Cerner Corporation
Second Quarter 2016
Earnings Conference Call
August 2, 2016

Moderator

Welcome to Cerner Corporation's second quarter 2016 conference call. Today's date is August 2, 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, which were solid across all key metrics.

Bookings, Backlog and Revenue

Our bookings revenue in Q2 was $1.40 billion, which reflects 9% growth over Q215. Note that this growth was driven on only 28% of bookings coming from long-term contracts in Q216 compared to 35% in the year-ago quarter.

Our revenue backlog ended the quarter at $15.0 billion, which is up 13% from $13.3 billion a year ago.

Revenue in the quarter was $1.22 billion, which is up 8% over Q215 and in the middle of our guidance range. The revenue composition for Q2 was $333 million in System Sales, $257 million in Support and Maintenance, $604 million in Services, and $22 million in Reimbursed Travel.

System sales revenue for the quarter was up 6% compared to Q215, with strong growth in software being partially offset by a decline in hardware. While hardware did decline year-over-year against a tough comparable, it was up sequentially and in-line with expected levels. Looking at system sales margin, it was up 150 basis points over last year, reflecting strong software and lower hardware.

Moving to Services, total Services revenue, including professional and managed services, was up 12% compared to Q215. This is in-line with our expectations and continues to reflect good execution by our services organizations.

Support and Maintenance revenue increased 1% over Q215, reflecting a tough comparable. Support and Maintenance is up 5% year-to-date and we expect similar mid-single-digit growth for the rest of the year.

Looking at revenue by geographic segment, domestic revenue increased 8% over the year-ago quarter to $1.073 billion and non-U.S. revenue grew 9% to $143 million.

Moving to gross margin. Our gross margin for Q2 was 83.1% which is up from 82.9% in Q215, reflecting strong software and services and lower hardware.

Earnings

Now I will discuss spending, operating margin and net earnings. For these items, we provide both GAAP and Adjusted, or Non-GAAP, results. The Adjusted results exclude share-based compensation expense, Health Services related amortization, acquisition related deferred revenue and other acquisition-related adjustments, which are detailed and reconciled to GAAP net earnings in our earnings release.

Operating Expense

Looking at operating spending, our second quarter GAAP operating expenses were $769 million compared to $762 million in the year-ago period. Adjusted operating expenses were $721 million, which is up 9% compared to Q215. This growth was primarily driven by growth in personnel expense related to revenue generating associates.

The total year-over-year change for each expense category in Q2 on an Adjusted basis was: 13% growth for Sales and Client Service; 2% decline in Software Development, 6% growth for G&A and Amortization of acquisition-related intangibles was down 12%.

Operating Margins

Moving to operating margins. Our Q2 GAAP operating margin was 19.8% compared to 15.3% in the year-ago period. Our Adjusted Operating Margin was 23.8% in Q2, which is down slightly from 24.2% in the year-ago period. This is in-line with our previous indication that we expect margin expansion to be limited in 2016, but we do continue to 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 Q2 were $166 million, or 48 cents per diluted share. Adjusted Net Earnings were $199 million and adjusted diluted EPS was 58 cents, which is up 12% compared to Q215.

The Q2 tax rate was 32%, which is in-line with our expected range of 32-33%.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q2 with $720 million of total cash and investments, which is up slightly from $707 million in Q1, with most of our free cash flow being used to repurchase shares. During the quarter, we executed $50 million in stock repurchases, buying back 938 thousand shares at an average price of $53.30. Year-to-date, we have purchased 3.7 million shares at an average price of $53.41 for a total of $200 million out of the $300 million stock repurchase program authorized in March of this year.

Moving to debt, our total debt, including capital lease obligations, is $585 million, which is down slightly compared to Q1.

Total receivables ended the quarter at $983 million, which is up $42 million from Q1. Our Q2 DSO was 74 days, which is an improvement of 2 days compared to Q1 and 7 days better than a year ago.

Operating cash flow for the quarter was $255 million, up from $109M in Q215 and down from $327 million in Q1. The sequential decline is driven mostly by timing of tax payments and an extra payroll in Q2. Year-to-date operating cash flow of $582 million reflects strong growth over the $323 million of operating cash flow in the first half of last year.

Q2 capital expenditures were $118 million, and capitalized software was $80 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $57 million for the quarter. This is up compared to negative free cash flow in Q215 and down from a very strong Q116 due to the lower operating cash flow and higher capital spending related to construction on our new campus.

