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CERN - Q2 2013 Cerner Corporation Earnings Conference Call

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OVERVIEW:

Co. reported 2Q13 revenues of $708m and GAAP net earnings of $112.9m or $0.32 per diluted share. Expects full-year 2013 revenues to be $2.95-3.05b and adjusted EPS to be $1.40-1.42. Also expects 3Q13 revenues to be $740-770m and EPS (before share-based compensation expense) to be $0.35-0.36.

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PRESENTATION

Operator

Welcome to the Cerner Corporation second quarter 2013 conference call. Today's date is July 25, 2013, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today by Cerner's management about future expectations, plans, perspectives, and prospects constitute forward-looking statements for the purpose of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. 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 the heading Risk Factors under Item 1-A in Cerner's Form 10-K, together with other reports that are furnished or to be filed with the SEC.

A reconciliation of non-GAAP financial measures discussed in this earnings call can be found in the Company's earnings release that was furnished to the SEC today and posted on the investor section of Cerner.com.

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

Marc Naughton - *Cerner Corporation - EVP and CFO*

Thank you. Good afternoon, everyone, and welcome to the call. I will lead off today with a review of the numbers. Zane Burke, Executive Vice President of our Client Organization, will follow me with sales highlights and marketplace trends.

Mike Nill, Executive Vice President and Chief Operating Officer, will discuss operations and our Works businesses, and Jeff Townsend, Executive Vice President and Chief of Staff, will discuss strategic initiatives and population health. Neal Patterson, our Chairman, CEO and President, will be available during Q&A.

Now I will turn to our results. We delivered very strong results overall Q2 with revenue being the one slight exception as it was at the low end of our guidance range, after again being impacted by reduced levels of lower margin technology resale. Our total bookings revenue in Q2 was $935 million, which is up 33% over Q2 of 2012 and is an all-time high for a second quarter.

Bookings margin in Q2 was $817 million, or 87% of total bookings. Our bookings performance drove a 23% increase in total backlog over Q2 of 2012 to $8 billion. Contract revenue backlog of $7.24 billion is 25% higher than a year ago. Support revenue backlog totaled $757 million, up 6% year-over-year.

Revenue in the quarter was $708 million, which is up 11% over Q2 of 2012 and at the low end of our guidance range. Recall that we had widened our guidance range for Q2 to allow for the potential of continued low levels of technology resale. This did occur, but revenue was within our widened guidance range.

Similar to Q1, the lower technology sales had limited impact on earnings. We do expect technology resale to increase in the second half of the year from current levels, but as we discussed last quarter, this is one of the least visible components of our business, so we will continue to use a wider guidance range.

The revenue composition for Q2 was $201 million in system sales; $165 million in support and maintenance; $322 million in services, and $20 million in reimbursed travel. System sales revenue reflects a 3% increase over Q2 of 2012 with strong growth in software and subscriptions being largely offset by the decline in technology resale. The strength of the high margin components of system sales is evident in the growth of our system sales margin dollars, which were up 36% year over year.

Moving to services, total services revenue was up 17% compared to Q2 of 2012, with strong growth in both managed services and professional services, and increasing contributions from ITWorks and Revenue Cycle.

Moving to gross margin, our gross margin for Q2 was 82.2%, which is up from 81.3% in Q1 of 2013 and 76.9% in Q2 of 2012. The large year-over-year increase in gross margin percent was driven by the lower mix of technology resale, strong software sales, and strong services margins. The strength in these areas is also reflected in strong year-over-year gross margin dollar growth of 19%.

Looking at revenue by geographic segment, domestic revenue increased 10% compared to Q2 of last year, even with the declines in technology resale. Global revenue growth was strong at 17%.

Looking at operating spending, our second quarter operating expenses were $404 million before share-based compensation expense of $11 million. This is a year-over-year increase of 17%, which is below the growth of our gross margin dollars, reflecting ongoing operating efficiencies.

Sales in client service expenses increased 16% compared to Q2 of 2012, driven by an increase in revenue-generating associates in our services business.

Our investment in software development was up 12% compared to Q2 of 2012. As we have discussed, we have been hiring in our R&D organization as well as utilizing consultants for targeted development work, and we expect our R&D investments to continue growing. This will continue to be reflected in increased gross spending and increased capitalized software throughout the second half of 2013.

G&A expense increased 37% compared to Q2 of 2012, driven by increased personnel expense related to our strong growth and higher amortization expense related to recent acquisitions and acquired intangibles.

Moving to operate margins, our operating margin in Q2 was 25.1% before share-based compensation expense, and was up 240 basis points compared to Q2 of 2012. This was driven by a combination of ongoing operating efficiencies, the lower level of low margin technology revenue, and strength in high margin areas I have discussed. We expect margin expansion to remain above 100 basis points for the year.

Moving to net earnings and EPS, our net GAAP earnings in Q2 were $112.9 million, or $0.32 per diluted share. GAAP net earnings included share-based compensation expense, which had a net impact on earnings of $6.7 million, or $0.02 per diluted share. Adjusted net earnings were $119.6 million and adjusted EPS was $0.34, which is up 17% compared to Q2 of 2012. The Q2 tax rate for adjusted net earnings was 34%, which is in line with our expected effective tax rate.

Now I'll move to our balance sheet. We ended Q2 with $1.5 billion of total cash and investments, which is flat compared to Q1. Total cash and investments include $969.5 million of cash and short-term investments, and $514 million of highly weighted corporate and government bonds with maturities less than two years.

Our total debt, including capital lease obligations, is $182 million.

Total receivables ended the quarter at $528 million, which is up $16 million from Q1. Our DSO in Q2 was 68 days, which is down from Q1 DSO of 69 days and 71 days in Q2 of 2012.

