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CERN - Q2 2019 Cerner Corp Earnings Call

EVENT DATE/TIME: JULY 24, 2019 / 8:30PM GMT

OVERVIEW:

Co. reported 2Q19 revenue of $1.431b, GAAP net earnings of $127m and GAAP diluted EPS of $0.39. Expects 2019 revenue to be $5.65-5.85b and adjusted diluted EPS to be $2.64-2.72. Expects 3Q19 revenue to be $1.405-1.455b and adjusted diluted EPS to be $0.65-0.67.

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PRESENTATION

Operator

Welcome to Cerner Corporation Second Quarter 2019 Conference Call. Today's date is July 24, 2019, 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; bookings; new solution, services and offering development; capital allocation plans; cost optimization and business simplification initiatives; and future business outlook, including new markets or prospects for the company's solutions and services. Actual results may differ materially from those indicated by the forward-looking statements.

Please see Cerner's earnings release, which was furnished to the SEC today and posted on the Investors section of cerner.com and other filings with the SEC for information on the most significant factors that could cause actual results to differ materially from those in the forward-looking statements. Additionally, a reconciliation of non-GAAP financial measures discussed in this earnings call can also be found in the company's earnings release available on cerner.com. Cerner assumes no obligation to update any forward-looking statements or information except as required by law.

At this time, I'd like to turn the call over to Brent Shafer, Chairman and CEO of Cerner Corporation.

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

Thank you, Daniel. Good afternoon, everyone, and welcome to the call. I'll spend the first few minutes providing some thoughts and commentary on the business, then ask our CFO, Marc Naughton, to take you through the financial results. When Marc concludes, Chief Client Officer John Peterzalek will provide some marketplace commentary. And finally, I've asked Don Trigg, our EVP of Strategic Growth, to talk about Cerner's growth strategies in adjacent markets.

Today, I'd like to share some thoughts on the early stages of Cerner's transformation. Internally, we're referring it as Cerner. Next, a term that signifies to our associates that the future is now. We spent the past 4 decades inventing, building, implementing and operating EHRs for our clients around the world. Over that time, Cerner has helped digitize nearly 50% of health care in the United States and, in the near term, secured the 2 largest contracts in the history of health care IT.

The next chapter for Cerner involves helping our clients drive a higher order of benefits from the digitized platforms that have been created. Our clients are focused on rising health care costs, industry consolidation, payment reform, pushing toward risk, the heightened impact of consumerism and the emerging role of artificial intelligence and machine learning.

Cerner's in the enviable position of being able to address all of these issues with evolving, knowledge-driven platforms that can impact the moment of decision for clinicians through financial and clinical analytics driven by high-quality curated data. This position is hard to replicate, and we recognize our strategies and actions must leverage this foundational market position.

Going forward, we will be recalibrating the company around our new operating model, a series of transformative actions to drive efficiencies and strategies that we believe will drive long-term growth and profitability. Since introducing our new operating model earlier this year, we've made considerable progress in realigning the company in a more client-centric manner. Additionally, we've identified and will be implementing cost optimization and business simplification initiatives that we expect to drive greater business efficiencies. Marc will provide an update on these initiatives in his remarks, but we expect these process improvements to deliver the operating margin targets we established for Q4 '19 and Q4 '20.

As we embrace the macro trends affecting health care and our market position, we've refined our strategic framework around 3 key areas that will guide our direction over the next several years. First, Cerner expects to deliver THE Software as a Service platform for health care. A modernized Millennium platform utilizing SaaS approach should help drive speedier adoption of advanced features and innovations for our clients and significantly greater user satisfaction. This platform can fuel an even higher level of digital disruption and enhance the ability to drive collaboration with third parties.

Second, we plan on being the PREMIER strategic health care partner as Cerner pursues adjacent markets outside the traditional hospital environment. We all recognize that health care is changing in profound ways. The convergence of political, economic, demographic and technological factors are leading to new venues and models of care. As pressure mounts to deliver value-based care, providers are increasingly building network strategies to enhance contracting power, improve patient retention and manage risks more predictably. These require robust, next-generation intelligence and analytical capabilities that Cerner is well positioned to provide.

