Cerner Corporation
Third Quarter 2016
Earnings Conference Call
November 1, 2016

Moderator

Welcome to Cerner Corporation's third quarter 2016 conference call. Today's date is November 1, 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 client achievements. Actual results may differ materially from those indicated by the forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements may be found under Item 1A in Cerner's Form 10-K together with the Company's other filings. A reconciliation of non-GAAP financial measures discussed in this earnings call can be found in the Company's earnings release, which was furnished to the SEC today and posted on the investor section of Cerner.com.

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

Marc Naughton

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

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

Now I will turn to our results. While solid overall, our results included bookings and revenue slightly below our guidance range and earnings at the low-end of our range.

Bookings, Backlog and Revenue

Starting with bookings, our bookings revenue in Q3 was $1.434 billion, which reflects a 10% decrease from a very difficult comparable in Q315, when bookings were an all-time high and had grown 44% over the prior year. Relative to our guidance, bookings were $16 million below the low-end of our range, but Q3 was still our second highest bookings quarter ever.

Our revenue backlog ended the quarter at $15.471 billion, which is up 11% from $13.876 billion a year ago.

Revenue in the quarter was $1.185 billion, which is up 5% over Q315 but $15 million below the low-end of our guidance range of $1.2 to $1.275 billion. The revenue shortfall was mainly in System Sales and was a result of lower-than-expected technology resale and software bookings for the quarter. The revenue composition for Q3 was $301 million in System Sales, $253 million in Support and Maintenance, $608 million in Services, and $22 million in Reimbursed Travel.

System sales revenue for the quarter was down 7% compared to Q315, with technology resale declining 21 percent and licensed software declining 12 percent, partially offset by 10% growth in subscriptions. System sales margin percent increased 150 basis points year-over-year to 69%, reflecting lower technology resale mix as well as lower commissions.

Moving to Services, total Services revenue, including professional and managed services, was up 13% compared to Q315. This is in-line with our expectations and continues to reflect good execution by our services organizations.

Support and Maintenance revenue increased 3% over Q315, slightly below our expectation of mid-single-digit growth due mostly to lower equipment maintenance revenue related to our lower technology resale.

Looking at revenue by geographic segment, domestic revenue increased 6% over the year-ago quarter to $1.06 billion and non-U.S. revenue was flat year-over-year at $130 million.

Moving to gross margin. Our gross margin for Q3 was 84.6% which is up from 83.1% in Q315, due mostly to the lower mix of technology resale and better services margins versus the year-ago period.

Earnings

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

Operating Expense

Looking at operating spending, our third quarter GAAP operating expenses were $759 million compared to $722 million in the year-ago period.

Adjusted operating expenses were $713 million, which is up 8% compared to Q315. This growth was primarily driven by growth in personnel expense related to revenue generating associates, which is reflected in the Sales & Client Service expense line that increased 11%. Software development increased 3%, G&A was basically flat, and Amortization of Acquisition-related Intangibles was down 30%, but this represents only a $1 million dollar decline from $3 million to $2 million as this line excludes Health Services acquisition-related amortization in the non-GAAP view.

Operating Margins

Moving to operating margins. Our Q3 GAAP operating margin was 20.4% compared to 19.1% in the year-ago period. Our Adjusted Operating Margin was 24.4% in Q3, which is essentially flat to 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 plus basis points annually after 2016.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q3 were $170 million, or 49 cents per diluted share. Adjusted Net Earnings were $203 million and Adjusted Diluted EPS was 59 cents, which is up 9% compared to Q315.

The Q3 tax rate was 30%, which is slightly below our expected rate. The benefit of this was largely offset by a $3.7 million write-off of a venture capital investment that is reflected in the other income line.

Voluntary Separation Program

Now I'd like to preview an expense we expect to incur in Q4. We recently offered a new voluntary separation plan, or VSP, to eligible associates. Similar to our program in February of last year, the VSP was made available to U.S. associates who meet a minimum level of combined age and tenure. The irrevocable acceptance period for most associates electing to participate in the VSP ends in December. Based on the number of eligible associates, and our estimate of participation, we expect the corresponding pre-tax charge in the fourth quarter of 2016 to be approximately $30 million.

