Zacks Small-Cap Research

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Semler Scientific (SMLR-OTC)

SMLR: Record Quarter. WellChec Reorg Prompts Upward Revision to Price Target

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $7.50/share. This equates to a price/sales (2016) multiple of about 5x which we think is a fair given the company's high revenue growth rate, beefy margins, scalability of operations and lower-risk business model (i.e. - licensing, outsourced manufacturing and R&D).

Current Price (10/28/16)	$1.58
Valuation	**$7.50**

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 had shown early promise but resource-intensive nature and low margins prompted reorg of that business. We view this as a positive move and one that should accelerate timeline for reaching profitability and cash flow break even.
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	**$3.50**
52-Week Low	**$1.12**
One-Year Return (%)	**-44.05**
Beta	**-0.12**
Average Daily Volume (sh)	**6100**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$8**
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 (%)	**64.3**
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	1982 A	2045 E	7164 E
2017					9717 E
2018					12438 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	-$0.07 A	-$0.11 E	-$0.57 E
2017					-$0.23 E
2018					-$0.04 E

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

WHAT'S NEW…

Q3 2016 Results: Focus Fully Back On QuantaFlo Which Turns In Very Strong Quarter, WellChec Business Deprioritized..

Semler reported financial results for the third quarter ending September 30. Revenue, which consisted of only contribution from the vascular testing business (i.e. WellChec again did not generate any revenue), was very strong relative to the year-earlier (i.e. Q3 2015) as well as quarter-earlier (Q2 2016) period. And while some of the relative strength in revenue relates to some QuantaFlo orders placed late in Q2 but not recognized until Q3 (i.e. some favorable order timing), we had already factored this into our estimate and sales still handily beat our number.

And revenue was not the sole upside surprise as a very healthy gross margin, reminiscent of pre-WellChec times, and lower than expected OpEx from continued diligence on cost control also contributed to what turned out to be the best quarter in company history. Not only did revenue set a new record, so did net loss – which at just $362k beat the prior best ($523k in Q3 2013) by more than $160k, or 31%. With management guiding for continued sequential revenue growth and an expectation that margins maintain and operating expense leverage improves, we think the company could be at operating income break-even over the very near-term.

Semler is also closing in on reaching a point of cash flow break-even and their decision to deprioritize WellChec was clearly made to try and accelerate that timeline. While the company had viewed the multi wellness testing service as a complement to their core instruments (i.e. QuantaFlo / FloChec), the viability, or proof-of-concept, of that business had yet to be fully established. WellChec had contributed significantly to revenue in late 2015 but that was compromised by the even more significant resources and related expense consumed in support of getting the business up and running and maintaining its operations. And with gross margins which we estimated in the low double digits (i.e. 10% - 20%) and which paled in comparison to the instruments business (i.e.70% - 80%), it seemed WellChec's days (in its original form) were numbered unless it could demonstrate the potential to significantly steepen its revenue curve and begin to establish scalability.

And while it's unclear the extent of revenue that Semler may generate from WellChec (in its current form) going forward with the company now acting as a "secondary vendor" of the testing service to home risk assessment (HRA) companies, it is very clear that the company's priorities have switched almost entirely back to their bread-and-butter and higher margin instruments business. That supposition is further reinforced by the fact (based on management's comments on the Q3 call) that WellChec now consists entirely of PAD testing (i.e. QuantaFlo) instead of the prior multi-test offering As such, we think it is a reasonable expectation that, at least over the near-term, there will be little-to-no meaningful revenue or expense related to WellChec (i.e. PAD testing through the HRA channel) - those expectations are now reflected in our model. Our model is subject to updating including potentially bringing WellChec back "online" if the secondary vendor status and HRC channel proves to be more meaningful than what is reflected in our current outlook for that business.

Q3 numbers…
Revenue of $1.98M represented growth of 27% yoy (from $1.56M) and 21% sequentially (from $1.64M). This was also a new record high in vascular testing revenue and ahead of our $1.84M estimate by about 8%. While SMLR does not break out vascular testing revenue by instrument, they did note on the call that approximately 50% of total revenue is 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, there is likely still a significant base of FloChec customers which have yet to upgrade (as of Q2 2016 ~85% of the installed base was still using FloChec). As such, we think there remains potential for significant migration-related growth ahead.

Management has consistently noted that 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. Prior to the most recent announcement relative to SMLR acting as a secondary vendor of WellChec to HRA companies, the company was guiding for their multi-test offering service to come back online (in its original form) in Q4 2016. We think the recent move to deprioritize (our word) WellChec to where the service now only encompasses vascular testing to HRA companies likely indicates it was too resource-intensive and low margin and, perhaps, not likely to be scalable enough to warrant continue operating in its original form. We think it was the right decision given the much higher margins, regular growth and less resource intensive business that vascular testing offers.

Gross margin of 79.9% compared favorably to the 75.4% in Q3 2015 as well as the 67.4% posted in Q2 of this year. It also was well ahead of our 69% estimate. While some of the relative strength in GM may be a result of lower depreciation expense from retired vascular testing instruments, it also is benefitting from the lack of contribution from WellChec, revenue from which was at relatively very low margins. And with the high-touch WellChec service shuttered, we expect gross margin to continue to benefit.