Operating cash flow for the quarter was $177 million. Q2 capital expenditures were $86 million and capitalized software was $44 million.

Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was $47 million. Free cash flow was lower than recent levels due to higher CapEx, driven by investments in our cloud infrastructure, the build-out of our new campus, and higher capitalized software. We expect capital expenditures to remain high in coming quarters as we continue these important investments in our growth.

Even at these levels of investment, we still expect to generate solid levels of free cash flow. We expect these investments to moderate by the second half of 2014 and for free cash flow to increase at that point.

Moving to capitalized software, the $44 million of capitalized software in Q2 represents 42% of the $103 million of total investments in development activities. Software amortization for the quarter was $23 million, resulting in a net capitalization of $20 million, or 20% of our total R&D investment.

As I have indicated, we expect capitalized software to continue increasing in the second half of 2013 as we invest in key growth areas. Since much of the incremental development involves using third-party developers, we expect the growth in capitalization to be temporary.

Similar to our overall CapEx outlook, we expect our capitalized software levels to flatten in 2014 and then decline in subsequent years.

Note that while we are increasing the dollar amount of software development costs capitalized, our total investment in R&D is growing by a higher amount, meaning that the net R&D expense on the income statement grew this quarter, as it will throughout the rest of the year. We view this investment in development, combined with our share buyback and acquisitions, to be a good use of our capital.

Regarding our share buyback, in Q2 we purchased $79 million worth of shares, bringing year to date repurchases to $142 million. We have purchased a total of 1.5 million shares, pre-split, which is the equivalent of 3 million post split so far this year. We have $28 million remaining from the $170 million that was authorized last December.

Now I will go through Q3 and full-year guidance. For Q3, we expect revenue between $740 million and $770 million, with the midpoint reflecting growth of 12% over Q3 of 2012. This revenue guidance range accounts for a wider range of results in technology resale and reflects expected ongoing strength in other areas.

For the full year, we continue to expect revenue between $2.95 billion and $3.05 billion, reflecting 13% growth at the midpoint. Given the lower technology sales in Q1 and Q2, we are biased towards the lower end of this range.

We expect Q3 adjusted EPS before share-based compensation expense to be $0.35 to $0.36 per share, with the midpoint reflecting 8% (sic) growth -- 18% growth over Q3 2012 reported adjusted EPS. For the full year, we expect adjusted EPS between $1.40 and $1.42, which is up from our prior guidance range of $1.39 to $1.42.

The midpoint reflects 18% growth over our 2012 reported adjusted EPS, and 21% growth when you adjust 2012 for a lower tax rate in Q2 and the gain on the investment sale we had in Q4.

Q3 guidance is based on total spending before share-based compensation expense of approximately $415 million to $425 million. Our estimate for the impact of share-based compensation expense is approximately $0.02 to $0.03 in Q3 and $0.08 to $0.09 for the full year.

Moving to bookings guidance, we expect bookings guidance in revenue Q3 of $875 million to $925 million with the midpoint reflecting 17% growth over Q3 of 2012. With that, I'll turn the call over to Zane.

Zane Burke - *Cerner Corporation - EVP, Client Organization*

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

Starting with our results, our bookings revenue in Q2 of $935 million is an all-time high for a second quarter and reflects 33% growth over Q2 2012. This increase was driven by strength across all our business models except for technology resale, and included strong contributions from ITWorks and Revenue Cycle, which Mike will discuss.

Looking at other bookings metrics, we had 28 contracts over $5 million, including 14 over $10 million. The mix of long-term bookings was 34% in the quarter, which is slightly higher than historical levels, due primarily to strength in ITWorks and RevWorks.

Our new footprint activity was again very strong with 30% of our bookings in the quarter coming from outside of our core Millennium install base. Again, including wins against our primary competitor.

In addition to ongoing competitiveness in the large hospital market, we also had strong results in the ambulatory space where we had an all-time high level of bookings in Q2. This strength was driven by six competitive displacements of three different suppliers. Note that these ambulatory wins include both clinical and revenue cycle, and our pipeline for both is very strong.

We also had record results in smaller hospitals with our Community Works business, adding several footprints during the quarter.

Another noteworthy area of strength this quarter was in the investor owned market. Operationally, we brought the first 10 sites live for a large investor owned client that just selected us in Q3 of last year for 19 sites. The ability to bring 10 hospitals live just 10 months from contract execution is something I believe only Cerner can do, and this execution should position us well for future opportunities with this client.

Our sales in the investor-owned market were also strong, with the highlight of being one of our largest clients selecting us to replace their existing hosting provider.

An area of emerging strength for Cerner that I would like to highlight is the public sector. Like investor-owned, we think there are strategic and operational competencies that are important to compete in this space. Our proven scale, predictable results and budgets, and ability to deliver value set us apart from others competing for this business.

In Q2 we demonstrated our ability to compete in public sector business with success in opportunities ranging from behavioral health to an Indian health services organization, to a very large state correctional health services organization that provides care to over 100,000 inmates. I believe our experience in this space positions us well for what we view is a growing public sector opportunity.

Our execution outside the US was also good in Q2. Highlights include good activity in England, Canada, Australia, and the Middle East, and an expansion of our relationship with AMEOS Group in Germany.

Moving to general marketplace observations, we continue to see more separation between the two most successful companies and the rest, most of which continue to struggle with execution. This is evident in our ongoing success at winning new footprints as well as activity in our pipeline.

Another industry observation is the operational and financial pressures on healthcare providers remains high. It is a challenge for them to keep up with meaningful use, healthcare reform, value-based purchasing, and other requirements, all while facing ongoing pressure on reimbursement.

Our solutions and services are very well aligned with helping our clients navigate these challenges, which is why we continue to have good results and a strong pipeline in what could otherwise be viewed as a challenging market.

