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CERN - Q2 2016 Cerner Corp Earnings Call

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OVERVIEW:

Co. reported 2Q16 revenue of $1.22b and GAAP net earnings of $166m or $0.48 per diluted share. Expects 2016 revenue to be $4.9-5.0b and adjusted diluted EPS to be $2.30-2.40. Expects 3Q16 revenue to be $1.200-1.275b and diluted EPS to be $0.59-0.61.

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PRESENTATION

Operator

Welcome to Cerner Corporation's second-quarter 2016 conference call. Today's date is August 2, 2016, 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, product development, new markets or prospects for the Company's solutions and services, and plans and expectations related to the health services business and other clients' achievements.

Actual results may differ materially from those indicated by the forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements may be found under Item 1A in Cerner's Form 10-K, together with the Company's other filings.

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

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

Marc Naughton - *Cerner Corporation - EVP, CFO*

Thank you, Howard. 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 additional highlights.

Now I will turn to our results, which were solid across all key metrics. Our bookings revenue in Q2 was $1.4 billion, which reflects 9% growth over Q2 of 2015. Note that this growth was driven on only 28% of bookings coming from long-term contracts in Q2 of 2016, compared to 35% in the year-ago quarter.

Our revenue backlog ended the quarter at $15.0 billion, which is up 13% from $13.3 billion a year ago. Revenue in the quarter was $1.22 billion, which is up 8% over Q2 of 2015 and in the middle of our guidance range. The revenue composition for Q2 was $333 million in system sales, $257 million in support and maintenance, $604 million in services, and $22 million in reimbursed travel.

System sales revenue for the quarter was up 6% compared to Q2 of 2015, with strong growth in software being partially offset by a decline in hardware. While hardware did decline year over year against a tough comparable, it was up sequentially and in line with expected levels. Looking at system sales margin, it was up 150 basis points over last year, reflecting strong software and lower hardware.

Moving to services, total services revenue, including professional and managed services, was up 12% compared to Q2 of 2015. This is in line with our expectation and continues to reflect good execution by our service organizations.

Support and maintenance revenue increased 1% over Q2 of 2015, reflecting a tough comparable. Support and maintenance is up 5% year to date and we expect similar mid single-digit growth for the rest of the year.

Looking at revenue by geographic segment, domestic revenue increased 8% over the year-ago quarter to $1.073 billion and non-US revenue grew 9% to $143 million.

Moving to gross margin, our gross margin for Q2 was 83.1%, which is up from 82.9% in Q2 of 2015, reflecting strong software and services and lower hardware.

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, health services related to amortization, acquisition-related deferred revenue, and other acquisition-related adjustments, which are detailed and reconciled to GAAP net earnings in our earnings release.

Looking at operating spending, our second-quarter GAAP operating expenses were $769 million, compared to $762 million in the year-ago period. Adjusted operating expenses were $721 million, which is up 9% compared to Q2 of 2015. This growth was primarily driven by growth in personnel expense related to revenue-generating associates.

The total year-over-year change for each expense category in Q2 on an adjusted basis was 13% growth for sales and client service; 2% decline in software development; 6% growth for G&A; and amortization of acquisition-related intangibles was down 12%.

Moving to operating margins, our Q2 GAAP operating margin was 19.8%, compared to 15.3% in the year-ago period. Our adjusted operating margin was 23.8% in Q2, which is down slightly from 24.2% in the year-ago period. This is in line with our previous indication that we expect margin expansion to be limited in 2016, but we do continue to believe we can expand margins 50 to 100 basis points annually after 2016.

Moving to net earnings and EPS, our GAAP net earnings in Q2 were $166 million or $0.48 per diluted share. Adjusted net earnings were $199 million and adjusted diluted EPS was $0.58, which is up 12% compared to Q2 of 2015. The Q2 tax rate was 32%, which is in line with our expected range of 32% to 33%.

Now I will move to our balance sheet. We ended Q2 with $720 million of total cash and investments, which is up slightly from $707 million in Q1, with most of our free cash flow being used to repurchase shares. During the quarter, we executed $50 million in stock repurchases buying back

938,000 shares at an average price of $53.30. Year to date, we have purchased 3.7 million shares at an average price of $53.41, for a total of $200 million out of the $300 million stock repurchase program authorized in March of this year.

Moving to debt, our total debt, including capital lease obligations, is $585 million, which is down slightly compared to Q1. Total receivables ended the quarter at $983 million, which is up $42 million from Q1. Our Q2 DSO was 74 days, which is an improvement of two days compared to Q1 and seven days better than a year ago.

