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EDITED TRANSCRIPT

CERN - Q2 2015 Cerner Corp Earnings Call

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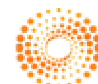
OVERVIEW:

Co. reported 2Q15 GAAP net earnings of $115m or $0.33 per diluted share. Expects 2015 revenues to be $4.475-4.575b and adjusted EPS to be $2.09-2.15. Expects 3Q15 revenues to be $1.15-1.20b and adjusted EPS to be $0.54-0.55.



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PRESENTATION

Operator

Welcome to the Cerner Corporation second-quarter 2015 conference call. Today's date is August 4, 2015, 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 expenses, product development, new markets, or prospects for the Company's solutions 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 - *Cerner Corporation - EVP and CFO*

Thank you, Kaylie. 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. Mike Nill, Executive Vice President and Chief Operating Officer, will discuss operations. And Neal Patterson, our Chairman and CEO, will join us for Q&A.

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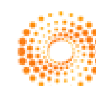

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Now I'll turn to our results. Similar to last quarter, we delivered results that were mostly in line with our expectations, with the exception of revenue. While we are disappointed that we were below our guided levels of revenue, our continued level of strong bookings and positive outlook set up a good second half of the year.

Our bookings revenue in Q2 was $1.29 billion, which is an all-time high and reflects 20% growth over Q2 of 2014, including record amounts of new business activity. Our revenue backlog ended the quarter at $13.3 billion, which is up $9.7 billion a year ago, and reflects the strong bookings in Q2 as well as the inclusion of backlog from Health Services.

Revenue in the quarter was $1.13 billion, which is up 32% over Q2 of 2014, and includes approximately $260 million of Health Services. The total is approximately $50 million below our guidance range, with approximately $40 million of the shortfall related to core Cerner, and $10 million attributable to Health Services.

On the Cerner side, the lower revenue and resulting low-single-digit growth is related to several factors: some are in-quarter dynamics; some are unique items in the prior-year period that drove 20% growth and created a tough comparable; and some are items that we didn't accurately forecast.

The first factor is lower growth and services, which is primarily because of a year-over-year decrease in third-party services. Recall that in Q2 of 2014 we had a revenue over-attainment of more than $20 million that was largely related to higher third-party services and reimbursed travel. We are using less third-party services this year. And travel revenue, excluding Health Services, was down approximately 50% year-over-year. Just adjusting for these two items brings Cerner's core growth from approximately 2% to 5%. As you know, third-party services are lower margin, and reimbursed travel is zero margin, so this lower revenue had little impact on our profitability.

Another factor that has impacted our services revenue is that we limited hiring in the months leading up to, and initial months after, the close of our Health Services acquisition. Our forecasting model did not fully reflect this. And we're now ramping up hiring to meet the strong demand reflected in year-to-date bookings and our forecast, which will drive stronger services revenues growth. But the impact of the additional resources, as well as the impact of additional opportunities we see for the Works businesses, will primarily be toward the end of the year and in 2016.

An additional factor impacting revenues in our bookings this quarter included a higher percentage from long-term contracts, resulting in a lower percentage of items that generated in-quarter revenue.

Finally, relative to Health Services, recurring revenue is tracking as we had forecasted, but nonrecurring revenue came in lower than expected. While we are having ongoing success with converting Health Services' clients to Millennium, there is a portion of their base that is sitting tight during the transition, which has impacted the rate at which they make add-on purchases for things like lower-margin hardware. Otherwise, everything we are tracking for Health Services is at or ahead of our expectations.

Now I will quickly go through the total revenue composition for Q2. Total system sales revenue was $315 million. Support and maintenance was $255 million. Services was $538 million, and reimbursed travel was $18 million. System sales revenue reflects a 34% increase over Q2 of 2014, with the growth mainly driven by an increase in subscriptions, which is where the addition of Health Services has had the biggest impact, as well as growth in licensed software. Our system sales margin percentage was 64.3%, which is down slightly from 65.3% in Q2 of 2014, and 64.7% in Q1. The decline was driven by lower tech resale margins.

Moving to services, total services revenue, including professional and managed services, was up 30% compared to Q2 of 2014, mainly driven by the addition of Health Services, as well as growth and core Cerner managed services. Support and maintenance revenue increased 45% over Q2 of 2014, reflecting the solid growth in core support and maintenance, and the addition of Health Services.

Looking at revenue by geographic segment, domestic revenue increased 30% over the year-ago quarter to $995 million, driven largely by the addition of Health Services. And global revenue grew 54% to $131 million, with good growth in core global revenue being augmented by the addition of Health Services.

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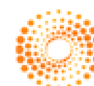

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Moving to gross margin, our gross margin for Q2 is 82.9%, which is up from 80.9% in Q2 of 2014, with the improved margin reflecting the lower level of third-party services and reimbursed travel.

Looking into operating spending, our second-quarter non-GAAP operating expenses -- which excludes share-based compensation expense, voluntary separation plan expense, and acquisition-related adjustments -- were $661 million, which is up 37% compared to adjusted Q2 2014 operating expenses. This growth was primarily driven by the addition of Health Services business.

The total year-over-year growth for each expense category on a non-GAAP basis was 32% for sales and client service, 42% for software development; 61% for G&A; and a 3% decline in amortization of acquisition-related intangibles, which is a new expense line we added this quarter. Note that this line is $25 million on our GAAP income statement, and $3 million in our non-GAAP results, since we are excluding amortization related to Health Services.

Moving to operating margins, our operating margin before share-based compensation, voluntary separation expense, and acquisition-related adjustments was 24.2% in Q2. This is essentially flat compared to Q2 of 2014, and up 50 basis points from last quarter. Similar to Q1, we achieved our second-quarter earnings on lower revenue, resulting in a higher operating margin percent than we originally projected.