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 average quarterly OpEx falling to $1.9M throughout 2016. In Q3, OpEx was just $1.8M, equal to 93% of revenue – which is the lowest (i.e. best) in company history.

Operating loss was just $255k in Q3 – also an all-time best. With management guiding for continued sequential revenue growth and indications that OpEx should remain relatively flat, we think operating leverage should continue to benefit and break-even operating income is reasonably attainable in the near-term.

In terms of cash, SMLR exited Q3 with $517k in cash and equivalents. Management noted on the call that they believe the current cash balance will be sufficient to get them to a point of profitability and positive cash flow generation. They also reiterated that in the event they do need additional operating capital, that they will seek to secure non-dilutive funding from sources such as loans as they have done in the past.

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 had shown early promise in terms of revenue generation but was a significant drain on resources and cash and came with relatively very low margins. We estimate that WellChec contributed approximately $1.7M, or about 25%, of total revenue in 2015. Operating loss was a dismal $8.4M in that year. The new version (i.e. vascular testing to HRAs) likely means much less revenue upside from WellChec but should certainly mean a dramatic improvement in profitability given the lack of related resource drain. As such, we think SMLR's move to as a "secondary vendor" was a wise one and one that should prove to benefit shareholder value. In fact, removing WellChec from our model resulted in a dramatic improvement to profitability beginning as early as Q4 of this year. We also now estimate SMLR will generate positive EPS in 2018 whereas prior to the WellChec-related reorganization we were modeling EPS of negative $0.24 in 2018.

We have total revenue growing 2% in 2016 but vascular testing revenue increasing 36% from 2015 to $7.2M. We think revenue grows another 36% in 2017 and graduates down to a low double digit growth rate through 2019. We think this is reasonable, or perhaps conservative, given the recurring revenue streams of the instruments business as well as the sizeable legacy installed base that has yet to migrate over to QuantaFlo.

We also expect to see much more scalability in operations as revenue grows and benefits are realized from the WellChec reorganization including much higher overall gross margins and less resource drain. The first nine months of 2016 were 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.

We use a 10-year DCF model to value SMLR. We model 10-year revenue CAGR of 18% (revised lower from 25% after removing WellChec), which again 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 2016 benefitting from lower removal of WellChec revenue as compared to the prior year but then remaining largely stable at around 75% in our out years. 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 2017 and for the full year in 2018.

Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $7.50/share (upwardly revised from $6.50/share prior to the WellChec reorg). This equates to a price/sales (2016) multiple of about 5x which we think is a 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). We also assign real value to the quality of management.

FINANCIAL MODEL

Semler Scientific, Inc

	2015 A	Q1A	Q2A	Q3A	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$7,001.0	$1,501.0	$1,636.0	$1,982.0	$2,045.0	$7,164.0	$9,717.4	$12,438.3	$14,304.1
YOY Growth	*92.6%*	*24.9%*	*25.6%*	*26.9%*	*-30.3%*	*2.3%*	*36.5%*	*28.0%*	*15.0%*
Cost of Revenues	$2,809.0	$417.0	$533.0	$398.0	$511.3	$1,859.3	$2,429.4	$3,109.6	$3,576.0
Gross Income	$4,192.0	$1,084.0	$1,103.0	$1,584.0	$1,533.8	$5,304.8	$7,288.1	$9,328.7	$10,728.0
Gross Margin	*59.9%*	*72.2%*	*67.4%*	*79.9%*	*75.0%*	*74.0%*	*75.0%*	*75.0%*	*75.0%*
R&D	$1,436.0	$270.0	$182.0	$183.0	$185.0	$820.0	$887.0	$934.0	$1,001.3
% R&D	*20.5%*	*18.0%*	*11.1%*	*9.2%*	*9.0%*	*11.4%*	*9.1%*	*7.5%*	*7.0%*
Selling & Mktg	$6,304.0	$974.0	$1,028.0	$950.0	$1,044.0	$3,996.0	$4,216.0	$4,683.0	$4,977.8
% Sell&Mktg	*90.0%*	*64.9%*	*62.8%*	*47.9%*	*51.1%*	*55.8%*	*43.4%*	*37.6%*	*34.8%*
G&A	$4,871.0	$772.0	$763.0	$706.0	$758.0	$2,999.0	$3,121.0	$3,426.0	$3,576.0
% G&A	*69.6%*	*51.4%*	*46.6%*	*35.6%*	*37.1%*	*41.9%*	*32.1%*	*27.5%*	*25.0%*
Operating Income	($8,419.0)	($932.0)	($870.0)	($255.0)	($453.3)	($2,510.3)	($935.9)	$285.7	$1,172.9
Operating Margin	*-120.3%*	*-62.1%*	*-53.2%*	*-12.9%*	*-22.2%*	*-35.0%*	*-9.6%*	*2.3%*	*8.2%*
Interest expense (income)	$82.0	$74.0	$96.0	$107.0	$112.0	$389.0	$468.0	$38.0	$38.0
Other Expense total	$82.0	$74.0	$96.0	$107.0	$112.0	$389.0	$468.0	$38.0	$38.0
Pre-Tax Income	($8,501.0)	($1,006.0)	($966.0)	($362.0)	($565.3)	($2,899.3)	($1,403.9)	$247.7	$1,134.9
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)	($362.0)	($565.3)	($2,899.3)	($1,403.9)	$247.7	$1,134.9
YOY Growth	*-88.3%*	*26.7%*	*28.0%*	*77.1%*	*86.6%*	*65.9%*	*51.6%*	*117.6%*	*-358.1%*
Net Margin	*-121.4%*	*-67.0%*	*-59.0%*	*-18.3%*	*-27.6%*	*-40.5%*	*-14.4%*	*2.0%*	*7.9%*
EPS	($1.73)	($0.20)	($0.19)	($0.07)	($0.11)	($0.57)	($0.23)	$0.04	$0.16
YOY Growth	*-56.3%*	*31.8%*	*30.0%*	*77.7%*	*86.9%*	*67.2%*	*58.6%*	*115.8%*	*-344.8%*
Diluted Shares O/S	4,928	5,124	5,124	5,124	5,124	5,124	6,000	6,700	6,900