Similar to our last VSP, we believe we will be able to fill many of the positions vacated by participating associates with existing associates, which should create efficiencies in the future while also creating career growth opportunities for our associates.

This completely voluntary program will have a very small impact on our total headcount as the number of eligible associates we expect to accept the offer represents less than 2% of our total associates. Also, this should not be viewed as a layoff or a sign we don't expect to grow. We've grown our headcount by over 2,000 people this year and expect to grow headcount next year as well.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q3 with $837 million of total cash and investments, which is up from $720 million in Q2. We did not repurchase stock during the quarter, which means $100 million still remains available for repurchase under the stock repurchase program authorized in March of this year.

Moving to debt, our total debt, including capital lease obligations, is $573 million, which is down slightly compared to Q2.

Total receivables ended the quarter at $985 million, which is essentially flat to Q2. Our Q3 DSO was 76 days, which is down 9 days from 85 in the year-ago period.

Operating cash flow for the quarter was $240 million, down from $272M in Q315. Year-to-date operating cash flow of $822 million still reflects strong growth over the $594 million of operating cash flow through the first three quarters of last year. We also expect strong Q4 cash flow.

Q3 capital expenditures were $110 million, and capitalized software was $74 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $56 million for the quarter. This is flat compared to Q2 and down compared to Q315. Year-to-date free cash flow of $266 million is nearly double the $134 million generated in the first three quarters of last year.

Next year, we continue to expect a decline in capital expenditures, which we expect to drive stronger free cash flow.

Guidance

Now I'll go through guidance.

- We expect revenue in Q4 to be between $1.225 and $1.3 billion, with the midpoint reflecting growth of 7% over Q415. Our guidance reflects our expectation that system sales will increase sequentially compared to Q3, but will still be below our original target for the quarter due to lower expected software and hardware.

- We expect Q4 Adjusted Diluted EPS to be 60 to 62 cents per share, which is below our original expectations due to the impact of the lower system sales. The midpoint of this range is flat compared to Q415, but recall we had a 3 cent tax benefit last year.

- Moving to bookings guidance, we expect bookings revenue in Q4 of $1.425 billion to $1.575 billion. The midpoint reflects 11% growth over Q415.

When added to year-to-date actuals, the midpoint of our Q4 guidance implies the following expected full-year 2016 results:

- Revenue of $4.8 billion compared to a guidance range of $4.9 to $5.0 billion.

- Adjusted Diluted EPS of $2.31 compared to guidance of $2.30 to $2.40; and

- Bookings of $5.5 billion compared to our stated target of exceeding 2015 bookings of $5.4 billion.

When compared to the guidance we provided a year ago, revenue is the only key metric projected to be below our previously guided range. Recall that I shared at our investor day in March that approximately 79% of the $5 billion midpoint of our original revenue guidance was scheduled to come out of backlog that existed at the beginning of 2016. This means that we expected about $4 billion of revenue to come from backlog that existed at the beginning of the year and the remaining $1 billion to come from current year bookings. So far this year, our conversion of backlog has been almost right at targeted levels and we expect that to continue. Where we have missed has been on contribution of bookings to current year revenue, which is reflected in the lower system sales. Fortunately, much more of this miss has been due to hardware than software, which is the main reason we still expect to be in our full-year adjusted diluted EPS guidance range.

Also, while below our initial range, our 2016 revenue is still expected to be 8-9% higher than 2015, which was a very tough comparable as it had grown 30% over 2014.

Now I'd like to provide initial expectations for 2017. We will provide more formal guidance after we report Q4 results and finalize our 2017 plan, but based on the initial version of our plan we currently expect:

- 2017 revenue between $5.2 and $5.45 billion, reflecting 11% growth at the midpoint; and
- 2017 Adjusted Diluted EPS between $2.50 and $2.70, reflecting 13% growth at the midpoint.

Current consensus estimates for both revenue and adjusted diluted EPS are at the high-end of these guidance ranges, largely reflecting the fact that consensus was formed before our Q3 results and Q4 guidance.