Operating cash flow for the quarter was $255 million, up from $109 million in Q2 of 2015 and down from $327 million in Q1. The sequential decline was driven mostly by timing of tax payments and an extra payroll in Q2. Year-to-date operating cash flow of $582 million reflects strong growth over $323 million of operating cash flow in the first half of last year.

Q2 capital expenditures were $118 million and capitalized software was $80 million. Free cash flow, defined as operating cash flow less, capital purchases and capitalized software development costs, was $57 million for the quarter. This is up compared to negative free cash flow in Q2 of 2015 and down from a very strong Q1 in 2016, due to the lower operating cash flow and higher capital spending related to construction on our new campus.

Year-to-date free cash flow of $209 million is in line with our expectations and we expect solid free cash flow for the rest of the year, even with spending on our campus remaining elevated. Next year, we expect a decline in capital expenditures, resulting in a stronger free cash flow.

Now I will go through Q3 and full-year 2016 guidance. For Q3, we expect revenue between $1.2 billion and $1.275 billion, with the midpoint reflecting growth of 10% over Q3 of 2015. For the full year, we expect revenue of between $4.9 billion and $5.0 billion. This range reflects a tightening of our previous range, mostly to capture the lower hardware revenue in the first half of the year, but it is still 12% full-year growth at the midpoint.

We expect Q3 diluted EPS to be $0.59 to $0.61 per share, with the midpoint reflecting 11% growth over Q3 of 2015. For the full year, we continue to expect adjusted diluted EPS to be $2.30 to $2.40, with the midpoint reflecting 11% growth over 2015.

Moving to bookings guidance, we expect bookings revenue in Q3 of $1.45 billion to $1.6 billion. The midpoint reflects a slight decline from Q3 2015, which was 44% higher than Q3 of 2014 and is by far the toughest comparable period from last year. The midpoint will still put the year-to-date bookings above 2015 and we expect growth in Q4 as well, so we are still on track for our stated goal of full-year growth over what was a very strong 2015.

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

Zane Burke - *Cerner Corporation - President*

Thanks, Marc. Good afternoon, everyone. Today, I will provide color on our results and make some marketplace observations.

Our bookings were a record for a Q2 and only second to our all-time high bookings at Q3 2015. As Marc indicated, our total bookings grew 9%, despite lower contributions from long-term bookings than last year.

The 28% of Q2 2016 bookings from long-term reflects contributions from both ITWorks and managed services, but was still below the elevated level of 35% in Q2 of 2015. The non-long-term portion of Q2 2016 bookings grew 20%, reflecting strong levels of solution and services sells both into our base and to new clients.

Bookings this quarter included several large contracts, with 45 contracts over $5 million, including 28 over $10 million. 34% of bookings this quarter came from outside our core Millennium installed base. This high level of new business is the result of an active replacement market and ongoing success against our primary competitor. The keys to our success continue to be our improved solutions, producible delivery capabilities, a lower cost of ownership, ability to deliver value, and our population health and open platform capabilities. I believe we compare favorably to our primary competitor in all of these areas and this was reflected in our win rate.

Overall, I believe Cerner is viewed as the safe choice for our current solution needs, as well as the best positioned supplier to help clients achieve value from their investments and position them for success as the market shifts from a focus on care to a focus on health and wellness.

A good example of the opportunity in the marketplace and our competitiveness was Covenant Health selecting Cerner, which we announced last week. Covenant Health is a 1,900-bed health system based in eastern Tennessee with 10 hospitals and nearly 100 ambulatory facilities. They will be deploying Cerner Millennium EHR and clinically-driven revenue cycle solutions, as well as the HealtheIntent population health solutions across all venues of care.

Cerner's integrated solutions across clinical and revenue cycle and acute and ambulatory, proven ability to deliver value at a predictable cost, and our population health capabilities are important differentiators for us when competing for this business.

Looking ahead, we believe the replacement market will remain active, given the high number of hospitals on legacy platforms, many of which are being sunset. This opportunity is reflected in our leading indicators, with our new business pipeline and sales activities at all-time highs.

Now I will discuss Revenue Cycle. We had another great quarter. All new EHR clients included Revenue Cycle as part of their purchase, reflecting a continued focus by the market on clinically-driven Revenue Cycle. This preference was also reflected in an ongoing success in our installed base, with several more large clients choosing Cerner for acute Revenue Cycle and ambulatory business office services.

In addition to a very strong quarter, we also made a great addition to our executive team. As we announced in July, Jeff Hurst will be joining Cerner on September 1 as Senior Vice President of Cerner Revenue Cycle Management and President of Cerner RevWorks. This is a new position and the existing Revenue Cycle and RevWorks teams will report to Jeff.