Third, we expect to be THE acknowledged and reliant source for curated health data. We have a rich history of aggregating, normalizing and disseminating patient data. As the acknowledged data source, we plan to develop a monetizable distribution model that provides access to legacy client segments and adjacent market prospects such as biopharma, payers and actuaries, to name a few. This "big data" strategy could be the key for new drug discoveries and the foundation for other use cases outside of the traditional health care space. We believe Cerner's approach to curated data will provide significant value to clients. Don will speak more on this topic, including sharing news of a new senior leader dedicated to the strategy.

These strategies coupled with our work to streamline the business underpin our long-term growth and profitability. We believe these strategies are well aligned with the needs of our clients and will increase our ability to create value for them.

I'd also like to commend our Cerner associates. We have an incredible talent pool and I believe the right culture to drive the transformation process and deliver the next chapter of Cerner's growth.

As it relates to financial results, I'm pleased with our second quarter results and now ask Marc to provide a more comprehensive commentary on the numbers. Marc?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Thank you, Brent. Good afternoon, everyone. I'm going to cover our Q2 results and future guidance.

This quarter, we delivered solid bookings, revenue and earnings.

I'll start with bookings, which were $1.432 billion in Q2 and near the high end of our guidance range. This is down from Q2 '18 bookings of $1.775 billion primarily due to a decline in long-term bookings, which we previewed last quarter. In addition, Q2 of '18 included the initial VA task orders, making it a tough comparable.

We ended the quarter with revenue backlog of $14.98 billion, which is up 1% over a year ago. Recall that our backlog calculation under the new revenue standard excludes revenue from contracts with termination clauses, even though such clauses are rarely exercised. When you combine the expected revenue from our backlog and the additional revenue expected from contracts not included in backlog, our revenue visibility remains at approximately 85% over the next 12 months.

Revenue in the quarter was $1.431 billion, up 5% over Q2 of '18 and in line with our expectations.

I'll now go through the business model detail and year-over-year growth compared to Q2 of '18.

Licensed Software revenue in Q2 was $197 million, up 14% over Q2 of '18, driven by strong bookings and good growth in both SaaS offerings and traditional software.

Tech Resale of $61 million decreased 19% compared to Q2 of '18, which was the strongest quarter of last year, and up 9% sequentially over Q1.

Subscriptions revenue grew 8% to $90 million. Professional Services revenue grew 8% to $485 million primarily driven by solid growth in implementation services.

Managed Services increased 4% to $298 million.

Support and Maintenance was basically flat, which is in line with our expectations.

And finally, Reimbursed Travel was down 5% from Q2 of '18 and potentially flat sequentially at $24 million.

Looking at revenue by geographic segment. Domestic revenue was up 5% from the year-ago quarter at $1.266 billion, and international revenue of $165 million was flat year-over-year. Note that similar to last quarter, our non-U.S. revenue growth was impacted by foreign currency rates and would have been mid-single-digit on a constant currency basis.

Moving to gross margin. Our gross margin for Q2 is 81.2%, down from 81.8% in Q1 of '19 and 82.5% year-over-year, driven by higher third-party services.

Now I'll 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, share-based compensation and permanent tax [items] (corrected by company after the call), acquisition-related adjustments, VSP and other organizational restructuring expenses, and other adjustments that I'll discuss in a moment and are also detailed and reconciled to GAAP in our earnings release.

Looking at operating spending. Our second quarter GAAP operating expenses of $1.031 billion were up 12% compared to $921 million in the year-ago period. In addition to the previously mentioned items, our GAAP expenses included a $7 million settlement with a former vendor and $20 million charge related to a client dispute that had been excluded from our adjusted results. Note that we also had a $16 million nonoperating gain related to the sale of our equity investment in the former vendor that was also excluded from our adjusted results.

Our adjusted operating expenses were up 4% compared to Q2 of '18.

