Cerner Corporation
First Quarter 2021
Earnings Conference Call
May 5, 2021

<u>Operator</u>

Welcome to Cerner Corporation's first quarter 2021 conference call. Today's date is May 5, 2021, and this call is being recorded. I'd now like to turn the call over to your host, Allan Kells, SVP, Investor Relations.

<u>Allan Kells</u>

Good morning everyone and thank you for joining us. On the call with me today are Brent Shafer, Chairman and CEO; Mark Erceg, our new Chief Financial Officer; Don Trigg, our President, and Travis Dalton, our Chief Client and Services Officer. Brent will start off the call with observations on our business and the marketplace, then hand it over to Mark to provide more detail on our results, outlook, and capital allocation plans. We'll then transition to Q&A and be joined by Don and Travis.

Before we start, I'd like to remind you that our comments will contain forward-looking statements, including projections for our business and other statements about future events. These comments are based on our current expectations and assumptions that are subject to risks and uncertainties. Our actual results could differ materially from those indicated by our forward-looking statements due to those factors identified in our earnings release which is posted to the investor section of cerner.com and other filings with the SEC. Cerner assumes no obligation to update forward-looking statements or information except as required by law.

We will also be referring to Adjusted, or non-GAAP, financial measures on this call for our discussion of Operating Margins, Earnings Per Share, and Free Cash Flow. A reconciliation of non-GAAP financial measures to GAAP financial measures can be found in our earnings release. These non-GAAP financial measures are not meant to be a substitute for, or superior to, financial measures prepared in accordance with GAAP.

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

Brent Shafer

Thank you, Allan. Good morning everyone and thanks for joining us.

We are now a year into the pandemic, and I remain impressed by the resilience of our clients on the frontlines and the efforts of our associates supporting them. As we have moved past the worst of the pandemic in most regions, an increasing portion of our role in assisting clients has been related to vaccine distribution. We have helped over 175 organizations with our mass vaccination solution, allowing clients to deploy and track vaccinations, document and report any reactions, and communicate with patients. We have also continued supporting our community, in partnership with local providers, and have now delivered over 90,000 COVID vaccinations as part of the Operation Safe initiative I mentioned on our last call.

As we've discussed throughout the past year, the pandemic accelerated many trends in healthcare that Cerner has been actively monitoring (and building out capabilities to support) for years. Among these is that providers face increasing pressure on cost and revenue, heightened consumer expectations, and shifts in care venues. We continue to believe we are well positioned to help our clients navigate these challenges while also enabling them to deliver improved clinical outcomes.

For example, our Real-Time Health System offerings bring near real-time enterprise transparency to help health systems perform at their peak efficiency, streamline operations, and improve care delivery. In addition, our Health Network capabilities enable our clients to coordinate care across multiple organizations regardless of the core EMR and help them optimize both fee for service and value-based payment models. And our enhanced consumer engagement solutions help providers meet the growing expectations by patients for a seamless digital experience.

We also continue to demonstrate our ability to bring innovation to the provider workflow to save time and address the very real issue of physician burnout. An example of this is a recent successful pilot of our AI-powered *Chart Assist*™ which abstracts data from a patient's chart and helps ensure the correct diagnosis and documentation. This replaces a process of having to do manual queries days after the patient was seen to capture a missing or incomplete diagnosis.

In summary, our ability to provide data-driven insights to providers and patients is at the core of the value we are providing. As a result, our clients are increasingly seeing value in our industry-leading ability to aggregate and normalize data so that meaningful insights can be gleaned.

We are also excited about the opportunity to use insights from data to play a role in improving the safety, efficiency, and efficacy of clinical research. Consistent with this, we took a major step towards this goal with our recent acquisition of Kantar Health. We are pleased to welcome their highly experienced team that brings a deep understanding of the needs of the pharmaceutical industry. We believe this is an important step as we partner with our network of provider clients to fundamentally change the time and cost of clinical trials.

I also wanted to comment on the information blocking rules that went into effect last month and the broader interoperability rules in the 21st Century Cures Act. As you know, we have been fully supportive of these rules as we believe they are an important step towards the healthcare industry finally realizing the potential of broad digitization, which should lead to improved outcomes, lower costs, and a better patient experience. Up to this point, the industry has spent billions of dollars on a base level of digitization, but the absence of broad interoperability has limited the return on this investment. As interoperability and secure access to data improves in coming years, we expect our proven ability to derive insights from data and push them to the right place at the right time will remain a key differentiator.

Now I'd like to provide a quick update on our Federal business. The Department of Defense continues to move full speed ahead with deploying MHS GENESIS, their Cerner-powered EHR. At the end of February, they went live at Naval Medical Center San Diego, which was their largest and most complex go-live to date. DoD officials said this was their smoothest go-live since the program began. In late April, DoD went live with Wave Carson across 12 states, two time zones and more than doubled the number of DoD commands now live.

