Cerner Corporation
Fourth Quarter 2016
Earnings Conference Call
February 9, 2017

Moderator

Welcome to Cerner Corporation's fourth quarter 2016 conference call. Today's date is February 9, 2017, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today constitute forward-looking statements, including without limitation, those regarding projections of future revenues or earnings, operating margins, operating and capital expenses, solution development, and new markets or prospects for the Company's solutions and services. Actual results may differ materially from those indicated by the forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements may be found under Item 1A in Cerner's Form 10-K together with the Company's other filings. A reconciliation of non-GAAP financial measures discussed in this earnings call can be found in the Company's earnings release, which was furnished to the SEC today and posted on the investor section of Cerner.com.

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

Marc Naughton

Thank you. Good afternoon everyone and welcome to the call.

I will lead off today with a review of the numbers. Zane Burke, our President, will follow me with results highlights and marketplace observations, and then Mike Nill, our Chief Operating Officer, will provide some operational highlights.

Now I will turn to our results. Q4 was a good finish to 2016 with bookings, revenue and earnings all in line with guidance, and cash flow was strong as well.

Bookings, Backlog and Revenue

Starting with bookings, our bookings revenue in Q4 was $1.437 billion, which reflects a 7% increase over Q415. Relative to our guidance, bookings were at the lower end of our range, primarily due to the lack of a new ITWorks deal in the quarter. For the full year, our bookings revenue was $5.446 billion, which is up slightly from a very tough comparable of $5.427 billion in 2015, when bookings grew 28% over 2014.

Our revenue backlog ended the year at $15.927 billion, which is up 12% from $14.195 billion a year ago.

Revenue in the quarter was $1.258 billion, which is up 7% over Q415 and at the mid-point of our guidance range of $1.225 to $1.3 billion. The revenue composition for Q4 was $352 million in System Sales, $255 million in Support and Maintenance, $626 million in Services, and $25 million in Reimbursed Travel.

For the full year, revenue grew 8% over 2015 to $4.8 billion.

System sales revenue for the quarter was down 8% compared to Q415, driven by declines in technology resale and software that were partially offset by growth in subscriptions. Note that our guidance had factored in the declines in technology resale and software, as they both had extremely tough comparables. I would note that software was up nicely sequentially over the lower levels we discussed in Q3. For the full year, system sales revenue decreased by 1% from 2015, but margin percent was up due to the lower mix of technology resale. We believe we are better positioned to grow System Sales in 2017 given an easier comparable and a good forecast.

Moving to Services, total Services revenue, including professional and managed services, was up 18% compared to Q415. Full-year Services revenue was up 16% over 2015. This growth is in-line with our expectations and continues to reflect good execution by our services organizations.

Support and Maintenance revenue increased 3% for the quarter and 4% for the year.

Looking at revenue by geographic segment, domestic revenue increased 7% over the year-ago quarter to $1.11 billion and non-U.S. revenue grew 8% to $145 million. For the full year, domestic revenue grew 9% and non-U.S. grew 6%.

As a preview to the annual update of our detailed business model that we'll provide at our investment community meeting on February 21st at HIMSS, I'd like to provide you with the total revenue and growth by business model for the full-year 2016.

- Licensed Software decreased 3% to $549 million;
- Technology Resale decreased 17% to $274 million;
- Subscriptions increased 14% to $442 million;
- Professional Services revenue grew 17% to $1.445 billion;
- Managed Services increased 14% to $982 million;
- Support & Maintenance was up 4% to $1.016 billion, and
- Reimbursed Travel was $89 million, which is up 22%

One thing to note about the slight decline in software for the year. This was largely due to a very tough comparable in 2015, which had a high level of traditional software revenue that is mostly upfront in nature. Traditional software declined from these elevated levels, and this decline was largely offset by an increase in SaaS revenue, which now represents over 30% of total software revenue. The biggest driver of the SaaS growth is population health. This year, we expect levels of traditional software revenue to remain relatively flat, but we expect ongoing strong growth in SaaS revenue. This should lead to better overall growth in System Sales and a continued favorable mix shift to more recurring revenue.

Moving to gross margin. Our gross margin for Q4 was 82.9% which is basically flat compared to Q415. Full-year gross margin of 83.8% was up from 83.0% in 2015.

