Cerner Corporation
Third Quarter 2015
Earnings Conference Call
November 3, 2015

Moderator

Welcome to Cerner Corporation's third quarter 2015 conference call. Today's date is November 3, 2015, 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 expenses, product development, new markets or prospects for the Company's solutions and plans and expectations related to the Health Services business and other client achievements. 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.

At this time, I'd like to turn the call over to Marc Naughton, Chief Financial Officer of Cerner Corporation.

Marc Naughton

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

I will lead off today with a review of the numbers. Zane Burke, our President, will follow me with results highlights and marketplace observations. Neal Patterson, our Chairman and CEO, will be available for Q&A.

Now I will turn to our results. Similar to recent quarters, our great success in the marketplace is reflected in our record bookings, but we delivered revenue slightly below expectations. Today we'll address the disconnect between our outstanding bookings in what remains a very strong marketplace and our near-term revenue shortfalls. While we are disappointed about delivering slightly lower-than expected revenue, our bookings this year coupled with our strong pipeline set us up for good revenue growth next year.

Bookings, Backlog and Revenue

Our bookings revenue in Q3 was $1.59 billion, which is an all-time high and reflects 44% growth over Q314, including record amounts of new business activity.

Our revenue backlog ended the quarter at $13.9 billion, which is up from $10.2 billion a year ago and reflects the strong bookings in Q3 as well as the inclusion of backlog from Health Services.

Revenue in the quarter was $1.13 billion, which is up 34% over Q314 and includes approximately $250 million from Health Services. The total is about $20 million below the low end of our guidance range, with approximately half of the shortfall related to core Cerner and half attributable to Health Services.

On the Cerner side, the shortfall is much lower than previous quarters mainly because we appropriately adjusted our forecast for lower services revenue which was the primary issue in prior quarters. This quarter, the lower than expected revenue was mostly a function of lower than usual levels of upfront software revenue on some of our larger contracts and technology resale being slightly below our expectations. On the software portion, I'd like to note that we had an all-time high level of software bookings, but a larger than normal portion of the contracts were structured in a manner that resulted in revenue being spread over a longer period. This is obviously good for future periods, but did impact our current quarter revenue.

Relative to Health Services, the lower revenue was spread among a few areas, including software, technology resale, and maintenance revenue and also reflects that we are continuing to fine tune our visibility in that space.

Another factor we have not discussed that has impacted revenue this year is foreign currency fluctuations. In Q3, revenue would have been nearly $20 million higher if you held exchange rates consistent with those in Q3 2014. While we had factored a portion of this into our guidance, it did have some impact beyond what we expected in Q3 and is also a contributor to the lower revenue for the year.

Now I'll quickly go through the total revenue composition for Q3. Total System Sales revenue was $325 million, Support and Maintenance was $245 million, Services was $539 million, and Reimbursed Travel was $19 million.

System sales revenue reflects a 45% increase over Q314, with the growth mainly driven by an increase in Subscriptions, which is where the addition of Health Services has had the biggest impact, as well as growth in License Software and Tech Resale.

Our System sales margin percent was 67.5%, which is up from 64.3% in Q2 due to a sequential decline in Technology Resale. The margin percent is down year-over-year mainly because Q314 had a very low mix of Technology Resale that resulted in an unusually high System Sales margin percent.

Moving to Services, total Services revenue, including professional and managed services, was up 30% compared to Q314, mainly driven by the addition of Health Services as well as growth in core Cerner Managed Services.

Support and Maintenance revenue increased 38% over Q314, reflecting growth in core support and maintenance and the addition of Health Services.

Looking at revenue by geographic segment, domestic revenue increased 35% over the year-ago quarter to $998 million and Global revenue grew 32% to $130 million, both driven largely by the addition of Health Services.

Moving to gross margin. Our gross margin for Q3 was 83.1%, which is basically flat both year-over-year and sequentially.

Operating Expense

Looking at operating spending, our third quarter non-GAAP operating expenses, which exclude share-based compensation expense, voluntary separation plan expense, and acquisition-related adjustments, were $661 million, which is up 36% compared to adjusted Q314 operating expenses. This growth was primarily driven by the addition of the Health Services business.

