

Cerner Corporation
Third Quarter 2021
Earnings Conference Call
October 29, 2021

Operator

Welcome to Cerner Corporation's third quarter 2021 conference call. Today's date is October 29, 2021, and this call is being recorded. I'd now like to turn the call over to your host, Allan Kells, SVP, Investor Relations.

Allan Kells

Good morning everyone and thank you for joining us. On the call with me today are Dr. David Feinberg, President and CEO and Mark Erceg, our Chief Financial Officer. David will begin the call with his initial observations since joining at the beginning of the month, then hand it over to Mark to discuss our results and outlook. We'll then transition to Q&A and be joined by Travis Dalton, our Chief Client and Services Officer.

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

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

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

David Feinberg

Thanks Allan. Good morning and thanks for joining us. This morning I am going to start by sharing a bit about myself and why I chose to join Cerner, then I'll provide some early observations and areas of initial focus.

For over 30 years, I've focused my career on making healthcare more accessible, more understandable, more equitable and more affordable. Early in my career, I developed a strong conviction that focusing on the patient is the only way to be successful. This was true at UCLA, where our focus on patient satisfaction was foundational to an operational and financial turnaround. As such, this "patient first" philosophy has underpinned my approach to everything.

At Geisinger, once we established the patient as being at the center of everything we do, we were able to expand that focus to the entire community. Having an integrated care and payment model, we showed that health care can be of the highest quality and affordable. We also created the world's largest bio bank of whole exome sequencing because we knew that in that DNA was information, we could use to keep our community healthy.

As part of our extensive use of technology at Geisinger, I built an important relationship with Google, which ultimately led to an opportunity to run Google Health. I am proud of the work we did there. On Search, YouTube, and Maps we provided the world with timely and authoritative medical information including our work on Covid, covid symptoms, vaccines, community mobility, exposure notification, and more. Our YouTube Covid information page had over 500B impressions. We worked in partnership with Ascension to help organize disparate medical records (including Cerner) so that nurses, doctors and other caregivers could easily find information about their patients.

Now, transitioning to Cerner, I feel that I have left an amazing tech company that is playing a role in health and joined an amazing health company that is using tech to improve people's lives.

I'd like to share initial observations. Cerner and, frankly, other EHR companies have done a good job of automating processes and digitizing medical records for more than 40 years. By itself, that's a huge accomplishment. But, it is very important that we acknowledge the fact that we haven't fully reached our potential.

Digitized records, for one, need to be more usable and provide actionable information. They need to be measured by how they enable caregivers to spend more time at the bedside and less time at the terminal. Improving the usability of *Cerner*[®] solutions is at the top of my list of things to get done.

And usability is just the beginning, not the true promise of the digital age. EHRs need to do a better job of:

- Helping patients avoid unnecessary tests and medications.
- Helping clinicians avoid errors and suggest what treatments may work best.
- Allowing us to understand the health of our communities, those at risk, and what interventions are working
- They also need to be predictive, so we can prevent unnecessary admissions and readmissions,
- They need to identify risks of conditions before they become chronic,
- **and** potentially help the world avoid, or at least minimize, the effects of the next pandemic.

Achieving these improvements will also require industry cooperation and compliance with interoperability requirements, something Cerner has been and will remain passionate about. The pipes are laid, which is wonderful, but we must make it easier to get the right information to the right people at the right time.

Cerner has made good progress at improving the flow of information, gleaning insights from data, and helping optimize the coordination of care through offerings like analytics, registries, referrals, and real-time health. These capabilities remain important to our clients and to Cerner's growth, and we will continue to enhance them as we fortify the EHR.

We also continue to believe in the potential of harnessing data to accelerate discovery and the deployment of therapies—and ultimately improve patient outcomes. We have a great opportunity to do this through *Cerner Enviza*SM, which combines the expertise of the Cerner and Kantar Health teams.

Something else I've heard plenty about is how important it is that Cerner make enhancements to our revenue cycle solution. We need to simplify billing for patients and providers, and that starts with making billing more integrated and seamless. We think the *RevElate*TM Patient Accounting offering we announced during our Health Conference earlier this month will do just that.

Importantly, as we do the work to strengthen our solutions and make them more dependable, we have an opportunity to improve job satisfaction for caregivers who are increasingly “burnt out” by the complexity and inefficiency inherent with today’s EHRs.

I know this focus will strengthen our client relationships and reduce client attrition, which is unacceptable in my view. We are going to set reasonable expectations with our clients and meet them. This will require discipline and focus. In the past, Cerner has simply tried to do too many things (by ourselves). Going forward, we are going to change our approach and only focus on a small number of important high-value areas—some of which we plan to achieve by partnering with highly capable organizations we believe can help us achieve our Mission (which is to “improve the lives of others”).