Jeff comes to us from Florida Hospital, a 2,700-bed acute care medical facility that is a member of the Adventist Health System, where he directed all financial and clinical revenue cycle functions and had a responsibility for key organizational strategies. He is a respected industry thought leader and proven executive and he brings an important provider perspective to Cerner.

As you know, we have made significant investments in Revenue Cycle that have led to very strong growth in recent years. Our hiring of Jeff is an indication that we believe we are still in the early stages of a significant growth opportunity as we help our clients navigate the rapidly evolving reimbursement landscape and that we are investing in talent that will help us capitalize on this opportunity and to contribute to the success of our clients.

Now I will shift to discussing our population health business, where we had a great quarter. We added several new clients to the HealtheIntent platform and we also expanded the scope of population health solutions at some of our largest existing clients. Our comprehensive approach to population health remains differentiated in the marketplace and we continue to add solutions to the HealtheIntent platform.

I believe we'll continue to displace numerous niche offerings because of the power of the platform and the ability to integrate with the EHR workflow.

The volume of clients that have purchased initial solutions on our HealtheIntent platform is impressive. We recently passed the 100-client milestone. We believe this positions us for a significant ramp in revenue in the coming years as these clients add more solutions and lives to the platform, which will increase the per member/per month rate and number of members.

We expect the driver of this to be ongoing shifts in reimbursement that are leading to more risk assumption by our clients and we believe the shift away from traditional fee-for-service is gaining momentum, with the Medicare Access and CHIP Reauthorization Act, or MACRA, and the new merit-based incentive payment systems ramping in coming years as CMS continues its focus on value and quality payments.

Moving to the ambulatory market, where we had record results with strength in ambulatory EHR, practice management, and business office services. (inaudible) recent quarters, our results include some of the largest acute-care clients choosing Cerner's clinic and Revenue Cycle solutions for their ambulatory settings.

We also had a strong quarter in the small hospital market. Our cloud-based CommunityWorks offering continues to be competitive against all niche small hospital vendors.

A recent noteworthy win for CommunityWorks was the displacement of a failed attempted go-live by a cloud-based vendor that has been making a push in recent years to expand from ambulatory market to hospitals. We have several active opportunities to displace this same competitor in both ambulatory and small hospital settings, suggesting their approach of spending about three times as much on sales and marketing as they do on research and development may not be the most effective approach for their clients.

Outside the US, despite some macroeconomic headwinds, we had a good quarter. Non-US revenue grew 9% year over year, with noteworthy areas of strength including Australia, Germany, and the Middle East. As Mike will discuss, the Middle East strength included ITWorks, which is a positive sign as it highlights a largely untapped global opportunity for ITWorks.

In summary, I am pleased with our execution in Q2 and believe we are well positioned to have a good second half for the year. With that, I will turn the call over to Mike.

Mike Nill - *Cerner Corporation - EVP, COO*

Thanks, Zane. Good afternoon, everyone. Today, I'm going to discuss ITWorks and Cerner's Model Experience initiative.

I will start with ITWorks. We had a good quarter with one new ITWorks client, a large expansion with an existing client, and a very strong sales back into our client base.

Regarding our new client, this client is not only new to ITWorks, but they are a new EHR client as well, and the EHR win displaces our primary competitor. The client is a new Children's Hospital in Dubai that was scheduled to implement our primary competitor's solution, but concluded Cerner is a better choice to meet their needs. Our ability to work quickly in order to enable them to be ready for the hospital scheduled opening date, as well as provide full IT services through ITWorks, were both key factors in us being selected.

In addition, the success we have had with another client in the region was very helpful in demonstrating the value of the ITWorks model, something our competitor does not offer.

Looking ahead, our pipeline for ITWorks is significant and includes some very large clients. While the timing of ITWorks deals has been lumpy and will likely continue to be, we are confident it will remain a strong contributor to our growth. The value proposition to our clients is very appealing, especially in an environment where they have pressure on operating costs, limited access to IT talent, and increasing pressure in light of the industry issues related to security.

Now I would like to briefly discuss an initiative we call Model Experience. The Model Experience is an extension of the model system, which we have discussed in the past. The Model Experience represents a meaningful shift in our approach to implement our solutions, workflows, and standards at our client sites. It presents all of Cerner's standards and content within a controlled environment, where the best practice for workflows and the latest capabilities are captured.

Then each client system can be optimized based upon their specific needs.

The Model Experience goes beyond just focusing on the EHR. It also provides clients optimal recommendations for leveraging HealtheIntent, Millennium, and CareAware solutions. In addition, the Model Experience uses a continuous advancement approach for adopting recommendations, which insures our clients will continuously be able to maximize the value of our solutions.

In summary, I believe the Model Experience positions us well for our clients to achieve value from their existing investments and keep up with the rapidly evolving healthcare landscape.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Charles Rhyee, Cowen.

