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CERN - Q1 2014 Cerner Corporation Earnings Conference Call

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OVERVIEW:

CERN reported 1Q14 revenue of $785m and GAAP net earnings of $119.5m or $0.34 per diluted share. Co. expects 2014 revenue of $3.25-3.4b and adjusted EPS of $1.63-1.67. Co. expects 2Q14 revenue to be $790-830m and adjusted EPS to be $0.39-$0.40.

CORPORATE PARTICIPANTS

Marc Naughton *Cerner Corporation - CFO*

Zane Burke *Cerner Corporation - President*

Mike Nill *Cerner Corporation - EVP and COO*

Jeff Townsend *Cerner Corporation - EVP and Chief of Staff*

CONFERENCE CALL PARTICIPANTS

Richard Close *Avondale Partners - Analyst*

Mohan Naidu *Stephens - Analyst*

Mike Ward *Sterne, Agee & Leach, Inc. - Analyst*

Steven Valiquette *UBS - Analyst*

Jamie Stockton *Wells Fargo Securities, LLC - Analyst*

Dave Francis *RBC Capital - Analyst*

Eric Percher *Barclays Capital - Analyst*

Leo Carpio *HM Global Capital - Analyst*

Garen Sarafian *Citigroup - Analyst*

Charles Rhyee *Cowen and Company - Analyst*

Michael Cherny *ISI Group - Analyst*

George Hill *Deutsche Bank - Analyst*

PRESENTATION

Operator

Welcome to the Cerner Corporation's first-quarter 2014 conference call. Today's date is April 24, 2014 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 recording projection of future revenue or earnings; operating margins, operating expenses, product development and new markets or prospects for the Company's solutions. 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 investors section of cerner.com.

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

Marc Naughton - *Cerner Corporation - CFO*

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 the results, highlights and marketplace observations. Mike Nill, Executive Vice President and Chief Operating Officer, will discuss our imperatives. Then Jeff Townsend, Executive Vice President and Chief of Staff, will provide an update on our focus on innovations with Intermountain Healthcare. Neal Patterson, our Chairman and CEO, is with a client today.

Now I will turn to our results. Our total bookings revenue in Q1 was $910 million which is an all-time high for a first quarter, and reflects 14% growth over our previous Q1 record results in Q1 of 2013. Bookings margin in Q1 was $824 million or 91% of total bookings. Our bookings performance drove a 22% increase in total backlog to $9.24 billion. Contract revenue backlog of $8.45 billion is 24% higher than a year ago. Support revenue backlog of $796 million is up 6%.

Revenue in the quarter was $785 million which is up 15% over Q1 of 2013. Revenue composition for Q1 was $207 million in system sales, $175 million in support and maintenance, $382 million in services and $21 million in reimbursed travel. System sales revenue reflect a 4% increase over Q1 of 2013 due to growth in software and subscription revenue which offset another decline in technology resale. The tech resale decline was in part due to a tough comparable in our global business where we had a large hardware sale in the year-ago period. But the rest of tech resale was also below our expectations. Our forecast reflects growth in tech resale for the rest of the year.

Q1 system sales margin dollars grew 21% over the year-ago period, driven by continued strong levels of higher margin system sales components of software and subscriptions.

Moving to services, total services revenue was up 25% compared to Q1 of 2013 with strong growth in managed services and professional services and good contributions from ITWorks and RevWorks. Support and maintenance revenue increased 9% over Q1 of 2013.

Looking at revenue by geographic segment, domestic revenue increased 21% for the quarter. Global revenue was down 16% from Q1 of 2013 which, as I mentioned, was a tough comparable for global. Zane will discuss our global outlook for the rest of the year, which is very good.

Moving to gross margin. Our gross margin for Q1 was 83.5% which is up from 81.3% in Q1 of 2013, reflecting strong software and subscription levels and a lower mix of technology resale. Looking at operating expenses, our first-quarter operating expenses were $463 million before share-based compensation expense. This is a year-over-year increase of 20%.

Sales and client service expenses increased 23% compared to Q1 of 2013, driven by an increase in revenue generating Associates in our services businesses and growth in depreciation.

Our investment in software development was up 12% compared to Q1 of 2013. As previously discussed, the growth of software development is due to increased focus on investing in growth initiatives. G&A expense increased 15% compared to Q1 of 2013 driven by increased personnel expense related to our strong growth and higher amortization expense related to recent acquisitions and acquired intangibles.

Moving to operating margins, our operating margin in Q1 was 24.6% before share-based compensation expense. This is down 10 basis points compared to Q1 of 2013 due to slightly higher growth and operating expenses. Our forecast for the rest of the year reflects approximately 100 basis points of margin expansion with less than that next quarter and more in Q3 and Q4. As you know, this can vary based on revenue mix and we will focus on delivering predictable levels of growth in gross margin and earnings dollars, which we did this quarter without margin expansion.

Moving in net earnings and EPS, our GAAP net earnings in Q1 were $119.5 million or $0.34 per diluted share. GAAP net earnings include share-based compensation expense which had a net impact on earnings of $9.6 million or $0.03 per diluted share. Adjusted net earnings were $129.1 million, and adjusted EPS was $0.37 which is up 11% compared to Q1 of 2013.

Recall that Q1 2013 had a lower tax rate that benefited adjusted EPS by $0.01. If you adjust Q1 of 2013 for this, our normalized growth this quarter would be 14%. The Q1 tax rate for adjusted net earnings was 34% which is in line with our expected effective tax rate. For the remainder of 2014, we expect our effective tax rate to remain within 50 to 100 basis points of 34%.

Now I will move to our balance sheet. We ended Q1 with $1.47 billion of total cash and investments compared to $1.43 billion in Q4. Total cash and investments include $1.03 billion of cash and short-term investments, and $437 million of highly rated corporate and government bonds with maturities less than two years. Our total debt including capital lease obligations is $160 million.

