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CERN - Q1 2016 Cerner Corp Earnings Call

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OVERVIEW:

Co. reported 1Q16 revenue of $1.14b and GAAP net earnings of $150m or $0.43 per diluted share. Expects full-year 2016 revenue to be $4.9-5.1b and adjusted EPS to be $2.30-2.40. Expects 2Q16 revenue to be $1.175-1.250b and adjusted EPS to be $0.56-0.58.

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PRESENTATION

Operator

Welcome to Cerner Corporation's first-quarter 2016 conference call. Today's date is May 5, 2016, 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 margin, operating and capital expenses, product development, new markets or prospects for the Company solutions and services and plans and expectations related to the health services business and other client achievement. 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 the earnings call can be found in the Company's earnings release which was furnished to the SEC today and posted in the investor section of Cerner.com.

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

Marc Naughton - *Cerner Corporation - CFO*

Thank you, Liliana. 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 the results highlights and marketplace observations. And then Mike Nill, our Chief Operating Officer, will provide some operational highlights. Now I will turn to our results.

Q1 was a solid start to the year. Bookings, earnings and cash flow were in our targeted ranges. Revenue was slightly below our targeted range but our full-year outlook remains intact. Our bookings revenue in Q1 was $1.17 billion, which is 2% lower than Q1 of 2015 in total but reflects strong growth of 18% when you exclude long-term bookings.

As we indicated, Q1 2015 included an all-time high level of long-term bookings of 37%, creating a tough comparable. And this quarter had its very low level of 24%. While this difference led to total bookings being basically flat, the strong growth in our non-long-term bookings reflects ongoing strong demand and new footprints, which Zane will discuss. In addition, we have a strong pipeline for work deals, so expect a mix of long-term bookings to normalize as we move through the year, which will benefit overall bookings.

Our revenue backlog ended the quarter at $14.6 billion, which is up 12% from $13 billion a year ago. Revenue in the quarter was $1.14 billion, which is up 14% over Q1 2015 but $12 million below our guidance range, due primarily to lower hardware sales. The revenue composition for Q1 was $279 million in system sales, $251 million in support and maintenance, $589 million in services, and $19 million in reimbursed travel. System sales revenue for the quarter was up 8% compared to Q1 of 2015, with growth in software and subscriptions offsetting a large decline in hardware. The lower hardware is reflected in the strong system sales margin percent of 68.1%, which is up over 300 basis points year over year. The lower-than-projected hardware revenue led to total revenue being slightly below our guidance range. While it is disappointing to be slightly below our guidance range, I believe the growth in software and the return to strong growth and services revenue is more indicative of our core business trends.

Moving to services, total services revenue including professional and managed services was up 20% compared to Q1 of 2015. This is in line with our expectation and reflects good execution by our services organization. Support and maintenance revenue increased 10% over Q1 of 2015.

Looking at revenue by geographic segment, domestic revenue increased 15% over the year-ago quarter to $1.005 billion and a global revenue grew 6% to $133 million.

Moving to gross margin, our gross margin for Q1 was 84.6%, which is up from 83.1% in Q1 of 2015, reflecting the lower mix of hardware as well as strong levels of service.

Looking at operating spending, our first-quarter non-GAAP operating expenses, which includes share-based compensation expense and acquisition-related adjustments, were $701 million, which is up 19% compared to adjusted Q1 of 2015 operating expenses. This growth was primarily driven by growth in personnel expenses related to revenue-generating associates, higher non-cash expenses, and having an extra month of health services expense in Q1 2016 compared to Q1 2015.

The total year-over-year growth for each expense category in Q1 on a non-GAAP basis was 22% for sales and client service, 4% for software development, and 25% for G&A. Amortization of acquisition-related intangibles was basically flat.

Moving to operating margins, our operating margin before share-based compensation expense and acquisition-related adjustments was 23.0% in Q1, which is down slightly from 23.7% in the year-ago period. As previously indicated, we expect margin expansion to be limited in 2016 due in part to growth in non-cash expenses. As we laid out at HIMS, we believe we can expand margins 50 to 100 basis points annually after 2016.

Moving to net earnings in EPS, our GAAP net earnings in Q1 were $150 million or $0.43 per diluted share. Adjusted net earnings were $182 million and adjusted diluted EPS was $0.53, which is up 18% compared to Q1 of 2015. Adjusted net earnings excludes share-based compensation expense, which had a net impact on GAAP earnings of $13.4 million or $0.04 per diluted share. Adjusted net earnings also reflects 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 $13 million and $0.04, respectively.

Other acquisition-related adjustments which reduced GAAP net earnings and diluted earnings per share by $2 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 $4 million and $0.01 respectively.

The Q1 tax rate for adjusted net earnings was 31%, which is slightly lower than our expected range of 32% to 33%.

Now I will move to our balance sheet. We ended Q1 with $707 million of total cash and investments which is up slightly from $686 million in Q4, with most of our free cash flow being used to repurchase shares. During the quarter, we executed $150 million out of the $300 million stock repurchase program authorized in March of this year, repurchasing 2.8 million shares at an average price of $53.45.

Moving to debt, our total debt including capital lease obligations is $595 million, which is down slightly compared to Q4.

Total receivables ended the quarter at $942 million, which is down $92 million from Q4. Our Q1 DSO was 76 days, which is an improvement of four days compared to Q4 and in line with our expectations.