In addition, providers are looking beyond their near-term challenges and increasing their focus on population health strategies to prepare for an expected industry shift to an at-risk model that incents keeping people healthy. Our capabilities in population health, combined with the large investments we are making in new solutions and services, are creating competitive differentiation and positioning us for sustained growth beyond the current EMR and meaningful use era.

Finally, industry consolidation is continuing with the biggest recent example being the announcement of Tenet purchasing Vanguard Health. This acquisition is another example where our large clients are being acquisitive to gain additional scale.

As have we discussed, this is a positive trend for Cerner, given our strong relationships with most of the largest health systems, which are also the most acquisitive.

In summary, the environment remains favorable for Cerner. We have a large pipeline of new footprint opportunities with only one primary competitor. Our solutions and services are well aligned with what healthcare providers need both today and in the future, and industry trends are creating additional opportunities for Cerner.

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

Mike Nill - *Cerner Corporation - EVP, COO*

Thanks, good afternoon, everyone. Today I am going to discuss Revenue Cycle and ITWorks, and provide a midyear update on our corporate imperatives. I will start with revenue cycle.

In Q2 we had very strong revenue cycle results that included another RevWorks client. The client we signed this quarter is a pediatric hospital that offers over 40 pediatric specialties and subspecialties and has had Cerner solutions since 1991. This partnership marks a milestone for us as it is our first pediatric hospital to choose RevWorks.

Like many of our long-term clients, the RevWorks alignment was viewed as a natural next step to continue driving value out of their investments. They are looking to strategically align with RevWorks in consideration of future regulatory requirements, financial predictability, and desire for innovation and best practice revenue cycle operations.

This selection, coupled with very large clients endorsing our Revenue Cycle solutions and services in recent quarters, reflects ongoing momentum in our Revenue Cycle business. This activity also represents early returns on the significant investments we had been making in our Revenue Cycle capabilities.

Our pipeline for Revenue Cycle solutions and full RevWorks services is very strong as a tighter link between clinical outcomes and revenue cycle continues to drive more clients to our integrated offering.

Q2 also included success within our ITWorks offering as we signed a contract that represents a major expansion in relationship with a client that began using Cerner solutions in 1989. This was our largest ITWorks client to date and is another example of how a very long-term relationship can continue to expand in meaningful ways.

The client has three hospitals with a total of more than 700 beds. Like our other ITWorks clients, their desire to strategically align with Cerner was based on a desire to keep up with current and future regulatory requirements, plans for continued growth, and a desire for innovation in health and care. As Zane discussed, our clients face ongoing pressures to address multiple industry requirements, while also controlling cost. Our Works offering provides a way for them to address these requirements, drive better performance, and control those costs.

Now I'd like to provide a midyear update on our corporate imperatives in areas of R&D investment. As you know, our imperatives in R&D investments are focused on physician experience, population health, and revenue cycle. Investment in these areas are strengthening our competitiveness while also setting us up for the next wave of growth. I'll start with physician experience.

We made very good progress in 2013 in enhancing our physician solutions for both inpatient and ambulatory settings. A major part of this effort has been PowerChart Touch, which is now generally available in the Apple Store for use on the iPad. PowerChart Touch's fast, easy, and smart solutions have been very well-received in the marketplace, and in May, PowerChart Touch received an award for best clinical healthcare experience application at the International User Experience Awards.

This award, along with the record results Zane discussed, is good validation of our work. Going forward, we remain focused on building out applications for the various specialties and creating seamless workflows across all devices.

Moving to population health, progress this year includes advancing our cloud platform and data analytics capabilities that are foundational to population health efforts. Also, our expanded partnership with Advocate Healthcare is a tremendous step forward, and is an exciting opportunity for us. Advocate is a thought leader regarding population health, so it means a great deal that they chose Cerner to partner to help develop the technology to manage the health and care of populations for which they have gone at-risk.

We have also made good strides with Revenue Cycle. The primary indicator of this progress is the demand for our solutions and services, which has picked up substantially in recent quarters. Our work has improved our competitiveness, as having Revenue Cycle solutions tightly integrated into the clinical process is important to ensure proper reimbursement in the new value-based payment models.

Going forward, we will continue to invest heavily in Revenue Cycle capabilities, including key differentiators like revenue analytics and care management.

In summary, while most of our competitors are bogged down with meaningful use and other regulatory requirements, we are investing heavily to position us for more market share gains and for long-term growth. We are seeing clients choose Cerner for the value we show today and for the fact that we have a vision that will sustain them in the future.

We believe we are the only Company in the industry making the investments in technologies, architectures, and solutions that will meet the needs of our clients over the long haul. We are future-proofing our clients, and it is good for our business as well as theirs.

With that, I'd like to turn the call over to Jeff.

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

Thanks, Mike. Today I'm going to talk about the Primary Health Network and provide an update on the work we are doing with Advocate Healthcare. I'll start with the Primary Health Network which is a pilot program we launched last month that connects incentives and aligns consumers and providers to facilitate improved health.

The PHN involves the health retailer, a high performance physician network, and innovative employers. A key component of the network is the use of selected retail locations to serve as access points for wellness screenings with a nurse. At these screenings, individuals will learn important elements about their health, receive tailored recommendations for becoming healthier, and select a primary care physician that aligns with their health needs and preferences.

Our Cerner Wellness Solutions and Healthe Intent platform provide the underlying technology for the program's wellness, condition management, education, performance analysis, and reporting components. We are pleased that the retail partner for this pilot is Walmart, which gives us the potential to have a significant impact on the health and wellness of communities, as 70% of America visits one of their stores every other week.

Kansas City-based Hallmark Cards is the first of multiple employer participants for the pilot. Hallmark's employees and their spouses now have convenient ways to discover their health status and connect with highly engaged physicians in the community who have been specifically selected for them based on their individual preferences.

