Zacks Small-Cap Research

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Semler Scientific (SMLR-NASDAQ)

SMLR: WellChec Revenue Jumps, Ironing Out Expense Wrinkles

Current Recommendation	**Buy**
Prior Recommendation	N/A
Date of Last Change	01/04/2015
Current Price (02/19/16)	$2.24
Target Price	**$6.00**

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 and is already making a significant revenue contribution. WellChec continues to score add'l contracts and is adding new tests to its menu of offerings which should push its sales even higher. Expenses expected to moderate in 2016, should improve operating loss and get closer to profitability. This coupled with QuantaFlo's growing installed base, additional Medicare Advantage plan customers and higher avg revenue per customer on the instruments' side bodes well for continued robust top-line growth for the foreseeable future.

SUMMARY DATA

52-Week High	**$5.80**
52-Week Low	**$1.78**
One-Year Return (%)	**-54.12**
Beta	**-1.30**
Average Daily Volume (sh)	**776**
Shares Outstanding (mil)	**5**
Market Capitalization ($mil)	**$11**
Short Interest Ratio (days)	**2.79**
Institutional Ownership (%)	**12**
Insider Ownership (%)	**22**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
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	**Small-Growth**
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	1456 E	1631 E	2951 E	3596 E	9634 E
2017					12682 E
2018					16480 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	-$0.31 E	-$0.28 E	-$0.23 E	-$0.15 E	-$0.94 E
2017					-$0.48 E
2018					-$0.27 E

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

WHAT'S NEW…

Q4 2015 Results: Huge Jump in WellChec Revenue, However Need To Iron Out Some Expense Wrinkles

Semler reported financial results for the fourth quarter ending December 31. Results were mixed – excitement of a huge jump in revenue was quickly tempered as your eyes moved down the income statement. Gross margin was more than halved and operating expenses doubled as compared to the averages of the first three quarters of the year. WellChec was the hero or the culprit, depending on how you interpret the results. What is clear is that Semler is still going through a learning curve as it relates to their recently launched diagnostic testing service and expects to take a little breather over the next (roughly) couple of quarters to regroup before re-engaging more emphasis on WellChec. Management noted on the call that two or four WellChec contracts were not profitable in Q4 but the other two did generate positive return including "respectable margins." They also sounded optimistic that they have learned from early missteps and believe WellChec will not only see growing revenue but will also contribute to profitability and expect this will happen later in 2016.

While SMLR does not formally break out operating results between the instruments business (QuantaFlo/FloChec) and WellChec, management did note that revenue was split ~51% instruments/49% WellChec. They also indicated gross margin in instruments remains at ~80%. This implies;

- WellChec revenue of ~$1.4M, which is almost 10x the ~$150k booked in Q3 2015. Based on our analysis, WellChec GM was approximately negative 16%
- Instruments revenue of ~$1.5M, compared to ~$1.4M in Q3 2015 and $897k in Q4 2014. For the full year, we estimate instruments-related revenue increased by about 45%.

The growing pains are evident in the negative gross margin of WellChec. Management continues to expect this to be in the positive 30% - 40% range, however, after the wrinkles are ironed out – much of which they implied should be the case when the diagnostic service gets back up to speed later this year. And while a significant portion of the OpEx increase was related to stock-based compensation management also indicated that WellChec consumed more than a normal amount of operating expenses in Q4 as a result of certain start-up costs – these are expenses that presumably will not recur. While the company expects to "limit" WellChec business until later in 2016 in order to lessen OpEx and conserve cash, for the full year they expect additional revenue from existing contracts as well as from new customers. Management noted on the call that they "believe that the opportunities and business prospects improved significantly during Q4 2015 as we fulfilled several orders for our WellChec service which represents a huge potential engine of growth for us". We currently model ~54% growth in WellChec revenue in 2016.

Meanwhile it appears that the instruments business continued to generate strong revenue, albeit what looks to be roughly flat q-o-q but about 45% for the full year. And again, GM at ~80% would be a solid positive. For 2016 the company expects this business to continue to grow the top line from further expansion of the installed base and improved pricing.