Operating cash flow for the quarter was very strong at $327 million, which is second only to our all-time high of $353 million in Q4. Q1 capital expenditures were $99 million and capitalized software was $75 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was $152 million for the quarter, driven by strong operating cash flow.

As previously indicated, we expect capital expenditures to increase in 2016 primarily due to construction of a new campus. We still expect to generate solid free cash flow, with growth in operating cash flow offsetting the increase in capital expenditures. Now I will go through Q2 and full-year 2016 guidance.

For Q2, we expect revenue between $1.175 billion and $1.25 billion, with a net point reflecting growth of 8% over Q2 of 2015. Note that we have widened our guidance range to provide cushion, given we were below our Q1 guidance due to the hardware.

Also, we expect revenue growth to be higher in Q3, which is an easier comparable period than Q2. For the full year, we continue to expect revenue between $4.9 billion and $5.1 billion, reflecting 13% growth over 2015 at the midpoint. We expect Q2 adjusted EPS before share-based compensation and acquisition-related adjustments to be $0.56 to $0.58 per share, with the midpoint reflecting 10% growth of Q2 2015 adjusted EPS. For the full year, we continue to expect adjusted EPS before share-based compensation and acquisition-related adjustments to be $2.30 to $2.40, with the midpoint reflecting 11% growth over 2015.

Our estimate for the impact of share-based compensation expense is approximately $0.04 in Q2 and between $0.16 and $0.17 for the full year. Moving to bookings guidance, we expect bookings revenue in Q2 of $1.35 billion to $1.48 billion, with the midpoint reflecting 10% growth over Q2 of 2015.

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

Zane Burke - *Cerner Corporation - President*

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

Starting with bookings, as Marc indicated, our total bookings were basically flat compared to the year-ago quarter, but our non-long-term bookings grew at 18%, and we expect long-term bookings to continue to increase as we move through the year.

Bookings this year included a strong level of large contracts, with 43 contracts over $5 million, including 18 over $10 million. Regarding long-term bookings contributions, we did have solid hosting bookings and a small ITWorks contract. But the total percent from long-term bookings was just 24% compared to approximately 30% to 31% in recent years. This was not a surprise to us, as we had indicated our guidance assumed a lower level of long-term bookings and our total bookings are within our guidance range. Going forward, our pipeline for works deals is strong, so I expect more contribution from long-term bookings in future quarters.

Now I will discuss the drivers of the strong growth in non-long-term bookings. The main highlight of the quarter was our continued success at gaining new clients. In Q1, 36% of our bookings came from outside our core millennium installed base, driven by an all-time high win rate against our primary competitor. As I've discussed, we believe we are much more effective against our primary competitor for several reasons including significant improvements in our solutions in recent years, predictable delivery capabilities, lower cost of ownership, ability to deliver value, and our population health and open-platform capabilities. In addition, we believe the heightened awareness of our primary competitor's higher cost of ownership, lack of system openness and limited population health capabilities has contributed to us being more effective against them.

Looking ahead, our pipeline for new business continues to grow, and other leading indicators such as reference activities are at all-time highs. With one major installed base facing a sunsetting of their solution, and another with over three-fourths of their base on legacy platforms, we expect the replacement market to remain strong over the next two to three years.

Our view the replacement market and overall opportunity to grow our business was also validated at HIMSS. This year we interfaced with clients and prospects representing over $8 billion of pipeline, which is an increase of 40% compared to last year. The EHR replacement market continued to be a large part of these conversations, but we also had a high volume of discussions with existing and new clients about other solutions and services such as revenue cycle, ambulatory, population health and our Works businesses.

Another highlight of the quarter was the strength of our revenue cycle business. As Mike will discuss, we continue to have a very high percent of new clients that include revenue cycle with their EHR purchase and more of our existing clients, including some of our largest, choosing to move to Cerner Revenue Cycle.

Moving to the ambulatory market, where we had a very good Q1 with strength in ambulatory EHR, practice management and business office services, this included some of our largest IDM and investor-owned clients choosing Cerner's clinical and revenue cycle solutions for their ambulatory settings. We also continue to see a high attach rate for ambulatory when health services clients are migrating to Millennium.

As we look to the rest of the year, there are many more opportunities to sell ambulatory solutions to the practices affiliated with our major health system clients. In addition, we are starting to see more opportunities at large stand-alone practices, where some of the best-of-breed suppliers continue to falter.

We also had a strong quarter in the small hospital market and our cloud-based CommunityWorks offering. Bookings from CommunityWorks were a record for first quarter, and it included a combination of standalone opportunities and health services migrations. Now I would like to provide a quick update on the Department of Defense project.

HIMSS proved to be a great opportunity to highlight the progress made by the Lighthouse partnership for defense health. We had a completely full house for all showings of a demonstration that highlighted the functionality of the DOD's model system, including some military-specific workflows, first-responder applications, mass vaccinations and theater synchronizations. We remain on track for pilot sites to go live late this year.

Moving to health services, we continue to have success at migrating health services clients to Millennium and remain ahead of our original expectations for migrations. Operationally and financially, we remain on track with the objectives we established when we did the acquisition. As I've said before, we are pleased with how Cerner and health services teams have come together, and I am impressed with how quickly health services associates have been able to add value in key areas of our business.

Outside of the US, we had a solid quarter. But most non-US markets continue to grow slower than our US businesses. In Q1, our global revenue grew 6%, driven largely by the extra month of health services, compared to Q1 of 2015. Longer-term, we remain positive on our global growth opportunity and believe this business will pick up as global economies strengthen. In addition, we believe global markets represent a significant opportunity for population health solutions, and our recently announced population health contract with World Health Partners in the UK is a good example.