Charles Rhyee - *Cowen and Company - Analyst*

Thanks, guys, for taking the question. I wanted to talk about the small hospital market, and clearly you are indicating that you're having a lot of success here, downstream in the market. What are the characteristics that these smaller hospitals are looking for right now? And what do you think is right now really differentiating? Is it the ability to still retain control over how their workflow and how they practice delivering here or can you talk about some of the characteristics when you are in discussions with them? Thanks.

Zane Burke - *Cerner Corporation - President*

Thanks, Charles. This is Zane. The characteristics are pretty straightforward. Healthcare is complex no matter how small the organization is, and so having the depth of a Millennium and Cerner full-functioning system, our ability to deliver in a cloud-based environment, which allows us to have a lower total cost of ownership, and a very fixed and predictable model is very appealing because they need the full-functioning solution set to be able to be delivered in a cost-effective manner.

And so, those are the key criteria. Many of them are in a situation where they are forced to leave their legacy provider, and so they are looking for a replacement that takes them to a safe place, as well as puts them in good standing from the long stead to connect into the evolving marketplace for healthcare.

Charles Rhyee - *Cowen and Company - Analyst*

That's helpful, and Marc, if I can talk about how that flows into the model. When you are selling down to the small hospital market in a cloud-based platform, is it a subscription model? And then, would that show up in the long-term bookings or is it because it is still a software sale, even if it is a subscription, it is not counted in that part of the bucket, in booking? Thanks.

Zane Burke - *Cerner Corporation - President*

This is Zane. It is a typical hosting software license arrangement. Sometimes the models are -- and it will include subscriptions at well, so it is our full-functioning Millennium solution set that has all the attributes that that would have. The financial model may be -- from a financing perspective may look different, but as it relates to bookings, it is going to flow through our model the same way.

Marc Naughton - *Cerner Corporation - EVP, CFO*

So (multiple speakers)

Charles Rhyee - *Cowen and Company - Analyst*

Okay, that's helpful.

Marc Naughton - *Cerner Corporation - EVP, CFO*

The long-term component is smaller because hosting is not as big a component of those deals.

Charles Rhyee - *Cowen and Company - Analyst*

Okay. Okay, that's helpful. Thank you.

Operator

Ross Muken, Evercore ISI.

Ross Muken - *Evercore ISI - Analyst*

I am curious in terms of the pacing of operating margin expansion throughout the year or what is contemplated in the second-half guide. Can you just help us understand in the face of what you did with revenue for the full year how to think about the other mechanics that would get us to the upper end of the earnings range for the year?

Marc Naughton - *Cerner Corporation - EVP, CFO*

Yes, this is Marc. I think the key thing relative to the revenue guidance was taking out the hardware component, the lower hardware that we had seen earlier in the year, and then flowing that through the rest, and that's why we took the higher end off the revenue.

I think as we roll forward, we still have a year where we expected our margins to be relatively flat year over year, and I think that's what we are seeing and what we are delivering. I think that's still our expectations as we roll through. Obviously, to the extent that we increase our higher-margin elements of the business, software, et cetera, there's a chance to increase the operating margins. But I think overall, given the mix we have, which feels like a pretty good mix between services, software, and the rest of our business, I don't know that we're going to have a big change in 2016 relative to margin expansion.

I feel very good as we roll into 2017 you will start to see us get back on the track of the 50 to 100 basis points of margin expansion that you have seen us historically be able to do, but that's right now our view as we look out at the second half of the year, and given our guidance for Q3, I think we'd be relatively flat year over year as we continue to see basically low double-digit revenue growth.

Ross Muken - *Evercore ISI - Analyst*

That's helpful. I guess what I was pointing at is it seems like it implies a little bit of improvement just because you have been down in the first part of this year, that thus the second half has to have a little bit more expansion.

But I guess one other quick thing, so on the international business, it looked like that improved sequentially. Maybe a little bit more color where you are seeing some of the demand there. And then, I guess, how you're thinking about that pacing through the rest of the year because the comps, I think, ease a little bit there.

Zane Burke - *Cerner Corporation - President*

This is Zane. As we mentioned in my comments, we saw strength in several areas, but heavily the Middle East, as referenced in Mike's commentary around the ITWorks perspective, and Germany as well. We saw good performance there.

And I think the piece around the Middle East is very pleasing, given the price of oil in that marketplace and really it's a proof point of really good work that is being done by the teams in the Middle East, as well as what some of that client had seen here to buy some of the ITWorks opportunities here that we have worked with in the US. So I think that model will continue to have -- create good opportunities for us across the globe.