We expect this dynamic to continue for the rest of the year with lower revenue being offset by lower expenses, resulting in no change to our earnings outlook, and a higher operating margin percent than we originally projected.

We now expect our non-GAAP operating margin for the year to be close to 2014 levels. This compares to an original expectation that it would go down approximately 200 basis points with the addition of Health Services.

Moving to net earnings and EPS, our GAAP net earnings in Q2 were $115 million, or $0.33 per diluted share. Adjusted net earnings were $183 million and adjusted EPS was $0.52, which is up 30% compared to Q2 2014. Adjusted net earnings excludes share-based compensation expense, which had a net impact on GAAP earnings of $14 million or $0.04 per diluted share; as well as the voluntary separation plan expense, which had a net impact on GAAP earnings of $28 million or $0.08 per diluted share.

Adjusted net earnings also reflect adjustments related to Cerner's acquisition of Health Services, including Health Services' acquisition-related amortization, which reduced GAAP net earnings and diluted earnings per share by $14 million and $0.04, respectively.

Other acquisition-related adjustments, which reduce GAAP net earnings and diluting earnings per share by $6 million and $0.01, respectively; and the acquisition-related deferred revenue adjustment, which is not included in GAAP net earnings, but increases adjusted net earnings and diluted earnings per share by $6 million and $0.02, respectively.

The Q2 tax rate for a adjusted net earnings was 33%, which is in our expected range of 33% to 34%.

Now I will move to our balance sheet. We ended Q2 with $857 million of total cash and investments, which is down slightly from $889 million in Q1 due to our negative free cash flow, which I will discuss in a minute.

Our total debt, including capital lease obligations, is $623 million. Total receivables ended the quarter at $1 billion, which is up $63 million from Q1.

Our Q2 DSO was 81 days compared to 79 days in Q1, and 66 days in the year-ago quarter. The higher DSO is primarily a function of the lower revenue in the quarter and some delayed billings for Health Services clients as we transition to our systems. As we move through the year, we expect DSO to come down as revenue increases and we get Health Services' billings caught up.

Operating cash flow for the quarter was $109 million, down from $214 million in Q1, due mainly to the voluntary separation plan expense and lower collections related to delayed billings. Q2 capital expenditures were $85 million. and capitalized software was $70 million.

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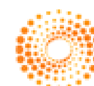

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Free cash flow -- defined as operating cash flow, less capital expenditures and capitalized software -- was negative $46 million for the quarter, driven by a combination of lower operating cash flow and higher capital spending.

Looking ahead, we expect operating cash flow to increase in coming quarters, as voluntary separation plan and acquisition-related expenses decline and we improve DSO. Some of the increased operating cash flow will be offset by capital expenditures tied to construction of our new campus, and Health Services' capital expenditures. We still expect free cash flow to improve meaningfully.

Now I will go through Q3 and full-year 2015 guidance. For Q3, we expect revenue between $1.15 billion and $1.2 billion, with the midpoint reflecting growth of 40% over Q3 of 2014. For the full year, we expect revenue between $4.475 billion and $4.575 billion, with the midpoint reflecting 33% growth over last year. This is lower than our prior guidance due to lower revenue in Q2, and also factors in the lower year-to-date run rate. As I indicated, the lower revenue is not expected to impact our earnings in Q3 or for the year.

For Q3, we expect adjusted EPS -- before share-based compensation, voluntary separation plan expense, and acquisition-related adjustments -- to be $0.54 to $0.55 per share, with the midpoint reflecting 30% growth over Q3 2014 adjusted EPS.

For the full year, we expect adjusted EPS -- before share-based compensation, voluntary separation plan expense, and acquisition-related adjustments -- to be $2.09 to $2.15, which is up from our previous range of $2.07 to $2.15, and reflects 28% growth at the midpoint. Our estimate for the impact of share-based compensation expense is approximately $0.03 to $0.04 in Q3, and $0.14 to $0.15 for the full year.

Moving to bookings guidance, we expect bookings revenue in Q3 of $1.35 billion to $1.45 billion, with the midpoint reflecting 27% growth over Q3 of 2014.

In summary, while we are disappointed that revenue was below our guidance, we are very pleased with our bookings results and outlook. Importantly, we believe we have appropriately adjusted our revenue guidance to factor in the lower first-half revenue and run rate.

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

Zane Burke - *Cerner Corporation - President*

Thanks, Marc. Good afternoon, everyone. Today I will provide color on our results and make some marketplace observations. I'll start with our results. Our bookings revenue in Q2 of $1.29 billion reflects strong growth of 20% over Q2 2014. Bookings this quarter included an all-time high level of large contracts, with 38 contracts over $5 million, including 23 over $10 million. We also had strong contributions from long-term bookings, with a large ITWorks contract and an expansion of an existing ITWorks relationship. This led to long-term bookings making up 35% of total, which is a few percent higher than normal.

The main highlight of the quarter was that we signed a record number of new footprints in both -- both in terms of number and dollars. This resulted in 34% of our bookings coming from outside our core Millennium installed base. This success reflects our strong competitiveness and the continued large opportunity for competitive displacements. Our wins span many market segments, including IDNs, regional hospitals, children's hospitals, community hospitals, state behavioral health, ambulatory surgery centers, and physician groups.

We are also continuing to sign Health Services clients to migrate to Millennium. These clients range from community hospitals selecting our CommunityWorks offering to large IDNs. And we continue to see cross-sell activity for solutions like population health and ambulatory.