Earnings

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

Operating Expense

Looking at operating spending, our fourth quarter GAAP operating expenses of $831 million were up 11% compared to $749 million in the year-ago period, and included $36 million of expense related to the Voluntary Separation Plan that we previewed on our Q3 earnings call. Full-year GAAP operating expenses were $3.106 billion, up 7% from $2.893 billion in 2015.

Adjusted operating expenses were $749 million, which is up 9% compared to Q415. This growth was primarily driven by an increase in personnel expense related to revenue generating associates, which is reflected in the Sales & Client Service expense line that increased 13%. Software development increased 3%, G&A was up 1%, and Amortization of Acquisition-related Intangibles was down 41%, but this represents only a $1 million decline from $3 million to $2 million as this line excludes Health Services acquisition-related amortization in the non-GAAP view.

For the full year, adjusted operating expenses were up 11% to $2.884 billion.

Operating Margins

Moving to operating margins. Our Q4 GAAP operating margin was 16.9% compared to 19.3% in the year-ago period, with the VSP being the main reason for the decline. Full-year GAAP operating margin was 19.0% compared to 17.7% in the year-ago period. Our Adjusted Operating Margin was 23.3% in Q4, which is down from 24.7% in the year-ago period. Full-year Adjusted Operating Margin came in at 23.6%, which is down from 24.3% last year. The lack of margin expansion in 2016 is consistent with our original guidance.

Going forward, we still see long-term margin expansion opportunities, but given a headwind created by a large expected increase in non-cash software amortization and depreciation expenses, including some that didn't come through as quickly as we expected in 2016, and the expected lower growth of traditional software revenue, our guidance for 2017 reflects operating margins of flat to slightly up. We also expect that our margins will be more sensitive to revenue mix in coming years. For example, if we experience an acceleration in our Works businesses in the next couple of years, which we believe is likely, it would contribute positively to revenue growth, but might create a mix that could limit margin expansion. Longer term, however, we believe that this could be more than offset as our SaaS revenue related to population health ramps. In addition, the headwind from non-cash expenses should subside after a couple of years, creating another opportunity for margin expansion. As a result of these dynamics, we believe modeling limited margin expansion for the next couple of years would be an appropriate baseline. We'll obviously continue to update our view as these dynamics play out, but we believe our outlook for operating margins in the mid-20% range and upper single-digit revenue and earnings growth is very solid for a $5 billion company.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q4 were $150 million, or 44 cents per diluted share. For the full year, GAAP net earnings were up 18% over 2015 to $636 million, or $1.85 per diluted share. Adjusted Net Earnings were $206 million and Adjusted Diluted EPS was 61 cents, which is flat compared to Q415, but recall we had a 3 cent tax benefit in Q415. For the full year, Adjusted Net Earnings were $790 million and Adjusted Diluted EPS was $2.30, which is up 9% from 2015.

The Q4 tax rate was 31%, compared to 27% in the year-ago period.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q4 with $466 million of total cash and investments, which is down from $837 million in Q3 primarily due to the use of cash for our stock repurchase program. During the quarter, we finished the remaining $100 million of stock repurchases authorized in March of 2016, and executed $400 million of the $500 million stock repurchase authorized in November 2016. For the quarter, we repurchased a total of 9.98 million shares at an average price of $50.10. For the year, we repurchased 13.7 million shares for $700 million, at an average price of $51.00.

Moving to debt, our total debt, including capital lease obligations, was $564 million, which is down slightly compared to Q3.

Total receivables ended the quarter at $945 million, which is down from $985 million in Q3. Our Q4 DSO was 69 days, which is down from 76 days in Q3 and 80 days in the year-ago period.

Operating cash flow for the quarter was $333 million. Q4 capital expenditures were $132 million, and capitalized software was $65 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $137 million for the quarter. For the full year, operating cash flow was $1.156 billion, capital expenditures were $459 million, and capitalized software was $294 million. Full-year free cash flow was $402 million, which is 25% higher than 2015. We are targeting an increase in free cash flow of at least $100 million in 2017, driven largely by an expected decrease in capital expenditures.

Guidance

Now I'll go through guidance.

