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Zacks Small-Cap Research

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Semler Scientific (SMLR-OTC)

SMLR: Q1 Beat Prompts More Upward Revisions. Modeling Positive Cash Flow From Here On Out

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 $12/share.

Current Price (05/03/18)	$9.33
Valuation	**$12.00**

OUTLOOK

Revenue, profitability and cash flow continue to show regular and significant improvement. This was a particularly impressive quarter, in our opinion. Q1 is typically SMLR's softest – and based management's comments, that is expected to be the case in 2018. So while we had expected to see some slight sequential revenue contraction from Q4 '17 (similar to what happened from Q4 '16 to Q1 '17), that did not happen due to very strong licensing revenue growth (~13%). And while it looks like per-use revenue contracted sequentially, that was not only expected but the contraction was considerably less than we had anticipated. Importantly, both licensing and usage fee revenue are expected to grow from these record levels.
Management is guiding for revenue to set a new annual record in 2018 and for profitability and cash flow generation to also continue to improve. We think 2018 will also mark the first full year of positive net income and operating cash flow. Importantly, SMLR is now not only generating positive cash from operations but is also handily covering capex. We have made upward revisions to our model but could still be too conservative.

SUMMARY DATA

52-Week High	**$10.30**
52-Week Low	**$2.75**
One-Year Return (%)	**237.09**
Beta	**0.33**
Average Daily Volume (sh)	**13,869**
Shares Outstanding (mil)	**6**
Market Capitalization ($mil)	**$55**
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 (%)	**48.7**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2018 Estimate	**25.9**
P/E using 2019 Estimate	**16.1**
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	4687 E	4906 E	5123 E	19179 E
2019					24306 E
2020					28812 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	$0.08 E	$0.08 E	$0.10 E	$0.36 E
2019					$0.52 E
2020					$0.58 E

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

Q1 2018 Results: *Blowout Quarter: Record Revenue (again), Op Income, Net Income. Upwardly Revising Estimates (again)…*

Semler reported financial results for their first quarter ending March 31, 2018. Revenue, profitability and cash flow continue to show regular and significant improvement. This was a particularly impressive quarter, in our opinion. Q1 is typically SMLR's softest – and based management's comments, that is expected to be the case in 2018. So, while we had expected to see some slight sequential revenue contraction from Q4 '17 (similar to what happened from Q4 '16 to Q1 '17), that did not happen due to very strong licensing revenue growth (~13%). And while it looks like per-use revenue contracted sequentially, that was not only expected but the contraction was considerably less than we had anticipated. Importantly, both licensing and usage fee revenue are expected to grow from these record levels.

And the significant revenue growth is just part of the story – operating income, net income and cash flow also continue to show regular improvement and also set new records in Q1. All are also expected to continue to improve and we think 2018 will be the first full year of SMLR generating positive net income and cash flow.

Management has delivered on their guidance – which included improvement in financial results – on both the income statement and on the balance sheet. During Q1 SMLR paid down more than $800k of debt. They have also consistently reiterated that they expected to reach a point of cash flow break-even without having to raise operating funds in a way that would result significant dilution to shareholders. They have also delivered on that and expect to be able to meet all of their remaining debt-related principal and interest payments through current cash and expected operating cash flow.

