Cerner Corporation
Third Quarter 2019
Earnings Conference Call
October 24, 2019

Moderator

Welcome to Cerner Corporation's third quarter 2019 conference call. Today's date is October 24, 2019, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today constitute forward-looking statements, including without limitation, those regarding projections of future revenues or earnings, operating margins, operating and capital expenses, bookings, new solution, services and offering development, and capital allocation plans; cost optimization and operational improvement initiatives; future business outlook, including new markets or prospects for the Company's solutions and services; and the expected benefits of certain of our collaborations. Actual results may differ materially from those indicated by the forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements may be found under Item 1A in Cerner's Form 10-K together with the Company's other filings. A reconciliation of non-GAAP financial measures discussed in this earnings call can be found in the Company's earnings release, which was furnished to the SEC today and posted on the investor section of Cerner.com. Cerner assumes no obligation to update any forward-looking statements or information except as required by law.

At this time, I'd like to turn the call over to Brent Shafer, Chairman and CEO of Cerner Corporation.

Brent Shafer

Thank you ____________________. Good afternoon everyone and welcome to the call.

I'll spend the first few minutes providing my thoughts on the business, then ask our CFO, Marc Naughton, to take you through the financial results. When Marc concludes, Chief Client Officer, John Peterzalek, will provide some marketplace commentary. I've also asked Don Trigg, our EVP of Strategic Growth, to talk about Cerner's growth strategies.

It's been an eventful quarter for Cerner. At the end of July, we announced our collaboration agreement with AWS and Amazon; the company has made good progress around transformation efforts; and, we recently concluded our annual Cerner Health Conference. It was another successful CHC where we hosted over 11,000 clients, partners, media and other health care affiliates from around the world. The theme of this year's conference was Now/Next. During my keynote address, I shared Cerner's improvements in addressing clients' needs today, then spent time talking about innovations for the future.

As we discussed last quarter, our strategic framework to deliver this innovation and growth is focused on three key areas: Software-as-a-Service, Health Networks, and Data-as-a-Service. Our recently announced relationship with AWS and Amazon is foundational to these areas. Our work with AWS is expected to enable delivery of scalable and secure solutions in a faster, more agile way, with the power of advanced artificial intelligence and machine learning tools embedded in the workflow. Our clients can expect to see advancement in the overall user experience for consumers and care teams, as well as their overall health system and financial operations. We plan to modernize our platforms and software development approach, increase the pace of innovation and speed to market, and lower the operational burdens for our clients. This also represents an opportunity to reduce Cerner's costs over time and is part of our focus on long-term profitability improvements. Further, the possibilities with a Cerner and Amazon collaboration are substantial given their vast consumer knowledge.

I'd also like to provide an update on other activity that is part of Cerner's broader transformation. We have spent most of this year focused on identifying and addressing inefficiencies and cost-optimization opportunities. While this work is ongoing, we are now putting additional focus on other improvements to drive long-term business transformation. This includes work on capability-building, automation, product management, and go-to-market strategy.

To help us deliver on the market and product management elements of our transformation, we recently created and filled the role of Chief Marketing Officer, which we announced in September. Darrell Johnson joins Cerner following a successful career at Medtronic. He has deep expertise in health care data ecosystems and is a recognized leader in marketing innovations and global brand positioning for devices, software, services and data platforms. I believe instituting a CMO role and integrating strategic marketing into our organizational structure will strengthen Cerner's portfolio and product management processes and also improve our brand and go-to-market strategies.

As it relates to the financial results, I'm pleased with this quarter's numbers. Against the backdrop of advancing our transformation, the team executed and delivered against the expectations we set. There's more work to do, but I'm confident that we have the right balance-of-focus on executing in the near-term and recalibrating the company for long-term, profitable growth.

I'll now hand the call over to Marc.

Marc Naughton

Thanks, Brent. Good afternoon everyone. I am going to cover our Q3 results and future guidance.