While not part of Q2, I'd like to highlight a significant win for Cerner that was announced today. We were recently selected by Baptist Health South Florida, a leading healthcare organizations in the region, to implement Cerner Millennium and Healthe Intent across their seven hospitals and over 50 outpatient facilities. Baptist Health is recognized as a national leader in quality, safety, and patient satisfaction. And they are looking to Cerner's solutions to optimize the physician experience, improve quality of care, and support their efforts to improve patient experience.

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In addition, they are expect -- leverage our enterprise-wide solutions and Healthe Intent platform to advance their goal of improving care coordination and reducing the cost of care.

This recent win, combined with our record level of new footprints in Q2, is evidence of strong momentum we have in the marketplace. Looking forward, we believe we can build on this momentum, and we remain bullish on new footprint opportunities.

Our positive outlook is based on a very large and active pipeline and all-time high levels of new business activity such as demos, reference calls and visits, and vision center visits. We continue to believe we have a multi-year opportunity to expand our client base, as about half the market is on a legacy system and we think will need to be replaced.

One observation about the buyer in today's market is they are very focused on the predictability of costs, and transparency to total cost of ownership. And we believe this is something that plays to our strength. We believe our ability to offer fixed fee pricing on implementations because of our automation tools and implementation methodologies is a competitive differentiator. We also differentiate in our ability to provide services ranging from remote hosting to taking over an entire IT department, which can make our clients' total cost much more transparent and predictable.

And in addition, I believe we have credibility in the industry because of our track record for delivering value. And this credibility is bolstered by our large presence in investor-owned systems that are known for making ROI-based decisions. These clients, along with many of our other large IDNs, represent some of the largest healthcare IT deployments in the industry.

I think it is worth noting that our ability to deliver value, on time and on budget projects, is a meaningful differentiator relative to our primary competitor, who has a long list of making headlines when the significant cost of deploying and maintaining their system is cited for -- as a key reason for job loss, financial challenges, and debt rating downgrades.

Another marketplace observation is that openness, interoperability, and population health capabilities are becoming more important. This also benefits Cerner because of a long-time commitment to interoperability and open standards and our robust Healthe Intent cloud platform for population health. We continue to expand the presence of Healthe Intent across our client base, and the number of opportunities outside of our base is growing.

Moving to our revenue cycle business, we had a good second quarter. All of our new EMR footprints in Q2 included revenue cycle, which supports what we have been saying about the market looking to buy integrated systems. Revenue cycle is an important component of almost all deals in our pipeline.

In addition, we are gaining momentum in our existing installed base, with several clients selecting us to replace their legacy revenue cycle systems in favor of an integrated system. Based on these trends and a growing pipeline for related services, I expect revenue cycle to continue contributing to our growth for years to come.

Moving to the ambulatory market, where we had an all-time high level of bookings in Q2. The bookings were driven by success at displacing our key competitors, both by expanding our solutions to the ambulatory venues of our acute care clients and as part of new business footprints.

In addition, we are continuing to have success selling ambulatory solutions into the Health Services base. Finally, we continue to gain momentum in ambulatory business office services, and expect there to be additional sites where we displace the cloud business office services offering of a certain cloud competitor because of our ability to demonstrate better service and value.

We also had a record bookings quarter in the small hospital market, driven by a combination of traditional new footprints, extensions to our health system clients, and Health Services migrations.

Outside of the US, we had a good Q2, with total revenue growth of 54%, consisting of good organic growth and the addition of Health Services. The organic growth was primarily driven by strength in the UK and the Middle East. We are also off to a good start at integrating the global

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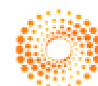

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components of Health Services. We now have a presence in more than 30 countries, and believe we are well positioned for our global business to be a good contributor to our growth over the next decade.

Before turning the call over to Mike, I'd like to comment on the recent announcement by the Defense Healthcare Management System Modernization project, referred to as DHMSM. We are pleased that last week the Department of Defense announced a decision to award the contract to Leidos, Inc. As you know, the Leidos partnership for Defense Health includes Cerner as the core EHR supplier.

We are honored, humbled, and excited to be part of a team that won what we believe was the most objective and comprehensive evaluation of technology platforms and solutions ever conducted.

We now have the opportunity for Cerner's suite of integrated solutions to replace the DoD's legacy health IT systems in its 55 hospitals and more than 350 clinics worldwide, as well as in ships, submarines, and other locations in the theater of military operations.

We are pleased to be partners with Leidos, Accenture, Henry Schein, and a number of small businesses partners in making this important transition for our military health system and its 9.6 million beneficiaries.

Intermountain Healthcare is also a strategic partner and is providing clinical governance of solutions and workflow. The partnership is fully prepared to meet the staffing requirements of DHMSM, and our globally deployed team stands are ready to support the DoD in DHMSM mission. We believe this is a positive development for our clients, and they should have confidence that Cerner will continue to execute to meet all their current and future commitments.

As many of you saw in the announcement, Leidos was awarded a contract for $4.3 billion over 10 years, consisting of a two-year initial ordering period; two- to three-year option periods; and another two-year option period. We are not able to comment on Cerner's portion of this. But note that we do not expect this to have a material impact on bookings, revenue, or earnings in the near term, since the project will have several phases and will start with a small initial rollout.

I know many of you also saw an $11 billion figure cited in regard to the contract before it was announced. As noted in the DoD's press release, this estimate is now approximately $9 billion and represents the total estimated program costs over 18 years, not the value of the contract awarded.

In summary, we believe this selection by the Department of Defense reflects positively on the achievements of Cerner, our partners, and all our clients. The Department of Defense is already in the Cerner family as a lab client, and we're excited to expand our relationship.