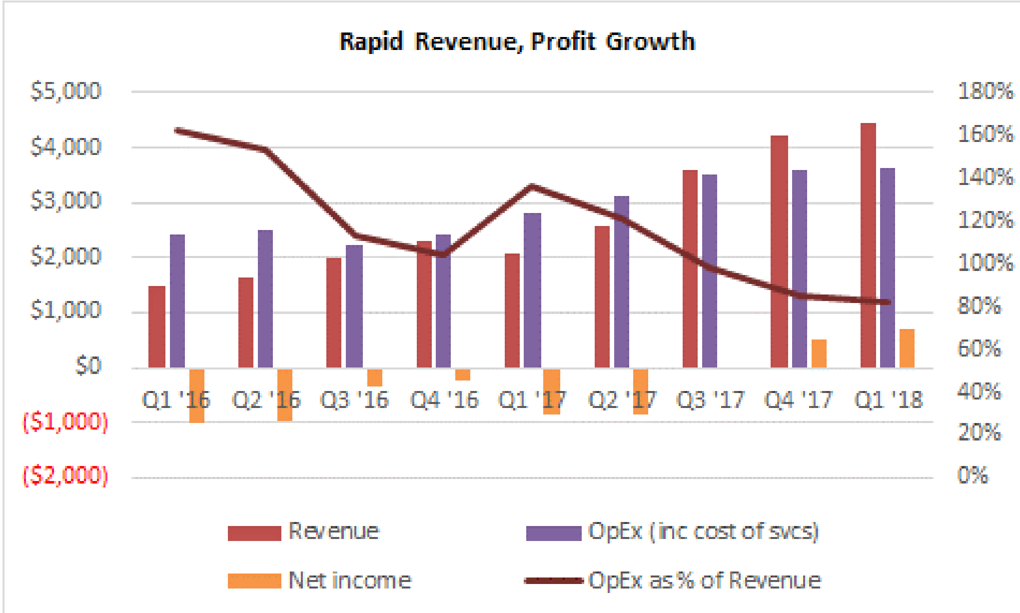
Q1 numbers…
Revenue was $4.5M, up 117% (+$2.4M) yoy, up 6% ($250k) sequentially and about 10% higher than our $4.0M estimate. It was also a new record high. Usage fees (from the HRA channel) were approximately $750k – which compares to $78k in Q1 and $926k in Q4 of 2017. Usage fees increased sequentially every quarter during 2017 and, on the Q1 call, management indicated that that pattern should repeat itself during 2018. Meanwhile, licensing revenue continues to charge higher. Licensing revenue was approximately $3.7M in Q1, up ~88% yoy (+$1.7M) and ~13% sequentially (~$425k).

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 should be well over $3M in 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.

Q1 operating expenses (including cost of revenue) were $3.7M, or 82% of revenue, which is not only well below our 94% estimate, it is also the lowest level in history. 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. The combination of ramping revenue and relatively flat growth in operating expenses has resulted in rapid improvement in operating income/loss.



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.

Q1 operating income was $813k – a new record high. The prior best, in Q4 '17, was $627k (ex-asset write down). The improvement is reflective of both revenue growth and relatively flattish opex – revenue increased 6% and opex as a percentage of revenue fell by 334 basis points.

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.

While the 10-Q is not yet filed, SMLR definitely generated significant positive cash flow during Q1. In addition, per the Q1 earnings release, SMLR's total liabilities decreased by more than $1M from Q4 '17 to Q1 '18 and they paid down approximately $880k in loans and related interest. Cash balance was $419k at the end of Q1 but that will benefit from collection of A/R – which grew by more than $1M (and there's no collections issues). And, as noted, SMLR expects to be able to meet all of their remaining debt-related principal and interest payments through current cash and expected operating cash flow.

We have, again, made meaningful upward revisions to our forecasted revenue and EPS in every period in our model. We are now modeling 2018 revenue and EPS of $19.2M (+54%) and $0.36, revised upward from $18.4M and $0.25.

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 two or three 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 throughout 2017 and, now, into 2018. We think SMLR has now reached a point of sustainable cash flow and believe 2018 will mark the first full year that the company not only generates positive income, but also positive operating cash flow.

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. R&D expense actually contracted to $367k in Q1 2018, although we think it could incrementally move up from here.

The good news is how these investments have already benefitted revenue growth and improved profitability – specifically that growth in revenue has significantly outpaced that of expenses from Q1 to Q2 (25% vs 12%) and Q2 to Q3 (40% vs 13%) and Q3 to Q4 (17% vs 3%, ex-one time charge) as well as yoy for the full year 2017 (68% vs 36%). The net result has been regular and significant improvement in profitability and cash flow. 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 will grow even faster which should result in continued improvement in net income and cash burn.

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, increasing order sizes and extension of the vascular testing business via the HRA channel. And with gross margins of ~80%+, instruments should be a strong driver of operating leverage.

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 should be well over $3M in 2018. The HRA channel has just recently grown out of its infancy. These HRA installations potentially represent more significant contribution given that this revenue model mostly hinges on per-test fees.

The recent investments related to product upgrades, certain software and integration customization work and infrastructure/capacity enhancement has already increased revenue growth but we think will provide even greater leverage going over the near term.

Management is guiding for revenue to set a new annual record in 2018 and for profitability and cash flow generation to also continue to improve. We think 2018 will also mark the first full year of positive net income and operating cash flow. Importantly, SMLR is now not only generating positive cash from operations but is also handily covering capex.

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 $200k 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.