With the Primary Health Network we are aiming to create an entirely new healthcare experience by engaging individuals with a team dedicated to their wellness and helping them create a medical home. Ultimately, this should lead to a community that delivers measurable, high quality, evidence-based health services at a reasonable cost, by aligning incentives with improved outcomes.

The PHN also can address access and capacity issues, drive referrals to primary care, and create more revenue opportunities for those that shift to manage contracts or add-on services create value against total cost. We are already working on plans to expand the PHN to additional markets, and I will provide updates on our initial pilot and expansion plans on future calls.

As you know, we are also invested heavily in systems to help our providers manage the health population. While our investments are very broad, a focused area of investment is tied to our work with Advocate Healthcare and Advocate physician partners, as this work will lead to solutions being used at scale beginning next year.

As a quick background, recall that we began an initial collaboration with Advocate in April 2012 to create new data-driven predictive models designed to improve patient health outcomes and safety. One of the first outcomes of this partnership was the joint development of a predictive agent for readmissions that has demonstrated significant improvement and predictive power as compared to the majority of the existing models.

A study highlighting this success was recently published in the online Journal of Public Health Informatics.

Our relationship expanded this year to further advance clinical integration and population health management capabilities across the continuum of care for the 500,000 lives for which they have gone at risk. We are enabling them to identify who in their population meets criteria across 16 specific registries and 60 performance improvement scorecards with the parameters Advocate has created.

As members needing care are identified, we will facilitate personalized interventions, enrollment and care management programs, and ongoing monitoring to allow Advocate to keep people healthy. This work with Advocate is going at a fast pace and is very complex.

An example of the complexity is that we are aggregating normalizing data from 52 different data sources, including multiple in EMRs, private and public payers, third-party billing and registration systems, and physician specialty scorecards. This requires the ability to take both structured and unstructured data and run it through our big data engine, using medical language processing, not just the more commonly used natural language processing, or NLP.

This allows us to enhance the data and map it to a normalized standard, so you'll have a highly structured longitudinal record that enables all of the real-time analytics I've discussed. The level of interest by our clients in what we are doing with Advocate in the population of health overall is very high.

This was demonstrated last week when we hosted our first Population Health Summit, which drew 144 client attendees. Clients were able to network and learn from each other on the other topics of population health management, readmission prevention, health information exchange,

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member engagement, patient centered medical homes, continuum of care, analytics, and quality measures. This summit validated the level of client interest in the direction we are going with our population health solutions.

In summary, I believe our approach to population health is differentiated in the marketplace. We believe many companies positioning themselves to suppliers of population health solutions underestimate the complexity, and none of them are addressing the population health opportunity with a comprehensive architectural approach that sets us apart.

Before turning the call over for questions, I'd like to highlight an announcement that was made yesterday by the CommonWell Health Alliance that CPSI and Sunquest Information Systems have joined as the newest members. They join Allscripts, Athena Health, Cerner, Greenway Medical Technologies, McKesson, and service provider Relay Health, in a collaborative effort focused on achieving interoperability and data liquidity on a national infrastructure.

As we have stated, achieving data liquidity is a critical foundation for delivering better coordinated, more effective care. And we believe the addition of CPSI and Sunquest strengthen these efforts. In addition to adding members, CommonWell also made significant progress recently at establishing a governance structure, developing services, and planning for an upcoming pilot program.

With that, let's open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Charles Rhyee, Cowen & Company.

Charles Rhyee - *Cowen & Company - Analyst*

Hey, guys. Thanks for taking the questions here. Marc, you know, you're obviously taking advantage of being a consolidator in the market. Not a -- your customers are being a consolidator in the market. You mentioned Tenet briefly here.

Can you kind of -- I know this is a contract that you kind of took over the entire thing a couple years ago. Can you maybe give us a sense on where you are, actually, with that client?

And, if I'm not mistaken, I think you already serve some of the Vanguard system. Can you talk about the mix there for you, and if that kind of transition is all over, when would you think about discussions with Tenet about that? Thanks.

Zane Burke - *Cerner Corporation - EVP, Client Organization*

Charles, this is the Zane -- just a couple comments. We are still engaged in the middle of the rollout -- a very successful rollout of the Tenet engagement.

They have rolled out to a number of their facilities. They are in the 30s in terms of their facility counts they have rolled Cerner out. So that's an active engagement that is still ongoing and there is a lot of work to do there.

Obviously, the Vanguard transaction hasn't been completed by Tenet, and we haven't had excessive dialogue about what that means for us. But that's a positive sign on that. There are about eight of the 20 -- I believe -- 28 facilities of Vanguard are Cerner facilities today.

Charles Rhyee - *Cowen & Company - Analyst*

Okay. Great. Then, maybe one follow-up. I mean, you were talking about the opportunities you have within your expanding relationship within your base here.

But thinking more broadly as the hospitals are getting impacted by sequestration and stuff, I think a couple days ago one of the IT service providers, which I think also implemented some Cerner and Epic as well, kind of talked about sequestration having some delays on some system development. Doesn't seem like it has really having an impact on you, but maybe you can kind of help us understand where some of the differences might be, what some of these service providers are seeing versus what you are seeing? Thanks.

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. The only one that I'm aware of that talked about [the lack of] market, I think others reporting indicated that anybody they were laying off, they would be happy to hire. So I think that was a very targeted view of the market.

We continue to hire kids off-campus and experienced people for our implementation teams. Our business is as active as it has ever been. Our backlog of those projects is as big as it's ever been.

So we are certainly not seeing any lack of demand for those services due to anything that the government is putting out there. In fact, the more things the government puts out there, the more we see an interest in systems, given their ability to reduce costs while meeting all these new requirements.