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

Zane Burke

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

Results/Marketplace

I'll start with bookings. While our Q3 bookings were slightly below our guidance range, it was still the second highest level of bookings in our history—second only to Q315. In addition, we expect to return to strong bookings growth in Q4.

Looking at mix, 34% of bookings in the quarter were from long-term contracts, reflecting one new ITWorks client and strong managed services bookings. This is in a more normal range for long-term bookings, but our year-to-date mix is still lower than normal because of lower long-term bookings in the first half of the year.

Bookings this quarter included several large contracts, with 35 contracts over $5 million, including 26 over $10 million.

From a new client perspective, 34% of bookings this quarter came from outside our core *Millennium*® installed base. This high level of new business reflects our ongoing competitiveness and good market activity. Looking ahead, we continue to believe the replacement market will remain active given the high number of hospitals on legacy platforms, some that are being sunset, while yet others are preparing for future regulatory and payment models that many legacy platforms are not well equipped to handle. As we have previously discussed, the timing of these contracts is proving to be less predictable, which I will discuss more in a minute.

Revenue Cycle

First, I'll provide some more highlights on the quarter. I'll start with revenue cycle, which continues to be a strong contributor to our results. The market remains very focused on clinically-driven revenue cycle, which is driving strong sales into our base as well as inclusion in new EHR deals. We also had good contribution from RevWorks services in the quarter with an expansion of an existing relationship and good contribution from our acute and ambulatory revenue cycle service offerings.

Our competitiveness in revenue cycle continues to improve across both acute and ambulatory, and this is reflected in the fact that we have displaced more than 10 different competitors so far this year.

Looking ahead, we remain optimistic that revenue cycle will continue to be a strong contributor to our growth. We still have significant white space on solution penetration and opportunities for our consulting services remains high.

Population Health

Now I'll shift to population health, where we continue to do very well. Our comprehensive approach to population health remains differentiated in the marketplace. The power of our platform and ability to integrate with the EHR workflow remain key differentiators, but we also continue to strengthen our competitiveness against the niche competitors we face across different categories, such as Registries, Enterprise Data Warehouse, Analytics and Care Management.

We are very pleased with our overall progress in population health. Just two and a half years after our first HealtheIntent solution went live, we have now sold solutions to over 100 clients, and the HealtheIntent platform has over 300 data connections from more than 80 unique sources.

As we've discussed, the scope of many initial population health contracts is small because most clients are not yet at risk for large portions of their populations. But, we expect that ongoing shifts in reimbursement will lead to broader risk assumption, which should lead to adoption of more solutions and more lives being managed on a per-member-per month model. Additionally, we are discovering through the use of our solutions that the access to more data will enhance our clients' fee for service models.

Also, our addressable market for population health goes beyond our traditional EHR clients to include ACO's, health plans, governments, and employers. In addition, the opportunity goes beyond modules on the HealtheIntent platform as there is a significant market to provide high-value services that complement our solution offerings. Mike will discuss an example of where we are doing this.

Ambulatory/CommunityWorks

Moving to the ambulatory market, where we had another very good quarter. This quarter again included multiple competitive displacements and strong contributions from ambulatory EHR, practice management, and business office services.

A noteworthy ambulatory win during the quarter was being selected to replace our primary cloud-based competitor for ambulatory EHR and business office services at a large investor-owned IDN that we believe is their largest client. We signed for one market in Q3 and anticipate expanding into other markets in the future. This was one of three displacements of this competitor in the quarter.

We also had a good quarter in the small hospital market. Our competitiveness in this market remains strong and we are having success against all competitors. In Q3, we added 8 community hospitals, with head-to-head wins against five different competitors.

Non-U.S.

Outside of the U.S., our revenue was flat year-over-year. Non-U.S. revenue represents about 11% of our total revenue, so the flat revenue in the quarter didn't really impact our total results. Despite some current macro headwinds, we do expect the non-U.S. market to become a more meaningful contributor to our results over the long-term given the relatively untapped EHR solution and services market. We also believe there will be a large market for our population health platform outside the U.S.