We use a 10-year DCF model to value SMLR. We now model 10-year revenue CAGR of 28%, which we think is reasonable if not conservative given the historical much higher rate of growth along with the recurring revenue model. 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. We look for 2018 revenue of $19.2M, net income of $2.6M and EPS of $0.36. This is revised up from $18.4M in revenue, $1.7M in net income and EPS of $0.25.

Updates to our forecasted revenue has also had a meaningful effect on the out-years in our model. We now look for revenue and EPS of $24.3M and $0.52 in 2019 (revised from $23.3M and $0.42) and $28.8M and $0.58 in 2020 (revised from $27.7M and $0.51).

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, now values SMLR at approximately $12/share. This equates to a price/sales (2018) multiple of about 4.5x – while a slight premium to the average medical device equipment multiple (~3.5x – 4.0x) we still think this is fair given the company's high revenue growth rate, beefy gross margins, scalability of operations and lower-risk business model (i.e. - licensing, outsourced manufacturing and R&D). In addition, we have underestimated SMLR's revenue growth rate as well as the rate of improvement in profitability and may still be erring on the side of too conservative.

FINANCIAL MODEL

Semler Scientific, Inc

	2016 A	2017 A	Q1A	Q2E	Q3E	Q4E	2018 E	2019 E	2020 E
Total Revenues	$7,435.0	$12,453.0	$4,463.0	$4,686.9	$4,906.3	$5,122.7	$19,178.9	$24,305.6	$28,811.6
YOY Growth	6.2%	67.5%	117.2%	81.8%	36.0%	21.6%	54.0%	26.7%	18.5%
Cost of Revenues	$1,873.0	$2,554.0	$704.0	$787.4	$809.5	$768.4	$3,069.3	$3,645.8	$4,953.6
Gross Income	$5,562.0	$9,899.0	$3,759.0	$3,899.5	$4,096.8	$4,354.3	$16,109.5	$20,659.8	$23,858.0
Gross Margin	74.8%	79.5%	84.2%	83.2%	83.5%	85.0%	84.0%	85.0%	86.0%
R&D	$867.0	$1,831.0	$367.0	$512.0	$520.0	$531.0	$1,930.0	$2,366.0	$2,679.5
% R&D	11.7%	14.7%	8.2%	10.9%	10.6%	10.4%	10.1%	9.7%	9.3%
Selling & Mktg	$3,827.0	$5,077.0	$1,705.0	$1,781.0	$1,835.0	$1,895.4	$7,216.4	$8,628.5	$9,450.2
% Sell&Mktg	51.5%	40.8%	38.2%	38.0%	37.4%	37.0%	37.6%	35.5%	32.8%
G&A	$3,028.0	$3,843.0	$874.0	$924.0	$1,095.0	$1,126.0	$4,019.0	$5,152.8	$6,050.4
% G&A	40.7%	30.9%	19.6%	19.7%	22.3%	22.0%	21.0%	21.2%	21.0%
Operating Income	($2,160.0)	($852.0)	$813.0	$682.5	$646.8	$801.9	$2,944.2	$4,512.5	$5,677.9
Operating Margin	-29.1%	-6.8%	18.2%	14.6%	13.2%	15.7%	15.4%	18.6%	19.7%
Other Expense total	$394.0	$656.0	$107.0	$87.0	$79.0	$61.0	$334.0	$135.0	$0.0
Pre-Tax Income	($2,554.0)	($1,508.0)	$706.0	$595.5	$567.8	$740.9	$2,610.2	$4,377.5	$5,677.9
Taxes	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$481.5	$1,249.1
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	$595.5	$567.8	$740.9	$2,610.2	$3,896.0	$4,428.7
YOY Growth	70.0%	41.0%	181.1%	170.1%	1484.9%	-191.7%	273.1%	-49.3%	-13.7%
Net Margin	-34.4%	-12.1%	15.8%	12.7%	11.6%	14.5%	13.6%	16.0%	15.4%
EPS	($0.50)	($0.27)	$0.10	$0.08	$0.08	$0.10	$0.36	$0.52	$0.58
YOY Growth	71.1%	46.7%	158.2%	151.2%	1129.5%	-162.2%	233.9%	-45.9%	
Diluted Shares O/S	5,124	5,672	7,280	7,300	7,350	7,400	7,333	7,500	7,700

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HISTORICAL STOCK PRICE

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