Marc Naughton - *Cerner Corporation - EVP, CFO*

And I think -- this is Marc -- I think we also see somewhat our traditional markets, Australia, Canada, seeing some activity beginning to percolate in the UK, which is a positive compared to where they have been. The one place that is not growing a lot more post the HS is Germany is doing well, but overall Europe is still an area we think should grow as those economies recover. But we were pleased certainly with the Middle East activity this quarter.

Ross Muken - *Evercore ISI - Analyst*

Great, thanks.

Operator

Sean Dodge, Jefferies.

Sean Dodge - *Jefferies LLC - Analyst*

So it sounds like you guys have been selling lots of Revenue Cycle software, but it has been a little while since we have seen a RevWorks deal signed. Can you talk about what is holding those back, and maybe more broadly the demand you are seeing for some of the intermediate stuff, the extended business office services?

Zane Burke - *Cerner Corporation - President*

Sure, this is Zane. I think you hit the nail on the head in terms of we have seen great market opportunity around the business office services for physicians, and then really the extended business office services doing more services along those lines. The growth has been very good in both of those areas.

As it relates to the full outsourcing, we have really taken the approach of digesting the clients that we have and really being focused on making sure that the next opportunity is a really good one for us, and we view the EBO services and the business office services as a great entree into the future of those Revenue Cycle opportunities. So we still see full Revenue Cycle outsourcing as a good marketplace for us, but we think it will grow into those markets over time through the business office services and the EBO, which have been very strong in demand.

Sean Dodge - *Jefferies LLC - Analyst*

Okay. And then on the third-quarter bookings guidance, Marc, as you mentioned, you guys are lapping a really big comp there. There was a large ITWorks and professional services contract that was previously discussed that flipped out of the fourth-quarter bookings. Are either or both of those assumed in the target?

Marc Naughton - *Cerner Corporation - EVP, CFO*

No, there is no anticipation that you're going to see our long-term bookings percentage do anything different as you did last year. We saw some mid-30%s and even higher percents from long term. This year, we have been below 30%. I think 30% is probably our target, so I think that's what you're going to see relative to the bookings.

We don't anticipate any large spikes from any deals that we have talked about before. Those deals are still out there, but I don't know that Q3 is the timing for either of those at this point.

Sean Dodge - *Jefferies LLC - Analyst*

Very good. Thanks for the color.

Operator

Greg Bolan, Avondale Partners.

Greg Bolan - *Avondale Partners - Analyst*

Thanks for taking the question. So, as I think about the -- Marc, you have talked about setting up well for margin expansion in 2017. Could you maybe just walk us through the variables, the stars that you see aligning to set it up for margin expansion next year?

Marc Naughton - *Cerner Corporation - EVP, CFO*

Yes, I think for us the key is continuing seeing the demand in the marketplace, obviously, continuing to be able to sell software and sell the higher-margin elements of the business that we have been seeing. If hardware continues to be at the current level, once we get through, that's assuming we can continue to grow the margins double digit, which we expect to do, that should improve the overall margins.

Historically, you have seen us leverage our spend. You have seen us leverage R&D growth relative to revenue growth, and those are the drivers that will kick in that you have seen traditionally for us that are driving some of that growth. I think even in our businesses, as we do the business model slide every year you see slight increases in contribution margins from each of those.

So, if you really just look at our size and the expense components, if you grow R&D slower than revenue and you grow SG&A slower than revenue, it gets you 50 to 100 basis points. So, really as long as we do those two things, we should get back on track.

Greg Bolan - *Avondale Partners - Analyst*

Okay, that's perfect. And then, just lastly, Zane, you broke up for a minute there. With regards to -- did you mention just with regards to the RFP pipeline or the business pipeline -- I think you had said all-time high or I can't -- you gave some color. Can you just repeat what you said?

Zane Burke - *Cerner Corporation - President*

Sure, and my comments were with the new business pipeline at an all-time high, as are our key leading indicators for all sales activities.

Greg Bolan - *Avondale Partners - Analyst*

Okay, got it, and that's across both the inpatient and the ambulatory side of the equation?

Zane Burke - *Cerner Corporation - President*

That's across our entire business, so it is the gross (multiple speakers) network.

Greg Bolan - *Avondale Partners - Analyst*

Okay, got it. Okay, thanks, guys.

Operator

Donald Hooker, KeyBanc.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

So you guys had great success, it seems like, displacing competitors and you can see that clearly in your data. I guess my question is, do the economics with the second go-round of hospitals and physicians looking at their core software systems now that we are in round two, is there a change in the economics of the deals in any way in terms of pricing? Are there more milestones? Are there more contingencies in the deals?