- We expect revenue in Q1 to be between $1.200 and $1.275 billion, with the midpoint reflecting growth of 9% over Q116.
- For the full year, we expect revenue between $5.1 and $5.3 billion, reflecting 8% growth over 2016 at the midpoint.
- We expect Q1 Adjusted Diluted EPS to be 57 to 59 cents per share, with the midpoint reflecting 9% growth over Q116.
- For the full-year, we expect Adjusted Diluted EPS to be $2.44 to $2.56, with the midpoint reflecting 9% growth over 2016.
- Moving to bookings guidance, we expect bookings revenue in Q1 of $1.125 billion to $1.275 billion. The midpoint reflects 3% growth compared to Q116. Note that our Q1 bookings guidance does not contemplate material contributions from ITWorks, but we do expect good contributions from ITWorks for the full year.

Our 2017 guidance reflects slightly lower ranges than what we provided based on our preliminary view on our last call. These lower ranges reflect our desire to factor in as much of the unpredictable nature of our business as possible and to make our guidance attainable as we look to avoid having another year where we miss elements of our guidance. While no guidance can be guaranteed, we believe the ranges we have provided are attainable.

For example, we indicated last year that 79% of our guidance midpoint for revenue before reimbursed travel was scheduled to come out of backlog. As we've discussed, we did a good job of delivering this expected revenue from backlog, but fell short on revenue from current-year bookings. Looking at 2017, approximately 82% of our guidance midpoint for revenue before reimbursed travel is scheduled to come out of backlog. This 3% difference represents approximately $150 million less reliance on current-year bookings than last year.

Looking at the earnings guidance, similar to our revenue, we are focused on setting an attainable range. In addition, our current view is that non-cash expenses will increase by more than $70 million in 2017, with the split roughly equal between software amortization and depreciation. We realize we projected a similar increase for 2016 and it ended up only being a little over $50 million. This was in part because we provided that projection before we had finalized our plan and also because the timing of some amortization starting pushed to 2017. As I mentioned, the headwind from non-cash expense increases should subside after a couple of years since the growth of our capitalized software has moderated and our capital expenditures are expected to decline.

Finally, for bookings, we will continue to provide guidance just one quarter at a time, but I wanted to make a couple of points. First, we do expect some very large bookings this year, but it may be difficult to precisely predict the timing. We will do our best to provide appropriate guidance ranges and position ourselves for a higher chance of an upside rather than a downside miss, but there may be some variability in a particular quarter. We do believe, however, we are in a good position for full-year bookings growth based on our pipeline of new EHR and revenue cycle footprints, revenue cycle and other solution whitespace in our base, and Works opportunities.

In summary, we feel like we finished the year on a solid note, and we have a good and attainable outlook for 2017.

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

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

Results/Marketplace

I'll start with bookings. Our Q4 bookings of $1.44 billion reflect 7% growth over 2015 and bring full-year bookings to above bookings for last year. Given the tough comparable of 28% growth in 2015, we view bookings in 2016 as solid, particularly when you consider the headwinds created by declines in technology resale and ITWorks bookings. I feel good about our ability to grow bookings in 2017 given we are past the technology resale headwind, have a strong outlook for Works bookings, and have a good pipeline for revenue cycle and replacement opportunities.

Looking at long-term bookings, 31% of bookings in the quarter were from long-term contracts, reflecting strong managed services bookings and no new ITWorks clients. For the year, long-term bookings were 30% of total bookings compared to 32% in 2015. In dollars, long-term bookings declined 8% for the year, while the rest of bookings increased 4%. While 2016 was disappointing from an ITWorks perspective, we believe 2017 will be a strong year, with much better contributions from ITWorks later in the year

Even with limited ITWorks bookings, our bookings for the quarter and year included a record number of large contracts. In Q4, 60 contracts were over $5 million, including 35 over $10 million. For 2016, 183 contracts were over $5 million, including 107 over $10 million. The high volume of large contracts reflects ongoing success with hosting, high attach rates of solutions like revenue cycle with EHR purchases, and growing deal sizes in areas like ambulatory and population health.

From a new client perspective, 37% of bookings this quarter came from outside our core *Millennium*® installed base. For the year, 35% of bookings came from outside our base compared to 36% last year. This sustained high level of new business reflects our ongoing competitiveness and good market activity. Looking ahead, we continue to believe the replacement market will remain active given the high number of hospitals on legacy platforms and the pressure to keep up with future regulatory and payment models that many legacy platforms are not well equipped to handle.