This quarter we delivered solid bookings, revenue and earnings.

Bookings, Backlog and Revenue

I will start with bookings, which were $1.651 billion in Q3, up 4% over Q3 of 2018 and at the high end of our guidance range.

We ended the quarter with a revenue backlog of $13.31 billion, which is down 9% from a year ago primarily due to the termination of a large outsourcing contract that I'll discuss in a minute. Also recall that our backlog calculation under the new revenue standard excludes revenue from contracts with termination clauses, even though such clauses are rarely exercised, and we had a higher than usual amount of these types of contracts in Q3. When you combine the expected revenue from our backlog and the additional revenue expected from contracts not included in backlog, our revenue visibility remains at approximately 85% over the next 12 months.

Revenue in the quarter was $1.429 billion, up 7% over Q318 and in line with our expectations.

I'll now go through the business model detail and year-over-year growth compared to Q318.

- **Licensed Software** revenue in Q3 was $155 million, up 10% over Q318 driven primarily by strong growth in our SaaS offerings.
- **Technology Resale** of $70 million increased 16% compared to both Q318 and last quarter.
- **Subscriptions** revenue grew 16% to $92 million.
- **Professional Services** revenue grew 11% to $507 million, primarily driven by solid growth in implementation services.

- **Managed Services** was flat at $302 million, with the lack of growth primarily related to the phase out of revenue from Health Services clients that made the decision to leave in past years and are just now getting transitioned out of our data centers. Note that our retention rate for Health Services clients is solid at about 80%, but there is still some impact from those that have left. Overall, our attrition remains very low and we expect managed services to return to modest growth in 2020.
- **Support & Maintenance** was also flat at $277 million, which is in-line with our expectations and also reflects the impact of attrition.
- And finally, **Reimbursed Travel** of $26 million was up 6%.

Looking at revenue by geographic segment, domestic revenue was up 6% from the year-ago quarter at $1.265 billion, and international revenue of $164 million was up 8% year-over-year.

Moving to gross margin. Our gross margin for Q3 was 81.0%, down from 81.2% in Q219 and 82.8% year-over-year driven by higher third-party services, largely related to our Federal business, and a lower margin mix within technology resale.

Earnings

Now I will discuss spending, operating margin and net earnings. For these items, we provide both GAAP and "Adjusted," or Non-GAAP, results. The Adjusted results exclude share-based compensation expense, share-based compensation permanent tax items, acquisition-related adjustments, organizational restructuring and other expenses, and investment gains that are all detailed and reconciled to GAAP in our earnings release.

Included in the organizational restructuring line this quarter is a $60 million charge related to the termination of our revenue cycle outsourcing contract with Adventist Health. This was a joint decision based on what we agreed was best for both parties and is also related to our previously communicated portfolio management process. This will result in revenue cycle operations being assumed by Adventist and Huron beginning in early November, with nearly 1,700 Cerner associates transitioning back to Adventist Health and Huron at that time. This will reduce annual revenue by approximately $170 million but have little impact on earnings. Note that Adventist Health has re-committed to all clinical and revenue cycle solutions and *ITWorks*SM services—this only pertains to revenue cycle outsourcing services.

One other item of note that is included in GAAP results but not our adjusted results is a $9 million non-operating unrealized gain on one of our equity investments.

Operating Expense

Now I'll walk through our operating expenses. Our third quarter GAAP operating expenses of $1.069 billion were up 18% compared to $903 million in the year-ago period largely driven by the restructuring charges.

Our adjusted operating expenses were up 6% compared to Q318. Looking at the line items for Q3, Sales & Client Service expense increased 6% year-over-year, primarily driven by an increase in personnel expense related to the growth in professional services. Software development expense increased 10% over Q318, driven by a 7% increase in gross R&D, a 6% increase in amortization, and flat capitalized software. G&A expense was down 8%, driven by a decline in both personnel and non-personnel expenses. Amortization of Acquisition-related Intangibles decreased slightly year over year.