Charles Rhyee - *Cowen & Company - Analyst*

Okay. That's helpful. Thanks a lot.

Operator

David Windley, Jefferies.

Dave Windley - *Jefferies & Company - Analyst*

I wanted to ask a couple of questions around population health. So your Advocate partnership, I believe, is moving very rapidly toward the system completion on that by the end of this year. So I am curious about, one, the commercialization opportunity of that system or something akin to it. And would those 144 who attended your Summit be the likely targets for that?

And then, on the cost side of things, would we see R&D tail off after that is complete?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Jeff, I'll let you maybe answer some of the Advocate questions. From a financial side we are clearly focusing on getting a lot done in a short period of time relative to population health. It's part of our overall investment in IP that you are seeing hitting this on the capital side.

That's not just limited to population health; obviously doing physicians and Revenue Cycle, which is a huge market potential for us going forward, are all things that we're working on. But those -- that really big push to get those projects out do tail off as we hit kind of the middle of 2014. So as we talked about in my script, the CapEx should reduce as we [end] 2014. But, Jeff, do you have any comments relative to the Summit and Advocate?

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

Yes. So, on Advocate, the way we somewhat probably look at it is they're one or two eras ahead, or cycles ahead, of most of the marketplace. So the solution set that they are taking forward, and as I outlined, with dozens of data sources and 16 registries, the rest of -- if I am summarizing the attendees to that conference, all have initiatives at various stages, whether they are shared savings programs, they are attempting member engagement, or they are just building data warehouses.

So the advantage of Advocate is the ability for them to see what does it look like when you put this entire stack together and begin to coordinate comprehensively versus at a component-based level. So we see them -- those other organizations as they continue to change their reimbursement contracts and take on more risk or launch broader ACO initiatives, will then fall in line and somewhat replicate or copy that Advocate roadmap.

Dave Windley - *Jefferies & Company - Analyst*

If I could ask one follow-up, Marc, on your new building build out, when those are complete and you are moving people into those buildings, should we anticipate a spike in operating costs or the combination of operating costs and depreciation in the income statement? And when would that hit, if we should?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, we are building the first building of the two-building complex campuses complete and people are moving in there as we speak. The cost of moving is very low because it's all basically taking people from Kansas City facilities and moving them just to a new facility.

So for the most part, the expense isn't very high. And many times it's the cost of a couple of cardboard boxes for them to put in their trunk to take over to the new building. Not that we are low-cost movers, but that is an approach that many of them take.

So you won't see any big costs. When the buildings are complete, they will start depreciating, but that will be over a 50-year life.

Dave Windley - *Jefferies & Company - Analyst*

Okay. Great.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Not a material impact.

Dave Windley - *Jefferies & Company - Analyst*

Super. Thank you.

Operator

Rob Jones, Goldman Sachs.

Rob Jones - *Goldman Sachs - Analyst*

Thanks. Thanks for the questions. I had a high level question. If you look at a lot of the hospital and med tech manufacturers, it seems like hospitals might have cut back on CapEx broadly. Is that something you guys have noticed in the marketplace? And, if so, are hospitals being more cautious around IT spending as well, in your view? Or has it been more restricted to things linked closer to utilization?

Zane Burke - *Cerner Corporation - EVP, Client Organization*

Rob, this is Zane. What we have seen is certainly people are being judicious about how they invest dollars, but that they use healthcare IT as one of the ways that they are actually going to drive costs out of their businesses. And so they are using that as a lever for that.

They have also looked at, I think, a number of the activities around ITWorks and RevWorks that Mike talked about with you, they are utilizing some of those services to help create more predictable cost models and actually drive better efficiencies, and use their funds in other ways. So it has created quite a bit of opportunity for us.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes. This is Marc. Just the CFOs I talk with, many of them talk about, from an MRI, from that type of CapEx standpoint that there was a race where I had to have the latest, greatest, most efficient. Now, nobody is -- you know, people are not investing quite as much in that infrastructure. They work just fine. So, many people part really investing -- needing to invest to keep up with a competitive environment relative to some of that hardware.

So we can certainly see a differentiation, at least when I talk to people, about what is on their CapEx list; things that are going to help them take 20% out of their operating cost as opposed to, I'm trying to get the next new thing so that I can attract radiologists or stand alone.

Rob Jones - *Goldman Sachs - Analyst*

Makes sense. And then if I could just follow up, it seems like you guys have had some success in the public sector. Can you maybe just discuss the trends of that market, specifically amongst those clients? And how are you thinking about the size of that overall opportunity?

Marc Naughton - *Cerner Corporation - EVP and CFO*

The trends have been -- there's actually funds there. We are seeing it for everything from how do we manage the health status of the population to everything up to the incarcerated folks. And so the gamut of public health is quite large, and there seems to be quite a bit of funding even in decreasing public budgets that are out there.

So we see it as a fairly significant opportunity and we are the only ones in the industry that provide the continuum of care across all those different marketplaces where we can actually go for -- hunt for dollars in those different markets.

Rob Jones - *Goldman Sachs - Analyst*

Got it. Thanks for the questions.

Operator

Steve Halper, Lazard Capital Markets.

Steve Halper - *Lazard Capital Markets - Analyst*

Relative to the lower sales on tech resale, can you identify what areas within tech resale were below your plan? And, as a follow-up, this is not the first time we have seen this. And how as a management team can you sort of get a better handle on that component, even though recognizing the bottom line impact is nominal?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, Steve. This is Marc. I mean, those are third-party resale items. They are not our items, and obviously we have a very small inventory of things that we actually put out there, such as our MedStation cabinets. But in the (technical difficulty) space has been probably the biggest impact for us.