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

Mike Nill - *Cerner Corporation - EVP and COO*

Thanks, Zane. Good afternoon, everyone. Today I'm going to discuss ITWorks and provide an update on our relationship with the University of Missouri. In the second quarter we established a new ITWorks relationship and also expanded an existing ITWorks relationship.

Our new ITWorks client is Catholic Health Initiatives, and this relationship was announced in July. CHI selected ITWorks to improve continuity of care across 47 hospitals in multiple clinic settings. And Cerner will assume operational and administrative responsibilities for [CHS's] IT at its facilities in multiple states that use Cerner Millennium. This will include current and future implementations, upgrades, enhancements, optimization, application and operational management, and support of the system and clinical service desk support.

CHI has been a client for more than 12 years, and this will tighten our alignment and support of CHI's vision of pioneering models to enhance patient care, safety, and clinical outcomes. The tighter alignment will also help accelerate the implementation of the latest technology advances available.

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The second ITWorks agreement I'd like to discuss is the expansion of our relationship with the University of Missouri Healthcare. MU has been a Cerner client since 1996, and we formed the Tiger Institute for Health Innovation with them in 2009. Tiger Institute has produced a number of innovations to transform the delivery of care. Examples include e-visit technology, integrating calculators into the EHR, and developing a consumer-facing mental health app. This year, the Tiger Institute launched OpenNotes, a function that gives patients access to their clinical notes through the MU healthy patient portal.

MU Health has also achieved multiple healthcare IT successes, including HIMSS stage VII; being the first academic medical center to meet Meaningful Use Stage II; and being designated most wired by AHA each of the past four years.

Going forward, the Tiger Institute will focus on redefining patient engagement through mobile healthcare, developing a population health strategy and network to better position MU Healthcare to lower costs while improving the health of Missourians, increasing the role of healthcare IT and academic medical research, helping transition to value-based payment models, and developing a Tiger Institute value creation office to identify cost savings opportunity.

The University of Missouri was one of the first ITWorks clients and Institute relationships. And we are very pleased with what we have accomplished together, as it demonstrates the power of close alignment with our clients.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Eric Percher, Barclays.

Eric Percher - *Barclays Capital - Analyst*

Just to start, Marc, as you were talking through the Health Services business, you mentioned that nonrecurring revenue was running a little lower on those that are sitting tight, and I'm not sure I quite caught that dynamic. Would you mind walking through that?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Sure. For clients that are not immediately looking to go transition to Cerner Millennium and make the switch, they are not putting in a lot of new solutions from HS into their environment. They are holding pat with their hand. That has impacted some of the services that we see normally from HS. It is certainly impacting what their normal hardware and third-party sales would be. Those clients don't want to invest in the current infrastructure if they think they're going to switch to Cerner; because many of them, when they switch to Cerner, will go to our hosted methodology and they won't need these computers and the hardware that they'd normally be buying.

So, we expect that as people decide what their time frame for moving is, that we will see that free up. And people will say, I've got a three-year window or whatever the window is; I need to make these purchases. And we'll see that start bouncing back.

But as we look at that business, the one thing that's lower is these add-on type sales into the base that surround their existing platforms. People are waiting to get their go-forward decision before they continue to make those incremental investments.

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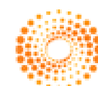

Eric Percher - *Barclays Capital - Analyst*

That's helpful. And my follow-up would be, as you think about the op margin and now that you won't have the 200 basis point impact, how much of that is attributable to mix versus actions that you've taken on expense?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I think that's a good point. When you look at the results for this quarter, clearly I think our licensed software was one of the strongest revenue quarters we've ever seen. So, that obviously brings with it much -- brings with it higher margins. It doesn't contribute as much to revenue growth, but it certainly contributes to earnings growth. I think, from a mix perspective, we saw that. We're just continuing to -- certainly on the HS side, the lower tech resale elements with lower margin, help overall margins; don't help the revenue so much.

And I think just the activity around the acquisition and thoroughly reviewing not only HS spending, but Cerner spending, to make sure we were appropriately investing, was good for the business. So I think that has overall given us a little bit of a tailwind from the expense side. It is a mix to some extent, but there is some real savings on the spending side that we have incurred. Part of it even is on the services business, where we are just starting to ramp up hiring now to meet the 2015 bookings demand that we saw the first half, and that we expect to see in the second half.

Eric Percher - *Barclays Capital - Analyst*

Very good. Thank you.

Operator

Charles Rhyee, Cowen and Company.

Charles Rhyee - *Cowen and Company - Analyst*

Marc, first on the revenue here. Obviously you talked about less third-party in the quarter than you expected. And now you're going to ramp up the hiring. Was there something that changed that made you realize that you needed to do more of a hiring that you didn't anticipate earlier? What was the signal to you that we didn't really have enough people for the demand?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I think we -- we're certainly meeting all of the demand for -- relative to project work and implementation work. Part of it was a desire to make sure that we thoroughly had a chance to review all of the HS service resources, decide what was needed to stay in that business, what we could convert to doing Millennium work. I think probably the services business we didn't address as much might have been some of the optional, non-implementation work that we often see and often get signed and executed within a quarter.

But I think that was prudent as we went through. I think I would certainly take it on me as probably not having the resource element reflected as accurately in our forecasting model as I should have; so a little bit of the lower revenue -- being a little bit lower than guidance is just on that. We have adjusted that going forward, so that the rest of the year we feel very confident on the revenue guidance that we provided. But it's not getting to these new projects as much as it is some of the ancillary service activities we get.

And then third-party, we really like to minimize how much we use third-party services. We had a lot of Meaningful Use activity in the year-ago quarter, lots of work going on. And that's why you saw the much higher third-party and the much higher travel revenue that came through the P&L.