Operating Margins

Moving to operating margins. Our GAAP operating margin in Q3 was 6.2% compared to 15.5% in the year-ago period. Our Adjusted Operating Margin for the quarter was 18.1%, down from 19.2% in Q318, but up from 18.0% last quarter and in-line with our expectations. The Adjusted Operating Margin implied by our revenue and earnings guidance that I'll discuss in a moment implies an expected Adjusted Operating Margin slightly over our targeted 20% for Q4. We also believe our ongoing business optimization efforts keep us on track for delivering our targeted Q420 Adjusted Operating Margin of 22.5%.

As I mentioned last quarter, we believe our ongoing cost optimization and business simplification efforts position us to continue improving our profitability beyond 2020. Further, we believe our platform modernization and move to the cloud represents another driver of margin improvement longer term. This will be a multi-year process, particularly for *Millennium®*, and most near-term benefit is largely offset by modernization investment. However, we expect the lower operating costs associated with this move along with efficiencies and improvements we are driving in our development process to meaningfully contribute to our profitability while also helping us deliver a differentiated solution to our clients at a lower total cost of ownership.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q3 were $82 million, or $0.26 per diluted share, which is down from $0.51 in Q318. Adjusted Net Earnings in Q3 were $212 million and Adjusted Diluted EPS was $0.66, compared to $0.63 in Q318.

Our GAAP and non-GAAP tax rates were both approximately 20% in Q3.

Balance Sheet / Cash Flow

Moving to our balance sheet, we ended Q3 with $633 million of cash and short-term investments, which is down from $954 million last quarter with our free cash flow being offset by $400 million of share repurchases. For the year, we have repurchased 14.4 million shares for $1 billion, at an average price of $69.53, and currently have $483 million of remaining authorization under our repurchase program.

Moving to debt, our total debt remained flat to last quarter at $1.039 billion.

Total receivables ended the quarter at $1.155 billion, down from $1.229 billion in Q219. Our Q3 DSO was 74 days, which is down from 78 days in Q219 and 82 days in the year-ago period.

Operating cash flow for the quarter was $351 million. Q3 capital expenditures were $111 million, and capitalized software was $66 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $174 million for the quarter.

We expect free cash flow to remain solid in Q4 and strong growth in free cash flow in 2020.

Capital Allocation

Moving to capital allocation. As I indicated, we repurchased $1 billion of stock in Q2 and Q3, leaving $483 million remaining on our current authorization. We still expect to execute the majority of the repurchase authorization by the end of Q1 of next year, subject to market conditions and other factors. We intend to continue funding this with a combination of cash from operations and debt, with the amount of debt depending on the timing of our repurchases and whether we use cash for M&A and other purposes.

Regarding M&A, we did just announce a definitive agreement to acquire AbleVets. The cash consideration for this acquisition is expected to total approximately $75 million and we expect it to close in Q4 of this year. We expect this to contribute approximately $90 million of revenue in 2020. As John will discuss, AbleVets is a great fit given their experience and the importance of our Federal business.

Moving to our dividend program, we paid our first two quarterly dividends of $0.18 per share on July 26th and October 9th.

Guidance

Now I'll go through guidance.

- We expect revenue in Q4 to be between $1.410 and $1.460 billion. The midpoint of this range reflects growth of 5% over Q418 and would bring full-year 2019 revenue to $5.685 billion, which reflects 6% growth over 2018 and is within our previously provided full-year guidance range. Note that guidance includes approximately $25 million of impact from the termination of our Adventist RevWorks agreement, and our Q4 guided growth would be 7% without this change. Also note that our guidance reflects minimal impact from AbleVets given it has not closed.
- We expect Q4 Adjusted Diluted EPS to be 73 to 75 cents per share. The midpoint of this range is 17% higher than Q418 and would bring full-year 2019 Adjusted Diluted EPS to $2.67, which reflects 9% growth over 2018.
- Moving to bookings guidance, we expect bookings revenue in Q4 of $1.450 billion to $1.650 billion. The midpoint of this range reflects a 21% decrease compared to the fourth quarter of 2018 and would bring full-year 2019 bookings to $5.876 billion, down 13% from 2018. The YoY decrease in Q4 is primarily driven by a couple of different factors. Historically, Q4 bookings have included large RevWorks extensions with Adventist Health that will no longer occur given the transition of those services back to Adventist. Additionally, as we've discussed throughout this year, we are taking a more selective approach to low-margin long-term contracts, which has led to a decline in those types of bookings that is expected to continue.