In 2012 we had a lot of sales. Those tend to be cyclical when you come out with a new model, then the cycle kind of flat until the next new model comes out and then it picks back up. So that has impacted the total tech resale probably as much as anything.

As a management team, we work as hard as we can, but when it is a third-party sales force that's doing the work and because of potential competition in certain areas, they don't want to share their information relative to what their pipeline looks like and their timing. We really have to kind of fly blind a little bit on that. So we do our best relative to creating a guidance range that can take the low and the high.

This quarter we came in at kind of the low end of what we expected. We think that is going to slightly increase the rest of the year. And obviously we would not want to create any expectations that we are higher than that because of the lack of visibility.

So I'm not sure -- I think, as a management team, we are doing everything we can to get a better view of it. We are continuing to roll out other opportunities in the hardware space, in the device space, expanding our portfolio so that we can get more diversity, which will help us be able to predict a little bit more accurately.

And, you know, Steve, as we have talked about for a long time, certainly at the top line impact, but given how -- if the revenue doesn't flow down to a great extent down to the earnings line, it is really just not something that we are overly concerned about. I think it is good revenue to get. It is part of our strategy of getting everything the client wants to buy coming through us, which we think will expand our opportunities as we move forward into these new areas. But, from a business standpoint, I think we are doing exactly what we need to do and what we can do. And you guys will just have to bear with us a little bit, given some of the variances.

Steve Halper - *Lazard Capital Markets - Analyst*

Great. Thanks.

Operator

Sean Weiland, Piper Jaffray.

Sean Weiland - *Piper Jaffray - Analyst*

So I look at your (technical difficulty) guidance and it implies (technical difficulty) revenues are going to have a pretty big ramp. Can you just talk about what is going to be driving that revenue growth in the fourth quarter, and also the sustainability of that growth into next year?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Relative to the -- on the Q4 elements? Relative to the year (multiple speakers) versus Q3 guidance is going to be?

Sean Weiland - *Piper Jaffray - Analyst*

Yes.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Obviously, Q4 is overall our strongest quarter. I mean, that's the quarter that we always do well in. There is a lot of pent-up demand.

We see a lot about opportunities in the marketplace that are going to be coming into our bookings that are going to create revenue opportunities, a lot of things that are in our backlog of that are going to continue to contribute to it. So I don't know if there's anything unique other than the success that usually comes with the fourth quarter driving that, which usually entails strong software and other things that are quick turnaround items, plus things that are building up in the backlog that will rollout. But there is nothing unique that I would identify.

Sean Weiland - *Piper Jaffray - Analyst*

Okay. And then, follow-up. Can you talk about -- I like the investments in the cloud infrastructure. Is your population health management platform (technical difficulty) deployed in a multitenant environment? And what do you think about the multitenant environment for kind of the core Millennium (technical difficulty) where you will be deploying your inpatient solutions via the cloud?

Mike Nill - *Cerner Corporation - EVP, COO*

This is Mike. Regarding population health, yes, the cloud -- I mean, basically by its -- by design is a multitenant environment that provides us with the scalability that we need to support countries for this type of application.

So regarding whether this will make its way into our existing solutions and inpatient environment, if we start with PowerChart Touch, PowerChart Touch is being implemented in a cloud type architecture. And we are doing that to deliver the response time and speed that is required for those type of tablet applications.

I think, over time, what we will find is we are not going to do a wholesale move of all of our current clinical applications into the cloud. I think there will be some opportunities to provide some functions on an as-needed basis, but that will be a gradual evolution over time.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Hey, Sean, this is Marc. Just -- not to step on Mike's toes here, but just go back to your revenue question. Do keep in mind that when we were talking that based on the hardware we are seeing, from a revenue perspective in Q4 that we have kind of indicated the low end of our annual guidance, is more likely. And I think if you factor that in, you're not going to see a huge ramping Q4 relative to what the revenue would look like.

The difference in potential for that to be bigger would be if hardware recovered stronger. But we don't know that that is something we are seeing on our radar today. So hopefully, that helps clarify it. Sorry.

Sean Weiland - *Piper Jaffray - Analyst*

That helps. Okay. Thanks so much.

Operator

David Francis, JAAG Research.

Dave Francis - *JAAG Research - Analyst*

A couple quick questions. First, Marc, on the system sales margin, understanding with the lack of hardware revenue pass-through there that the margin is naturally going to be higher. It was exceptionally high this quarter and I guess I am wondering what should we be looking for in terms of where does that level top out. And what should we be expecting from a software margin perspective going forward for the Company as you guys continue to push the envelope on that?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, relative to systems sales gross margin, at 82.2%, it is up less than 100 basis points over Q1. So I think given the current state of our hardware sales, we are kind of looking that that is probably the range that our gross margins are going to be in.

So I don't know that that is historically high -- well, I would have to go back and see how high that is -- but certainly it is strong. Is going to reflect lower hardware and it's going to reflect the continuing strong software that we have been seeing. So based on those -- the diversity of those margins that are contributing to gross margin, we think kind of what we see in the first two quarters should be what we continue to see for the year.

Dave Francis - *JAAG Research - Analyst*

Okay. Thanks. And a quick follow-up. Relative to the activity that you've seen among the buyers and what your Works service lines offer them relative to more efficient use of capital and what have you, argue expecting to see any kind of acceleration in terms of deals signed there? Or should we continue to look for just one or two bigger deals per quarter here over the next several quarters? Thanks.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes. This is Mark. I think if you are going to say one or two deals a quarter would be an acceleration. We kind of have indicated that when we thought we'd hit a good stride, we would be doing one a quarter. We are getting pretty close to that. Is there opportunity to expand on that? I think there is. Zane, what are your thoughts?

