# Cerner Corporation
## First Quarter 2016
## Earnings Conference Call
## May 5, 2016

### Moderator

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 margins, operating and capital expenses, product development, new markets or prospects for the Company's solutions and services 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, 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.

## Bookings, Backlog and Revenue

Our bookings revenue in Q1 was $1.17 billion, which is 2% lower than Q115 in total, but reflects strong growth of 18% when you exclude long-term bookings.  As we indicated, Q115 included an all-time high level of long-term bookings at 37%, creating a tough comparable.  And this quarter had a very low level at 24%.  While this difference led to total bookings being basically flat, the strong growth in non-long-term bookings reflects ongoing strong demand and new footprints, which Zane will discuss.  In addition, we have a strong pipeline for Works deals, so we expect the 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 $13.0 billion a year ago.

Revenue in the quarter was $1.14 billion, which is up 14% over Q115, 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 Q115, 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 in 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 Q115.  This is in-line with our expectations and reflects good execution by our services organization.

Support and Maintenance revenue increased 10% over Q115.

Looking at revenue by geographic segment, domestic revenue increased 15% over the year-ago quarter to $1.005 billion and 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 Q115, reflecting the lower mix of hardware, as well as strong levels of services.

## Operating Expense

Looking at operating spending, our first quarter non-GAAP operating expenses, which exclude share-based compensation expense, and acquisition-related adjustments, were $701 million, which is up 19% compared to adjusted Q115 operating expenses. This growth was primarily driven by growth in personnel expense related to revenue generating associates, higher non-cash expenses, and having an extra month of Health Services expense in Q116 compared to Q115.

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.

## Operating Margins

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 HIMSS, we believe we can expand margins 50-100 basis points annually after 2016.

## Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q1 were $150 million, or 43 cents per diluted share. Adjusted net earnings were $182 million and adjusted diluted EPS was 53 cents, which is up 18% compared to Q115. Adjusted net earnings exclude 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 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 $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 32-33%.

## Balance Sheet / Cash Flow

Now I'll 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 4 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.

## Guidance

Now I'll go through Q2 and full-year 2016 guidance.

- For Q2, we expect revenue between $1.175 and $1.25 billion, with the midpoint reflecting growth of 8% over Q215. Note that we have widened our guidance range to provide cushion given we were below our Q1 guidance due to 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 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 56 to 58 cents per share, with the midpoint reflecting 10% growth over Q215 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 4 cents in Q2 and between 16 and 17 cents 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 Q215.

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

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

## Results/Marketplace
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 18% and we expect long-term bookings to increase as we move through the year.

Bookings this quarter 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 30-31% 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'll 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 have discussed, we believe we are much more effective against our primary competitor for several reasons, including: significant improvements to 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, have 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 activity, are at all-time highs. With one major installed base facing a sunsetting of their solutions and another with over three fourths of their base on legacy platforms, we expect the replacement market to remain strong over the next 2-3 years.

Our view of the replacement market and overall opportunity to grow our business was also validated at HIMSS. This year we interacted 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.

## Revenue Cycle
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 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.

## Ambulatory/CommunityWorks

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 IDN 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 at 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 with our cloud-based CommunityWorks offering. Bookings from CommunityWorks were a record for a first quarter and included a combination of stand-alone opportunities and Health Services migrations.

## DoD

Now I'd 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 Leidos 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.

## Health Services

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 the Cerner and Health Services teams have come together and impressed with how quickly Health Services associates have been able to add value in key areas of our business.

## Global

Outside of the U.S., we had a solid quarter, but most non-U.S. markets continue to grow slower than our U.S. business. 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 Wirral Health Partners in the UK is a good example.

## Population Health

On that note, I'll 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 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 adding *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 and manage 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 percent of Medicare payments to value-based payment models by the end of 2018, and to tie most remaining traditional FFS payments to quality measures. More recently, CMS announce the Comprehensive Primary Care Plus model, which is yet another push towards more fee for value payment models that directly incent proactive population health management. There are also 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**

Thanks Zane. Good afternoon everyone.

## *HealtheIntent*

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 the *HealtheIntent* platform in 2012. In September of 2013 we made an on-time delivery of HealtheRegistries$^{SM}$, the first solution on the platform. We have 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 from more than 80 unique systems, ranging from EHRs to insurance claims feeds 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 it 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. The solutions are complementary to the function of EHR and device platforms, and they have the potential to create a lot of value, and the maturity of the platform and introduction of solutions are working out well with the timing of the market. We believe *HealtheIntent* is unmatched in scope and scale and that it will continue to win out over the many best-of-breed niche solutions we compete against today, much like our Millennium platform has proven to be superior in the EHR era.

## Revenue Cycle

Moving to revenue cycle, as Zane indicated 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 than full RevWorks 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*$^{TM}$ 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 many 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.

Finally, I'd like comment on the recent increase in headlines related to IT security in health care. We take security very seriously and invest heavily in protecting information in our systems. This has resulted in a good track record of protecting our clients' data. The increase in industry issues related to security and recognition by our clients that we have a strong competency in security 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 clients look for help in securing information beyond their Cerner solutions.

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