Looking at the line items for Q2. Sales and client service expense increased 4% year-over-year, primarily driven by the increase in personnel expense related to our services businesses. Software development expenses increased 9% over Q2 of '18 driven by a 5% increase in gross R&D, a 7% increase in amortization and flat capitalized software. GA expense was down 8% driven in part by lower personnel expense. Amortization of acquisition-related intangibles decreased slightly year-over-year.

Moving to operating margins. Our GAAP operating margin in Q2 was 9.2% compared to 15.2% in the year-ago period. Our adjusted operating margin for the quarter was 18.0%, down from 18.7% in Q2 of '18 but up from 17.5% last quarter and in line with our expectations. Our guidance for Q3 reflects flat margins compared to Q2 due to normal seasonality of revenue mix in Q3 and the fact that most of our initial cost-optimization efforts won't have a meaningful impact until Q4. We believe we remain on track to deliver our targeted 20% adjusted operating margin in Q4 as our forecasted revenue mix is better, and we expect to benefit from the initial impact of our operational improvement efforts. Further, our ongoing work with AlixPartners continues to support our targeted Q4 2020 target adjusted operating margin of 22.5%.

Now I'll provide an update on our business-optimization efforts. Since our last call, we have created a detailed list of opportunities and kicked off projects to achieve our targeted cost optimization and process improvements. In total, there are 165 initiatives focused on cost optimization, portfolio and product management and business simplification. The benefits from these initiatives are expected over 3 waves with initial benefits expected in Q4 of '19, followed by a second wave of benefits by the middle of 2020 with the third wave expected to drive benefits in the second half of 2020 and beyond. We expect these initiatives to result in controlled and/or reduced expenses across all of our operating expense lines and to positively impact the profitability of all business models.

The current expected phasing aligns with both our Q4 '19 and Q4 of '20 adjusted operating margin targets, and our expectation is that these benefits and related margin expansion opportunities will extend beyond 2020 as longer-term benefits of the business simplification initiatives should have an impact into 2021 and beyond.

Finally, I'd like to share how we are approaching this from a governance standpoint. We have created a transformation management office that is led by Cerner's COO, Mike Nill; our Chief of Staff, Kimberly Gerard; and 2 leaders from AlixPartners. The transformation management office will oversee the execution of the 165 initiatives and be responsible for change management and resolving issues that arise. This includes weekly and biweekly reporting and tracking across all initiatives. Our Executive Committee and the Finance and Strategy Committee of our Board are updated regularly on the progress.

As I indicated on our last call, this will be hard work, but I am pleased by the rigor with which the executive team is embracing the effort. We believe with enhanced efficiency, better processes and improved focus we are delivering ongoing profitable growth while also accelerating value creation for our clients.

Moving to net earnings and EPS. Our GAAP net earnings in Q2 were $127 million or $0.39 per diluted share, which is down from $0.51 in Q2 of '18. Adjusted net earnings in Q2 were $215 million, and adjusted diluted EPS were $0.66 compared to $0.62 in Q2 of '18.

Our GAAP tax rate was 17.6% for the quarter. Our non-GAAP tax rate was 19%, which is 2% lower than last quarter and contributed to our EPS upside this quarter.

Moving to our balance sheet. We ended Q2 with $954 million of cash and short-term investments, which is up from $904 million last quarter. Our total debt increased by $600 million from last quarter to $1.039 billion as we took on debt to repurchase 8.7 million shares in the second quarter for $600 million at an average price of $68.91. Following the Q2 repurchases, we have $883 million of remaining authorization under the current program.

Total receivables at the end of the quarter were $1.229 billion, up from $1.159 billion in Q1 of '19. Our Q2 DSO was 78 days, which is up from 76 days in Q1 of '19 and 77 days in the year-ago period. Operating cash flow for the quarter was $207 million and was impacted by the VSP and other organizational restructuring events I mentioned earlier. Q2 capital expenditures were $159 million, and capitalized software was $70 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was negative $22 million for the quarter driven by a combination of lower operating cash flow and higher capital spending, as previewed on our last quarter call.