On that note, I will now discuss our overall population health business. The HealtheIntent platform is increasingly becoming a differentiator when we compete for new EHR business and also represents a major business opportunity inside and outside of our installed base. In Q1, most of our new footprints included population health solutions, and I believe our population health capabilities are contributing to our increased success against our primary competitor. In addition, the pipeline of our existing clients looking at HealtheIntent remains strong.

As I've discussed, health systems are increasingly being asked to live in two worlds: a future state driven by reimbursement models aligned to risk and quality outcomes, and a current state where fee-for-service is still the predominant model. We believe HealtheIntent can help our clients compete more effectively on quality and efficiency in today's environment and also prepare them to more actively engage in managed populations in the future state. As a result, it is proving to be very attractive, even to clients who aren't going directly at risk today.

Additionally, the shift away from traditional fee-for-service is gaining momentum. Most of you are already aware of the plan CMS laid out last year to shift 50% of Medicare payments to value-based payment models by the end of 2018 and tie most of the remaining traditional fee-for-service payments to quality measures. More recently, CMS announced the comprehensive Primary Care Plus model, which is yet another push towards more fee-for-value payment models that directly incent for active population health management. There are other reimbursement programs targeted at areas like joint replacement and chronic care management that are contributing to demand for our population health solutions.

In summary, there is a significant amount of change occurring in health care, and this change is creating meaningful opportunity for Cerner. With that, I will turn the call over to Mike.

Mike Nill - *Cerner Corporation - COO*

Thanks, Zane. Good afternoon, everyone. I wanted to start by building on some of Zane's comments on HealtheIntent by providing some perspective about its scope and scale. We began building HealtheIntent platform in 2012. In September of 2013, we made an on-time delivery of HealtheRegistries, the first solution on the platform. We are rapidly expanded the number of solutions and data sources connected to HealtheIntent. We now have six core solutions, with 10 more planned by the end of the decade, and have connected nearly 300 data sources for more than 80 unique systems ranging from EHRs to insurance claim fees to device data to open-source environmental data.

HealtheIntent has already become a very large platform. It currently has 5.5 petabytes of data, 59 million persons and is performing more than 100,000 processing jobs daily across activated clients, giving them access to near real-time data. It supports the automation of personalized plans for care and programmable intelligence, and enables strategic payer and provider network management that is informed by analytics and research.

Like Cerner Millennium, HealtheIntent is a platform that enables a family of solutions. Those solutions are complementary to the function of the EHR and device platforms, and they have the potential to create a lot of value. And the maturity of the platform, the introduction of solutions are working out well with the timing of the market. We believe HealtheIntent is unmatched in its scope and scale and that it will continue to win out over many of the best-of-breed net solutions that we compete against today, much like our millennium platform has proven to be superior in the EHR market.

Moving to Revenue Cycle, as Zane indicated, we had a very strong quarter. We had record bookings driven by a high attach rate of Revenue Cycle in new EHR business and existing EHR clients choosing to add Revenue Cycle. In addition, we had good contributions from RevWorks extended business office services, which are shorter engagements then full rev cycle for things like staff augmentation, business office management, transition services and other targeted projects.

One highlight during the quarter was Universal Health Services, one of the largest hospital management companies in the nation, selecting Cerner's Millennium revenue cycle solutions. Combined with their existing Cerner clinical solutions, this will create a clinically driven revenue cycle system which we believe is the best approach and the way almost all health systems are looking to go.

Our revenue cycle pipeline is very strong, with more IDNs and investor-owned clients expected to move to our revenue cycle solutions. In addition, Revenue Cycle is part of almost every new client opportunity, and our pipeline for new clients is also very strong, as Zane discussed.

In summary, our investments and execution in the Revenue Cycle space have led to much stronger competitiveness, contributed meaningfully to our growth and created a substantial pipeline of opportunities going forward.

To close, I would like to comment on the recent increase in headlines related to IT security in health care. We take security very seriously and invest heavily in protecting the information in our systems. This has resulted in a good track record of protection for our clients' data. This increase in industry issues has related to security and recognition by our clients that we have a strong competency and security and is contributing to increased opportunities for our remote hosting business.

In addition, we believe the industry focus on security could increase opportunities for ITWorks relationships as our clients look for help in securing the information beyond their service solutions.

With that, I would like to turn the call over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Eric Percher, Barclays.

Eric Percher - *Barclays Capital - Analyst*

Marc, I appreciate your comment about service and software being indicative of the long-term trend. As you think through your forecast for the year, could you walk us through some of maybe the -- what is most predictable versus where you have the most variability? Obviously you are calling for long-term or ITWorks deals this year. But can you line up which areas are most predictable and whether -- and how you feel about that service and software going forward?

Marc Naughton - *Cerner Corporation - CFO*

Sure. We started the year talking about the fact that our backlog had a significant amount of 2016 revenue in it, that 79% of the revenue for the year was going to be coming out of backlog. And actually based on what we saw in the first quarter, that backlog is generating the revenue that we've expected.

And as you know, through last year services was an issue that we were dealing with. This year, services is on track. We have added a lot of people to that organization last year, all revenue-producing associates. And I think they are delivering -- they're generating their backlog and they are delivering that backlog as we expected.

The thing that hit us this quarter is that 21% that is going to come from current-quarter bookings. And most of those feed into the system sales line on the income statement. So when you look at the system sales line, the growth there was pretty low and primarily driven through lower hardware.