Zane Burke - *Cerner Corporation - EVP, Client Organization*

We feel like there is great opportunity there and I think you have hit it, Marc. I think we see continued demand for those type of services in our base and I think there is an opportunity for some of that to accelerate.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, I think the key is that, as systems look to handle their costs and reduce their costs, our Works business is absolutely are in tune with that approach because we are going to help them manage and actually probably reduce their overall spending on a like for like basis from what they are doing. So in that environment, we are getting more and more people looking at us for an option to help them drive the costs cut that they need to remain competitive.

Dave Francis - *JAAG Research - Analyst*

Great. Thanks.

Operator

David Larson, Leerink Swann.

David Larson - *Leerink Swann - Analyst*

Hey, guys. Great quarter. Zane, can you talk briefly about these investments that have been made into the physician user experience? And can you talk about PowerWorks; how that product has evolved? And, just in general terms, of the 45,000 doctors that are currently on your client, are they all on PowerWorks or are some of them on PowerChart?

And then can you also just talk about Ascension Health and their decision to go with Athena? Thanks a lot.

Zane Burke - *Cerner Corporation - EVP, Client Organization*

David, you had a number of questions, so I'll see if I can't answer those. If I miss one, please help me come back to it. But Cerner ambulatory, which is what we refer to our solution, we are a leading web and integrated Cerner -- the integrated solution. And so many of the wins over the last 24 months and this growth that we've had has been in our integrated environment.

We continue to market and sell the PowerWorks environment, which is typically done for affiliated physicians, which is also the Cerner Millennium solution, just in a hosted model. We have had great success actually in the Business Office Services and Revenue Cycle side with our Business Office Services and our Millennium solution in the Revenue Cycle particular space. We have actually crossed the 50,000-physician mark for doctors overall that using some form of Cerner ambulatory solutions in that setting.

As it relates to one of the competitors in this space and our client, obviously Ascension is a significant client of Cerner's. It is very committed to the inpatient solution. My understanding is that that particular arrangement is more of a hunting license within that organization and reflects that overall.

So I like our competitive position against that particular competitor over the long term, and actually one of our displacements was actually related to that environment and a number of competitive wins versus that particular supplier.

David Larson - *Leerink Swann - Analyst*

Okay. That's very helpful. And then, has there been recent new releases or new versions of PowerWorks that came out in 2013? And can you talk about maybe the functionality in those new versions relative to previous versions?

Zane Burke - *Cerner Corporation - EVP, Client Organization*

So the functionality within Cerner Ambulatory and PowerChart overall, we've had a number of enhancements in that regard over the last 24 months -- 24 to 36 months. And is an absolutely lead with for Cerner today and is really one of the best. It's actually the number one black book ambulatory EHR out there.

And so the enhancements that we have made to the solution overall from an ambulatory perspective have been extremely well received by our clients, as well as the early returns around PowerChart Touch in the ambulatory environment, which that is the first venue which that application will hit as well.

David Larson - *Leerink Swann - Analyst*

Great. Thanks a lot. Congratulations again on a good quarter.

Operator

Michael Cherny, ISI Group.

Michael Cherny - *ISI Group - Analyst*

Good afternoon, guys. So just taking in a little bit, you mentioned how long-term bookings number for the quarter was a little bit above the elevated level. I think you said 34% relative to where it has been previously.

As you think about that as a percent of total bookings, particularly into the population health management push, which seems to be a little -- a combination of service and technology, maybe more service-oriented, how do you expect that trend to move over time? Are we more likely to see it closer to that mid-30%'s level or is that 25% to 30% range you have historically talked about the more likely level?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes. I mean, Michael, my crystal ball is not clear enough to know even exactly what the population health business model is going to be as it rolls out in its various venues to be able to kind of know how long-term those might be and where they're going to fall. So, clearly, if it is a PM/PM for extended period of time, then that is -- wouldn't be a longer-term booking.

I think certainly in the near and medium-term, that the 30% or so bookings being long-term reflects our overall growth in bookings and the fact that Works business are really starting to gain momentum and starting to get some traction. So we will certainly, if that moves much off the 30%, we'll talk to you about what we are seeing that is moving that, if it is moving up or down.

As the Works businesses start clicking, if I get to the suggested two Works deals a quarter, and if I am doing ITWorks and RevWorks, it could impact it. But we have such strong demand for all of our other existing solutions and our services and things that don't go into long-term, and a lot of the new business that we are getting and we are signing up, most of that is a short-term or at least not in our long-term bookings.

So I think that the likelihood is that will stay in that same range for a while and if we are going to see a movement out of that, we'll try to give you a heads up as to that. But in the near-term, I don't see -- we'll get a nice balance where both elements of the portfolio are growing at a similar rate.

Michael Cherny - *ISI Group - Analyst*

No. Thanks. That's helpful. All my other questions have been asked.

Operator

Greg Bolan, Sterne, Agee.

THOMSON REUTERS

Greg Bolan - *Sterne, Agee & Leach, Inc. - Analyst*

Hey, thanks, wanted to ask kind of a quarterly ritual question, Marc, on uses of cash. Any update there as it relates to what you guys are thinking about?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, Greg. I mean, today, obviously, we reported -- and talking about cash flow, how we could spend a lot of the cash flow and coming up with about $47 million of free cash flow. So we are certainly investing that cash flow that was driving in the quarter in some of our infrastructure, obviously from a billing perspective, the infrastructure on a CapEx side relative to our population health and other initiatives and certainly on the stock buyback and on the R&D investments.

So I think kind of on a quarterly basis, we have got a big focus on investing back in the business. The $1.5 billion number we kind of hit, we've been at for a couple of quarters. So we are really investing the cash we have earned since then back into the business.

We think that's the best path. We still are going to keep an eye on that $1.5 billion; keep an eye on the marketplace. We are always interested in things that can add to our portfolio without impacting our single architecture strategy.