As a reminder, QuantaFlo is the next-gen PAD testing instrument which launched in Q3 and not only has several advantages over the legacy FloChec instrument (compatible with electronic medical systems and enhanced labeling), it is also higher priced than its predecessor. SMLR has discontinued FloChec and is now only shipping QuantaFlo. They are upgrading existing accounts which are currently using FloChec and, facilitated by additional Medicare Advantage plans coming online on a fairly regular basis, signing new accounts. Customer feedback on the new machine, per management's comments, has been "outstanding". We are modeling 32% growth in instruments-related revenue in 2016.

The numbers…

Q4 revenue of $2,934k was up 178% yoy, up 88% sequentially and about 68% better than our estimate ($1,745k). The difference from our estimate relates entirely to a beat in WellChec, which contributed ~49% of total revenue. Instruments and WellChec (approximate) revenue and our estimates were; instruments $1,496k A vs. $1,545k E and WellChec $1,473k A vs. $200k E.

Gross margin was 33.2%, down from 75.4% in Q3 when WellChec accounted for only ~10% of total revenue and from an average of 79.1% over the first three quarters of 2015 when WellChec accounted for ~7% of total revenue. We estimate WellChec gross margin was around negative 16% in Q4 – which relates to the two (of four) accounts in the quarter which were unprofitable. Management noted that the two profitable accounts were brought on later in

Q4 – which may suggest potential WellChec profitability in 2016 is off to a good start. We currently model GM of about 58% in 2016, down from 60% in 2015.

Q4 operating expenses were ugly. At $5.2M they were almost double that of Q3 ($2.7M) as well as the average of the first three quarters of the year ($2.5M). Some of the increase management attributed to start-up costs of WellChec. But $2M or more management noted relates to stock-based compensation – which was the result of accelerated vesting of certain stock options. Which we interpret as a cleansing of the capital structure – the implication is that this level of stock-based comp expense will not repeat in 2016. And if that is indeed the case (which is what we assume in our model), we would expect a much improved operating loss. SMLR expects OpEx in Q1 2016 to be at more normal levels – which we interpret to be ~$2.5M. But expect this to come back up as WellChec comes back online later in the year.

Q4 net loss and EPS were $4.2M and ($0.84), compared to $1.6M / ($0.32) in Q3 and $1.2M / ($0.25) in Q4 2014. For the full year net loss and EPS were $8.5M and ($1.73) compared to $4.5M and ($1.10) in 2014. For 2016 we are looking for; Total Revenue of $9.6M (+36%), Instruments revenue of $7.0M (+32%), WellChec revenue of $2.7M (+54%), Gross margin at 57.8% (59.9% 2015) and net loss/EPS of $5.4M / ($0.94).

Valuation / Recommendation

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. And with gross margins of ~80%, instruments should be a strong driver of operating leverage.

The WellChec business is off to a strong start – at least from a revenue perspective. This segment is much more difficult to model given that contracts can be fairly short term and there is little visibility on length and size of contracts or what may be in the customer pipeline. However, management's comments indicate that they have had a positive reception from customers and view WellChec as having significant potential in not only top-line growth but now with learning-curve related wrinkles being ironed out, in positively contributing to profitability. The current year, particularly the back half when WellChec operations are expected to resume more substantially, may be a better gauge of the viability of this segment.

We have revenue growing in the mid 30% in 2016 and graduating down to the mid teens in the out-year (2019) in our model. We think this is reasonable, or perhaps conservative, given the recurring revenue streams of the instruments business and the very strong revenue growth that WellChec has recently exhibited. Our revenue estimates, like all of our inputs, are subject to change.

We also expect to see much more scalability in operations as revenue grows and "learning-curve" expenses related to WellChec begin to temper. We expect this to result in improved operating leverage in 2016 and beyond.

We use a 10-year DCF model to value SMLR. We model 10-year revenue CAGR of 25%, which again we think is reasonable if not conservative given the historical much higher rate of growth along with the recurring revenue model and strong start to WellChec. We show gross margins slightly contracting through 2016 with steepening growth of WellChec but then leveling out, scaling operating expenses consistent with growing revenues and efficiencies in SG&A. Our 10-yr DCF model, which uses an 11% discount and 2% terminal growth rate, values SMLR at approximately $6.00/share. This equates to a price/sales (2016) multiple of about 5.5x which we think is a fair given the company's high revenue growth rate, 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.