And as we kind of go through what we think for the year and the remaining quarters, we think hardware will bounce back to the levels that we expected. But we were clearly short in Q1. The business is out there. We certainly -- as we forecasted, saw deals, some of which kind of moved out and will help us achieve our targets in Q2 through Q4 on the hardware side.

But I think, relative to our highly visible revenue, all of those elements of the business are really hitting on all cylinders at this point.

I think it's important to note when you look at our revenue growth too, really it's helpful. And I know it's harder because with HS now becoming more part of our overall revenue, and we are not really even able to break out separately --. But I think if you look at revenue growth for Q1, and if you take out -- basically look at Q4 of HS revenue, which is in the $240 million, $245 million range, really Q1 was about a 10% overall revenue growth. I think that is more indicative of the organic growth of the Company, assuming that HS -- health services basically stays flat on the revenue basis and was similar to what Q4 was. I think you're going to see Q2 be growth in the 12% organic range, and you will see that continuing to increase, helping drive our overall growth for the year in the 13% revenue range.

So, I'm not excited that we didn't hit our revenue guidance this quarter, but the fact that it was related to hardware, which is a little bit harder to forecast, comes in and out in the same quarter. Doesn't concern me relative to the rest of my business.

Eric Percher - *Barclays Capital - Analyst*

Right. And with respect to those long-term bookings you are indicating for the year, is that a requirement of meeting the Q2 bookings target, or can you get there or even if those are not until later in the year?

Marc Naughton - *Cerner Corporation - CFO*

Yes. Right now our expectations is that the works business is really kind of our second-half phenomena more than Q2. We expect to start getting back to more than 24% of our bookings coming from long-term, but we are not -- it is not going to get up to 37%. We think it will start recovering to be more in the 30% to 32% range that we've seen. But it doesn't have to do anything heroic. It just has to be more of the normal course. And we knew coming into Q1 that we really weren't set up with any large works deals and that's why we previewed it with everyone.

Eric Percher - *Barclays Capital - Analyst*

Thank you for that detail.

Operator

Steve Halper, FBR.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

Just to get into the revenue shortfall, what sort of hardware revenue didn't materialize as expected? And over the years, it's been pretty difficult for you to forecast that number. This is not the first time it's happened. So why is that?

Marc Naughton - *Cerner Corporation - CFO*

Well, because it tends to be a replacement. Right, Steve? So it's not something -- there is no bridge on fire, no building that is burning that they have to replace immediately. So we had -- of the shortfall, the $15 million to $20 million that was kind of a shortfall for hardware. A good chunk of that was large clients who host themselves that were going to do large-scale replacements of computers; so, hardware. Another component of it was the slightly lower device resale, but that was actually a smaller component.

A lot of it was large hardware deals that likely will happen later in the year. But those clients for whatever reason pushed off renewing -- updating their infrastructure for some period of time. It is something that they have flexibility on. Those machines continue to work, so that's why it's a little bit harder to tie down the exact period it's going to be.

As you saw in our guidance for next quarter, we took the bottom end of our guidance down $25 million to make sure that we meet our guidance range for revenue next quarter. And a lot of that was just to say if hardware is going to be harder to forecast using our traditional approach to doing that, which is about the only way that we can really do it, we're going to bake that in until we see that hardware start recovering. Certainly I expect it as we move through the year to get back on track and deliver the quarterly numbers that we projected and planned. But Q1 was short, and I don't know that we end up making that up during the year.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

Right. And as you think about the hardware delays, over the course of time is there anything that you have been able to read into a customer when they push off hardware upgrade? Or is it simply just, like you said, nothing is on fire here and they can put that off?

Zane Burke - *Cerner Corporation - President*

Steve, this is Zane. There is nothing to read into those particular pieces. They are typically not tied to large new business transactions, not tied to significant upgrades of the solutions and additional solutions they are buying. They are typically purchased on a different cycle. So they are -- they run their own process, et cetera. So I just don't think there's anything to read into the rest of the elements.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

Okay. Thank you.

Operator

David Larson, Leerink Partners.

David Larsen - *Leerink Partners - Analyst*

Can you please talk a bit about the patient accounting solution within Millennium? Roughly how many customers do you have on that product? What sort of investments have been made into it? And what are your thoughts around Soarian's patient accounting solution? Could that potentially be the go-forward strategy in some cases? Thanks.

Zane Burke - *Cerner Corporation - President*

David, this is Zane. We have hundreds of Millennium patient accounting clients on the acute side and thousands on the ambulatory side. And so lots of progress over the years in that side. It is a significant investment for Cerner in terms of where we are putting research and development as we continue to develop what we're doing, both acute ambulatory and across the entire continuum of care. So Revenue Cycle is a big focus for us.

Soarian is a go-forward strategy, but it is only as it relates to stand-alone business. It is actually something that was -- Soarian was architected to be a stand-alone patient accounting solution. About 25% of the market still looks for stand-alone patient accounting solutions. Soarian is doing -- financials is very strong, very solid. We will continue to develop that out for that marketplace. But in an integrated basis, Millennium patient accounting, Millennium clinicals are the go-forward strategy on an integrated basis.

Marc Naughton - *Cerner Corporation - CFO*

Yes, this is Mark. I think it's important to note that almost -- probably every deal we sold in the last 12 months that has been new for EMR and EHR has had Millennium Revenue Cycle included in it. Because people want that enterprise view. It's our Millennium only works with our Millennium Clinicals, but our expectation is over time all of our clients will eventually go to that enterprise system.