Total receivables ended the quarter at $564 million, which is down $19 million from Q4. Our DSO in Q1 was 66 days, which is down from the Q4 DSO of 67 days and down from 69 days in Q1 of 2013. Operating cash flow for the quarter was $156 million. Q1 capital expenditures were $70 million and capitalized software was $45 million.

Free cash flow defined as operating cash flow less capital expenditures and capitalized software was $42 million for the quarter. Looking at capitalized software, the $45 million of capitalized software in Q1 represents 40% of the $111 million of total investment in development activities. Software amortization for the quarter was $25 million, resulting in net capitalization of $19 million or 18% of our total R&D investment.

Note that operating cash flow is impacted in Q1 by the timing of tax payments and other working capital elements, which reduced operating cash flow by over $80 million as compared to Q1 of 2013. I also wanted to point out that we received a $48 million cash grant in Q1 from the Kansas Department of Commerce in connection with the construction of our continuous campus. While this will show up in the financing section of our cash flow, it is not really debt and I view it as another element of cash flow.

Looking at the rest of the year, we expect stronger operating cash flow and, as a result, stronger free cash flow. Our outlook for capital expenditures and capitalized software remains the same as what we provided last quarter. We expect capital expenditures to be $260 million to $280 million for the year, which is down from $353 million in 2013.

We expect capitalized software to remain in the mid-$40 million range throughout the year, which will lead to it being flat or slightly higher than the $175 million capitalized in 2013. This reflects a reduction in the use of third-party developers which will be offset slightly by an increase in our own developers.

Regarding our share buyback, we purchased 1.3 million of shares for approximately $75 million during the quarter. And now have $142 million remaining from the $217 million that was authorized in December.

Now I will go through Q2 and full-year 2014 guidance. For Q2 we expect revenue between $790 million and $830 million with the midpoint reflecting growth of 14% over Q2 of 2013. For the full year, we expect revenue between $3.25 billion and $3.4 billion, reflecting 14% growth at the midpoint. This is up from our prior range of $3.2 billion to $3.4 billion.

We expect Q2 adjusted EPS before share-based compensation expense to be $0.39 to $0.40 per share, with the midpoint reflecting 16% growth over Q2 2013 adjusted EPS. Q2 guidance is based on total spending before share-based compensation expense of approximately $470 million to $480 million. For the full year, we expect adjusted EPS between $1.63 and $1.67 with the midpoint reflecting 17% growth. This is up slightly from our prior range of $1.62 to $1.67. Our estimate for the impact of share-based compensation expense is approximately $0.03 in Q2 and $0.11 to $0.12 for the full year.

Moving to bookings guidance, we expect bookings revenue in Q2 of $1.0 billion to $1.06 billion with the midpoint reflecting 10% growth over Q2 of 2013, which is our toughest comparable of the year having grown 33% over 2012.

In summary, we are pleased with our results in Q1 and believe we are positioned for a good year. With that, I will turn the call over to Zane.

Zane Burke - *Cerner Corporation - President*

Thanks, Marc. Good afternoon, everyone. Today I will provide Q1 highlights and discuss marketplace trends.

Starting with our results, our bookings revenue in Q1 of $910 million reflects 14% growth over Q1 2013 as a record for our first quarter. This growth was achieved despite another weak quarter of technology resale. In addition we had no new ITWorks or RevWorks deals in the quarter, but we did have contributions from scope expansions at existing ITWorks clients and good sales of Revenue Cycle solutions.

For the quarter we had 23 contracts over $5 million, including 13 over $10 million. The mix of long-term bookings was 28% in the quarter which is lower than recent quarters because of less contribution from the Works businesses. Note that our pipeline is strong for our Works businesses and we still expect to have very good bookings this year.

25% of our bookings this quarter came from outside of our core millennium install base, reflecting ongoing competitiveness. As we highlighted at our recent Investor Day, we continued to have significant opportunities to gain share as we believe we are in the early stages of another wave of EMR purchases that will disproportionately go to Cerner or our primary competitor.

With our win rate against this competitor significantly improved, we are positioned for good share gains in coming years. The volume of potential business was also very apparent at HIMSS this year where we interacted with more potential new clients than we ever have.

Now I will cover some of the specific areas that contributed to our Q1 results. I will start with Revenue Cycle. While we didn't have a new RevWorks deal in Q1, contribution from Revenue Cycle was still good. This was driven by ongoing sales of our broad suite of Revenue Cycle solutions. Our forecast for the year calls for ongoing strength in solution sales and increased contribution from RevWorks.

Overall, the outlook for our Revenue Cycle business remains positive, as revenue and costs are top of mind for all providers and the importance of Revenue Cycle being integrated with clinical solutions continues to increase as the industry shifts to at-risk models.

The opportunity is significant in our installed base as many of our large clients are still on antiquated Revenue Cycle solutions. Revenue Cycle is also part of almost every opportunity for our business outside our base. And the improvements we have made in recent years have been an important part of our increased competitiveness.

In addition, we think the delay in ICD-10 will be a slight positive to our Revenue Cycle business because we had some prospects that were going to wait until after the deadline to install new solutions that can now consider installing them before the new deadline.

Our Population Health organization also delivered strong results driven by demand for HIE, Patient Portal, enterprise data warehouse and clinical process optimization. In addition we had additional sales of our new Healthe Intent Smart Registry Solution and had a strong pipeline for the year.

Moving to the ambulatory space where we had a strong Q1 with our clients continuing to favor our integrated offering over standalone solutions, we had six different displacements of our key competitors and two strategic business office services deals during the quarter. we also had a very good quarter in the small hospital market adding five new Community Works clients bringing eight clients live and hosting a record level of prospective clients in our Vision Center.

Outside of the US we had a strong quarter from a booking standpoint driven by contributions from the Middle East, Canada, Australia, Ireland, and England. However, revenues declined by 16% largely due to a tough comparable related to technology resale. For the year, we still expect double-digit revenue growth outside of the US, driven by the strong bookings in Q1, a good bookings forecast and an easier comparable period the rest of the year.