Year-to-date free cash flow of $209M is in-line with our expectations, and we expect solid free cash flow for the rest of the year even with spending on our campus remaining elevated. Next year, we expect a decline in capital expenditures, resulting in stronger free cash flow.

Guidance

Now I'll go through Q3 and full-year 2016 guidance.

- For Q3, we expect revenue between $1.2 and $1.275 billion, with the midpoint reflecting growth of 10% over Q315.

- For the full year, we expect revenue between $4.9 and $5.0 billion. This range reflects a tightening of our previous range mostly to capture the lower hardware revenue in the first half of the year, but is still 12% full-year growth at the midpoint.

- We expect Q3 adjusted diluted EPS to be 59 to 61 cents per share, with the midpoint reflecting 11% growth over Q315.

- For the full-year, we continue to expect adjusted diluted EPS to be $2.30 to $2.40, with the midpoint reflecting 11% growth over 2015.

- Moving to bookings guidance, we expect bookings revenue in Q3 of $1.45 billion to $1.6 billion. The midpoint reflects a slight decline from Q315, which was 44% higher than Q314 and is by far the toughest comparable period from last year. The midpoint would still put year-to-date bookings above 2015 and we expect growth in Q4 as well, so we are still on track for our stated goal of full-year growth over what was a very strong 2015.

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

Our bookings in Q2 were a record and only second to our all-time high bookings in Q315. As Marc indicated, our total bookings grew 9% despite lower contributions from long-term bookings than last year. The 28% of Q216 bookings from long-term reflects contributions from both ITWorks and managed services, but was still below the elevated level of 35% in Q215. The non-long-term portion of Q216 bookings grew 20%, reflecting strong levels of solution and service sales both into our base and to new clients.

Bookings this quarter included several large contracts, with 45 contracts over $5 million, including 28 over $10 million.

34% of bookings this quarter came from outside our core *Millennium®* installed base. This high level of new business is the result of an active replacement market and ongoing success against our primary competitor. The keys to our success continue to be our improved solutions, predictable delivery capabilities, lower cost of ownership, ability to deliver value, and our population health and open platform capabilities. I believe we compare favorably to our primary competitor in all of these areas and this is reflected in our win rate. Overall, I believe Cerner is viewed as the safe choice for current solution needs, as well as the best positioned supplier to help clients achieve value from their investments and position them for success as the market shifts from a focus on care to a focus on health and wellness.

A good example of the opportunity in the marketplace and our competitiveness was Covenant Health selecting Cerner, which we announced last week. Covenant Health is a 1,900-bed health system based in eastern Tennessee, with 10 hospitals and nearly 100 ambulatory facilities. They will be deploying *Cerner Millennium* EHR and clinically-driven revenue cycle solutions as well as *HealtheIntent™* population health solutions across all venues of care. Cerner's integrated solutions across clinical and revenue cycle and acute and ambulatory, proven ability to deliver value at a predictable cost, and our population health capabilities, were important differentiators for us when competing for this business.

Looking ahead, we believe the replacement market will remain active given the high number of hospitals on legacy platforms, some that are being sunset. This opportunity is reflected in our leading indicators, with our new business pipeline and sales activity at all-time highs.

Revenue Cycle

Now I'll discuss revenue cycle. We had another great quarter. All new EHR clients included revenue cycle as part of their purchase, reflecting a continued focus by the market on clinically-driven revenue cycle. This preference is also reflected in ongoing success in our installed base, with several more large clients choosing Cerner for acute revenue cycle and ambulatory business office services.

In addition to a very strong quarter, we also made a great addition to our executive team. As we announced in July, Jeff Hurst will be joining Cerner on September 1st as senior vice president of Cerner Revenue Cycle Management and president of Cerner RevWorks. This is a new position and the existing revenue cycle and RevWorks teams will report to Jeff. Jeff comes to us from Florida Hospital, a 2,700-bed acute-care medical facility that is a member of Adventist Health System, where he directed all financial and clinical revenue cycle functions and had responsibility for key organizational strategies. He is a respected industry thought leader and proven executive, and he brings an important provider perspective to Cerner.

As you know, we have made significant investments in revenue cycle that have led to very strong growth in recent years. Our hiring of Jeff is an indication that we believe we are still in the early stages of a significant growth opportunity as we help our clients navigate the rapidly evolving reimbursement landscape, and that we are investing in talent that can help us capitalize on this opportunity and to contribute to the success of our clients.