We expect to provide our outlook for 2020 on our Q4 call.

In summary, we are pleased with our solid results in the third quarter. We have made good progress this year, but there is still a lot of work to do, and we expect to continue executing against our plan as we finish 2019 and move into 2020.

With that, I will turn the call over to John.

John Peterzalek

Thanks Marc. Good afternoon everyone. Today, I will provide results highlights and a quick update on our Federal business.

Results Summary

I'll start with our bookings, which grew 4% over last year and were at the high-end of our guidance. Consistent with recent quarters, we had a lower level of long-term bookings compared to last year, with the percent of bookings coming from long-term contracts in the quarter at 29% compared to 34% in Q3 of last year. Excluding these long-term bookings, our bookings grew at a double-digit rate in Q3.

We had solid contributions this quarter from all key areas, including revenue cycle, Federal, and our Strategic Growth businesses, which include Population Health, health networks, employer, consumer, Data-as-a-Service, and other adjacent markets.

Coming out of our health conference early this month, I had several positive takeaways.

- Our clients are creating tremendous value with our solutions. Clients led over 200 presentations, education sessions and demonstrations where these accomplishments were shared with over 11,000 attendees.
- They are committed to getting current and staying current, which is an important foundation for our longer-term shift to a single-instance cloud platform.
- They are excited and enthusiastic about our collaboration with AWS and Amazon, our commitment to innovation and the vast opportunities that a cloud-enabled platform brings.
- Finally, we heard positive feedback on our revenue cycle progress, and this sentiment is also reflected in our pipeline, which includes some large clients initiating the move to *Cerner®* revenue cycle.

I also wanted to share a noteworthy success story that demonstrates the benefits of changes we have made over the past 18 months to become more client centric. This client is an academic system that had low satisfaction with their *Cerner®* solutions just a couple of years ago. By turning our focus to getting them current on the latest software release and strong alignment with our Model Experience, they have become a top reference site with strong system performance and improved clinician productivity. We are also in the process of converting 125 of their clinics from our primary competitor's system to Cerner. This demonstrates the value of our client-centric operating model with a focus on getting clients current and aligned with standards, which helps make them successful and can drive broad levels of satisfaction and opportunities to expand our relationship.

Now I'll provide an update on our Federal Business, where we had a very busy quarter. We brought a wave of four sites live for DoD in September and expect the next waves of sites to go live in the fall of 2020. We are also kicking off the Coast Guard project this quarter. For VA, we expect the Initial Operating Capability go-live and the kick-off for additional waves to occur in the spring of 2020.

Before I close, I'd like to provide a little more color on the AbleVets acquisition that Marc mentioned. We believe bringing the AbleVets team on board will provide Cerner additional capacity and technical expertise that will be very valuable in the federal space. As a trusted partner in our EHR Modernization program with the VA, they are highly specialized in cybersecurity, agile engineering, analytics and technology enablement, with deep experience in delivering value to federal health clients. As we prepare for upcoming key milestones on our Federal projects, integrating the AbleVets team into our business is a natural next step, as we expect their expertise will accelerate Cerner's success in providing integrated, seamless care for Veterans, Service members and their families.

With that, I'll turn the call back over to Don.

Don Trigg

Thanks, John. Good afternoon everyone.