In the Middle East we brought our pilot site live for the Ministry of Health in Saudi Arabia in just nine months which is a record for a global go-live. This is no small feat. It is a 500-bed hospital where we automated inpatient and outpatient physician and nursing workloads across emergency, surgery, laboratory, pharmacy, and medical record departments.

We also had six more hospitals in the Middle East achieve HIMSS EMR adoption stage VI giving us 13 compared to just one for all other competitors combined. We believe this success positions us for more business in the region.

Now I will cover a couple more marketplace observations. Healthcare providers remain focused on controlling costs and increasing quality while juggling requirements for meaningful use, healthcare reform, value-based purchasing and ICD-10. We believe IT is the biggest lever to help providers navigate these changes and facilitate a transition to an at-risk model that incents keeping people healthy.

We also expect that as providers focus on controlling costs, they will continue to look at acquisitions to attain scale. As we've mentioned, this trend has benefited Cerner because our clients have been the most active acquirers and we expect this to continue. Each of the last two quarters have included bookings contributions from clients buying solutions for acquired hospitals.

In summary, Q1 was a solid start to the year and I felt good about a highly successful 2014. With that I will turn the call over to Mike.

Mike Nill - *Cerner Corporation - EVP and COO*

Thanks, Zane. Good afternoon, everyone. Today I am going to provide a quick update on our corporate imperatives.

Recall that our imperatives are captured in the long acronym, PPR/CIM+1, with the PPR representing our focus on Physician, Population Health and Revenue Cycle and the CIM+1 representing continuum of care, intelligence, member engagement and personalized medicine.

I will start with physician experience. With physician productivity being key to a clinical enterprise and meaningful use accelerating physician adoption, having solutions that optimize the physician experience is critical. As a result, we have invested and continue to invest heavily in physician experience and productivity. The record results for our physician solutions that we have experienced over the past two years are evidence that these investments are paying off.

We are also investing to support the evolution to a Population Health model in which the physician is going to take on a team, managing thousands of people that are on registries. This brings me to Population Health. As you know, one of our development partners for Population Health is Advocate Health who has over 500,000 lives for which they are financially at-risk. So they are incented to keep people healthy.

We achieved a major milestone last year by releasing our Healthe Intent Smart Registry Solution just seven months from contract signing. Healthe Intent Smart Registry is a part of our Healthe Intent cloud-based platform which is a multipurpose programmable platform that aggregates, normalizes, and standardizes clinical, financial, and broader population data.

While it is still early in the development of our Population Health solutions in the evolution of the market, we are pleased with our progress and believe we have the most comprehensive approach. Third-party validation of this came in the ChilMark Research report about their experience at HIMSS where they asked multiple purported population health solution providers to explain their process map for enabling a client to effectively move to a Population Health model of care. They indicated that Cerner was the only supplier to articulate such a process map.

Moving to Revenue Cycle. We continue to have outstanding results that I believe are directly attributable to the large investments we have been making. While we have not added a full RevWorks client in recent quarters, our pipeline remains strong and we expect 2014 to be another strong year for Revenue Cycle as a whole. We also remain excited about the potential of our work with Intermountain Healthcare to build an activity-based costing system which will further our differentiation.

Now I will quickly cover the CIM+1 part of our imperatives. The first is continuum of care which reflects the view that you have to include the entire continuum of care in any complete Population Health model. It is not just the doctor's office or hospital.

Cerner has the broadest suite of solutions across the continuum, including solutions for home care, long-term care, skilled nursing facilities, behavioral health, rehabilitation facilities, and employers. In addition, we are proving the ability to connect to non-Cerner solutions across the continuum through our work with Advocate where we are connecting approximately 70 data sources. Our ability to aggregate the information across the continuum, perform analytics and put the relevant information back into the workflow is a big differentiator.

Moving on to intelligence. Due to work with client partners we have created industry-leading predictive capabilities for sepsis and readmissions that show our ability to embed intelligence in information technology. In the case of readmissions, the predictive algorithm we have worked with advocate to refine performs 20% better than industry average and has been deployed at 120 non-Advocate sites.

Intelligence is also a large focus of our work with Intermountain Healthcare, where we have a huge opportunity to positively impact healthcare by embedding their care process models into our EMR-agnostic Healthe Intent platform.

Now I will cover the member engagement. As organizations become accountable for not only the care but also the health of their patients, the way they connect to them will change. No longer are people just patients. Each person is now an important member of the client's population with whom they must engage and help manage their health and care needs.

In 2013, we enhanced our member engagement capabilities with the addition of Pure Wellness, a comprehensive wellness portal that reaches millions of members through employer, health plan, and health system clients.

Finally, the +1 represents personalized medicine and the inclusion of the genome in diagnosis and treatment. [Turns have] been focused on the power of genomics and it has impacted the clinical processes dated back more than a decade when we released Millennium Helix. With the cost of genetic testing coming down, we are starting to see more opportunities in this area.

For example, we announced in late 2013 that we are working with Claritas Genomics to advance personalized medicine by building tools to integrate ordering of genomic sequencing tests, laboratory processing, results interpretation, and incorporation of the results into the EMR.

In summary, we are making great progress on all of our imperatives. This year we expect to continue to advance these imperatives as we focus on helping our clients use our intellectual properties as a lever to improve quality and safety while controlling costs.

With that I will turn the call over to Jeff.

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

Thanks, Mike. As Mike shared we have been accelerated our innovation and market validation through strategic partnerships. This is more than just traditional office site deployments. These are highly aligned engagements that enable us to work at the edge, in a living laboratory environment, provides immediate feedback with short cycle times.

As we highlighted with multiple client presentations during our investor event at HIMSS we have been given the opportunity to work side-by-side with these organizations as they transform towards a future state. For Cerner, this creates an environment where ideas and concepts can more quickly evolve into real-world production solutions. The byproducts of these relationships are much more than software solutions. It is about embedding the systemic framework for change, enabling what the Institute of Medicine calls a learning health system.