Zane Burke - *Cerner Corporation - President*

This is Zane. In terms of the economics, they are fairly similar in terms of economics. And depending on the situation where the client is getting out of, you may end up having some more milestone elements and some things around the contracts that may be a little more challenging for those that have failed to deliver. So sometimes you pay -- you have to account for the fact that there have been past failures by others. But for the most part, we are not seeing that broadly in our contracts to date.

Marc Naughton - *Cerner Corporation - EVP, CFO*

Yes, I would say -- this is Marc -- I would say the milestone, we referenced those maybe a quarter or two ago for some very distinct contracts that had the flavor that Zane talked about. Really since then, I can't recall anyone that has had a milestone of any significance that was -- that would have impacted what we did.

So, I think certainly they want to make sure that they are getting what they're paying for. Luckily, our reputation and our ability to deliver is minimizing the contractual requirements that we would have that would impact the financials, for the most part.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Got you. And then, if I may, divert and ask another question, about CommunityWorks and the small hospital market, which seems interesting. I know you guys are generating business there, both by displacing competitors and, I guess, migrating health services clients as well. Roughly speaking, how much of your growth there is one versus the other? Is it mainly through migrating health services clients or is it more displacing competitors? If you could give us a rough sense of the market.

Zane Burke - *Cerner Corporation - President*

Sure, this is Zane. It is actually coming mostly from the displacement of other competitors. We have had great success on the health services migrations in the lower end of the marketplace and our win rate for those is in the high 90s, 90 percentile for that client base, so it has been very successful. But the bulk of it is coming at the expense of replacing our competitors.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

And that business is growing, obviously?

Zane Burke - *Cerner Corporation - President*

And that business has continued to grow. We are having -- we are on track for our best year yet.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Thank you very much.

Operator

Steve Halper, FBR.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

As you sign HealtheIntent contracts, what percentage is on a PMPM basis versus a traditional software model?

Mike Nill - *Cerner Corporation - EVP, COO*

Steve, right now 100% of those are being signed on a PMPM basis. Once again, a lot of them are smaller pilots, but we want to introduce that payment model and I think -- because the advantage to us from that model is as they expand PMPM for the applications they have signed up for, as they expand applications and they expand members, the PMPM naturally grows that revenue stream, so that's why we go to market that way.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

And do the clients ask for traditional software model or is it just not an option?

Zane Burke - *Cerner Corporation - President*

This is Zane, Steve. What you'll see is once you educate people through the difference and what they need over time, because the content is ever changing, the hosted element of it, it's a true cloud-based platform, so it's not -- it doesn't have the same characteristics as their former models have had, so -- and most of our clients are getting comfortable with that type of model for cloud-based offerings.

Marc Naughton - *Cerner Corporation - EVP, CFO*

And much of the revenue they are expecting to generate or be helped by the system, they're getting paid in some form or fashion based on the number. So, aligning the payments to their revenue stream is pretty logical to them.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

All right, so as you sign more -- last question, as you sign more of these contracts on a PMPM basis, at what point do you start disclosing them? At what point do they become significant, at least in the business-model view that you would provide once a year? Do you have a timeframe for that?

Zane Burke - *Cerner Corporation - President*

Steve, I don't have a timeframe in my head. I think when it becomes a big enough number that it makes a difference from the analysis, but once again, because of the size of most of these deals, we haven't reached there and I don't know that I can give you a date by which we will reach that. But certainly when it becomes something that is notable, and the likelihood is when it gets to a level where it becomes notable, it is going to be on a fairly high-growth trajectory.

Marc Naughton - *Cerner Corporation - EVP, CFO*

And just for a little color, we did have two deals that were actually in our significant bookings that -- so if you look at those contracts, over $5 million. We had two population health deals which were over the $5 million mark, so we are seeing some increase in the size of those opportunities as well.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

(multiple speakers). So you calculate some sort of -- I guess you have a time-based contract and you calculate the PMPM off of the full length of the contract?

Marc Naughton - *Cerner Corporation - EVP, CFO*

Their committed per member per month.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

Over, however, whatever timeframe, right, whether it be five, seven, or 10 years?

Marc Naughton - *Cerner Corporation - EVP, CFO*

The term of their agreement, which is typically a three- to five-year agreement.

Steve Halper - *FBR Capital Markets & Co. - Analyst*

Got it. Okay, that's helpful. Thank you very much.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Good afternoon and thanks for taking the question. I guess, Zane, if we talk about the health services base, typically in M&A in this space you see it, it accelerates the go-forward decision-making process. What percentage of the health services base do you think has made a go-forward platform decision and what has the retention there looked like?

Zane Burke - *Cerner Corporation - President*

George, I don't have the exact numbers handy in terms of as it relates to the exact numbers that have made a go-forward decision, so I'll have to provide that to you later.