This new approach will provide the best (and most efficient) path to engaged clients, providers, and patients—as well as the best way for Cerner to deliver sustainable and profitable long-term growth. The current leadership team has done a lot of good work to address this ahead of my arrival. Their progress is already showing up in improved performance with clients and strong financial results.

For example, Jerome Labat, our Chief Technology Officer, has made progress on platform modernization and advancing our approach to development. This is critical to driving needed R&D efficiencies, improving quality, increasing the speed at which we get capabilities to our clients, and lowering the costs of running and supporting our products.

Travis Dalton, our Chief Client and Services Officer, continues to grow our federal business while simultaneously strengthening our client and services organizations.

Tracy Platt, our Chief Human Resources Officer, has helped Cerner navigate a period of significant change while driving improvements in compensation practices, associate satisfaction, and diversity, equity, inclusion and belonging.

And, since joining earlier this year, Mark Erceg has quickly created and put in place new management reporting capabilities that are helping us make more informed decisions relative to our CAPEX spending, R&D investments, product portfolio, partnership arrangements, and our operating structure. Mark has also helped us expand our Adjusted Operating Margin and improve free cash flow generation. We are making better use of our balance sheet by increasing our share repurchase program.

While I have been pleased with my direct leadership team, I have also been wildly impressed by the passion and enthusiasm of my 25,000+ Cerner colleagues. I have already had numerous interactions that make it clear (to me) that they understand our job is much bigger than just digitizing records.

I believe Cerner is well positioned to better serve patients, create meaningful value across healthcare and drive long-term profitable growth while doing so. All of Cerner has already taken important initial steps towards better execution and focus, and this is showing up in our business results.

A big piece of that has been our success with the Federal business, which Mark will discuss now, before he provides his customary financial update.

Mark Erceg

Thanks David and good morning everyone.

Federal Business

Our federal business remains solid with the Department of Defense and the United States Coast Guard continuing to deploy their Cerner-powered EHR. For example (in August) the Coast Guard's Pacific Wave went live, bringing with it an additional 14 clinics and 17 sickbays located in Alaska, California, Guam, Hawaii, and Washington State.

In addition (at the end of September) the DoD experienced another successful deployment, expanding their footprint by 4,800 end users across 130 locations in Hawaii. The DoD is now using *Cerner* solutions in 17 states, over 1,000 locations, and serving around 64 (thousand) end users. Together we are on pace to meet their full deployment schedule (on time and on budget) by the end of calendar year 2023.

Moving to Veterans Affairs (in July) VA officially released the findings of their 12-week strategic review. Throughout the review, the VA Secretary remained committed to Cerner (and we remained committed to the Secretary and all of Americas veterans).

During that same month, our team also worked with VA leadership and providers (at Mann Grand-staff Medical Center) to implement additional capabilities as we continue providing seamless care for our nation's Veterans. And, just last month, we secured additional VA funding to support deployments to future locations.

Third Quarter P&L

Now, moving to our financial results. Overall, we are very pleased with our third quarter results. Bookings were up 23 percent versus a year ago to \$1.8 billion. Bookings this quarter included strong contributions from our Federal business and also reflect new footprints.

That said, please note that some of the bookings strength was the result of some larger transactions getting done in the third quarter that we had originally expected to transact in the fourth quarter. The strong bookings this quarter brings year-to-date bookings growth to 13 percent. Our revenue backlog also grew, ending the third quarter at \$13.1 billion, which is up 1 percent versus year ago.

Revenue of \$1.47 billion was up 7 percent over the year-ago quarter, driven in large part by strong growth in Federal and approximately \$45 million of incremental revenue from the Kantar Health acquisition we completed earlier this year. Organic growth in the quarter was approximately 4 percent.

Just like bookings, our revenue in the third quarter was a little bit stronger than our initial expectations with about a half point of growth (which we originally expected to post in the fourth quarter) finding its way into the third quarter (driven by the bookings upside).

Gross margin was down 20 basis points from a year ago at 82.9 percent primarily due to a slightly higher mix of third-party services. Adjusted Operating Margin, however, expanded 150 basis points—from 20.4 percent to 21.9 percent, driven primarily by continued expense control, including the initial impact of the actions we discussed last quarter.

Namely, a reduction in force, the classification of several properties as “held for sale” and the write-down of certain in-process R&D for products that we deprecated as part of our drive to focus on the core (which David referenced during his remarks).

Those actions were a good start, but we have identified (and are actively pursuing) additional opportunities to improve profitability as we work towards our goal of delivering a mid-20 percent Adjusted Operating Margin by Fiscal 2024.