To go a little deeper on what this looks like in practice, I am going to provide an overview of what we are working on with Intermountain Healthcare. When we announced the partnership, one of my early quotes was that this partnership could accelerate clinical computing by at least a decade. I still believe that. There are several areas of innovation that will contribute to this; and over a few short months of engagement, the opportunity list continues to grow.

The first is around Intermountain's Care Process Models. These are summarized guides to clinical decision-making, focused on both conditions and specific decision points within a care process. They are highly contextual moment in time decisions that remove variants and produce the best outcome at the most appropriate cost, all in the context of the patient, provider, and venue.

The system awareness of context is the most important part. It is what removes the clutter and noise. When we have done well, the system anticipates the next move. The ability to use a variety of trigger events to push the decision moment space up in the conversation makes the work flow dynamic. Think of it as a clinical navigation system, a GPS for medicine.

The big next step is making Intermountain's Care Process Models EMR-agnostic, yet still inside the workflow. This will enable a new standard of care where we create the moment and time experience to support the decision and at the right moment in time it will surface contextually inside the workflow of the physician, without upgrades, mapping of interfaces or retraining of the workforce.

This puts us on a path to accelerate a lot of the work done by the industry today by embracing and advancing current work more quickly. We think these models have the potential to be the next generation of workflow, completely self-contained diagnostic treatment outcome and reimbursement containers. They could easily become the new transaction that replaces the claim in the fee-for-service world.

A key enabler, much of what we are doing is our commitment to having the most open and interoperable EMR platform on the market. Most of the discussion today around interoperability is pretty basic and moving at a very slow pace. At HIMSS, Cerner and Intermountain showed the power of landing an emerging set of standards we have tagged SmartOnFHIR. Using the SMART standard to provide plug-in web experience within the workflow and HL's Fast Health Interoperability Resources commonly referred to as Fire.

We showed the ability to plug non-Cerner and Non-Intermountain application into the workflow contextually. One example was showing a consumer-friendly growth chart app developed at Boston Children's, spanning both Intermountain's existing clinical system and Cerner Millennium to create a continuous story. This allows us to more rapidly unlock the same potential for open platform development that has been experienced in other industries, which we believe will disrupt the current paradigm of how an EMR is used in the delivery of healthcare.

What we were doing with Intermountain and what has already been done with Advocate around interoperability and real-time analytics is a big differentiator for Cerner. Many of you probably saw dozens of booths at HIMSS, highlighting the data warehouse showing elegant graphs to purport to provide great insight into the data. However if you can't get that insight back into the workflow when the physician is making the decision at what I call the moment of relevance, then you are just reporting the news versus making the news.

Another focus of our innovation with Intermountain is with their transformation lab where multiple technologies and partners come together to innovate in a start-up style environment. One of the examples I talked about at HIMSS was advancing past device integration and the interoperability to environment orchestration with their CareAware platform. For example with the ability to continuously stream vitals off of devices, the physician's order for IV meds can be placed to give the medication entitled a vital such as heart rate reaches a specific range and once it gets into that zone then taper back or stop the medication. The ability to coordinate devices to create an outcomes-based ordering capability is very plausible and will have a predictable impact on quality, cost, and outcomes.

The last area of innovation I would like to cover is what we are calling an activity-based EMR. The core component here is to dissect all the activities of medicine into Lego-like components so that you snap them together around a purpose. Dr. Brent James at Intermountain has done a lot of work in this space and has componentized a large number of procedures, activities, and what he calls risk scores. Those number over 800 which are drivers for clinical care.

This ability to group things together into components and have the option to now snap together workflows that drives change rapidly into the clinical process while knowing costs, measures, and outcomes is very powerful.

What is unique about the approach we are taking together is the inclusion of goals and outcomes associated to the activities. If you looked at just costing with the pure resources for a consumption-based model, you missed the fact that the activities were aligned to an expected outcome. In some cases, those outcomes or events or risks you are tempting to avoid. While the cost of a manual capture of vital signs versus a wearable continuous device will be different, the ability to constantly monitor the patient's status continuously changes the outcome risk well beyond the comparable resource costs of collecting the data.

If you are going to attempt to impact appropriateness, cost, and quality at the same time, you have to include expected and actual outcomes mapped to activities.

In summary, the most exciting part of this partnership is not the individual innovations or the potential impact they can have. It is the next generation of Cerner's consulting methodology rooted in agile development techniques, being applied to support both the implementation of core solutions and the continuous overlay of new solutions and decision-support capabilities. The key objective is to move away from the traditional waterfall IT approach of static, one-size-fits-all projects to a more nimble, continuous innovation environment that anticipates and embraces change.

In the case of Intermountain, we are running on a six-week model system release cycle producing workflows, contents, solutions, and education materials that come together into a comprehensive release. This approach creates a culture of continuous improvement versus a one-time conversion mentality.

The emerging toolkit from the methodology combined with activity-centric design and componentized care decisions on top of an open platform are the foundational building blocks of the next generation of clinical computing. This is very important work and we have a sense of urgency driven by entrepreneurial inpatients' sense of responsibility to improve the overall system and competitiveness. This urgency also comes from our belief that the rest of this decade will include more changes in healthcare than what has occurred in the last six decades combined. The solutions will need to keep up. IT organizations will have to reinvent their methods and provider organizations will demand a more dynamic and contextual experience. Our role has always been to anticipate the future of healthcare and create solutions to meet those needs. Now is the window to accelerate.

With that I will turn the call over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ricky Goldwasser, Morgan Stanley.

Ricky, your line is open, check your mute feature. Ricky, check your mute feature. Richard Close, Avondale Partners.

Richard Close - *Avondale Partners - Analyst*

Real quick question because I know there's probably a logjam here. But on the RevWorks, you commented you haven't seen anything the last couple of quarters. Can you talk a little bit maybe about what is holding up additional contracts from coming into the bookings? Are you seeing increased competition the likes out there of Optum and Dignity? Obviously you have got Conifer and Paralon and some of those. Give us an update on your view of that, the lay of the land in that area.