As it relates to the win rates, I can tell you that we modeled out as part of the acquisition where we anticipated those -- what our win rates would look like, and those have mirrored what our expectations have been almost exactly in terms of where we thought we would end up, both in the small end of the spectrum to the larger end of the spectrum, so our win rate has been actually quite high in the low end and then in the larger upper end, it has been -- it is a little bit north of our traditional win rate.

George Hill - *Deutsche Bank - Analyst*

Okay, and then, Marc, I guess my quick follow-up would be it sounds like the retention has been in line with expectations. But we know that there has been some churn. I guess, can you talk me through the synergy delivery and have the synergies on the deal thus far been delivered, or has some of the churn in the client base eaten away at some of the synergy opportunity? And I guess just trying to think about returns on the deal and whether or not the deal is measuring up to expectations?

Marc Naughton - *Cerner Corporation - EVP, CFO*

Sure. Keep in mind that certainly when we bought them and closed, there were already a small group of clients that had decided and notified Siemens that they were leaving the fold. Every one of those is still writing me their monthly check or owes me their monthly check for the contract duration, which can extend from anywhere from three to five more years.

So the impact of a client making the decision to leave actually tails off -- has a very long tail to it. So from our business-model perspective and certainly in the nearer term that we've been working through, the synergies primarily, as we talked about, were cost related and I think we have done a very good job of delivering on those cost synergies.

So, I think overall if you look at the bottom line of HS, we are ahead relative to an OE, slightly ahead of where we would have modeled ourselves. I think we are slightly ahead of where we would have expected from a retention standpoint. So, to date, we are actually very pleased at how it is modeling out and how these clients are starting to really get into the Cerner mode and see us as their provider, moving their allegiance over from the HS folks. So, to date, things are working very well.

George Hill - *Deutsche Bank - Analyst*

Okay, I appreciate the color. Thank you.

Operator

Jamie Stockton, Wells Fargo.

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

Thanks for taking my question. I guess maybe, Marc, on the support and maintenance line, I know you said mid single-digit growth or somewhere thereabouts the rest of the year. It is a little bit of a slowdown. Is this just the law of large numbers or is there any change in the way you are signing contracts that would be creating any headwind for that line?

Marc Naughton - *Cerner Corporation - EVP, CFO*

No, there is no change in how we bill or how we sign contracts relative to support and maintenance. The HS acquisition obviously came in, brought a big bolus of support dollars there that came in Q2 a year ago. Those dollars were a little bit higher, they were a little bit lower in Q3, and then evened out as we rolled forward. So, that's -- when you look at this quarter, there is a little bit of a lower percent increase.

But based on the size and the law of large numbers, and basically as we continue to turn on projects at our normal pace, you're going to look at as that number gets large somewhere in mid single-digits growth on that line.

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

Okay. And then maybe just as far as the guidance is concerned, if I take what you have done year to date and I back out what your guidance is for 3Q, there is a decent step up in the fourth quarter to get to the midpoint of the annual revenue guidance. Is there anything notable that would be occurring in the fourth quarter that would get us to that number, like an unusually strong hardware quarter or anything like that that we should be keeping in mind?

Marc Naughton - *Cerner Corporation - EVP, CFO*

No, there's nothing from a hardware perspective. I am past the time when I am counting on hardware to deliver anything to my topline.

No, that's just the strength of the business, a little bit of Q4 impact. We are getting into a time when you are seeing a little more of the cyclical nature of the business where we had a traditional strong Q4. I think as we look at the backlog, as we do all the analysis that we do from our forecast meetings and forecast not only the next quarter, but obviously three more quarters out, Q4 is just lining up to be a good, solid quarter with nothing unique driving that revenue increase. It is just the business and driving the revenue out of the backlog.

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

Okay, that's great. Thank you.

Operator

Jeff Garro, William Blair & Company.

Jeff Garro - *William Blair & Company - Analyst*

Good afternoon, guys, and thanks for taking the question. Maybe to follow up on Jamie's question a little bit there, and, Marc, you seemed to allude to this a little bit already, but curious whether we will return to the traditional seasonality of the business here in Q4, and really specifically in terms of bookings.

Marc Naughton - *Cerner Corporation - EVP, CFO*

I think as we look at Q4, some of the seasonality we see on the income side. You'll see -- certainly, we expect Q4 to be traditionally a little bit stronger bookings quarter. I think Q3, our guidance is that we are going to actually have a really good bookings quarter. It is just against the comp that went up 44% in the year-ago quarter.

So, I think we are -- once again, we don't talk about bookings outside of the oncoming quarter, but we are very comfortable that for the full year we would expect to grow bookings. And so, obviously, to do that we would expect to have a pretty decent Q4.