When you look -- relative to the numbers that Zane had, they are pretty accurate. Hundreds of hospitals, thousands of clinics. It's a contemporary solution in a time where there is -- there aren't that many of them that are contemporary and its enterprise. So it's the two things the market's looking for.

David Larsen - *Leerink Partners - Analyst*

Okay. And then Marc, I think I heard -- if I heard you correctly, organic growth in the quarter was 10% for revenue?

Marc Naughton - *Cerner Corporation - CFO*

Yes. Once again, we don't have a precise number for health services to give you. But basically if you factor in the $240 million, $245 million that was in Q4 for health services and roll that forward, [Zumat] was the same amount in Q1. The Cerner revenue components of Q1 grew about 10%.

David Larsen - *Leerink Partners - Analyst*

Okay, great. Thanks very much.

Operator

Dave Francis, RBC Capital.

Dave Francis - *RBC Capital Markets - Analyst*

Keeping on the theme of Revenue Cycle, can you talk a little bit from a macro perspective what is going on in the marketplace that is driving this focus on Revenue Cycle for you guys? What has changed from or what you have done internally from a product and solution offering respective to become more competitive on that front? And talk a little bit about what happened with the Universal Health solution to drive their decision to unify the solution on your platform.

Zane Burke - *Cerner Corporation - President*

Sure, this is Zane. From a new business perspective -- Dave, I'm going to take your multipart question in parts.

So from a -- what's driving the marketplace -- overall marketplace trends, from a new-business perspective, most everyone wants an integrated clinical and financial system together. And as you think about a go-forward strategy to prepare for bundled payments, to prepare for really the at-risk models, all the things that are occurring, people are looking for those integrated clinicals and financials. And that is frankly the same thing that is driving the marketplace trend in our own installed base is those organizations want to get prepared for the future and have the foundational Revenue Cycle solutions that matches their clinical systems from an integrated perspective.

So that's one of the marketplace elements. Additionally, you have a number of bases that are being sunsetted, so there is obviously with one large installed base being sunsetted. You've got another installed base that's on a legacy solution and has to be migrated and brought to a current platform. And so those are driving a lot of the macro-level marketplace trends. And it's pretty logical as you think we are in a post-ICD 10 era, but there was some pent-up demand for Revenue Cycle on that side. So I think there is kind of those elements as a rate to that.

From our perspective it's -- we've invested significantly over the last several years in Revenue Cycle from a solution and services point of view. And being able to have that demonstration of those -- of that functionality live in our clients has been very beneficial for us. And that -- as we continue to drive across the other continuum of care and our vision of one bill across the continuum of care, I think that is a strong vision that clients are looking for. And as they think in the future that that will work towards that, I think the UHF's conversation is really -- they've been a long-term health services client. They have been a long-term -- on the financial side, they been a long-term Cerner client on the clinical side. And so putting those together in that same construct of having strong foundational solutions from an integrated perspective, acute, and ambulatory as they move forward is important to their clinical integration strategy. And then they also have some expertise from a billing perspective that we really like working with those folks. And that's a big positive for our teams as well because we've done a lot of work on the services and process side.

So that -- I feel really good about where we are and the progress we're making and the trend line and trajectory for rev cycle.

Dave Francis - *RBC Capital Markets - Analyst*

Great. Thank you.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

I guess, Zane, I will start with do you guys see anything in any of the numerous CMS demonstration projects that are expected to roll out over the next year or two? I guess that particularly excites or worries you as it relates to the market opportunity if any of these were to be adopted more broadly?

Zane Burke - *Cerner Corporation - President*

We are really excited about -- the at-risk piece just drives the need for more population health solutions. And take that buzzword out, you just need to have access to the data of that person and that patient no matter where they are in the continuum of care. You've got to have mechanisms to be able to track it moving forward. The more need for data liquidity across the continuum of care, the more need for solutions like HealtheIntent. And so almost every single one of the initiatives has a big value there.

There is also a number of state-driven initiatives, so whether it's New York district program, you look at the number of Medicaid initiatives, we see a big demand in markets where we haven't participated in the past where we see great opportunities for us to participate. So I think the state and local governments will be additional areas of focus for us, and you will see future announcements in both -- in those areas and opening up Cerner into markets where we haven't participated in the past.

So all of those are big drivers for IT and for both core foundational EMRs because you have to have this solid, strong foundational plumbing to succeed in the future world. And then you've got to have the tools to be able to track the information no matter where they are, whether it's a Cerner EMR or whether it's claims data or whether it's PVM data, all those types -- whether it's federal databases themselves. All of that needs to come together into a way which people can track the information no matter where the person goes and really enhance the ability to manage risk in a better way. So all of this makes me feel really good about the future.

George Hill - *Deutsche Bank - Analyst*

Okay. That's helpful. And Marc, just kind of a quick follow-up for you. As it relates to the R&D line, I thought we were expecting to see a big step up in Q1 as there was a bunch of capitalized R&D that was going to flow through that line in Q1, I guess. Have we not started to amortize the capitalized portion yet? I guess is there a product that we haven't (inaudible) at or is showing up in another line item?

Marc Naughton - *Cerner Corporation - CFO*

Well, I think the -- I think you did see a step up in Q1. But I think that our cap rate also was a little bit higher because a lot -- we are working on a lot of new stuff, so the capitalization rate was slightly higher in the quarter as well. So I think the net net effect was that you had -- saw a slight year-over-year increase in the R&D spend. So that the amortization -- that uptick was offset a little bit by a little bit higher capitalization.

