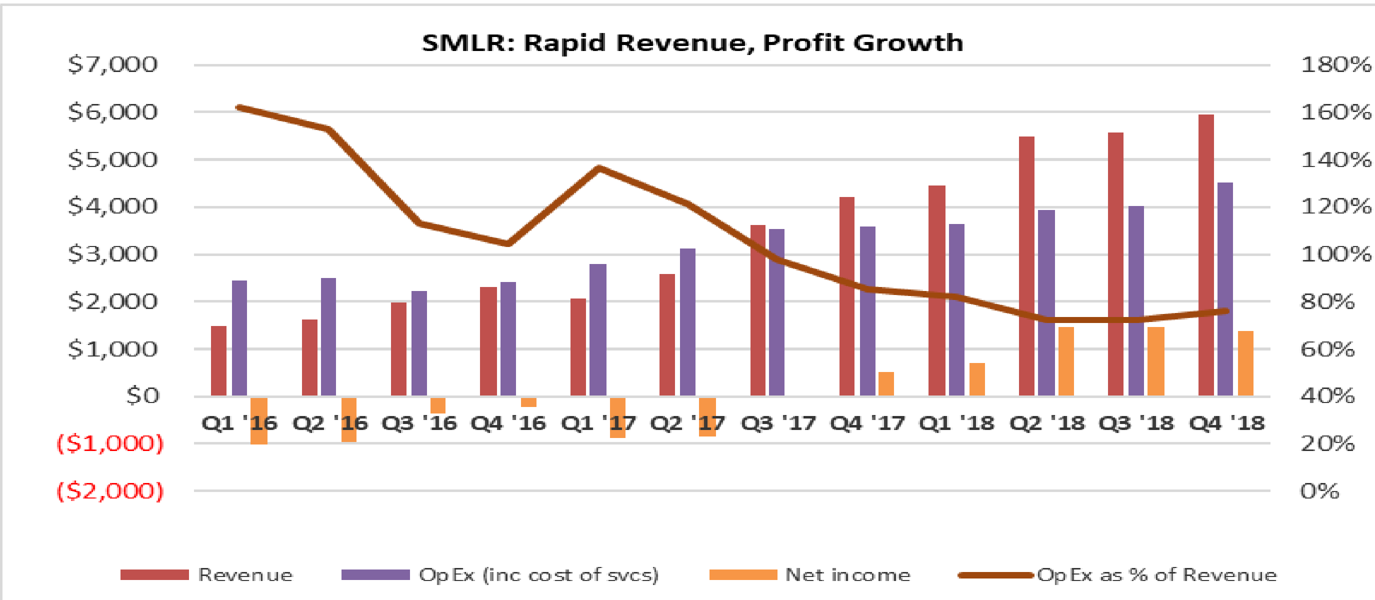
Management continues to guide for revenue to grow faster than expenses and for profitability and positive cash flow to persist. While the guidance includes the potential for some variability in the topline as associated with some 'bulky' order flow, the expectation remains that revenue will grow sequentially and continue to trend higher for the long-term. Gross margins ended 2018 at an average of better than 87% and could still have more room to widen. And while we may see some additional spend related to sales and support infrastructure as well as on areas aimed at enhancing the customer experience, management has demonstrated an ability to turn those 'investments' into revenue and profitability growth in short order. Our updated model shows SMLR generating revenue and EPS of $28.4M and $0.91 in 2019, which implies respective growth of 32% and 39%. If our model proves reasonably accurate, we think operating cash flow could be in the range of $10.5M - $11.5M, and possibly even higher. As it is now, we model cash flow of approximately $11.0M in 2019.

NASDAQ uplisting is in view…
The strong income growth, balance sheet cleansing and rapid increase in shareholders equity has gotten SMLR ever-closer to meeting NASDAQ eligibility requirements. Stockholders' equity increased by $6.8M through the course of 2018, including by $1.9M in Q4, and ended the year at $4.2M. We think SMLR is likely to meet the $5M minimum stockholder equity requirement for uplisting to NASDAQ by the end of Q1 (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 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 Q4 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. The last three or four quarters have further bolstered our confidence in that regard.

Q4 numbers…
Revenue was $6.0M, up 42% (+$1.8M) yoy, up 7% ($385k) sequentially and about 2% (-$124k) lower than our $6.1M estimate. It was also a new record high. Citing a trend of both fixed and variable-type licenses which has resulted in less meaningful distinction between their previously-reported revenue categories of licensing (i.e. implied 'fixed') and usage (i.e. 'variable') fees, management noted that they will now report monthly revenue as either 'fixed' or 'variable'. That breakdown was not shared on the Q4 call although may be something that we can provide some discussion around in future periods.