We think fair value is $6.00/share which is significantly greater than the current market value. Our recommendation is Buy.

FINANCIAL MODEL

Semler Scientific, Inc

	2015 A	Q1E	Q2E	Q3E	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$7,001.0	$1,456.0	$1,631.0	$2,951.0	$3,596.0	$9,634.0	$12,682.1	$16,480.2	$20,319.7
YOY Growth	*92.6%*	*21.1%*	*25.2%*	*88.9%*	*22.6%*	*36.1%*	*31.5%*	*28.0%*	*16.5%*
Cost of Revenues	$2,809.0	$364.0	$407.8	$1,469.0	$1,829.0	$4,069.8	$4,759.5	$6,026.8	$7,415.7
Gross Income	$4,192.0	$1,092.0	$1,223.3	$1,482.0	$1,767.0	$5,564.3	$7,922.6	$10,453.4	$12,904.0
Gross Margin	*59.9%*	*75.0%*	*75.0%*	*50.2%*	*49.1%*	*57.8%*	*62.5%*	*63.4%*	*63.5%*
R&D	$1,436.0	$388.0	$341.0	$360.0	$325.0	$1,414.0	$1,116.0	$1,087.0	$1,219.2
% R&D	*20.5%*	*26.6%*	*20.9%*	*12.2%*	*9.0%*	*14.7%*	*8.8%*	*10.0%*	*6.0%*
Selling & Mktg	$6,304.0	$1,455.0	$1,512.0	$1,665.0	$1,555.0	$6,187.0	$6,717.0	$7,253.0	$7,802.8
% Sell&Mktg	*90.0%*	*99.9%*	*92.7%*	*56.4%*	*43.2%*	*64.2%*	*53.0%*	*47.2%*	*38.4%*
G&A	$4,871.0	$820.0	$804.0	$810.0	$805.0	$3,239.0	$3,591.0	$4,218.0	$4,897.0
% G&A	*69.6%*	*56.3%*	*49.3%*	*27.4%*	*22.4%*	*33.6%*	*28.3%*	*27.4%*	*24.1%*
Operating Income	($8,419.0)	($1,571.0)	($1,433.8)	($1,353.0)	($918.0)	($5,275.8)	($3,501.4)	($2,104.6)	($1,015.0)
Operating Margin	*-120.3%*	*-107.9%*	*-87.9%*	*-45.8%*	*-25.5%*	*-54.8%*	*-27.6%*	*-12.8%*	*-5.0%*
Interest expense (income)	$82.0	$31.3	$31.3	$31.3	$31.3	$125.0	$125.0	$25.0	$25.0
Other Expense total	$82.0	$31.3	$31.3	$31.3	$31.3	$125.0	$125.0	$25.0	$25.0
Pre-Tax Income	($8,501.0)	($1,602.3)	($1,465.0)	($1,384.3)	($949.3)	($5,400.8)	($3,626.4)	($2,129.6)	($1,040.0)
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)	($1,602.3)	($1,465.0)	($1,384.3)	($949.3)	($5,400.8)	($3,626.4)	($2,129.6)	($1,040.0)
YOY Growth	*-88.3%*	*-16.8%*	*-9.2%*	*12.4%*	*77.4%*	*36.5%*	*32.9%*	*41.3%*	*51.2%*
Net Margin	*-121.4%*	*-110.0%*	*-89.8%*	*-46.9%*	*-26.4%*	*-56.1%*	*-28.6%*	*-12.9%*	*-5.1%*
EPS	($1.73)	($0.31)	($0.28)	($0.23)	($0.15)	($0.94)	($0.48)	($0.27)	($0.13)
YOY Growth	*-56.3%*	*-7.0%*	*-4.6%*	*27.2%*	*82.7%*	*45.3%*	*49.1%*	*42.8%*	*51.8%*
Diluted Shares O/S	4,928	5,200	5,200	6,000	6,500	5,725	7,550	7,750	7,850