Marketplace / Closing

Now I'd like to provide some perspective on our results and observations on the marketplace. Despite what was in most ways a solid quarter, we are always disappointed when we don't deliver against the guidance range we established, so I'd like comment about what I think are some of the elements contributing to results being somewhat less predictable. While our pipeline has continued to increase this year and is at record levels, we are in a period where the timing of closing opportunities has been more challenging.

In the EHR replacement market, there continues to be a significant number of replacement opportunities, and we continue to win a majority of them. However, the reduced number of hard deadlines tied to regulatory mandates has impacted the client's sense of urgency. As I indicated, I believe this is primarily a timing issue as deals in our forecast are changing from a calendar perspective, but not being lost.

We have also had less contribution from our ITWorks and RevWorks businesses this year despite a strong pipeline of opportunities. These opportunities remain, and I believe we'll see much stronger contributions from these businesses in 2017.

Overall, I feel good about our ability to grow bookings in 2017 given the pipeline for larger Works contracts, ongoing EHR replacement opportunities, and an expected continuation of the ramp in contributions from population health. And as Marc discussed, our initial view of 2017 reflects good top- and bottom-line growth.

In summary, while our results were slightly below our guidance range for revenue and bookings, I still view our results as solid and, with a strong pipeline in place, believe we remain well positioned for growth going forward.

With that I will turn the call over to Mike.

Mike Nill

Thanks Zane. Good afternoon everyone. Today I am going to discuss *ITWorks* and Cerner's collaboration with a large employer and leading health system.

ITWorks

I'll start with *ITWorks*. We had a good quarter with one new *ITWorks* client and strong sales back into our client base.

Our new client in the quarter was a community hospital that also has six clinics. Like most of our ITWorks clients, they added additional solutions to their roadmap as part of their agreement. In this case, they will be adding critical care, oncology, and cardiology solutions. In addition, they are adding HealtheIntent population health solutions.

As Zane mentioned, we have had less ITWorks activity so far this year than we expected, but our pipeline remains strong and includes some clients that are much larger than any of our existing ITWorks clients, which is why we are confident about growth in ITWorks bookings in 2017. The value proposition to our clients remains 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.

Employer/Provider Collaboration

Now, I'd like to discuss a new partnership between Cerner, a large employer and Memorial Hermann. Together, the three of us have collaborated to create a high-performance health network for employers.

Employers are looking for strategies to improve quality, cost and experience. Leading health systems are creating, and looking to grow, their insurance offerings. As this emerging market takes shape, Cerner is investing in new capabilities to address this market opportunity. We think the chance to positively disrupt, and drive revenue, is compelling.

Cerner and Houston-based Memorial Hermann have a long history of collaboration and innovation. In addition to broad adoption of Cerner Millennium solutions, they were an early adopter of our initial *HealtheIntent* population health solutions and have been steadily adopting more solutions and replacing niche suppliers over the past three years. This has contributed to their success at running one of one of the largest, best-performing ACOs in the country.

Memorial Hermann also has its own health plan built around their vast provider network in Houston. Within their plan, they have created a custom, fully-insured product for a Fortune 500 employer. As part of the overall approach, Cerner is providing a concierge member service that will be tightly integrated into the health plan and health system helping members maximize their benefits. We are also providing the technology for the consumer engagement platform, which brings disparate patient and member portals into an organized, consolidated experience.

As you know, we have administered our own health plan for the past decade, which has allowed us to reduce the growth in our health care cost while also leading to better health of our associates. By leveraging this experience and partnering with an innovative world-class provider like Memorial Hermann and a large forward-thinking employer, we are building an approach to value-based care that can be a model for other markets.

We believe large health systems are uniquely positioned to play a key role in helping employers move towards value-based care. By offering high-performance networks comprised of high-quality doctors, they can provide plans that help employers bend the cost curve while also providing a better overall experience and improving the health of their workforce.

We look forward to sharing more about this collaboration as we move through open enrollment and launch this offering, and then expand these capabilities to other leading health systems, employers and markets.

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