Zane Burke - *Cerner Corporation - President*

I would actually describe it more as when we thought ICD-10 was going to occur there was more of a natural holding in terms of when you would take one of those RevWorks opportunities and from a transition perspective when it would make sense. With the delay in ICD-10 piece, we think it makes sense that some of those will actually come forward a little bit sooner now and we see some really good opportunities in that pipeline. So I don't see it really from a competitive perspective. It is really more of a natural progression in the timeline.

Richard Close - *Avondale Partners - Analyst*

And quick follow-up with respect to patient financial accounting system on the Rev Cycle. I think you mentioned the opportunity to be able to jam in some systems due to the delay. Is there any type of quantification you can give in terms of what you would expect size of bookings in that product area?

Marc Naughton - *Cerner Corporation - CFO*

We wouldn't have any specific guidance relative to Rev Cycle solutions. The demand is in our pipeline and certainly would be reflected in the booking guidance we provide. But it does feel like with ICD-10 being pushed that people are starting to look at acquiring financial systems probably for implementation after ICD-10 goes live. And we are starting to see that activity.

Richard Close - *Avondale Partners - Analyst*

Okay, thank you.

Marc Naughton - *Cerner Corporation - CFO*

Before. I'm sorry before ICD-10 goes forward. Not after.

Operator

Mohan Naidu, Stephens.

Mohan Naidu - *Stephens - Analyst*

Jeff, on ISC Intermountain are you already replacing the health system they are using or how far are you guys before you can do that?

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

We are still, we are just a few months into the project, but the expectation is that we will replace both health in that health 2 system starting later this year.

Mohan Naidu - *Stephens - Analyst*

All right, a follow-up on the same thing on the care process models that you talked about in innovation. Are you planning such a way that you can take that out and offer it the other clients and how does it -- how do you expect that to work?

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

Yes. So the plan is to not only develop them to run inside the systems here, but to have those externalized so that they cannot only be used by existing Cerner clients, but non-Cerner clients as well. And we have a short list of candidates we started working with inside the base that will pilot that for us this summer.

Mohan Naidu - *Stephens - Analyst*

Thank you very much.

Operator

Greg Bolan, Sterne, Agee.

Mike Ward - *Sterne, Agee & Leach, Inc. - Analyst*

This is [Mike Ward] in for Greg today. We just have one quick question.

If you think about your current wallet share of the installed base of hospital clients, how much room do you think there is to grow?

Zane Burke - *Cerner Corporation - President*

The question is based on our installed base, the opportunities within the installed base. Certainly a lot of our growth is predicated on taking market share in addition to our installed base. I think the level of growth when you look at just some of our newer offerings such as RevWorks and ITWorks when you only have double-digit barely ITWorks and single-digit RevWorks and 300 clients that could take those offerings over time, that that is a pretty large opportunity and it is actually dollars already coming out of their wallet that they are already spending that they would merely redirect to Cerner. Those are usually pretty good chunks of dollars that would come into us.

So I think, relative to the current share of their wallet, while we are certainly an integral part of their IT strategy, many of our large clients don't even have Cerner throughout all of their hospitals. So there's a process that they have undertaken and continues to be underway. So there's opportunities to sell more into the base as they expand. Certainly as market consolidates and they acquire more hospitals there's more chance to expand.

So I don't know -- I don't see us limited based on our current market share of wallet. I think there's plenty more opportunities for us to go get more business out of the existing client base in addition to the other opportunities we see out there.

Mike Ward - *Sterne, Agee & Leach, Inc. - Analyst*

Great. Thanks.

Operator

Steven Valiquette, UBS.

Steven Valiquette - *UBS - Analyst*

Good afternoon. So with the ICD-10 delay, it sounds like it has opened up some conversations on new RevWorks projects which is obviously positive. I guess I'm curious is there any chance you have seen any uptick in conversations on new EHR projects since the delay? Has there been any shift in focus of clients away from RCM and back towards the EHR with the delay or is it maybe too optimistic to make that assumption? Curious to hear your thoughts on that. Thanks.

Zane Burke - *Cerner Corporation - President*

We haven't -- I haven't necessarily seen where that piece is out there yet. It is not reflected in our guidance at this point in time, but I think there's a sentiment as people figure out how they are going to shift their projects they are clearly going to look at other things that they can go accelerate. And so that is a net positive. I certainly have been pleasantly surprised overall by the number -- when we talked about this second buying wave, the second buying wave it could accelerate some of that long-term bubble that we see out in the future of clients that are prospects that actually have achieved even as high as HIMSS level 7 on other providers and are yet active in the marketplace, looking at exchanging their EHR because they don't feel like the solution they have will suit their future needs. So I think that there's opportunities in that with the push of ICD-10.

Steven Valiquette - *UBS - Analyst*

I guess so besides the reference that you mention are there any other product categories that are noteworthy that you've seen an uptick in interest since the delay? Any other shifts that are worth mentioning?

Zane Burke - *Cerner Corporation - President*

Not at this time. I think ambula -- I think some of the integrated ambulatory because of the issues with the position documentation requirements for ICD-10, I think we will see -- I haven't seen it yet, but I do think we will see that ambulatory uptick will continue for us and that we will have continued strength in the ambulatory side. And that shift in ICD-10 could have net positive to us from the ambulatory side.

Steven Valiquette - *UBS - Analyst*

Okay, got it. Thanks.

Operator

Jamie Stockton, Wells Fargo.

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

Good evening. Maybe the first one, Zane, I think this is for you. Stage II of meaningful use -- doesn't seem like there have been a lot of attestations across any of the vendors so far. Can you give us some sense for how you feel like hospitals are faring in that?