George Hill - *Deutsche Bank - Analyst*

Okay, yes. I guess I should have just said versus (inaudible). Okay. All right. Thank you very much.

Operator

Mohan Naidu, Oppenheimer.

Mohan Naidu - *Oppenheimer & Co. - Analyst*

Marc, maybe a quick one on the tech resale. In the last few years, you've seen a decline in the mix effect of resale revenues as to overall revenues. If you look at your internal models, how much are you still baking in for 2016?

Marc Naughton - *Cerner Corporation - CFO*

Revenue from basically tech resale, which is primarily hardware and also the resale of other third-party software, relative to our total number, it's 5%, 6% of revenue. It's a fairly small number. I think if you looked at our slides that we provided at HIMSS, tech resale was probably $330 million in total. So I think if that gives you a sense, we don't expect that to grow. But in our world, that $330 million is just -- is ripe for the taking because we have those client relationships, we know who to go to and we know when they are looking to go acquire that. We don't make a whole lot of money out of the hardware. So, yes, it's bad when it doesn't hit the revenue; it doesn't really have much of a bottom-line impact.

Selling that -- the solutions and third-party software has more margin. So the reality is in this quarter when we were actually below tech resale revenue, we hit our margin number because of the margin we were driving out of the third-party software and the higher margins that comes with.

So -- but it's not a growing part of our business, but we expect it to continue to drive out at least that kind of level of revenue. And since it's for us the dollars that we get from the people that work on that small team, probably are the highest dollars we drive out of any associate in the Company. So it's worth the effort that we spend on it. It's not going to be a material driver of the business and that's one reason why. Being short that number in Q1 is not very concerning to me.

Mohan Naidu - *Oppenheimer & Co. - Analyst*

Okay. That's fair enough. And maybe Zane, for you, on the small hospital, you said you saw a record number of deals in Q1. What is really happening in that marketplace? I thought there was slowdown in the market in the last year, year and a half. Now it seems to be -- that market seems to be picking back up again.

Marc Naughton - *Cerner Corporation - CFO*

Our experience has been that market has been very, very strong for the past couple of years and continues to -- our outlook for that is very good. So the activity levels are very high.

And so there is a few things going on there. It all comes back to all health care, no matter if it's big or small, deserves a highly robust clinical foundational system by which to do business. And so those small organizations need very robust systems to operate in this environment. They need the same types of systems that the largest organizations need.

And what you're seeing there is the lack of capabilities by some of the smaller providers to provide that type of deep clinical skills and functionality.

So as we look forward, we continue to see that being a very good market. It was obviously a record for our CommunityWorks business. And as we look through the rest of the year, we anticipate it to be very, very strong.

Mohan Naidu - *Oppenheimer & Co. - Analyst*

All right. You don't do Revenue Cycle in that market yet.

Marc Naughton - *Cerner Corporation - CFO*

We do. Actually, it is a full Revenue Cycle and ERP and clinicals.

Mohan Naidu - *Oppenheimer & Co. - Analyst*

Okay, got it. Thank you.

Zane Burke - *Cerner Corporation - President*

One of the strengths for us in that market is we offer a heck of the solution and capabilities because of our CommunityWorks approach to hosting the technology that allows those levels of institutions to be able to afford it. And when you compare us to what they -- the other people that are in that marketplace, for the most part, we are so much better on the technology side. I think that helps drive our success.

Mohan Naidu - *Oppenheimer & Co. - Analyst*

All right. Thanks a lot, Marc and Zane.

Operator

Sean Wieland, Piper Jaffrey.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

So you talked about a higher attachment rate of Revenue Cycle pop health and ambulatory. Can you give us a sense of how much of a lift you get on a deal side relative to a standalone clinicals deal when you do those attachments?

Marc Naughton - *Cerner Corporation - CFO*

We talked about the attachment principally around the health services side. But you are absolutely right; the attachment belongs also in the new business side for ambulatory and pop health and rev cycle.

You'll see percent -- particularly if there's ambulatory involved, you're talking about a 30% uplift when you see the full spectrum of those. Often what happens in the initial new business activities is the population health is kind of a small starter kit. So it will allow us to build upon that over the long run.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

Okay. And you had two large services contracts that were delayed from Q4 if I remember right. Were either of those in the Q1 bookings?

Mike Nill - *Cerner Corporation - COO*

They were not. Our expectation coming in, I think maybe some of our conversation was that we have one deal that will happen later in the quarter. We had a partial or component of another one that did hit Q1, but not of the size that was originally contemplated. We expect that to be more. And certainly, once again, no material ITWorks deals in the quarter.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

Okay. And then the expected growth in the works deals you said in the back half of the year, are those leaning towards RevWorks or ITWorks?

Marc Naughton - *Cerner Corporation - CFO*

Right now, ITWorks is the bigger population. As you will recall, we kind of slowed down on the RevWorks side relative to what -- letting ICD 10 play out, focusing on the dentists and really working to make that a premier place to show our skills. So I think that right now ITWorks is primarily the thing that is showing up on the list, and I think it's even some of the stuff that Mike talked about relative just our capabilities, our ability to do security. All the things that we experience and have worked for here are things and skills outside of just running your health information platform that our clients are looking for. So they are looking to extend their capabilities by having us do that activity.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

All right. That's helpful. Thank you.