For example,

- We continue to shrink our physical footprint as evidenced by the designation of two additional buildings as “held for sale” during the third quarter. These two buildings represent an additional 435 thousand square feet of space—bringing the total amount of square footage we have already sold or plan to disgorge up to 1.5 million square feet (since the start of the year).

- We are continuing to critically review and evaluate our product set and take “end of life” decisions so our R&D investment can be channeled towards the products with the highest return profiles.
- We are systematically reviewing our extensive list of partnerships—which currently number in the hundreds. While we have a tremendous opportunity to improve the top and bottom-line performance of many of our partnerships we also plan to reduce or eliminate some non-value-added arrangements so we can focus our precious resources on the most impactful or promising relationships.
- In addition, we recently completed a comprehensive analysis of third-party software and discovered we are running over 750 unique titles, which currently costs us over \$330 million dollars (annually) for perpetual licenses, subscriptions, and support. We will be taking concerted steps to actively managed (and hopefully reduce) this number (and the associated cost) going forward.

I could continue but let me comment on just one more area—because I am particularly excited about it. Over the past several years and (in large part) because our client satisfaction has not been as high as it should be, it has been hard for Cerner to consistently pass along CPI escalators which are embedded within many of our contracts.

Going forward, and as we take up David’s challenge to focus on the “patient” and only do a few critically important things (really) well, we plan to stop or jettison “side pursuits” that (in many cases) have proven to be nothing but resource drains and distractions.

As we do this, we should have an opportunity to strengthen our price integrity in the marketplace which, I believe, has the potential to be a significant source of (incremental) and profitable revenue growth in the years ahead.

So, in summary, we’ve made good progress at improving margins this year (and plenty of opportunities remain) to help us achieve our goal of mid-20 percent Adjusted Operating Margin by 2024.

Wrapping up the P&L, Adjusted Diluted EPS was \$0.86 per share, which is up nearly 20 percent over last year due to stronger Adjusted Operating Earnings, a lower tax rate and a lower share count.

Balance Sheet / Cash Flow / Capital Allocation

Moving to our balance sheet, we ended Q3 with \$782 million of cash and short-term investments, which is down from \$885 million last quarter, primarily driven by \$375 million which we spent on share repurchases during the quarter. This brings our purchases through the end of the third quarter up to \$1.1 billion.

Our quarter ending debt position was unchanged versus Q2 at \$1.8 billion.

Operating cash flow for the quarter was \$435 million. After \$48 million of capital expenditures and \$76 million of capitalized software, free cash flow came in at \$312 million, which is 32 percent higher than a year ago. Year-to-date free cash flow is \$765 million, which is up 66 percent compared to the same period year-ago.

Guidance

Moving to guidance.

- We expect revenue in Q4 to grow (upper) mid-single digits compared to Q4 of 2020. This includes approximately \$50 million of revenue from *the* Kantar Health acquisition (which is now part of *En-viz-a*), bringing fourth quarter *organic* growth to the low-to mid-single digit range. This guidance also implies full-year 2021 revenue growth of approximately 5 percent—which is consistent with our prior guidance. *Organic* growth for the year would also be in the mid-single digit range.

- We expect fourth quarter Adjusted Diluted EPS growth of 10 to 13 percent over Q4 of 2020. The high end of this range would bring full year Adjusted Diluted EPS to \$3.30, which would be growth of about 16 percent over last year. Importantly, this is \$0.05 higher than the full-year guidance we provided last quarter and \$0.15 cents higher than the midpoint of the original guidance we provided at the beginning of the year.
- For the fourth quarter we expect our tax rate to be approximately 19 percent.
- And, I am very happy to communicate that we now expect to generate more than \$950 million of free cash flow for the full year. If achieved, that would be a new record amount—breaking last year’s \$857 million (which was also a new record high at the time) by roughly \$100 million dollars.
- Finally, we remain on track to repurchase up to \$1.5 billion of stock this year, which we believe will make better use of our strong balance sheet and free cash flow while still maintaining ample access to capital to fund high return organic growth opportunities and potential future acquisitions (provided, of course, that those acquisitions are attractive both strategically and financially).

In summary, I am very pleased with how the entire Cerner team has been performing, which has directly contributed to our strong third quarter and year-to-date results. I also want to take a moment to extend my warmest welcome to David and express my genuine excitement upon his arrival.

David has quickly bonded with the entire Cerner Family, connected with an impressive number of clients, and sharpened Cerner’s strategy and focus. We are all energized by David’s presence and feel like all the pieces are quickly coming together—which (we believe) will (over time) allow Cerner to fully realize its significant potential to positively impact healthcare while also generating meaningfully higher levels of total shareholder return.

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