Zane Burke - *Cerner Corporation - President*

Sure. We did actually have our first attestation and so, as you know, the publicly available data is lagging in terms of what else is out there, but I will tell you we did have our first attestation in the first quarter. And we anticipate a significant number of clients here in the second and third quarters, tracking that very closely. And we -- working with those clients developed plans for how they will be rolling out be so I would anticipate you will see Cerner clients in the second quarter, a very significant chunk of those attesting at this point. As far as competitors, I have not seen any other competitor that has attested for stage II meaningful use yet at this point. But again, publicly available data is lagging by about 60 days.

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

Has the experience of the hospitals that have been going through that decision process -- have there been any unexpected hurdles that you have been hearing from the feedback you've been getting?

Zane Burke - *Cerner Corporation - President*

I think any time you are doing you things you get -- there's always some twists and turns in every environment is a little bit unique to the organization and so as you go through that, there are some tweaks. But overall our clients are tracking very well. We have got a discrete plan for every single client that we have out there around meaningful use too, and to ensure that they achieve the dollars that they deserve to achieve.

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

Okay. And just on Community Works, you know, from the hospitals that we have been talking to, it feels like maybe 2014 is the first year where you are seeing a lot of the smaller facilities that are in the orbit of larger health systems start to look at transitioning to whatever system that large health system (inaudible) closes on. Are you feeling that in the marketplace or has that already been a trend that has been going on for a while and we are just now picking up on it with our checks?

Zane Burke - *Cerner Corporation - President*

Well, I think there -- I think you are touching on one element that is coming more about where health systems are identifying or kind of caught more of that feeder system to their overall broader strategies, and the critical access hospitals are wanting to connect -- the big systems want those connections to mature and so we are seeing that out there. And I would call that probably more of a future development.

Obviously we have highlighted some of the acquisition activity which there's the two forms, the affiliation and tighter linkage or acquisition model, and I think you are going to see more of joint venture, more affiliations along with I do anticipate an uptick again. Once because of the ICD-10 delay, I think you will actually see an uptick back again on the acquisition side.

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

Thank you.

Operator

Dave Francis, RBC Capital Markets.

Dave Francis - *RBC Capital - Analyst*

Couple of longer-term growth-oriented questions. And I think, Zane, this one is for you. Understanding the need for care coordination and population health in the healthcare marketplace, as you look at your customers how would you characterize where the provider market is today from both an operational and a cultural perspective to actually be able to use the IT tools that you are developing for that part of the market today?

Zane Burke - *Cerner Corporation - President*

It depends very much on the geography. So -- and the management teams overall. So those geographies where -- and clients that are more risk-oriented are, they are ready for the tools today. There are certain geographies and certain clients that are not either, they don't have -- not necessitated to actually go swim towards the risk yet today because their model is more distilled to fee for service and they don't see it coming. Or they are frankly hoping against hope that the old model will stay. And so those clients are not quite as far along in their thinking or their thought process there. So I would describe it as the early movers are ready for the tools today. Those that aren't in the early movers it is a little bit more evangelical conversation that we have with them.

Dave Francis - *RBC Capital - Analyst*

And when you say ready do you mean from a we bought into that concept perspective or that we are structurally ready from an incentives and reorganization of the operating teams and all that kind of stuff that needs to happen as well?

Zane Burke - *Cerner Corporation - President*

Yes, there's varying degrees. There are those on the very early side that are fully ready. They are absolutely moving towards the risk in advance of even the models being out there. So that such that they are prepared. And we actually have a number of clients today that are full incentives changing their workflow models and changing really the way that they think and they have one foot in the fee-for-service model and one foot and the risk side. They are fully into the beginning to think about the at-risk even at the expense of the fee-for-service model because they know it is the inevitable future.

Dave Francis - *RBC Capital - Analyst*

And as a quick follow-up, turning to the Revenue Cycle, to what degree have you looked at or are you changing your Revenue Cycle solutions to address the increase and high deductible health plans that are being sold in the market today going forward and the increasing direct patient payment portion of the overall healthcare spend as it relates to your clients' Revenue Cycle needs?

Zane Burke - *Cerner Corporation - President*

Always the ever-changing environment out there, there's continual revisions to the solutions and elements that we do. But that has not been a big driver in our immediate elements but we are clearly very close to how -- the thought processes there and how the future is going to play out.

Marc Naughton - *Cerner Corporation - CFO*

Yes, it is part of the reigning measures and mandates that we continue to see. This is Marc and we just -- certainly software keeps up with all the regulatory requirements that are going to be baked in in the business needs of our clients. So we are ready [for it].

Operator

Eric Percher, Barclays.

Eric Percher - *Barclays Capital - Analyst*

I would like to ask about the international market. I know that you see strength ebb and flow in this market. I am curious hearing about the go live in Saudi Arabia, how much of what you are targeting is Advanced Systems for hospitals versus other geographies where you may be looking at the most simple system to get through the door and up and running?

Zane Burke - *Cerner Corporation - President*

That's a great observation. As you are obviously aware, certain global markets have lower levels of clinical automation. I would tell you that the Middle East is actually a very high level of clinical automation so it is a very --. So it's much a heavier depth of automation that many other global marketplaces. The Saudi space is very much in the Middle East space is very much in deep clinical thought processes.

Eric Percher - *Barclays Capital - Analyst*

And are you going into areas where you are starting with a strong base or is it that you are starting from scratch with a very high funding and bar to hit?

Marc Naughton - *Cerner Corporation - CFO*

For Saudi it was a single pilot. We were (multiple speakers) their process was a selected single pilot. We have turned ours on. We have delivered. We don't know that any other -- of any other pilots that have even started in that process.

So we believe that first to market, first to install, first to see the benefit is going to give us an advantage. But currently once again they don't have a large procurement in place. They are doing it on a hospital-by-hospital basis. We are just very pleased to have our first one up and running and doing very well.

Zane Burke - *Cerner Corporation - President*

And I will just, for color purposes, in the rest of the Middle East I think you see a lot of early demand for Population Health tools because those countries are thinking at the Population Health level and so they are thinking about things a little bit differently. And I think you'll see them move more quickly over time because they have the ability to do it in a contained smaller environments and in a way that they can regulate. I think there is quite a bit of demand in the Population Health side in the Middle East.