The total year-over-year- growth for each expense category on a non-GAAP basis was: 32% for Sales and Client Service; 37% for Software Development, and 62% for G&A. Amortization of acquisition-related intangibles, which you'll recall is a new expense line we added in Q2, was basically flat. Note that, similar to last quarter, this line is $25 million on our GAAP income statement and just $3 million in our non-GAAP results since we are excluding amortization related to Health Services.

Operating Margins

Moving to operating margins. Similar to the past 2 quarters, we delivered basically in-line earnings on lower revenue, resulting in a higher operating margin percent than we projected at the beginning of the year. Our operating margin before share-based compensation expense, voluntary separation expense, and acquisition-related adjustments was 24.5% in Q3. This is down 90 basis points year-over-year due mostly to the very low tech resale in Q314, and up 30 basis points from Q215.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q3 were $147 million, or 42 cents per diluted share. Adjusted net earnings were $189 million and adjusted EPS was 54 cents, which is up 29% compared to Q314. Adjusted net earnings exclude share-based compensation expense, which had a net impact on GAAP earnings of $14 million, or $0.04 per diluted share; as well as the voluntary separation plan expense, which had a net impact on GAAP earnings of $2.5 million, or $0.01 per diluted share. Adjusted net earnings also reflect adjustments related to Cerner's acquisition of Health Services, including: Health Services acquisition-related amortization, which reduced GAAP net earnings and diluted earnings per share by $15 million and $0.04, respectively; other acquisition-related adjustments, which reduced GAAP net earnings and diluted earnings per share by $4 million and $0.01, respectively; and the acquisition-related deferred revenue adjustment, which is not included in GAAP net earnings, but increased adjusted net earnings and diluted earnings per share by $6 million and $0.02, respectively.

The Q3 tax rate for adjusted net earnings was 32%, which is slightly below our expected range of 33-34%.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q3 with $766 million of total cash and investments, which is down from $857 million in Q2 primarily due to the use of cash for our repurchase programs. During the quarter, we finished the remaining $100 million of repurchases authorized in 2014 and purchased $100 million of the $245 million authorized in September of this year. In total, we repurchased 3.2 million shares at an average price of $61.91.

Moving to debt, our total debt, including capital lease obligations, is $631 million, which is basically flat compared to Q2.

Total receivables ended the quarter at $1.05 billion, which is up $50 million from Q2. Our Q3 DSO was 85 days compared to 81 days in Q2 and 67 days in the year-ago quarter. The higher DSO is primarily a function of the lower revenue in the quarter and we are also still working through some delayed billings for Health Services clients as part of the transition. We do expect DSO improvement in Q4.

Operating cash flow for the quarter was $272 million, up from $109 million in Q2. Q3 capital expenditures were $88 million, and capitalized software was $72 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was $111 million for the quarter, driven by strong operating cash flow.

Guidance

Now I'll go through Q4 and full-year 2015 guidance.

- For Q4, we expect revenue between $1.15 and $1.2 billion, with the midpoint reflecting growth of 27% over Q414. Our Q4 revenue guidance combined with year-to-date results puts us slightly below the low end of previously provided full-year guidance as we have factored in the lower results from Q3 and lowered Q4 to reflect a similar run rate.

- So far this year, a favorable mix of revenue, lower expenses and Health Services synergies, have allowed us to deliver mostly in-line earnings despite our lower revenue. Looking at Q4, we do expect the lower revenue to have some impact on earnings, mainly due to the continuing effect of lower services revenue and the impact of lower upfront software on some contracts. We expect Q4 adjusted EPS before share-based compensation, voluntary separation plan expense, and acquisition-related adjustments to be 56 to 58 cents per share, with the midpoint reflecting 21% growth over Q414 adjusted EPS. This range is below consensus estimates and slightly below our original plan, but it does get us to the low-end of our most recently provided full-year guidance. Also, the Q4 guidance combined with year-to-date results still reflects strong growth of 26% for the full year.

- Our estimate for the impact of share-based compensation expense is approximately 3 to 4 cents in Q4, which equates to 14 to 15 cents for the full year.

- Moving to bookings guidance, we expect bookings revenue in Q4 of $1.45 billion to $1.55 billion, with the midpoint reflecting strong growth of 29% over Q414 and 31% growth for the full year.