Moving to Veterans Affairs. As most of you know, VA Secretary Dennis McDonough recently launched a strategic review of the VA's EHRM program while at the same time making it clear he is committed to Cerner and this program. We believe this review is analogous to the steps taken by the DoD during their initial go live. We welcome (and strongly support) this review because it allows us to bring new VA leadership up to speed on both the successes and challenges of the program, capture their input and then move forward *together* as we continue providing seamless care for our nation's Veterans. We expect to exit this review stronger and ready to push forward with deployments at additional sites this year. During this review, we expect the impact on our results will be *largely* mitigated since "work on the ground" continues as we prepare for go-lives at future sites. However, the review could shave up to one point off our projected revenue *growth* rate this year versus what we had originally expected.

Moving to our results, we had a solid first quarter. And, as Mark will share, we now expect to deliver *stronger* earnings than our prior outlook despite slightly lower top line *growth* (due to the VA's strategic review). This is possible because we have sharpened our focus and are moving forward with a renewed sense of urgency to continue delivering value to our clients and shareholders. Specifically, we are going faster on efficiency initiatives already being actioned by our Transformation Office, continuing (and broadening) our product and business portfolio reviews, and adjusting our organizational design to centralize key functions. These actions all have a common goal—to tighten our strategic focus so we can more effectively deliver value to our clients while also contributing to sustainable long-term profitable growth for our shareholders.

You'll hear from Mark Erceg in a moment, but I'd like to say that in the two months he has been our CFO, he has been invaluable in helping us identify additional opportunities to improve our business and providing enhanced management reporting that is enabling better-informed decisions. We are delighted to have him as part of the Cerner family.

I also would like to comment on the recent passing of Linda Dillman, a longstanding member of the Cerner Board. She spent over 10 years on the Cerner Board and was a trusted advisor to many on the leadership team, including wise counsel to me as I was joining Cerner. She will be tough to replace, but we are actively seeking qualified candidates. Linda will be deeply missed.

Before turning the call over to Mark, I'd like to comment on the news about my expected departure. As noted in the press release, the board and I have started a process to identify Cerner's next CEO. Once the Board has named a successor, I plan to serve as an advisor to ensure a smooth transition. It has been an honor to be a part of Cerner the past three years. I connected to Cerner's mission from the beginning, and the dedication of our associates and clients inspires me every day. I am proud that Cerner is in such a strong position and that we have made good progress towards improving our operating model and strengthening our leadership team.

Because of this progress, I believe my successor will take the reins at a time Cerner is poised to accelerate its impact on healthcare.

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

Mark Erceg

Thanks Brent and good morning everyone. Today I will cover our first quarter results and provide a guidance update, but first I'd like to share some early observations from my first two months at Cerner.

First, the people are incredible. Cerner associates are dedicated, passionate professionals who are fully committed to the cause—which is merging technology with healthcare to improve outcomes for those we serve and love. As Brent often says: "Cerner is striving to bring the joy back to practicing medicine" and that is a mission I can proudly lend my full efforts against.

Second, the business is fundamentally sound. Cerner provides real solutions to real problems. Cerner has deep technical know-how, unique capabilities, and significant competitive advantages, as well as an exceedingly strong balance sheet.

Third, while Cerner does have the associates and the capabilities (and has created significant value for clients and shareholders since its inception) there is a clear recognition that a lack of focus and (at times) sub-optimal execution has caused revenue growth to slow and margins to compress—which, in turn, has resulted in bottom quartile total shareholder return versus our proxy peer set over the past several years.

This understanding is what led the Board, Brent and the Senior Management team to initiate a series of actions to improve results. I believe the actions taken so far are a good start, and I am excited to play a role in increasing the pace of change so Cerner can realize it's full (and considerable) potential faster. We believe these actions will allow Cerner to help more people than ever before whilst also generating leadership levels of Total Shareholder Return.

So, with that understanding and my sincere thanks to Brent and the Board for giving me the opportunity to be part of the team, let me move on to summarize our first quarter results. Please note that my commentary will focus on key points of emphasis—since I have no intention of simply repeating information ***already*** contained within the press release.

First Quarter P&L

Overall, we delivered a solid quarter. Bookings were up 13 percent versus a year ago to $1.23 billion, and we ended the quarter with a revenue backlog of $13.1 billion. While this is admittedly down 3 percent from a year ago, that was primarily due to the impact of divestitures.

Revenue in the first quarter of $1.39 billion was down 2 percent compared to last year and included lower than anticipated Software, Technology Resale and Reimbursed Travel. However, after adjusting for divestitures, our first quarter revenue *grew* roughly 2 percent year-over-year.

Gross margin was *up* 140 basis points from a year ago to 83.4 percent, reflecting improved revenue mix due to lower levels of outsourcing, third-party services, and reimbursed travel (and) Adjusted Operating Margin expanded 200 basis points—from 19.4 percent last year to 21.4 percent this year.