Marc Naughton - *Cerner Corporation - CFO*

I would just point out that inside of the tender we are in, we already have a lot -- multiple private hospital clients in Saudi. So we certainly are not looking at our first footprint in the country. We have multiple footprints there. And if you look overall in the Middle East, we have an order of magnitude more HIMSS level VI clients in the Middle East.

So I think that supports Zane's point of these are complex clinical environments, and I think that is supported by the HIMSS level we're seeing in our client base.

Eric Percher - *Barclays Capital - Analyst*

Could you just remind me the tender next step or the size of the opportunity you hope to address?

Marc Naughton - *Cerner Corporation - CFO*

There is no prescribed next step once we deliver the pilot. It is up to them to take the next step. There are well over 200 hospitals that would qualify for this opportunity, and so that's the order of magnitude.

Eric Percher - *Barclays Capital - Analyst*

Thank you.

Operator

Leo Carpio, HM Global.

Leo Carpio - *HM Global Capital - Analyst*

Good afternoon. I am just going to change the tone of the conversation. What is in the competitive environment so far in terms of the deal flows you are seeing this year in terms of who needs to keep competing against and since we are anticipating a replacement cycle, it sounds like [the props] thinking that maybe a duopoly is going to emerge and become de facto by next year in the market for you.

Zane Burke - *Cerner Corporation - President*

I think you just answered your own question which is we do see it as a duopoly. That's principally who we are competing against. As one other competitor sometimes you might have an income that is given an opportunity in that particular organization to have an opportunity to compete against the two of us on that side, and so that is typically how a typical arrangement would go.

For us, we have seen a 20% increase in our pipeline since Q1 of 2013. So when you look at the opportunity side of this, we are seeing an acceleration of pretty dramatic opportunities across all segments of our business.

Leo Carpio - *HM Global Capital - Analyst*

Quickly the ICD-10. You mentioned that this could be a positive for you for this year. And at some (inaudible) shuffling through their priorities and figured out what products you want to move forward with. Is that more a case of the midsize hospitals or is it just in general that you are seeing that?

Zane Burke - *Cerner Corporation - President*

It is in general that we are seeing that. So I think there is an ability for some of the midsize hospitals to move a little bit quicker because it is single projects and their planning cycles can be a little bit different. But those ICD-10 resources can be reapplied somewhere else and in many of them we are planning to do a Revenue Cycle selection after the ICD-10 element, which now allows them to think about doing it now. And the same thing goes on the RevWorks side of that conversation.

Leo Carpio - *HM Global Capital - Analyst*

Okay. Thank you.

Operator

Garen Sarafian, Citigroup.

Garen Sarafian - *Citigroup - Analyst*

First question is a pretty broad level and on EMR displacements. I guess I am a bit surprised to hear the strength of the displacement market for the EMRs this year as we talked to industry participants. So could you offer a bit more color as to what you are seeing versus maybe what you were thinking a few months back or any changes in the pockets of opportunity? And I guess also the vendor group that you are competing against, if there have been any changes?

Zane Burke - *Cerner Corporation - President*

Well, we have been highlighting this second wave for quite some time and actually we believe it is a five- to seven-year wave of second buying. And I think recently [Class] actually verified what we have been saying is a second wave of buying decisions. And again as evidenced by the 20% increase in my pipeline which is also inclusive of my new clients which is actually an excess of 20% increase over Q1 of 2013, we are seeing it flow through and, again, it's -- the competitors, our principal competitor and the incumbent that exists out there primarily.

Garen Sarafian - *Citigroup - Analyst*

Okay but I guess it is no change versus your expectations a few months back then? It is sort of as expected.

Zane Burke - *Cerner Corporation - President*

I think the only thing that is evolving probably a little bit different from me is I'm seeing as I mentioned from a color perspective, some clients which you would say are highly automated today have reached a good level of automation with an incumbent solution. But they feel like that foundational solution won't last, stand the test of time. are beginning to think about changing their core EHR solution. And I would say some larger organizations fit that model that I wouldn't necessarily would have been [thought have been] in the marketplace. And I can see them coming into the marketplace over the next 12 months.

Garen Sarafian - *Citigroup - Analyst*

Got it. Okay. Secondly, not to be the ICD-10 topic to death, but at this point would another delay beyond next year really matter for your business? What are clients saying at this point? Are they making any decisions around ICD-10 for next year?

Zane Burke - *Cerner Corporation - President*

At this point, no. They are not really making -- they are on standby to secretary discretion on how this works. So they are just on standby and I think they are going to begin to plan as if it is not there would be my sense. Now many of them had invested heavily to prepare and we are advising our clients to stay on a prepared path because you don't want to waste the work.

In fact, if it is -- actually comes in within a year, but I think most clients are -- will pretend as if it is not there unless they weren't ready for it at this point in time, in which that case that gives them an opportunity to take a second swing and get prepared for that.

Garen Sarafian - *Citigroup - Analyst*

Okay, great. Thanks.

Operator

Charles Rhyee, Cohen and Company.

Charles Rhyee - *Cowen and Company - Analyst*

Marc, just had a quick question about the guidance, some of that going forward. You talked about expectations on the margin expansion, 100 basis points rest of the year. Did I hear you correctly when you said second quarter may be a little bit less than that, the back half a little bit more? And then if that is correct in the back half, does that --? Are you thinking both quarters are like that or when we just lump two of these together in aggregate will be greater than 100? Thanks.

Marc Naughton - *Cerner Corporation - CFO*

Yes, no, I think on a quarterly basis the expectation would be Q2 a little bit lower, Q3 and Q4 a little higher so that for the year we end up with our 100 basis point improvement. I think it is important when you look at Q1 where we actually had just a basically flat operating margin percent that even in a quarter where we had tech resale go down which normally will help us with our margins, that the client tech resale actually was almost equally offset by a 27% increase in software.