Now I'd like to provide initial expectations for 2016. Note that these comments should be viewed as preliminary until we finalize our financial plan and provide more formal guidance when we report fourth quarter results.

- We currently expect 2016 revenue to be over $5 billion, which equates to growth of at least 13% on top of what is projected to be approximately 30% growth in 2015. We realize that the growth this year benefited from our acquisition and has come in below our original targets, but growing 13% on top of a 30% growth year is still strong. Our 13% target does include a benefit of having 12 months of Health Services revenue in 2016 compared to 11 months in 2015, but that only equates to about 2% of growth for the year, so our full-year growth target is still double digit even excluding the extra month.

  While there are obviously many assumptions that go into projecting future revenue, we do feel positive about our ability to deliver good growth in 2016. A key element to our confidence in 2016 revenue is our backlog, which has grown significantly this year due to our record bookings and the addition of the Health Services business. This larger backlog translates into better visibility for 2016. As we look at the rollout of backlog in 2016, we currently expect approximately 75% of our revenue to come from backlog, which is higher than historical levels.

Another key assumption is that we do believe the market opportunity remains strong, which Zane will discuss.

- For earnings, we currently expect adjusted diluted earnings per share before share-based compensation and acquisition-related adjustments between $2.30 and $2.40 cents per share, with the midpoint reflecting 13 percent growth over 2015 expected results.

  This range is below the current consensus estimate of $2.52, which was formed in the absence of company guidance. We believe the primary potential differences between our preliminary view and the consensus estimate may include higher non-cash expenses and professional services contributions. Regarding non-cash expenses, our current estimates reflect an increase in depreciation and amortization of more than $75 million in 2016, which equates to nearly $0.15 of earnings per share, and we believe consensus estimates have less than this for a non-cash expense impact. The large increase in amortization is tied to a significant amount of previously capitalized software expected to become generally available, and the large increase in depreciation is related to recent increased levels of capital spending.

  Relative to services contribution, while we expect strong growth in services revenue and earnings contributions next year, the growth will be coming off of the lower 2015 levels we have discussed.

  We do not intend for these comments to precisely reconcile our preliminary view to analyst estimates, but more to provide our thoughts on potential differences.

In summary, we realize this has been a challenging year relative to delivering against our revenue expectations. As I indicated, we believe revenue growth will be good next year and that we have visibility to this growth, partially driven from a backlog that has benefited from what has been by far the best year of bookings in the history of our company.

With that, I will turn the call over to Zane, who can talk about why our bookings are so strong.

Zane Burke

Thanks Marc. Good afternoon everyone. Today I'll provide color on our results and make some marketplace observations.

Results/Marketplace

I'll start with our results. Our bookings revenue in Q3 of $1.59 billion reflects strong growth of 44% over Q314.

Bookings this quarter included another all-time high level of large contracts, with 45 contracts over $5 million, including 31 over $10 million. For long-term bookings, we did have two ITWorks contracts, but the overall mix of long-term bookings was in a more normal range of 31%, which makes the strength of the bookings even more impressive because it wasn't driven by elevated levels of longer-term contracts.

A highlight of the quarter was that we again signed a record number of new footprints, with 39% of our bookings coming from outside our core *Millennium*® installed base. So far this year, we have signed more new footprints, measured by dollars and count of sites, than any full-year in our history. This success reflects our strong competitiveness and the continued large opportunity for competitive displacements. Our success this quarter and the opportunities in our pipeline span many market segments, including: IDNs, regional hospitals, Children's hospitals, Community hospitals, state and federal, behavioral health, ambulatory surgery centers, and physician groups.

A particularly noteworthy area of success is large IDNs and investor owned health systems. In addition to McLaren Health Care selecting Cerner for EHR, Revenue Cycle and Population Health, which they announced last month, we also gained another large investor owned health system as a client during the quarter. In addition, one of our existing investor owned clients chose to move forward with Cerner for an additional 24 sites. These are in addition to Baptist Health South Florida and Department of Defense, which we talked about on our last call, but occurred during the third quarter.