Revenue Cycle

Now I'll provide highlights from the quarter and year. I'll start with revenue cycle. 2016 was a very strong year, which included 19% revenue growth and record bookings. This growth was driven by ongoing success at increasing penetration of revenue cycle in our installed base and also related to our strong levels of new EHR footprints, almost all of which included revenue cycle. This success reflects the significant investments we have made in our revenue cycle solutions and the focus by providers on achieving clinically driven revenue cycle. Beyond our solutions, we also had a strong year in revenue cycle services, driven by acute and ambulatory business office services.

Operationally, I believe 2016 was an important year in terms of building on the progress of previous years and strengthening the foundation for further revenue cycle success. We advanced our capabilities in several important areas, including: increasing associate expertise through a revenue cycle certification program, improving our delivery infrastructure, and making many important code enhancements to position our clients for ongoing success.

We believe all of this hard work positions us well going forward, and our forecast reflects strong growth in 2017. We expect this growth to come from ongoing strength in both solutions and services, including some larger RevWorks opportunities that are in our pipeline.

Population Health

Now I'll shift to population health. 2016 was a good year for our population health business. In total, our population health revenue grew 13%, with very strong growth of our *HealtheIntent* solutions being partially offset by a decline in revenue from legacy reporting solutions that are part of our total population health revenue.

We made significant progress in 2016 and we believe we are well positioned going forward. I believe our vision and solutions are resonating in the market and we are seeing broad success. Our client base is rapidly expanding and includes a diverse portfolio of clients, including small and large health systems from inside and outside our base; proven leaders in population health and those just beginning the journey; health plans, employers, states, and governments. This diversity represents the reality of a connected health community and allows us to prove our ability to meet the unique needs of each segment and provide value across the continuum.

From a solution standpoint, 2016 was an important year of progress. *HealtheRegistries* and *Scorecards* are being widely deployed; *HealtheEDW* and *Analytics* are growing quickly; our *HealtheCare* Care Management solution is now deployed and is an important part of most new sales decisions; and *HealthePrograms* went live for the first time, delivering a new level of personalized classification, prediction, and population monitoring. *HealtheIntent*, our unified architecture, remains differentiated and continues to scale to massive population sizes—now approaching 100 million people and more than 6 petabytes of data.

From a marketplace standpoint, we believe we are near an inflection point. The business models and health information technology strategies are shifting. The key question for us regarding population health has not been if the shift will occur but when and how fast. Our analysis, in concert with industry experts, predicts we are just entering the transition with the largest shift from fee-for-service to at-risk models occurring between 2018 and 2020 across the health system, health plans, Medicare, Medicaid, and self-insured providers. This shift brings significant change to the business model of providing care and managing health, and to the necessary information technology support.

As we move closer to this shift, we are focused on delivering value for those clients who have already placed their trust in us to ensure they successfully make the transition and thrive in the emerging models. We are streamlining our implementations, expanding our solution portfolio to manage high-performance networks, providing tighter provider workflow integration, actively engaging consumers, supporting enterprise-wide analytics, harvesting data to create new intelligence, and creating an open ecosystem to empower the innovators.

We are also building out a portfolio of advisory, infrastructure, and operational services to help our clients navigate the journey.

As part of our normal annual planning process, we have revisited both our short-term and long-term population health outlook. Near-term, we have a significant pipeline of opportunities that exceed the collective amount of business we've signed in the past several years. This demand and our expectations that the shift to at-risk models will accelerate in the next few years makes us feel good about our longer-term goals for population health as well. Our operational and sales execution these next few years will be very important, and I feel good about our ability to deliver.

Ambulatory/CommunityWorks

Moving to the ambulatory market, where we had another very good quarter and year.
For the year, ambulatory bookings grew 16% over 2015, which was a tough comparable as ambulatory bookings had grown over 50% in 2015. We had 28 displacements of our primary ambulatory competitors. 2016 was also a big year for ambulatory business office services and included several displacements of our primary cloud competitor.

In the small hospital market, we had a great year with our CommunityWorks offering, adding 26 new footprints and bringing our total number of CommunityWorks clients to more than 150. Our outlook is good with new business activity at an all-time high.

In addition, our competitiveness is very good and our win rate was over 60% for the year. We continue to be successful against our primary cloud competitor in this market and have already had displacement opportunities in situations where they were not able to deliver.