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Charles Rhyee - *Cowen and Company - Analyst*

That's helpful. And then as a follow-up, obviously you highlighted how revenue cycle management is an important area. Can you talk about how you feel about your capabilities in this regard internally? And would you -- you have obviously a lot of cash on the balance sheet. Is there any thoughts to deploy that to -- add to your capacity there -- capabilities to it? Thanks.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, from revenue cycle, I think we're very happy with where we are at relative to the solution that we have out there, and relative to the -- certainly the initial RevWorks and revenue cycle activities. As we've talked about in the past, we can do anything from a full outsourcing of the revenue cycle, which we call RevWorks, to business office, to just assisting with providing the solution that is state-of-the-art relative to revenue cycle.

So, as far as deploying our capital in some type of an acquisition that would be in that space, I think we're very happy with where we're at right now. And I think we're doing the normal Cerner strategy of developing, spending our capital on R&D, and taking the market share, right now kind of a client at a time.

Charles Rhyee - *Cowen and Company - Analyst*

Thank you.

Operator

Donald Hooker, KeyBanc.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

It seems like this ITWorks business is doing very well. You gave some numbers for last year, it did well; and it seems like you keep landing nice deals there. I keep wondering, in my mind, whether ITWorks is perhaps somewhat of a leading indicator, as well, of business for you? Is it the case where people adopt the ITWorks service, and then you can really sell more product to them? Or is it a lagging indicator where it's a culmination of a relationship with the client?

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. ITWorks usually tends to be later in the lifecycle of the client. It's really an indicator that the client has decided to go all-in Cerner, and that they are going to replace every ancillary system they have with Cerner. They want to do it as quickly as possible. They want to do it with people who really know how to go operate in that environment. That's usually where we see the ITWorks activity occurring.

Certainly as we have more and more experience, more and more clients that we can show as examples of how this works, it is getting to be something that our client base is developing a higher level of interest. They want to make sure that they can get their costs managed well and that they can be certainly predictable. And ITWorks lets them make their costs in the IT space highly predictable relative to running their system.

So it really is -- although when they sign up for ITWorks, there certainly is follow-on solutions as they switch out those ancillaries that occur. But really once they go into ITWorks, there's follow-on business, but that's really almost -- not necessarily a culmination of the relationship; but, at that point, we are pretty sticky in their environment. And switching from that is very, very difficult; and certainly we don't give them any reason to want to switch.

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That is in -- certainly the ITWorks opportunity, we see RevWorks starting to be able to follow in that same line as we get through ICD-10. We think the desire for many systems to get out of the revenue collection business and outsource the revenue cycle is going to continue to build. And we think actually when we look at how do we grow our revenue in the future, we think those Works businesses are certainly big opportunities. Because each ITWorks business is at least a $7 million to $10 million a year of additional revenue, and some of them will be more than that.

Our pipeline for the next 12 months on Works business is pretty strong.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Got you. And then one other one, and I'll hop off. You all have mentioned that you had strong growth in this smaller hospital segment. I guess I'm thinking here of the CommunityWorks offering. I also -- I've heard anecdotes of that moving into larger -- that offering is, well, successfully selling into larger hospital settings. Is that true? Are you seeing more traction in CommunityWorks in larger hospitals than you had seen before? Or is it still predominantly the small hospital?

Zane Burke - *Cerner Corporation - President*

This is Zane. It still predominantly a small hospital offering. What we have seen are certain large clients that want to create part of their networks and use the CommunityWorks model in some of those critical access connector facilities. So, if you've heard about that in some of the larger organizations, it may be part of their feeder systems as they look to create more network in their own areas.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

And did you say how many sites you have live on that service? Can you share that?

Marc Naughton - *Cerner Corporation - EVP and CFO*

I don't know if I have got that number right offhand, but I bet I can get it before we finish the call.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Okay. Thank you very much.

Zane Burke - *Cerner Corporation - President*

This is Zane. We have 90 sites that are contracted. Not all of those are live at this point in time.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Thank you.

Operator

Michael Cherny, Evercore.

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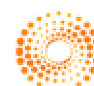

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Michael Cherny - *Evercore ISI - Analyst*

Going back to the DoD contract, it's been less than a week since you and Leidos and your partnership were awarded that contract. Have you heard from any of your customers or potential prospects already in terms of what this means in terms of the way the view you? I assume some of your key customers -- obviously Intermountain is thrilled to see -- but any other feedback from the field?

I know you talked about the implementation and the resources you're going to have to make sure this contract is executed on plan. But I'm curious more to the upside, if people view this in the market in terms of further validating just how successful you've been.

Zane Burke - *Cerner Corporation - President*

This is Zane. Clearly, our clients are actually very excited for the win. We've seen a lot of very positive momentum from them. And, really, I do expect it to have a positive impact as we look forward to some of the competitive environments. And as you look at where we come out of Q2, with our best win rate with the highest number of new footprints in our history, and then you add to that the selection by the DoD and our announcement today on South Baptist South Florida, you get a flavor for what's happening in the marketplace, that the momentum is clearly on our side. And so I do think that's a big positive.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Michael, this is Marc. I think certainly it is pretty near-term, but we had a lot of momentum going. This merely continues that strong momentum. I think this certainly was a process that was more rigorous than any you've ever seen, and to win is a big accomplishment. And I think as you look at our Q3 bookings guidance, which is up significantly, you are seeing not only our existing momentum, but our belief that this will help us close business as soon as Q3.

Michael Cherny - *Evercore ISI - Analyst*

Got it. Thanks, that's helpful. And then just one question, too. Long-term bookings as a percent of total has been spiking up. I know we talked a bit about the Works deals. Is there any change in some of the long-term bookings you have in terms of how they are being recognized? Are you seeing any elongation or potential shortening of some of the bookings that have gone to that number, versus maybe two, three, four years ago?