We believe our vision to create a Health Network Architecture (HNA) for providers of care in every community will be realized in the decade to come. The addressable market is far larger than the integrated EMR category that Cerner fundamentally created. Progress was made in the 3rd quarter to lead it.

One of the strongest provider brands in healthcare is Pennsylvania-based Geisinger. They share our vision to architect a 'system' of health and care. In Q3, Geisinger designated our EMR-agnostic *HealtheIntent®* as their preferred health network platform for a 10-year term. They also will continue to leverage our Wellbeing application for member engagement within their health plan.

Market reaction has been quite favorable. Health systems are seeking solutions to help them scale growing health networks with high levels of technology heterogeneity and a shifting mix of employed and affiliated providers. We believe Cerner is well-positioned to meet that market need.

Beyond Geisinger, the emerging market reach of *HealtheIntent* can be seen in the recently released CMS data on Medicare Shared Saving ACO performance. CMS announced over $700 million in 2018 MSSP savings after accounting for shared savings and losses, with Cerner's clients generating nearly more than $200 million of savings via their MSSP ACOs. Advocate Physician Partners (APP), Hackensack Alliance and Memorial Hermann were among the top performers.

As long-term and post-acute care become an increasingly meaningful part of the Health Network, we also took steps in Q3 to strengthen our continuum of care strategy. We announced ResMed's Brightree home health product will be our go-forward market solution. ResMed and Cerner also will use *HealtheIntent* as a health network platform for post-acute care assets. This strategy, coupled with condition and therapeutic-specific analytic opportunities in areas like sleep, give ResMed and Cerner the potential to build a category-leading presence in a post-acute market with significant momentum.

In the state government space, we extended a meaningful relationship in the third quarter with the Texas Department of Aging and Disability (TDAD) to bring a holistic care offering to Texas' senior and disabled population. It is a solid use case for how Cerner's extended care and behavioral health assets, managed services and proven history of innovation and solid record of delivery drove a compelling win strategy.

We also announced an investment and partnership in the third quarter with i2i Systems. i2i commands 25% market share within the Federally Qualified Health Centers segment, covers nearly a third of all Medicaid patient data and has a strong payer business with 13 managed care clients. The relationship already has delivered our first material win at a FQHC/community health network based in North Carolina. *Cerner* technology will help provide Medicaid recipients with care coordination and management across a state level network looking to tackle rising Medicaid costs.

Whether the financing model is Medicaid, Medicare Advantage or commercial insurance, we see the person at the center of any true Health Network Architecture. During Q3, we delivered a new version of our Wellbeing application. We also launched a consumer framework that delivers one seamless consumer experience for both our application as well as client-developed and 3rd party applications. As part of that overall strategy, we added consumer self-pay capabilities from Palo Alto-based Simplee. We also augmented our patient access and online scheduling capabilities through a partnership with Boston-based Kyruus.

Cerner's Health Network Architecture (HNA) vision has four core pillars: automate the care process; connect the person; structure, store and study the data; and then 'close the loop' by pushing those analytic insights back into the care process.

I believe our Health Network Architecture vision is more relevant today than when it was first sketched for an MBA class in the 1990s. Our strategic urgency to advance it has never been greater. The quarter just concluded was foundational for doing so.

With that, let me turn the call back to Brent.

Brent Shafer

Thanks Don and thanks again to all of you being on the call. As you heard from the team, we are continuing to execute against our targets and advance our strategies. To summarize:

- Our transformation work remains on track and is advancing beyond cost optimization to include broader structure and process changes and automation;
- We are executing against opportunities in our core while also building pipeline and capabilities in our strategic growth areas; and
- We are actively executing our portfolio management strategy and demonstrated increased willingness to partner when it accelerates opportunities and strengthens our capabilities.

In summary, I believe this represents solid progress on our pursuit of sustainable and profitable growth which I believe can be achieved while playing a key role in driving meaningful improvements in health care quality and efficiency.

Now I'll turn the call over to the operator for questions.