So our revenue line was solid and obviously I like the higher-margin but in Q1 we also had some significant investment in R&D expense and some increases in some G&A along with the client services expense that increased to support the strong increase in that revenue. So I think from an overall standpoint, Q1 came out very good for us. We love the dollars we drove out, but certainly a little bit lower and the margins. We think that will kind of settle back to the 100 basis points by the time we end the year with Q3 and Q4 being at a higher level than you will see in Q1 and Q2.

Charles Rhyee - *Cowen and Company - Analyst*

And just, too, when I think about the back half, because obviously you gave us what you think the expense, the aggregate expense will be in the second quarter should we think that the margin improvement that as we accelerate north of the 100 basis points will be more from gross margin? Or is it more from taking expense out further? Thanks.

Marc Naughton - *Cerner Corporation - CFO*

That should be basically the continuing you will see more leverage from overall spending where you are going to see revenues increasing at a rate that is higher than our spend is increasing. Traditionally where you have seen us get our leverage.

Charles Rhyee - *Cowen and Company - Analyst*

Okay, great. Thanks.

Operator

Michael Cherny, ISI Group.

Michael Cherny - *ISI Group - Analyst*

Good afternoon. Marc, first just one quick clarification. Did I hear you right? You said 27% software growth in the quarter?

Marc Naughton - *Cerner Corporation - CFO*

Correct. And in fact I had a 27% decrease in tech resale on the revenue side. So it just so happened that from a revenue standpoint those basically offset. Obviously I am really excited about the software increase and while disappointed that the tech resale was lower when we were getting to a point where we weren't going to have to talk about that anymore the pipeline for tech resale would indicate that it will get back to the levels we had basically that we had expected, where we were basically trending similar to where we were last year.

Michael Cherny - *ISI Group - Analyst*

Yes, I think we are all excited to stop talking about that. So I think I am in the same camp as you. (multiple speakers).

Then one quick question on the international market. We touched on Saudi Arabia and the great success you had there. When you think globally about the countries that you are in maybe outside Saudi Arabia, just because of the recent focus, what do you think is the one country or region that has the greatest opportunity to pursue a US-like model, you know, a broader based digitization of the health system? Is it somewhere like Brazil? Is it somewhere -- [or] the UK finally getting their act in gear. I guess what is the most optimistic international market for you guys?

Zane Burke - *Cerner Corporation - President*

Well, I think the UK does represent from a near-term perspective one of the biggest and best opportunities. I think that people are in the UK as they come out of the NHS trust model are recognizing a need to actually have deep clinical systems and I think those trusts that are more progressive and forward-thinking are headed that way, and have spent some time with some clients recently who are -- who have come to that conclusion even at the risk of their having to pay significantly additional dollars from the -- as opposed to going to the open-source NHS model. So I think that represents a great opportunity for us.

I think Australia is still a very good market broadly speaking for us, in addition to the Middle East. And I think Brazil is a longer term play that we will have to see how that rolls out.

Marc Naughton - *Cerner Corporation - CFO*

I think we are even seeing aggregation of populations in Canada as well as part of their health system's going more provincial and trying to get almost the entire province on a single platform so that they can manage the health of that population. So and I think Australia obviously with Queensland activities there where -- we are doing an entire territory. So I think those and we are -- actually talked earlier about Middle East being countries, those countries aren't large and they can actually automate a Population Health strategy and the entire country without having (technical difficulty). So lots of opportunities on the global side.

Michael Cherny - *ISI Group - Analyst*

Appreciate that. Thanks for the color.

Marc Naughton - *Cerner Corporation - CFO*

Why don't we take one more question?

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Good afternoon. One quick question. Marc, I wasn't able to get the trend file open yet. Can you tell me what the percentage of bookings that came from new clients in the quarter was?

Marc Naughton - *Cerner Corporation - CFO*

25%.

George Hill - *Deutsche Bank - Analyst*

25%. Okay, thanks. And then a follow-up question on the bookings. If we look at this quarter's bookings, I don't know if you can break it down into broad buckets for us, but if there is 25% that comes from new, can you tell us what percentage is coming from cross sell, what percent is coming from renewals, what percent is coming from what I would call the meaningful client expansion? Call it two buckets, right, client expansion of people who buy more widgets from you and people who acquire facilities and then need to roll the technology out to acquired facilities. I guess I am just trying to understand what bookings mix is looking like these days.

Marc Naughton - *Cerner Corporation - CFO*

Yes, I think from a view, you might have -- most of our sales are perpetual license so there's not so much a renewal element to our -- we certainly have an element of subscription business, it's part of our revenue stream, but not a huge part of it. Most of the bookings are coming from new sales of software. They are coming from new sales of services, from implementation from a variety of support services, business office.

There are some minor amount of hosting renewals that occur. But for the most part, George, I would say that the vast majority of those bookings are new agreements for new things to those clients.

George Hill - *Deutsche Bank - Analyst*

Okay. So I guess when you get the big work steals and the bigger deals, we didn't see any of us this quarter and that's what we'll see in the future continue to drive the upside to numbers and a lot of these cross sell opportunities are what should remain visible bookings opportunities might be the right way to think about or the opportunities that will be readily available from the installed client base.

Marc Naughton - *Cerner Corporation - CFO*

Yes, I think that is fair. I don't know that the Works things do have some level of visibility because certainly they have got some risk down factors to an extent as we are providing guidance. But I think that is a fair statement.

George Hill - *Deutsche Bank - Analyst*

Okay. Appreciate you squeezing me in. Thanks.

Marc Naughton - *Cerner Corporation - CFO*

Thanks. Well, I appreciate everybody attending the call today. Neal's not here for wrap-up, so I just want to thank you for attending. I know we ran a little late and I hope you heard a good story here. We are excited about the rest of this year as our pipeline is firming up well and we see a lot of opportunity.

So with that, enjoy the rest of your day. Thanks for attending.

Operator

Thank you for your participation in today's call. This concludes the presentation. You may now disconnect. And have a great day.