Marc Naughton - *Cerner Corporation - EVP and CFO*

No, we're using the same approach. It's just a lot -- the deal mix just happened to have more of the 10-year deals as a component of it relative to the traditional 30% or so that we've seen in the past. It comes and goes depending on what the deal is.

Zane Burke - *Cerner Corporation - President*

This is Zane. And principally we had two very large Works deals in the last two quarters, which is also a bigger indicator in the mix of how [this works]; so given the size of those two big items that had some impact on the percentage size of that.

Michael Cherny - *Evercore ISI - Analyst*

Got it. I guess it helps for the visibility long-term. So, thanks, guys.

Operator

Steve Halper, FBR.

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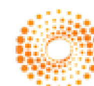

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Steve Halper - *FBR Capital Markets - Analyst*

If you think about the revenue miss from the first quarter, and you have the second revenue disappointment this year; and so now you're telling us that you scrub those numbers. And now the guidance is -- you feel really confident in that. But could you tell us what didn't happen, or what changed from one quarter to the next? Just trying to understand what's at work here.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Steve, it's a great question. Clearly as we went into Q2 and prepared to talk to you guys last time, services is primarily the focus for us relative from a revenue perspective. Licensed software is doing well, other elements are doing well. We are seeing some lower tech resale from certainly from HS, and a little bit from us, which is impacting revenue. But the lion's share of it is related to services.

Some of that is, as I indicated, as we went through in more detail this quarter and reviewed our forecasting process, I think we were -- there was something in those forecasts that gave us a bigger number than it should have. And that included including more third-party. Because third-party is something we have a little hard time getting visibility to, because it's not necessarily -- while it's coming out of the backlog, it's not necessarily something that's coming out of our resources, so it's a little bit of a different model.

So I think services clearly missed their forecast in this period. And I think, just in the quarter, there was a couple of deals that had some -- that would have contributed some decent-sized revenue to the quarter for -- not necessarily high-margin revenue, but some revenue. It didn't happen in the quarter that we would have forecasted, from a revenue perspective.

But at this point, I think there's nothing in the business that is causing us to miss our guidance. I think it's more of the guidance was probably higher than it should have been when we went into last quarter. We have now adjusted it. I feel very confident -- as you know, and you could expect -- I beat this really hard since we closed the quarter and prior to that, to understand it well. And I'm pretty confident that we've got good numbers out there for you going forward. And pretty confident that that services business bounces back as we continue to run the momentum in 2015, continue to add to our services personnel, and have that pipeline of Works businesses that we think will contribute pretty significantly, likely to the 2016 revenue number.

So, definitely take it as my bad on the guidance variance to date, but I'm not going to have a my bad next quarter.

Steve Halper - *FBR Capital Markets - Analyst*

Right. And just quickly, the Baptist deal was not in the quarter bookings?

Mike Nill - *Cerner Corporation - EVP and COO*

That's correct. That was a Q3 signing.

Steve Halper - *FBR Capital Markets - Analyst*

Okay. And CapEx expectation for the rest of the year around the new campus?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, as we go forward you're going to see us obviously spending more than we did in [2014]. Steve, on cash flow you see us having periods where we invest in capital heavily. If you go back to 2012, we had 100% -- we delivered free cash flow at 100% of net income. In 2013 we bumped up

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CapEx significantly, and that went down to 34%. Last year, we had less CapEx. This year we're going to have strong CapEx. So you are kind of looking at building CapEx of -- probably somewhere in the $150 million range. So it will be pretty strong; and our other capital expenditures, including HS, will be up from last year.

But as we roll forward and we get that campus -- the first phase of the campus completed, you should see us starting to bounce back from a free cash flow perspective. We got hit pretty hard this quarter from just a working capital perspective, in that probably $100 million of working capital on the balance sheet items just went negative relative to operating cash flow. That will reverse as we go forward. Plus, my expectation, as we roll forward into 2016 and 2017, is you see us getting -- working our way closer to getting to our goal of net income equaling free cash flow.

Steve Halper - *FBR Capital Markets - Analyst*

And what was the $150 million number that you just put out there?

Marc Naughton - *Cerner Corporation - EVP and CFO*

That was basically building CapEx, kind of rough estimate of what we would probably spend. Because right now, the last half of this year will be a pretty intensive investment relative to our buildings.

Steve Halper - *FBR Capital Markets - Analyst*

Okay, thank you.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Marc, I think I'm going to want to drill into this services revenue shortfall a little bit more, too. If we look at kind of from where the guidance originally came out to February to where we are now, it's almost a $0.5 billion negative revision at the revenue line.

Can you talk to us a little bit more about where those services revenues lines get sprinkled on the income statement? Is any of it in system sales? Is it all just in that services sub line under support maintenance and services?

And then if a lot of this is tied to third parties, that seems like a real big move relative to the size of what we expected, the income statement line there to look like for the year. Can you give us some examples functionally of what's going on that's pushing that line around in a pretty significant direction?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, I have to do math on the $0.5 billion number. But I think the key is, relative to -- compared to the year-ago quarter, when we had a bunch of third parties getting to the Meaningful Use projects, that we are not doing that as much. That is harder for us to forecast, and we did not do a very effective job of putting into our forecast the significantly reduced number. So that's what was probably $20 million in the year-ago quarter that we are lower than that this quarter. So that's a pretty big change relative to the total.

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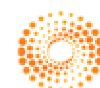

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I think your -- part of the difference you talked about when you're going back to the revenue line -- you've got to go back to last quarter where we talked about the Health Services deferred revenue. It was about $100 million. So there's other elements than just services if you are going to step back for revenue discussions we've had in the last 12 months.