Operator

Jamie Stockton, Wells Fargo.

Jamie Stockton - *Wells Fargo Securities, LLC - Analyst*

Maybe just a follow-up on what George was asking earlier on pop health. I think Mike said that you've got six core solutions that you are out there with today, and there are 10 that are on the horizon between now and the end of the decade. A couple of things. Could you talk about with a typical deal that you are signing today, how many of the six solutions are they taking upfront?

And then maybe as a follow-up to that, is there something within those incremental 10 that you've got on the horizon that you are working on from the development standpoint where you say, man, once we get that out of the door, that will really be a positive catalyst for our effort in this area? Thanks.

Zane Burke - *Cerner Corporation - President*

Sure. This is Zane. Typically in a new business situation, there will be two small -- well, I say almost pilot-like population health elements. And we can grow even in those two segments because they will be for a smaller portion of their population. They may say, gosh, I've got a shared savings plan. I've got something that I am actually actively managing. A population, it's a small population, I want to see that. But often it's things such as registries. So just maybe even having the diabetic registries. So there will be small elements which gets the framework in place, which is really important for us. Because it creates that framework upfront which allows us to add on at a lower cost as we move forward and really scale out.

And so, often what you will see is these small pilots -- small starters with one or two solutions and then growing forward. Our existing clients are taking the solutions that are generally available. But very similar to this, they are taking a more practical approach to whatever lives that they have at risk or conditions that they want to manage and creating a framework to grow that over time.

So we can grow exponentially both within the platform -- within the solution set itself because we will add more population to that, as well as we will add more capabilities and functionality, which creates additional sales opportunities for us.

And so for me, it is -- I'm just anxious to really have an opportunity to provide that full-scale, enterprise-wide solution set which is our vision and what many of our clients are purchasing. And really it will take a lot of the noise out from some of these small niche pop health players that are out there.

Marc Naughton - *Cerner Corporation - CFO*

This is Mark. I think that if I was going to pick care management as something that I think is really critical -- when we have a niche company making inroads into one of our clients, we've got -- we are out there with it, but we need to refine our content, we need to improve that, we need to make that world-class. When we hit that, that to me is a little bit of a tipping point of -- that is really population health.

And so I think you do that, you add to the registry, to the data analytics, the warehouse capabilities that we've already de-levered -- and we are already in the market out there, we have those solutions out there. But I think we are continuing to develop that to be able to be the lead -- a lead solution that really helps turn the tide on increasing the population that this has today. Because right now, as Zane said, it's usually a smaller population which, from a booking purpose, means it's a smaller booking for us.

Jamie Stockton - *Wells Fargo Securities, LLC - Analyst*

Mark, if care management is one of the areas that you feel like is going to be a tipping point, is it just going to be in a technology-focused way? Or do you feel like the health systems are really looking for someone that they can lean on to also provide that care manager on an outsourced basis?

Zane Burke - *Cerner Corporation - President*

This is Zane. There's clearly large services opportunities associated with population health, and there's an opportunity to go provide additional services similar to what we've done in other parts of our business to help clients scale. And I think the interesting part is I think there will be -- many of us think of population health that some of these large organizations -- I think you even think about some really small organizations. They can actually get their hands around that smaller population and really understand the full continuum of care and really can go after it in a different way. Those are going to be a lot of the clients that actually also need a lot of help with the services in the care management. So you absolutely point out a great point that that is going to be there.

Jamie Stockton - *Wells Fargo Securities, LLC - Analyst*

Thank you.

Operator

Robert Jones, Goldman Sachs.

Robert Jones - *Goldman Sachs - Analyst*

Actually just wanted to stick with population health and I guess first say congrats on the Centra deal. I thought it was interesting that in the Centra announcement it mentioned HealtheIntent would not only be used as the major pop health platform or tool for the health system but also for their health plan. I was wondering if maybe you could just walk through specifically what you will be providing on the health plan side. And then from an economic or business model standpoint, how does this deal compare to prior or other HealtheIntent contracts that you signed?

Zane Burke - *Cerner Corporation - President*

Well, this is Zane. I'm not going to comment on the specifics of the Centra economics. But the -- Centra is a fine organization. They have a number -- they are a fully clinical integrated model in central Virginia that has a health plan. And they are actively seeking taking on risk in their geography, and they put a model together to do that. What we are doing at the plan level is really helping them get access to all the data that they need no matter where it is. And they will take the full capabilities of HealtheIntent over time as we deliver them. So they are absolutely an organization that has bought into the vision of the enterprise-wide scale. And so we will deliver additional capabilities which will help both at -- not just at the IDM level but really at the plan level to help them manage that risk in a better way. And I think they are doing it in a smart, intelligent way, which is swim towards the risk and take the first dollar coverage and that's what we are helping to do.

And so they purchase what we have generally available. But their commitment to us over the long term is to roll out things as we release them.

Robert Jones - *Goldman Sachs - Analyst*

Got it. Thanks so much.

Operator

Garen Sarafian, Citigroup.

Garen Sarafian - *Citigroup - Analyst*

First, a clarification question. On the wider-than-normal revenue guidance range where Marc, you said that it was broader by about $25 million on the low end, I believe. So was that solely due to the unpredictability in system sales for no other reason? Did I understand that right?

Marc Naughton - *Cerner Corporation - CFO*

Yes, yes. Basically, it's hardware. And the rest of our business was very comfortable with us being where we projected and where people are -- where our range would have put -- landed at a midpoint. But given this quarter and given how those deals are now moving around a little bit from a timing perspective, I thought it was prudent to go ahead and lower the bottom end of the range for -- just to take into account hardware potential differences from our projections.