Adjusted Operating Margins benefited from our continued cost optimization efforts and divestitures, and to be fair, we also had *some additional expense benefit* related to COVID (of approximately $10 million dollars) in areas such as facilities and travel.

As Brent indicated, we are *leaning* into our operational improvement efforts and based on my initial assessment, I believe mid-20 percent Adjusted Operating Margins should be obtainable by 2024 (as per our pre-COVID commitments).

To achieve this, we are moving faster on our existing roadmap of costs optimization and process improvement initiatives and adding additional initiatives (including a full review of where COVID era savings can be made permanent in areas such as facilities).

We are also going deeper on our product portfolio review with an eye towards consolidating and focusing on items that create the most client value.

Finally, we are significantly building up our internal management reporting capabilities to enhance decision making and drive accountability.

Importantly, these actions will enhance (not dilute) our primary focus—which is delighting our clients and motivating and encouraging our associates to reach their full potential ***because we know*** that having fully engaged associates and satisfied clients is a clear recipe for marketplace success and strong shareholder return.

To finish off the P&L, our tax rate was 21 percent for the quarter and Adjusted Diluted EPS was $0.76 a share. This was up 7 percent over last year (due primarily to operating margin expansion).

Balance Sheet / Cash Flow

Moving to our balance sheet, we ended Q1 with $1.47 billion of cash and short-term investments and $1.84 billion of debt after drawing $500 million on our Shelf agreement during the quarter. We did this at very attractive interest rates—placing $400 million of private placement 10 year debt at 2.59 percent and $100 million of 5 year debt at 2.0 percent.

We did this to pre-fund the Kantar Health acquisition which closed April 1st and to partially fund future stock repurchase efforts. Operating cash flow for the quarter was $450 million. After $76 million of capital expenditures and $83 million of capitalized software, free cash flow came in at $291 million.

Capital Allocation

As we move to capital allocation let me take just a few seconds to share my views as it relates to cash and balance sheet management. First, as an unapologetic capitalist, let me state *very clearly* that whatever cash we have on our balance sheet belongs to our shareholders—and we are simply the stewards of those funds. As such, the first call on cash is managing and investing in the core business (wisely) behind high return propositions.

Second, we aim to provide a competitive dividend yield. Presently, our dividend payout ratio is approximately 28 percent, but I anticipate that trending up over the next several years to somewhere in the low 30's.

Third, we will consider strategic acquisitions if (*and only if*) we believe they will enhance our competitive position in the marketplace, exceed our cost of capital, be accretive (over-time) and create shareholder value.

Finally, with any remaining excess cash (or investment grade debt capacity) we may look to opportunistically repurchase our own shares if we believe the stock is trading below its intrinsic value.

So, against that backdrop, we returned $417 million to shareholders during the first quarter, including $67 million in dividends and $350 million of share repurchases. And, as noted in the earnings press release, our Board just recently approved a new repurchase program that authorizes the purchase of up to $3.75 billion of shares through the end of 2023.

With that new authorization in hand, we expect to repurchase "up to" $1.5 billion this year (up from our previous guidance of "up to" $1 billion). Importantly, we believe this level of activity will make better use of our balance sheet (and anticipated cash flow) while still maintaining ample access to capital for potential investments (or acquisitions) ***within*** the confines of a strong investment grade balance sheet.

Guidance

Moving to guidance.

- We expect revenue in Q2 to grow, organically, by high-single digits over Q2 2020. This is because while Q2 2020 included about $40 million of revenue from businesses that have since been divested, we expect Kantar Health to now contribute a similar (offsetting) amount.

- For the full year, we continue to expect mid-single digit revenue growth—which is (generally) consistent with the growth implied by the previously provided dollarized range, but the recent VA *assessment* (which we fully support) and the associated *review*, has likely cost us somewhere between a half point and one full point of revenue growth *this year* (as some deployment work gets shifted out of Fiscal 2021).

- For EPS, we expect Q2 Adjusted Diluted EPS growth of approximately 20 percent over Q2 of 2020, which (you will recall) included a large (negative) impact from COVID of approximately $0.10 to $0.15 per share.

- For the full year, we expect Adjusted Diluted EPS to be *over* $3.20 per share, reflecting growth of at least 13 percent over last year. This compares to our prior range of $3.10 to $3.20 per share, with the higher expected earnings being driven by additional margin expansion efforts and an increase in share repurchase (which, collectively) should more than offset any slight loss in revenue related to the VA *assessment*.

- For the second quarter and the full year we are expecting a 21 percent tax rate and (as it relates to cash) we expect to generate around $900 million of free cash flow for the full year—up from $857 million last year.

In summary, I am very excited to be at Cerner. I think we have a tremendous opportunity to positively impact healthcare while also growing and creating significant shareholder value. We are acting with urgency to achieve this, and I look forward to sharing our progress with you as we move through the year.

With that, I will turn the call over to the operator for questions.