But from a services perspective, key for us is forecasting accurately based on our backlog that's got to be delivered, and the resources we have available to go deliver that. And we did not do that as effectively in Q2 as we should have. We have now gone through that forecast, and with a fine-toothed comb. So, from a business perspective, it's pretty logical that we're -- with less third parties, that revenue is not going to be there.

We'll then deliver the services from our own personnel. And we're adding to that personnel line every day, certainly with a lot of the college hires coming out of schools that will hit us basically Q2, Q3. Those are the resources we need to go out and deliver the work that Zane and his team are delivering for us.

So, that will drive out the revenue that we've got projected. We're up against a very difficult comp relative to 2014, where we grew revenue 70%. You've got to, back of your mind at least, keep that present. Because if you just look at the two years, we still are growing revenue relatively good on average.

In addition, as we roll into next year, because of what we see -- or, at least, what I see -- in the opportunities from the Works businesses, and as we ramp up the services opportunities from a delivery perspective, we should still be talking about being able to deliver double-digit growth in 2016. Obviously, it's early to talk about that. We haven't given any guidance to that. But I believe it is laying out in a way that some of these Works deals could be a significant tailwind for us to get that double-digit revenue growth.

George Hill - *Deutsche Bank - Analyst*

Okay. Maybe asked another way, it sounds like -- is this a capacity issue at your guys' end? Do you guys -- do you not have the service capacity to --?

Marc Naughton - *Cerner Corporation - EVP and CFO*

No, no. We have plenty of people to go address the work. They key is the implementation work that we're working on primarily now is that which was signed in 2014. We've seen a lot more activity in 2015. We're ramping up so that when those projects get to the point where they need to be sources, we'll be absolutely ready to go -- to go deliver those.

But from a revenue standpoint, the ability -- because of preparing for HS to onboard, being very careful about over-hiring, there are certain optional services elements that are not related to implementation that we didn't necessarily go after. That work is always going to be there. We can go pick that up at a later time. But we wanted to make sure that we didn't hire a bunch of people relative to the work that was going to be able to be out there.

When you look at services you also have a little bit of an HS element that, just because of the transition, that they are not as efficient as we would normally have our services people be from availability standpoint.

So, those are all factors into it. At this point, I think we've got the right number out there. We feel very confident in it. We are delivering on projects as we believe we should be delivering. And we are not resource-constrained relative to the business.

George Hill - *Deutsche Bank - Analyst*

Okay, all right. I appreciate the color. Thank you.

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Operator

Ryan Daniels, William Blair.

Jeff Garro - *William Blair & Company - Analyst*

It's Jeff Garro in for Ryan. I wanted to ask about the better profitability. Previously you have talked about margins declining this year because of Health Services, but now they are looking flattish year-over-year. So does that mean we should expect less of a lift in 2016? Or should intermediate-term margin targets be moving up?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, I think at this point, we probably need to digest; and obviously when we get to Q3, we'll give you our first view of what 2016 looks like. Certainly we like the fact that our margins are trending higher, that we didn't have the negatives that we anticipated with Health Services.

But I think relative to 2016, it's a little early for us to give you a good view as to what that number is going to be. Our expectation obviously with Health Services was that once we set the baseline, that we would be migrating them toward our margins, which should allow for margin improvement. So that would be my expectation. But at this point, it's a little early to quantify it.

Jeff Garro - *William Blair & Company - Analyst*

That's fair. And then just to follow up on that, though, it does seem like on the expense side of things, both in terms of Health Services and Cerner, you are doing well to take a close look at the business and manage those expenses.

How does that offset potential shifts in the business mix, where maybe some of these services that are going to come back in 2016 and the Works businesses -- how those are going to mix in with the rest of the business model? And if there's anything from an accounting perspective that we should think about in terms of longer-term margins, that would be helpful as well.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, most of the hiring that you could expect us to do will be on people that are revenue-producing. And for the most part, our services businesses have a contribution margin in excess of 30%. So that's, given our current operating margins, those people coming on and delivering revenue is going to be accretive to our operating margins.

So I think that when you see us increasing spending, it will be in revenue-producing areas. The Works businesses are a little bit unique in that, for the most part, I'm taking over an existing workforce. So I don't have to ramp up, internally, my resources to be able to handle that work. For the most part, I bring in a team that is already doing that work. And I have a core group of people in Cerner that can add some of that initial initiation of the client as part of their normal workflow.

So that's easier from a resourcing perspective. Because once they come on, they are instantly workforce-in-place. The revenue and the expense is driven immediately, without having to -- for us to do any resourcing.

Jeff Garro - *William Blair & Company - Analyst*

Great. Thanks for taking the questions, guys.

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Operator

Matthew Gillmor, Robert W. Baird.

Matthew Gillmor - *Robert W. Baird - Analyst*

Just a couple quick clarifications. Marc, you provided some commentary around the DSO trends. Can you maybe give us a little more detail on the delayed billings you mentioned? And also, do you anticipate DSOs can get back down to the mid-60 range, or should we be thinking about a higher long-term target?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, I think the key for -- just on the billings was -- the hardest part of some of the acquisition work is getting bills out to the clients, and making sure the bills are right so that they can get paid. I think if you look at our receivables, you'll see that they were pretty significant increase in those receivables. So I think we did a good job as we closed out Q2 of getting bills out.

But you got to get the bills out before you can start getting paid. So that was a key focus for us. And I think that's -- now that those bills are flowing, that we should start seeing the cash come in. And that will impact the receivables by reducing them, which obviously will help our DSO number.