Q4 operating expenses (including cost of revenue) were $4.5M, or 76% of revenue, which is up from 72% (record low) in Q3'18 but well below the 91% in the prior year period. For the full year, operating expenses were $16.2M, equal to 75% of revenue, which compares to $13.3M and 107% of revenue in 2017. 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.



Q4 net income was $1.4M – about 5% lower than Q3'18, the third highest (behind Q2 and Q3'18) in company history and more than 5x the $254k of net income in Q4'17. 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 2018: excluding changes in working capital, cash flow from operations was positive $1.87M. Free cash flow was $1.667M. Through the first nine months, cash flow and free cash flow were $4.89M and $3.36M
- FY 2018: we estimate full-year cash flow was approximately $7M (we'll know specifically when the 10-K is filed).

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 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 model 10-year revenue CAGR of ~32%. We show flattish gross margin from the very healthy current level (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 $28.4M, $7.6M and $0.91.

EPS in our out-years is now $1.06 (upwardly revised from $0.89) in 2020 and $1.36 in 2021.

Cash flow multiple puts fair value at $45/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 ~$11M in 2019. Assuming a long-term sustainable cash flow growth rate of 7.0%, at a 10% discount rate, the Gordon Growth Model implies a (1/0.10 – 0.070 =) 33x cash flow multiple. This values SMLR at ~$45/share today on a fully-diluted basis. Our price target is based on SMLR generating $11M 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.