While we continue to expect cash flow to be impacted by organizational restructuring costs and elevated capital spending, we do expect improved operating and free cash flow for the rest of the year. We also expect operating cash flow growth and a decline in capital expenditures to lead to good free cash flow growth in 2020.

Moving to capital allocation. As I indicated, we repurchased $600 million of stock during Q2, leaving $883 million on our current authorization. We still expect to execute the majority of the repurchase authorization by the end of Q1 of next year, subject to market conditions and other factors. We intend to continue funding this with a combination of cash from operations and debt, with the amount of debt depending on the timing of our repurchases and whether we use cash for other purposes such as M&A.

Regarding our dividend program, we officially declared our first quarterly dividend during the quarter with a payment date of July 26. The Board approved a quarterly dividend at $0.18, which is up from our initial estimate of $0.15 that we provided when we first announced our intent to initiate a dividend. Our initiation of a dividend combined with our increased share repurchase activity reflects our commitment to returning capital to shareholders and our belief in Cerner's long-term potential.

Now 'll go through guidance: We expect revenue in Q3 to be between $1.405 billion and $1.455 billion. The midpoint of this range reflects growth of 7% over Q3 of '18. For the full year, we continue to expect revenue between $5.65 billion and $5.85 billion with a $5.75 billion midpoint reflecting 7% growth over 2018. We expect Q3 adjusted diluted EPS to be $0.65 to $0.67 per share. The midpoint of this range is 5% higher than Q3 of '18.

For the full year, we continue to expect adjusted diluted EPS to be between $2.64 and $2.72, which reflects 9% growth at the midpoint.

Moving to bookings guidance. We expect bookings revenue in Q3 of $1.5 billion to $1.7 billion. The midpoint of this range reflects a 1% increase compared to the third quarter of 2018, which had increased 43% over the prior third quarter.

In summary, we are pleased with our solid results in the second quarter, and we remain focused on delivering improved operating performance and creating shareholder value as we position Cerner for long-term, profitable growth.

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

John T. Peterzalek - *Cerner Corporation - Executive VP & Chief Client Officer*

Thanks, Marc. Good afternoon, everyone. Today, I'm going to cover our bookings and provide a quick update on our federal business, then turn it over to Don to discuss strategic growth.

I'll start with our bookings, which were at the high end of our guidance with solid contributions from all key areas of our business. As we projected, we had a lower level of long-term bookings compared to last year with the percent of bookings coming from long-term contracts in the quarter at 22% compared to 35% in Q2 of last year.

As we discussed last quarter, the lower level of long-term bookings is in part driven by our decision to be more selective as we consider certain low-margin, long-term contract opportunities. This does not mean we are not pursuing revenue cycle and IT services contracts, just that we are being more disciplined about the role we play in how we structure the contracts. We believe this discipline will allow us to focus on high-quality business that aligns with our emphasis on profitable growth.

Moving to new business mix. We had a solid quarter with 33% of bookings coming from outside our core Cerner Millennium installed base, including a contract with a large investor-owned health system to replace their existing EHR and revenue cycle systems at 7 hospitals, 25 clinics and 12 freestanding emergency departments.

In the federal states, our projects with the DoD and VA are both progressing as planned. For DoD, we are continuing our work on the first wave of sites beyond the Initial Operating Capability sites with go-live on track for this fall. Similarly, our work with the VA has continued as planned, and we remain on track to ramp our work on the project as we go through the remainder of this year and into next year with the initial sites still expected to go-live in 2020.

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

Donald D. Trigg - *Cerner Corporation - EVP of Strategic Growth*

Thanks, John. Good afternoon, everyone. Brent spoke at the outset about the strategic push by health systems to build out provider networks and win the ZIP Codes in which they operate. It's a core multiyear growth strategy. Solid progress was made in the second quarter to advance it.

While the macro health network trend is part of an overall shift to value, we're seeing near-term traction in areas such as out-of-network referrals that they're generating revenue today and [are preparatory] for risk contracting over time. We also are seeing buying activity around foundational network capabilities ranging from enterprise security to quality and regulatory compliance.