Jeff Garro - *William Blair & Company - Analyst*

Fair enough. One more for me. We're coming up on almost a year of the announcement of the population health win from an Epic customer, Geisinger Health. So I am curious if that win has led to further conversations with Epic customers about the HealtheIntent platform and if they are to the decision-making point yet.

Zane Burke - *Cerner Corporation - President*

So this is Zane. We have actually had a number of Epic clients that have made HealtheIntent decisions and signed contracts, and we just have not disclosed those separately from that, so we do continue to see that trend. We have a number of opportunities in our pipeline that we continue to work and the success with our clients -- with our pop health clients in that space is garnering a lot of interest in that client base.

Jeff Garro - *William Blair & Company - Analyst*

Great. Thanks for taking the questions, guys.

Operator

Sandy Draper, SunTrust.

Sandy Draper - *SunTrust Robinson Humphrey - Analyst*

Thanks very much. Zane, maybe a follow-up to your comment about -- I think you said all of the people that are purchasing the Cerner Millennium platform on the clinicals are now -- are also purchasing the Revenue Cycle product. I am just curious if you can give us any either qualitative or quantitative numbers in terms of over the last couple years how that has trended, and then how many have actually implemented versus [to-be] implemented and how many are going Big Bang? Are they doing clinicals and they wait a couple of years and then they come back to the Revenue Cycle?

Marc Naughton - *Cerner Corporation - EVP, CFO*

This is Marc. Just to set the stage, while people -- Revenue Cycle is very active, about 25% of our base has Revenue Cycle, so while it has been very active recently, it is still a very low level of penetration into our base, so that's just from a perspective. While we are doing really well, we still have a lot of runway left.

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Zane Burke - *Cerner Corporation - President*

So Marc is referring to our installed base overall, which -- but most -- I think what you had seen over the last couple of years has been an integrated Revenue Cycle, clinical and Revenue Cycle decisions, and that number has continue to inch up, where this quarter was 100% of them selecting Revenue Cycle as part of that.

And the -- from an implementation perspective, we are into the thousands of ambulatory providers and we are into the hundreds of Cerner Millennium sites, so lots of scale across different sizes of organizations, so from small to extremely large organizations running Cerner Revenue Cycle across that, and that has helped with the credibility of the solution side as we move forward.

As it relates to individual projects, those really come down to the individual client situation themselves. Many are Big Bang model, so I would say half of those are Big Bang, and I would say the other half, they have some phased approach based on what their risk tolerance is, what the sunset solutions are that they are facing, and what the key criterias that they are looking at operationally to solve. So, those come down to an individual client base decision.

Sandy Draper - *SunTrust Robinson Humphrey - Analyst*

Great, that's really helpful. And then, maybe just one quick follow-up for Marc on -- could you just give the -- I missed the amortization of cap software and capitalized software numbers, if you can just give those again? Thanks.

Marc Naughton - *Cerner Corporation - EVP, CFO*

Okay, let me -- . I tell you what, Sandy. Let me give you a call and we will get to that (multiple speakers)

Sandy Draper - *SunTrust Robinson Humphrey - Analyst*

That's fine. I can just follow up with Allan or email Allan or you. Thanks.

Zane Burke - *Cerner Corporation - President*

Okay. Why don't we take one more question?

Operator

Richard Close, Canaccord Genuity.

Richard Close - *Canaccord Genuity - Analyst*

Great, thank you for slipping me in. Just a clarification on the population deals -- population health deals over $5 million. Just wanted to make sure that those are only population health. Is that correct?

Marc Naughton - *Cerner Corporation - EVP, CFO*

That's correct.

Richard Close - *Canaccord Genuity - Analyst*

Okay. And second, my second question is talking about all-time highs pipeline. Is there anything with respect to the conversion of the pipeline into bookings that we should take into consideration? Any changes in the current marketplace that maybe leads to faster conversion or slower conversion, things such as consolidation in the marketplace or regulations or election?

Marc Naughton - *Cerner Corporation - EVP, CFO*

Individually, there can -- all those kinds of things can impact any individual deal, but at the macro level, from a pipeline perspective, we are not seeing any variance in our conversion rate as we progress through the stages of the pipeline.

But as can happen with any individual particular deal, there can be a number of circumstances that impact that individual situation. But from a macro perspective, the trend lines have stayed the same on the conversion time.

Richard Close - *Canaccord Genuity - Analyst*

Okay, thank you.

Marc Naughton - *Cerner Corporation - EVP, CFO*

Thank you. I appreciate everyone's time this afternoon. We are very pleased with our results for the quarter. It was nice to deliver on all cylinders, and we look forward to talking with you next quarter. Goodbye.

Operator

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