And a lot of the acquisitions you have seen us do in the last one or two years have been things such as behavioral health, that has actually put us into some of these government markets that you can't even submit an RFP if you don't have that specific requirement. So I think we're going to continue looking at that and we are comfortable with where we are with cash now.

We will continue to look at stock buybacks. Obviously, we have a little bit left to finish up our current one. But, right now, I think we like what we are doing with our cash and we are going to look at continuing to keep that $1.5 billion in our pocket as we see opportunities develop.

Greg Bolan - *Sterne, Agee & Leach, Inc. - Analyst*

Fair enough. And just kind of thinking about it, and I apologize if I missed it, if you made any comments on this, Marc. But, just with regards to the pipeline and the magnitude of it, just kind of recalling sometime around this time last year, just how you felt about the pipeline going into the back half, specifically into the fourth quarter. Just wanted to see if maybe you could characterize, maybe qualify, if you would, where you are versus, say, historically just in terms of all-time high or close to it, or how are you thinking -- or what does it look like at this point?

Zane Burke - *Cerner Corporation - EVP, Client Organization*

This is Zane. We just completed our forecasting process where we actually go through and talk about that next (technical difficulty) pieces. And I can say that it was an all-time high and so we did see -- we have seen significant growth in the pipeline across all segments inclusive of our global segments and the domestic as well.

Greg Bolan - *Sterne, Agee & Leach, Inc. - Analyst*

Great. Fantastic. Thank you.

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. The marketplace is as strong as we have seen it. The things that we are rolling out -- the new businesses -- RevWorks, ITWorks, are just exactly what certainly our clients are looking for. And I think about we talked about some of the other competitors clients starting to come back to the market.

This forecast meeting we just had, 2014 looks like the time when we are going to start seeing those come in more than a onesie-twosie fashion. So we like the market that we see, certainly for the rest of the year and actually into the visibility we had in kind of the early part of 2014.

Greg Bolan - *Sterne, Agee & Leach, Inc. - Analyst*

Very good. Thank you.

Operator

Gavin Weiss, JPMorgan.

Gavin Weiss - *JPMorgan - Analyst*

Thanks very much. You mentioned the CommonWell announcement of a few new members there. What steps have been taken in this group today and where do you see the real implications of this going forward?

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

This is Jeff. As far as the group goes, kind of since our HIMSS announcement, I would say there has been three paths that the broad group has been working on together. One is to go form the real entity, the governing principles around that entity, and how it evolves over time. The second path would be on the pure technology itself.

And so, taking the library of existing standards that are out there and attempting to accelerate those that make sense to achieve that, that objective around that ID and to get that into the market more quickly. So how do you introduce new standard without it becoming almost another way of a meaningful use where the suppliers have to go do a lot of work back in their EMR and that delays adoption.

So I think you will see, as we introduce the pilots, that will probably be one of the areas I am probably most excited about and the work that has been done to date.

The third category is to actually go pick those target markets that have, in a community, enough of a sampling of all the participants. And, as I briefly said in my comments, I think we are down to 3 to 5 communities that we have honed in on to go bring this up in the near term.

So my expectation is, over the next few months, you will begin to actually see demonstrations of the solution in a more open platform that allows others to go adopt it more quickly.

Gavin Weiss - *JPMorgan - Analyst*

Okay. Great. Thank you very much.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Why don't we take one more question?

Operator

Jamie Stockton, Wells Fargo.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Good evening, guys. Thanks for taking my questions. I guess, just real quick, Zane, you said that you guys had had a record quarter for ambulatory deals -- all-time record, I think. It seems like you have had a couple of great years from an ambulatory standpoint.

Can you talk about -- and maybe this is a question for Mike -- I don't know -- from an implementation standpoint, have you really hit the inflection point as far as getting those docs live? Or is that something that is still in front of us?

Zane Burke - *Cerner Corporation - EVP, Client Organization*

This is Zane. Many of those are still in front of us, so we did have a number of physicians go live in the first six months of the year. So I think we went live with about -- over 4000 physicians since the beginning of the year. But we've added significant in excess of that. So we have a number of those to go live in front of us.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Okay. And then, maybe this one is for Mike, but the Works deals, I would imagine that all of the effort that is going to go into ICD-10 is probably causing hospitals some stress on top of meaningful use. I was just curious if, among the various topics that are driving the IT or the RevWorks deals, if ICD-10 is toward the top of the list or could that potentially accelerate some near-term opportunity from a Works standpoint?

Zane Burke - *Cerner Corporation - EVP, Client Organization*

This is Zane. Again, just in terms of the market opportunity for that, there is opportunity around ICD-10 services, but it's not the primary driver of either RevWorks or the ITWorks elements.

RevWorks side -- many of them are preparing -- they are really thinking about, yes, ICD-10 is part of the first hurdle they have to get over, but they are really preparing for multiple hurdles as it relates to changes in what is going to occur in the reimbursement elements of this. And, in terms of really getting an updated Revenue Cycle solutions and processes around that, ITWorks piece is really much more around fixed predictable costs at a time when they have kind of an insatiable appetite for IT solutions and services.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Okay. That's great. Thanks, guys.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, this is Marc, I want to thank everybody for being on the call today. We are very pleased with the result and certainly the activity that we see in the market going forward. It really is at an all-time high as we have indicated.

We are very focused investing in our platform. You are going to continue to see us use cash to do that for a targeted period of time that will end in 2014, where you will see us go back to kind of traditional free cash flow levels that are near 100% of our net earnings.

So I think we are doing the appropriate thing in investing in it at a time when the market is there, and when we think we know what the market is asking for. So we feel great about the business and we look forward to having a chance to talk with you all later. Thank you very much.

Operator

This concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.