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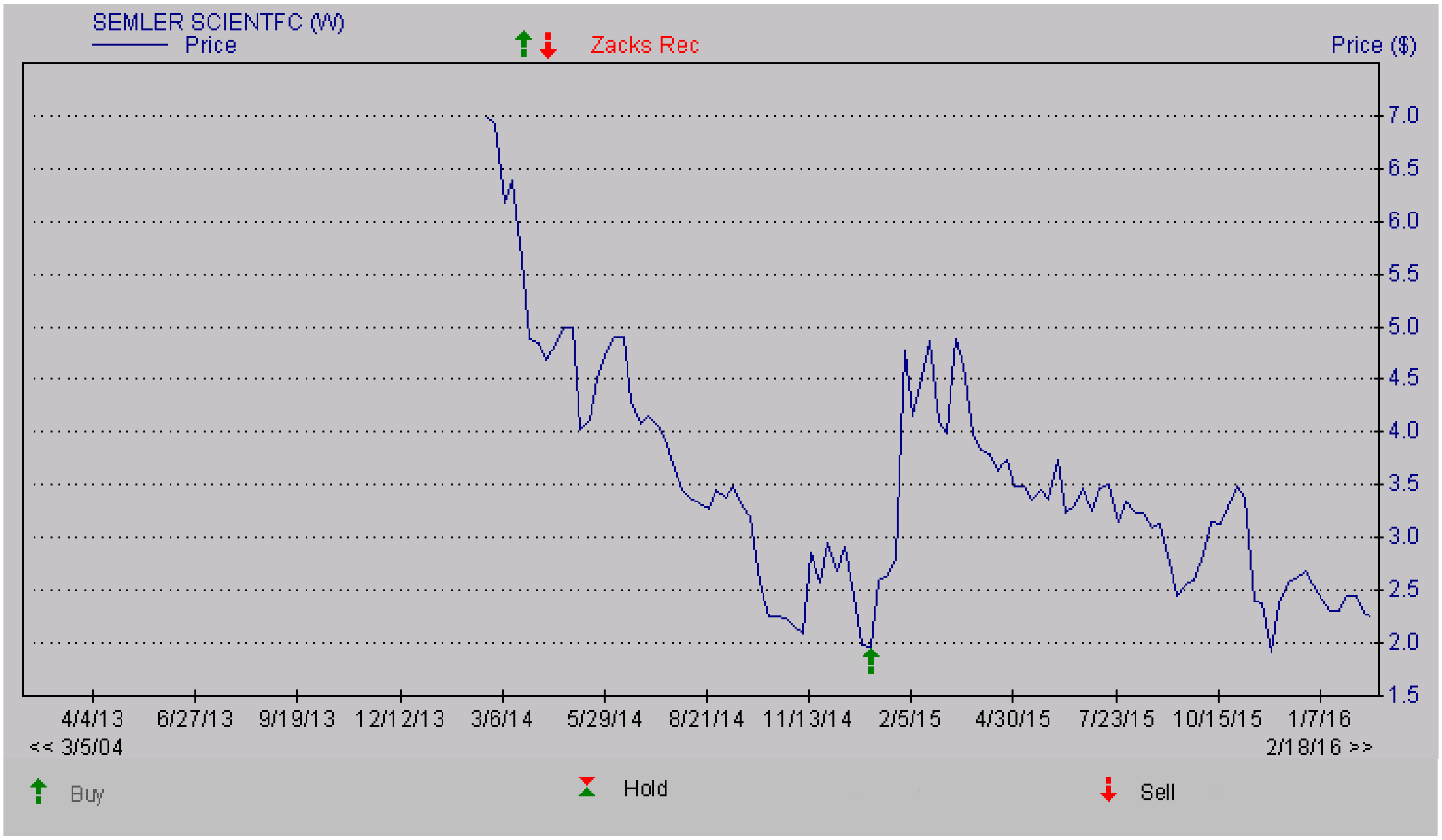
HISTORICAL ZACKS RECOMMENDATIONS



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