Enterprise security was a particular bright spot in first half of the year. Bookings exceeded $50 million, and our pipeline supports a strong second half that would reflect 30% growth year-over-year. From tap-and-go access with a persistent connected desktop to multifactor authentication for meds management, we have a clear value proposition in an area with significant trend.

Post-acute sales, which includes behavioral health, home health, long-term care and rehab, was another component of the health network with solid first half performance. The team delivered 25 discrete contracts, driving over 30% bookings growth with 70% of the signed business occurring outside of Millennium Hospital client base. Post-acute sales trends position us well on several fronts, including our naviHealth partnership focused on BPCI Advanced.

Brent also discussed our strategic ambitions to grow our curated data services assets. Our global market share, our clinical research practice and our overall platform leverage provide natural points of differentiation in a segment with a significant $60-plus billion addressable market. As part of our push into the data services space, Art Glasgow has joined Cerner within the strategic growth organization. Art not only is a former CIO of Duke University Health System, he also served as a Chief Product Officer at Optum. The early returns have been positive. We've made progress in the pharma and life sciences space, leveraging our HealtheIntent data labs assets and our collaboration with the Duke Clinical Research Institute. There also is good traction in our HealtheHistory business, which provides record retrieval for life insurance, legal and other administrative use cases. Our health network business and our investment in the data space both are part of an overall portfolio management model seeking to maximize our return on invested capital.

Another area of progress related to the portfolio management review process that Brent initiated relates to product areas where we've targeted an alterative go-to-market strategy. A near-term example of this is the agreement we recently signed with GetWellNetwork. As part of the relationship, we'll migrate Cerner clients off our inpatient patient engagement solution myStation. We also will be adding GetWell Loop to our larger Consumer Framework as we push to accelerate our consumer revenue beyond the patient portal space.

We're constantly striving to embody the same entrepreneurial spirit that we used to build the company. Our team is always impatient to go faster. I believe we made reasonable progress in the second quarter on accelerating our health network businesses, laying the foundation for a meaningful data business and advancing our efforts at company-level portfolio management.

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

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

Thanks, Don. As you heard from Marc, John and Don, we're making good progress on several fronts. We've established a rigor around our cost-optimization and process improvement efforts that I believe will not only help us deliver our near-term targeted financial results but also position us for high-quality growth going forward.

We've demonstrated good execution on our core markets, including solid booking results from our core clients and ongoing execution on our federal business, which includes the largest health care IT projects in the history of our industry. And we're making good progress at creating growth from emerging market opportunities that will be important to Cerner's long-term growth.

I'm pleased with the team's execution during the time with significant change occurring both inside and outside Cerner.

Now I'll turn the call back over to our operator, and we'll open up for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Charles Rhyee with Cowen.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Wanted to talk about your efforts in moving the data science -- sorry, data services area. And maybe can you give us a sense on time lines where -- that we can look at in terms of milestones and guideposts or when you'd be -- will expect to monetize this product more, I guess, significantly? And just maybe more color around there.

Donald D. Trigg - *Cerner Corporation - EVP of Strategic Growth*

Yes. So this is Don. So I think, as long-term followers of the stock, this is a space that we've always had an interest in if you go back to some of the original design strategies around Millennium when we talked about the opportunity to structure, store and study of the data and then pushed those insights back into the care process. This is an area of long-time interest and focus.

Secondly, I think we feel like there's a near-term opportunity for us to really build on the strategies in the life sciences and pharma space, starting with the work we did with Duke and also in the medical retrieval space, again, leveraging the strategies around de-identified data and consent-based use cases.

And then I think, finally, we're very excited about Art Glasgow joining the organization. He brings particular competency in the space, including competency as it relates to the provider network and how we think about activation or research enablement of our client base.

So I think, as I said in the script, we're cautiously optimistic about the progress we've made, and we see that a much larger potential, but we're going to continue to work on that effort in the back half of the year.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

And just a follow-up. You're sitting already on the data itself. And you mentioned earlier about the HealtheIntent lab, and obviously, a lot of capabilities. Is this something where we should expect really internal development? Or is this something where you would look externally maybe to make an acquisition to increase your capabilities in this area?