As far as the what is the optimum DSO number, 66 days was a pretty -- when you're selling into healthcare, which is a traditionally slow pay industry, 66 days was a pretty low number. I'm not willing to say that that's not the number that we should be targeting and shooting for. But we'll certainly be looking at it carefully as we go forward. And once we start getting the trend down, we should get a better view as to -- if there should be a different expectation to getting down to that. But I think anything from around 70 is probably a pretty good target for us to be shooting for.

Matthew Gillmor - *Robert W. Baird - Analyst*

Okay, great. And then I just wanted to add one follow-up on the DoD contract. I know you haven't provided a lot of details around this, and I understand the sensitivity. But can you maybe give us a sense in terms of timing for when you'll be able to discuss the financial implications in more detail?

Zane Burke - *Cerner Corporation - President*

This is Zane. It is still in the procurement stage, so there's still pieces of that. So I would anticipate it will be over the next 30 to 90 days, depending on what the rest of the procedures look like as part of that.

Marc Naughton - *Cerner Corporation - EVP and CFO*

As soon as we're able to, we'll --.

Zane Burke - *Cerner Corporation - President*

Let you know.

Matthew Gillmor - *Robert W. Baird - Analyst*

Okay. Thanks a lot.

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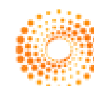

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Operator

Nicholas Jansen, Raymond James.

Nicholas Jansen - *Raymond James & Associates, Inc. - Analyst*

Most of my questions have been asked. But I just wanted to get a little bit more detail surrounding the better margin performance in context of the synergies from the HS transaction thus far.

I understand the mix component, but just wanted to get a sense of -- are we pulling forward synergies, which are driving better margins? Or are the synergies tracking as expected, and we should think about the building, as previously communicated, through 2017? Thanks.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, I think our prior communication relative to what we think HS does through in 2017 is still on track. I don't know that, as I said, HS is doing a good job of delivering -- just based on our expectations, except for the add-on sales into their base. So I think they are on track, and we would expect them to deliver the 2017 synergies that we've discussed.

Nicholas Jansen - *Raymond James & Associates, Inc. - Analyst*

And then my last question would be in terms of the growth R&D spend. Obviously you guys spend a lot of money when you factor in capitalized development costs and things along those lines. Wanted to get a sense of how you guys measure return on that investment. Certainly it has ballooned over the years, and it's paying dividends through strong bookings growth. But wanted to get a better sense of your ultimate view on R&D dollars, and maybe when we can see that number potentially start to level off a little bit, to drive faster earnings growth. Thanks.

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. As we've moved forward certainly over the last three and four years, we've become even more convinced that acquiring technology is not an effective strategy relative to the complex systems that we're developing. So, we have decided we are going to invest the dollars that we might spend in acquisitions, invest that in R&D and put -- building the capacity. As a finance guy, trying to compute in ROI on broad R&D -- if someone has got a good way of doing that, let me know. For me, it's been a matter of faith that we need to invest in it.

We certainly have a rigorous process by which we examined hundreds of projects, and then decide which one of them is going to get the resourcing to get the work done. And a component of that is the expected economic return we think that that's going to drive.

So there is an ROI component. But I think we have -- our strategy so far has proven very effective: to build it ourselves, to incorporate it into the Millennium and Healthe Intent platforms, and that's probably more of a focus of ours than deciding, based on each project, what the ROI is.

It's such a big view of the world we have relative to R&D that trying to segment out a single solution would be difficult.

Zane?

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Zane Burke - *Cerner Corporation - President*

Yes, I would just look at this and say, I think we see so much opportunity out there in the future that we're going to see us continue to invest in R&D and develop the solutions. Because the future outlook is incredibly bright. And as we look forward, we're continuing to invest for the future of the Company, and we'll continue to make those investments.

Marc Naughton - *Cerner Corporation - EVP and CFO*

And that being said, certainly we are investing a lot of money in R&D. And it would be logical to me that the increase in R&D spend grows at a slower rate than the growth of revenue. So there should be, based on the size of that number, leverage in the future. But we are right now in an environment where we are highly competitive, lots of business activity. And we're going to invest to meet that opportunity.

Nicholas Jansen - *Raymond James & Associates, Inc. - Analyst*

Thanks for the questions.

Operator

Jamie Stockton, Wells Fargo.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, why don't we make this the last question?

Jamie Stockton - *Wells Fargo Securities - Analyst*

All right, Marc. I'll sneak in the last question.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Absolutely, Jamie. Go ahead.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Just an easy one. And you may have already touched on this, and I missed it. But we've seen the longer-term portion of bookings elevated for a couple of quarters here. Should we view this mid-30s range as the new reality? You guys have a good opportunity on the Works front, not only I would assume within your customer base, but the Siemens base as well. You are obviously looking for a very healthy bookings number in the third quarter. Could you just touch on that, please?

Marc Naughton - *Cerner Corporation - EVP and CFO*

It still is pretty quarter-dependent. A lot of it's driven by -- is there a large Works deal that's going to (technical difficulty)? So I think that we talked about, can we get to a point where we've got a good-sized Works deal every quarter on a pretty consistent basis? If we got to that point, would we get into the mid-30s relative to a percent from long-term? I expect our non-long-term booking to continue to grow as well.

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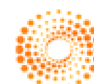

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So, I don't know that I'm at a point where I think 35% is the number that is going to be the standard, going forward. I'd say, let's see what the percent is in Q3 and then we'll revisit that.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Okay. Thank you.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I want to thank everyone for joining the call today. We appreciate your attendance, and we look forward to talking to you in the next days and months. Thanks for your attention. Bye-bye.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone have a wonderful day.

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