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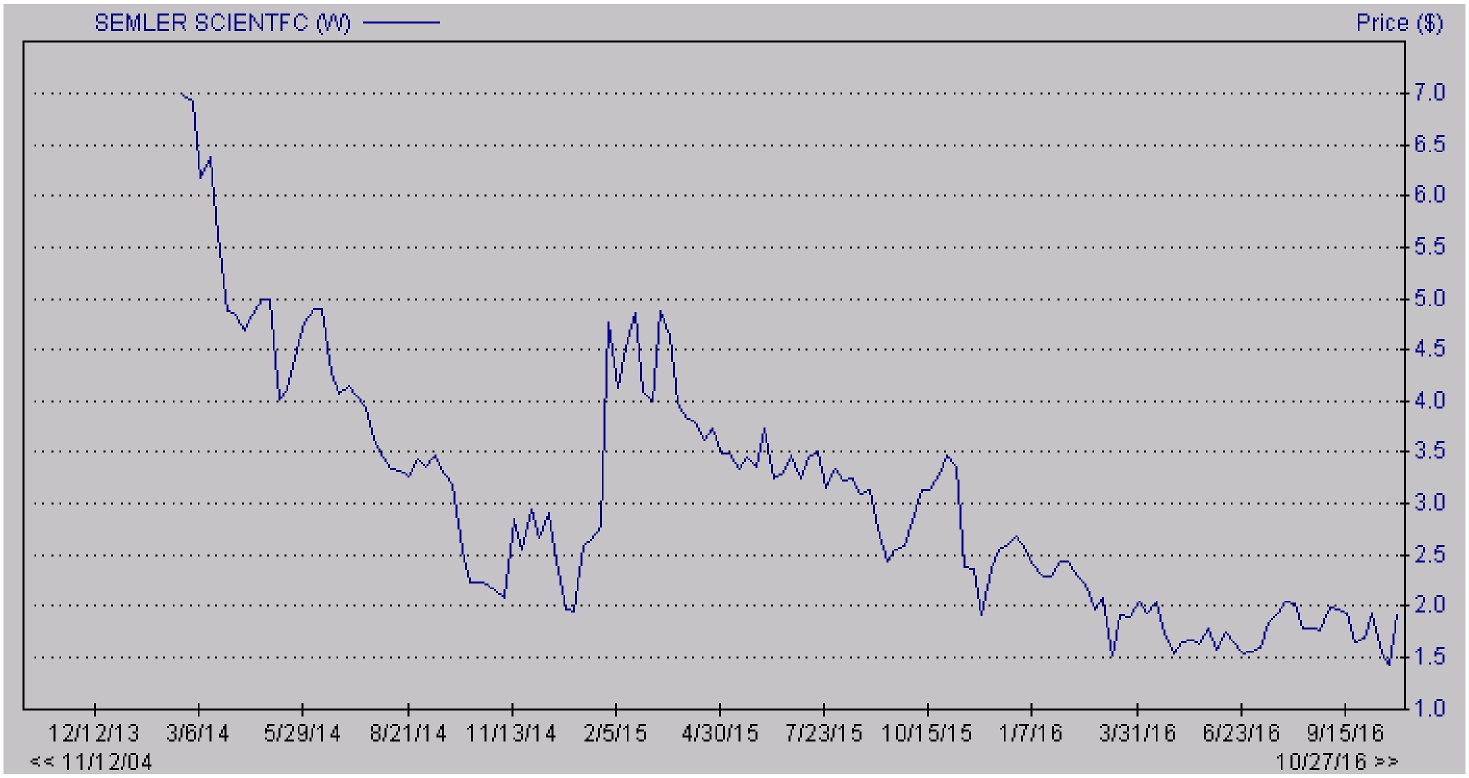
HISTORICAL ZACKS RECOMMENDATIONS



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