Department of Defense

Next, I'd like to provide a quick update on our project with the Department of Defense. Earlier this week, we had a successful first go live at the Fairchild Air Force Base clinic near Spokane, Washington. There will be more go live events over the summer. From there, we expect to begin broader deployment over the next several years. This has been an exemplary project so far and the early success is the result of great effort by the Department of Defense, Cerner, Leidos, Accenture and other partners. The Department of Defense will have a presence with us at HIMSS, which will give people an opportunity to learn more about what we are doing together.

Non-U.S.

Outside of the U.S., we had a solid finish to the year. Non-U.S. revenue grew 8% for the quarter. This brings full-year non-U.S. revenue growth to 6% for the year, which compares to 9% for domestic revenue. Areas of strength in 2016 included Germany, the Middle East, and Ireland. Overall, we are starting to see increased activity outside the U.S. and expect the non-U.S. market to become a more meaningful contributor to our results given the relatively untapped EHR market, opportunities to rollout our Works businesses and our population health platform.

Marketplace / Closing

Now I'd like to provide some observations on the marketplace. Last quarter I talked to you about the reduced number of hard deadlines and regulatory mandates and how this was impacting our clients' sense of urgency in some cases. Shortly after we reported, the election results surprised many and led to wide-spread speculation about the demise of health care IT due to uncertainty surrounding the future of Obamacare and the timing of the shift to value-based care.

The election result and ensuing speculation didn't really impact our business in Q4, as most of our solutions are at a high strategy level and were relatively unaffected, and this helped us deliver all key metrics within our guidance range.

As for the new administration, it is too early to tell if it will have a material impact going forward; however, we believe the fundamental shift towards value-based care will continue in almost all scenarios. We feel good about our outlook for the year and believe our guidance ranges represent solid and attainable growth.

In summary, I am pleased with our solid results and believe we are well positioned for growth in 2017.

With that I will turn the call over to Mike.

Mike Nill

Thanks Zane. Good afternoon everyone. Today I am going to discuss *ITWorks* and a model we are increasingly using with clients to maximize value creation.

ITWorks

I'll start with *ITWorks*. As Zane has already discussed, we did not have a very good year for new ITWorks deals. However, we did have strong sales back into our ITWorks base, established an important global ITWorks footprint, and delivered solid financial results. As a result of this activity and our strong bookings in 2015, our total ITWorks revenue increased 28% in 2016.

It is important to point out the success of our existing ITWorks clients, as that is a key reason we have built a large pipeline of new prospects. Overall, our ITWorks clients have our highest client satisfaction levels, are very referencable, have a high penetration of Cerner solutions, and show very well in industry measures, such as the EMR adoption model and "most wired" recognition.

Looking ahead, several opportunities we contemplated in 2016 are lining up for 2017, and these along with other opportunities in our pipeline set us up for a strong year. We still strongly believe in the ITWorks value proposition and it remains appealing to our clients in an environment where they have pressure on operating costs, limited access to IT talent, and increasing pressure to keep up with IT security issues.

Value Creation Office

Now I'd like to briefly discuss another approach to client alignment called a Value Creation Office, or VCO. This is a fundamental shift in how we are working together with our clients. We are embedding teams to live and work with selected clients to build a deeper understanding of their business and the communities they serve. We establish a joint governance process where we look at organizational improvement opportunities and build business cases for investments to achieve those improvements.

As improvements are achieved and value is created, Cerner and the client share the financial benefits. Some examples of areas we have had success include: coding, infection control, sepsis, VTE prevention, readmissions, ambulatory practice and population health. Much of this success is driven by leveraging Cerner technology to optimize workflows and minimize variations in care processes.

Another focus of most of our VCO alignments is creating a business analytics platform for the entire health care enterprise and using it to monitor enterprise performance and assess new opportunities for performance improvement, which then become new opportunities for value creation.

So far, we have more than five clients where we have some form of VCO structure, and we have had success at creating value in all cases. I am personally part of the governance committee for one of these clients, and we jointly generated millions of dollars of value in the past year.

In summary, I think the VCO model will become increasingly common as it is a great way to achieve a return on technology investments through improved quality and financial performance while creating a tighter alignment between Cerner and our clients.

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