Garen Sarafian - *Citigroup - Analyst*

Got it. Useful. And then my follow-up is back to UHS, which I felt was a strategically significant win since some of the feedback that we have received just from the communities is just seeing more data points on scale implementation of your Millennium rev cycle solution. So I'm wondering how long does it take for that -- for a large client to be able to sell that -- sell this? Or how does this win sell other clients? Has it happened -- I think was about a month ago. So maybe did this directly lead to additional sales you wouldn't have gotten otherwise? Or if there is any other additional color there would be helpful.

Zane Burke - *Cerner Corporation - President*

This is Zane. I think it's continued momentum -- positive momentum on the revenue cycle side. We've had a number of clients that have made a number of very large IDNs that have actually -- that have made a Cerner Revenue Cycle decision. I think you look at the UHS decision as -- especially when you are in the investor-owned side, that adds to the IASIS footprint. I think you look forward to some other announcements in the investor-owned segment around Revenue Cycle. I think that's a strong statement about how solid the solution set is.

And so all of those help. And the ability to have those come online and be fully referenceable, it makes it even better. Work at (inaudible) Mountain has been very strong. Work at Via Cristy has been very good. So those types of references have helped the revenue cycle side out. And the more that we add to that, the more it will lend itself to the credibility side of what we are doing around rev cycle.

So, all of those ideas are incremental positive. I think it's a strong statement from the investor-owned side, the number of clients that are signing on.

Garen Sarafian - *Citigroup - Analyst*

Okay, great. Thank you.

Zane Burke - *Cerner Corporation - President*

Why don't we take one more question?

Operator

Ricky Goldwasser, Morgan Stanley.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Couple of questions. First of all, you might've addressed this and I missed it. But when I look at the trend report, 24% of the contract dollars are from long-term contracts, and this is kind of I think the lowest I've seen. So what's driving it?

Marc Naughton - *Cerner Corporation - CFO*

Yes, Ricky. This is Mark. We kind of have previews coming into this quarter that we didn't expect to see ITWorks deals of any size. And that's what happened. So a lot of those long-term larger deals are what drives the long-term bookings and makes that usually kind of a low 30s percent. When you compare that with the 37% we had in the year-ago quarter, which was heavy on some of the long-term, you really kind of have a significant mix difference. So that's the primary reason we didn't have those long-term bookings.

When you take out the long-term component for the year-ago quarter and this quarter, you actually saw about 18% growth in non-long-term bookings. So that's more reflective of the overall business. We do expect those ITWorks deals to start hitting the bookings as we move through the year. But Q1, we knew was going to be a little bit light, and that's why we previewed our bookings wasn't going to -- was going to be relatively flat with our estimate but that we would all grow bookings obviously as we go through the year, which are kind of Q2 to 10% growth if the midpoint reflects.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay. And then when we talk about replacement opportunity, obviously 36% of clients -- new clients and that has -- we've been kind of like this, kind of trending up the last few years. Talk about a pipeline of $8 billion. But what is the typical value of a replacement client? Because I'm assuming the typical replacement client value now is broadly smaller than what it was like as a greenfield four or five years ago. So can you just give us a sense of what goes into that $8 billion opportunity?

Zane Burke - *Cerner Corporation - President*

This is Zane. So the $8 billion was specifically reflecting the pipeline we tested HMS. Our pipeline is significantly larger than that. We don't disclose that number other than to say that it has continued to grow. So as we've harvested the pipeline, we've actually continued to grow that pipeline. But the $8 billion is specific to the HMS element.

The mix of business in there is highly dependent on the size of the organization that signs. And so -- which has been -- that has been a blend of that. There is -- the large regional players are very active in the market. The investor-owned segment has been very active. And so across the different segments. And I think you just have to look at the growth numbers, given the pipeline is growing. It's -- the business activity is very, very strong.

Marc Naughton - *Cerner Corporation - CFO*

I think -- this is Marc. I think as you see the number of large deals we signed, those are good. Continue to have good numbers there. A replacement deal means they are going to buy everything. So that makes it a bigger deal. They are going to buy rev cycle. They are going to buy all the clinicals. They are going to buy -- probably buy out -- they are going to buy almost everything they've got something of in their organization whether it is from a single supplier or not. They're going to have to buy all that. So those transactions actually tend to be pretty large relative to those organizations.

So, once again, it varies by size of the organization and end-users and number of facilities. But it's why the replacement market is very attractive for us.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay, and one last one on pop health. I know Marc, you mentioned it. The booking value could be smaller just because of the modular component like you start with care management. But what's the average length of the pop health deals?

Marc Naughton - *Cerner Corporation - CFO*

Today, most of them have been pilots. So they might be three to five years in length. So it's -- once again, usually a single one or two of the solutions for a pilot period. So a little bit different than we expect the long-term approach to that to be. But that's why they really haven't had an impact on our bookings today.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Got it. Okay, thank you.

Marc Naughton - *Cerner Corporation - CFO*

All right. Well, I want to thank everyone for being on the call. We see our Q1 results as a solid start to the year. Our pipeline continues to reflect significant market opportunities, and we are continuing to invest heavily in the innovation of solutions and services that will create future value for our clients. So with that, I'll bid you good day. Thanks so much.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes today's program. You may now disconnect. Everyone have a great day.