As I've mentioned before, I believe a key element of our success is driven by our track record for delivering projects on-time and on-budget as well as creating measurable value, which aligns well with our clients focus on making ROI-based decisions.

This ability to deliver value along with predictable costs and timeline serves as a differentiator relative to our primary competitor. I believe their list of clients where the significant costs of deploying and maintaining their system has been cited as a key reason for financial challenges is starting to impact them in the marketplace. This not only differentiates us in the sales process, it has also contributed to some of their existing clients switching to Cerner, even after spending $100+ million on their system.

We are also continuing to sign Health Services clients to migrate to *Millennium*, including both IDNs and small hospitals. Overall, we remain pleased with our progress with the Health Services base, with migrations continuing at a good pace.

Population Health

Now I'd like to highlight an important announcement we made during the Cerner Health Conference that represents a major milestone for our *HealtheIntent™* platform. During Neal's keynote address, we announced that Geisinger Health System, a national model for high quality and high value health care, decided to use our *HealtheIntent* population health platform to extend their data-driven population health capabilities. Cerner and Geisinger share a core belief that managing the health of populations requires access to information outside traditional health care domains, and we are excited to be a strategic part of Geisinger's ability to provide systems-level insights to manage population health at scale. This relationship builds on a proof-of-concept project that started last year, where Geisinger leveraged *HealtheIntent*, our system-agnostic, near real-time platform that normalizes data, to aggregate clinical and financial data from its core EHR and other sources, such as its insurance company.

We believe this decision makes a clear statement to the market, as Geisinger uses our primary competitor for their core EHR and is one of their longest-duration and most significant clients. We believe this demonstrates that our capabilities could not be equaled by our competitor and that the *HealtheIntent* platform is the right platform to support Geisinger's quest for ongoing innovation.

I also think this makes it clear that our investments in interoperability and open platforms that enable client and third-party innovation are paying off. This is a great example of why we believe Cerner is positioned to play a major role as health care continues to shift from a fee-for-service model to outcomes-based reimbursement models that incent keeping people healthy.

Revenue Cycle

Moving to our revenue cycle business, we had a good third quarter. We continue to have a high take rate of revenue cycle in our new EHR footprints, which supports what we have been saying about the market looking to buy integrated systems. A key element of our success in revenue cycle has been the increasing number of proof points with our clients. As one quick example, I'd like to share something from a thank you note a client CFO sent us recently. In the note, he indicated that in the past year they had: decreased AR days 19%; increased Average Daily Revenue 22%; and reduced "Discharged Not Final Billed" days by 33%.

These success stories are becoming more common and add to our momentum in the marketplace.

Ambulatory/CommunityWorks

Moving to the ambulatory market, where we had an all-time high level of bookings in Q3, surpassing a record we just set last quarter. The bookings were driven by success at displacing our key competitors both by expanding our solutions to the ambulatory venues of our acute care clients and as part of new business footprints.

In ambulatory business office services, we had two displacements of a certain cloud competitor. Our opportunity to displace this competitor resulted from their lack of execution, failure to meet established objectives, rising costs after teaser rates, and a realization by the client that they ended up needing similar or more staff even though they thought they had outsourced the function to our competitor because they left much of the harder and more complex work to the client.

We also had a strong quarter in the small hospital market and passed the 100 client milestone with our cloud-based CommunityWorks offering. This quarter's success was again driven by a combination of traditional new footprints, extensions through our health system clients, and Health Services migrations. We expect the CommunityWorks offering to exceed 125 clients by year-end. In addition, CommunityWorks opened up two new markets by completing multiple client conversions within stand-alone Orthopedic Surgical hospitals along with a multi-site clinically integrated network in the state of Iowa. We continue to believe there is a good market opportunity for Cerner in the small hospital market and are very pleased with our competitiveness in this market.

Global

Outside of the U.S., we had a solid Q3 with revenue growth of 32% and good bookings in Australia, United Kingdom, and the Middle East. We continue to make progress with integrating the global components of Health Services, which is augmenting our global presence and positioning us for good long-term contributions from our global business.

In summary, I am very pleased with the success we are having in the marketplace and maintain a positive outlook because of our large pipeline, broad solution and service offerings, and strong competitive position.

With that I will open the call for questions.