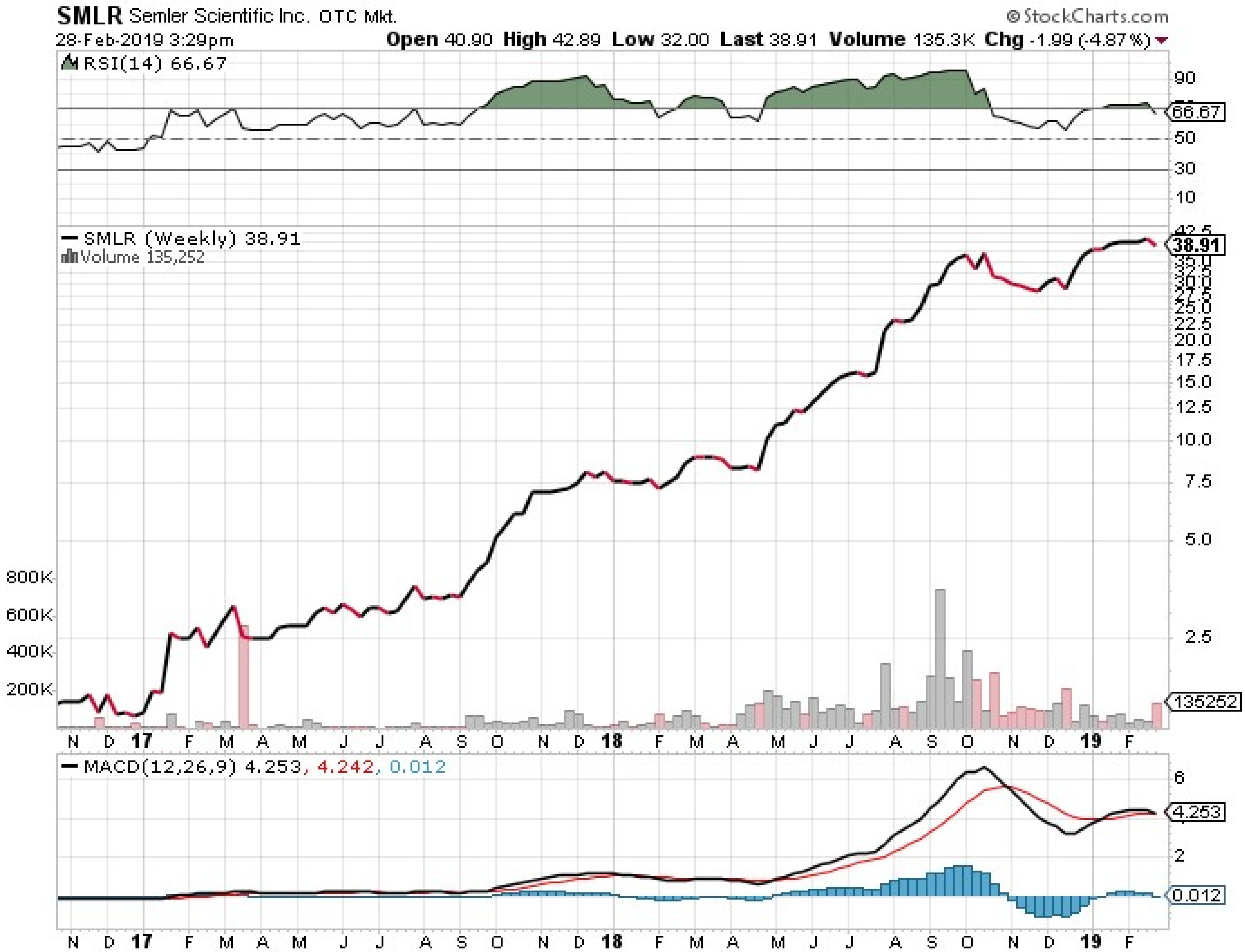
FINANCIAL MODEL

Semler Scientific, Inc

	2017 A	2018 A	Q1	Q2	Q3	Q4	2019 E	2020 E	2021 E
Total Revenues	$12,453.0	$21,490.0	$6,603.3	$6,719.3	$7,269.3	$7,762.7	$28,354.7	$35,683.6	$43,789.1
YOY Growth	*67.5%*	*72.6%*	*48.0%*	*22.5%*	*30.3%*	*30.2%*	*31.9%*	*25.8%*	*22.7%*
Cost of Revenues	$2,554.0	$2,703.0	$766.0	$766.0	$814.2	$853.9	$3,200.0	$3,925.2	$4,816.8
Gross Income	$9,899.0	$18,787.0	$5,837.3	$5,953.3	$6,455.1	$6,908.8	$25,154.6	$31,758.4	$38,972.3
Gross Margin	*79.5%*	*87.4%*	*88.4%*	*88.6%*	*88.8%*	*89.0%*	*88.5%*	*89.0%*	*89.0%*
R&D	$1,831.0	$2,086.0	$677.0	$702.0	$715.0	$731.0	$2,825.0	$3,354.3	$4,028.6
% R&D	*14.7%*	*9.7%*	*10.3%*	*10.4%*	*9.8%*	*9.4%*	*10.0%*	*9.4%*	*9.2%*
Selling & Mktg	$5,077.0	$7,201.0	$2,126.3	$2,150.2	$2,282.6	$2,406.5	$8,965.5	$11,240.3	$13,136.7
% Sell&Mktg	*40.8%*	*33.5%*	*32.2%*	*32.0%*	*31.4%*	*31.0%*	*32.0%*	*31.5%*	*30.0%*
G&A	$3,843.0	$4,159.0	$1,201.8	$1,276.7	$1,308.5	$1,467.2	$5,254.1	$5,780.7	$7,006.3
% G&A	*30.9%*	*19.4%*	*18.2%*	*19.0%*	*18.0%*	*18.9%*	*16.8%*	*16.2%*	*16.0%*
Operating Income	($852.0)	$5,341.0	$1,832.3	$1,824.5	$2,149.1	$2,304.2	$8,110.1	$11,383.1	$14,800.7
Operating Margin	*-6.8%*	*24.9%*	*27.7%*	*27.2%*	*29.6%*	*29.7%*	*28.6%*	*31.9%*	*33.8%*
Other Expense total	$656.0	$301.0	($7.2)	($8.8)	($10.1)	($11.0)	($37.1)	($66.2)	($98.7)
Pre-Tax Income	($1,508.0)	$5,040.0	$1,839.5	$1,833.3	$2,159.2	$2,315.2	$8,147.2	$11,449.3	$14,899.4
Taxes	$0.0	$26.0	$44.1	$141.2	$166.3	$185.2	$536.8	$2,518.8	$3,277.9
Tax Rate	*0.0%*	*0.5%*	*2.4%*	*7.7%*	*7.7%*	*8.0%*	*11.0%*	*22.0%*	*22.0%*
Net Income	($1,508.0)	$5,014.0	$1,795.3	$1,692.1	$1,992.9	$2,130.0	$7,610.4	$8,930.4	$11,621.5
YOY Growth	*41.0%*	*-432.5%*	*154.3%*	*16.5%*	*35.8%*	*53.6%*	*51.8%*	*17.3%*	*-30.1%*
Net Margin	*-12.1%*	*23.3%*	*27.2%*	*25.2%*	*27.4%*	*27.4%*	*26.8%*	*25.0%*	*26.5%*
EPS	($0.27)	$0.66	$0.22	$0.20	$0.24	$0.26	$0.91	$1.06	$1.36
YOY Growth	*46.7%*	*-347.2%*	*123.0%*	*5.4%*	*29.0%*	*49.5%*	*39.1%*	*16.3%*	*27.9%*
Diluted Shares O/S	5,672	7,630	8,304	8,325	8,340	8,340	8,327	8,400	8,550

Brian Marckx, CFA

HISTORICAL STOCK PRICE



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