Population Health

Now I'll shift to discussing our population health business, where we had a record quarter. We added several new clients to the *HealtheIntent™* platform and also expanded the scope of population health solutions at some of our largest existing clients. Our comprehensive approach to population health remains differentiated in the marketplace, and as we continue to add solutions to the *HealtheIntent* platform, I believe we'll continue to displace numerous niche offerings because of the power of the platform and ability to integrate with the EHR workflow.

The volume of clients that have purchased initial solutions on our HealtheIntent platform is impressive—we recently passed the 100 client milestone. We believe this positions us for a significant ramp in revenue in coming years as these clients add more solutions and lives to the platform, which will increase the Per-Member-Per-Month rate and number of members.

We expect the driver of this to be the ongoing shifts in reimbursement that are leading to more risk assumption by our clients. And we believe the shift away from traditional fee for service is gaining momentum, with the Medicare Access and CHIP Reauthorization Act, or MACRA, and new Merit-based Incentive Payment Systems ramping in coming years as CMS continues its focus on value- and quality-based payments.

Ambulatory/CommunityWorks

Moving to the ambulatory market, where we had record results with strength in ambulatory EHR, practice management and business office services. Similar to recent quarters, our results include some of our largest acute care clients choosing Cerner's clinical and revenue cycle solutions for their ambulatory settings.

We also had a strong quarter in the small hospital market. Our cloud-based CommunityWorks offering continues to be competitive against all of the niche small hospital vendors. A recent noteworthy win for CommunityWorks was the displacement of a failed attempted go live by a cloud-based vendor that has been making a push in recent years to expand from the ambulatory market to hospitals. We have several active opportunities to displace this same competitor in both ambulatory and small hospital settings, suggesting their approach of spending about 3 times as much on sales and marketing as they do on R&D may not be the most effective approach for the client.

Non-U.S.

Outside of the U.S., despite some macro-economic headwinds, we had a good quarter. Non-U.S. revenue grew 9% year-over-year, with noteworthy areas of strength including Australia, Germany, and the Middle East. As Mike will discuss, the Middle East strength included ITWorks, which is a positive sign as it highlights a largely untapped global opportunity for ITWorks.

In summary, I am pleased with our execution in Q2, and I believe we are well positioned to have a good second half of the year.

With that I will turn the call over to Mike.

Mike Nill

Thanks Zane. Good afternoon everyone. Today I am going to discuss *ITWorks* and Cerner's Model Experience initiative.

ITWorks

I'll start with *ITWorks*. We had a good quarter with one new *ITWorks* client, a large expansion with an existing client and very strong sales back into our client base.

Regarding our new client, this client is not only new to *ITWorks*, but they are a new EHR client as well, and the EHR win displaces our primary competitor. The client is a new children's hospital in Dubai that was scheduled to implement our primary competitor's solution, but concluded Cerner is a better choice to meet their needs. Our ability to work quickly in order to enable them to be ready for the hospital's scheduled opening date as well as provide full IT services through *ITWorks* were both key factors to us being selected. In addition, the success we have had with another client in the region was very helpful in demonstrating the value of the *ITWorks* model, something our competitor does not offer.

Looking ahead, our pipeline for *ITWorks* is significant and includes some very large clients. While the timing of *ITWorks* deals has been lumpy and will likely continue to be, we are confident it will remain a strong contributor to our growth. The value proposition to our clients is very appealing, especially in an environment where they have pressure on operating costs, limited access to IT talent, and increasing pressure in light of the industry issues related to security.

Model Experience

Now I'd like to briefly discuss an initiative we call Model Experience. The Model Experience is an extension of the Model System, which we have discussed in the past. The Model Experience represents a meaningful shift in our approach to implementing our solutions, workflows and standards at our client sites. It presents all of Cerner's standards and content within a controlled environment, where the best practice for workflows and the latest capabilities are captured. Then each client's system can be optimized based on their specific needs.

The Model Experience goes beyond just focusing on EHR. It also provides clients optimal recommendations for leveraging HealtheIntent, *Millennium* and *CareAware* solutions.

In addition, the Model Experience uses a continuous advancement approach for adopting recommendations, which ensures our clients will continuously be able to maximize the value of our solutions.

In summary, I believe the Model Experience positions us well to help our clients achieve value from their existing investments and keep up with the rapidly evolving health care landscape.

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