Donald D. Trigg - *Cerner Corporation - EVP of Strategic Growth*

Well, I think it's a great question. I think comprehensive strategy at the magnitude we'd want to see really enable this strategy probably is the combination of build, buy and partner, and that's certainly part of the analysis that we continue to do in the back half of the year. But I'd -- certainly won't be an exclusive build strategy, and partnership has already been a pretty significant feature of the strategy and the approach. And one of the things that we really like here as we think there is a win for not only for patients, as Brent described, but a real opportunity for us to bring together life sciences and pharma and our provider organizations in a way that allows, particularly community hospitals, the opportunity to participate in research economics in a way that hasn't historically been the case.

So there's a lot of positives here, and we've got a strong leader with some early traction in trend.

Operator

And our next question comes from Michael Cherny with Bank of America Merrill Lynch.

Michael Aaron Cherny - *BofA Merrill Lynch, Research Division - Director*

Marc, I want to dive into the comments about some of the process efficiency enhancements that you're focused on. I think you said 165 different initiatives that you're looking at. I guess how do you think about attacking them and lining them up and prioritizing them at a point where you're also going to make sure that you're not doing anything to starve the business and meaningfully impact the growth rate, the top line going forward as well?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. Michael, clearly, one of the reasons we have a 165 is we want each of these cases to be a very discreet targeted area for which we can determine what the impact on the business is going to be, both positive and if there are any positive negative impacts. So that's why we have that level of targets. The majority of these things are focused around things we've talked about, including spans and layers, portfolio management, facilities, nonpersonnel costs, process improvements, all of the things that you normally go after in these spaces. And I think we definitely have a view relative to the business and a promise among ourselves that we're not going to screw up what we think is a really good business and the opportunities we have in front of us. So we're going to deliver for our clients. We're going to deliver for the VA, the DoD, all of our clients that we have commitments with, we're going to deliver for those.

And relative to portfolio management, we're going to make decisions so that we actually choose the things we're going to really work on and deliver, ideally, things that deliver value for our clients, including the data business. And we're not going to invest in the things that don't. So I think it's going to be a well-reasoned bet.

And there's probably a little bit of angst as to so when I'm going to start to see the benefits following from this. And as we talked about, kind of Q4 is when we start seeing the benefits, and that's because we are trying to take a reasoned approach for executing in Q3 to get these things going -- to really start driving the benefits with a goal of by the time we get to Q4, we get the first phase benefits underway and we're writing them into the P&L.

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

I'd just add to that, Marc. This is Brent. I think the approach we're taking is very rigorous and very deep and is really intended to be very thoughtful so that we're not doing damage as opposed to sort of a peanut butter spread across a line item across the company, which could be -- could have the opposite effect. So it's a detailed, laborious approach, but I think it's going to yield very good results for us.

Operator

And our next question comes from Jamie Stockton with Wells Fargo.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

I guess -- and I think maybe it was in Brent's comments, and there was a comment about moving to more of a SaaS platform. And I know you guys, you have the CommunityWorks model, and then you also have a number of tools that are already web-based like HealtheIntent. Should we read into that, that maybe there's going to be a more aggressive push to migrate Millennium broadly outside of the CommunityWorks model to SaaS over the next few years? Just any color around that would be great.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Sure. This is Marc. Yes, we didn't -- don't mean to indicate that we are converting to a SaaS business model anytime in the near future. I think we see SaaS approach as a way to keep our clients current, deliver the value for what they pay for by getting them the most recent release. Our CommunityWorks example is probably the best example we have of that. But we host 80% of our clients. So to a great extent, they are used to benefits of SaaS but that they're not having to run the technology or worry about those elements. But what they're not getting is the currency and being on the current version.

So I think you will see us kind of be a more of a CommunityWorks-style model of fewer releases on a more current basis and getting our clients to that. Given our already hosted model, the economics will evolve over time. There won't be as quick cutoff or a quick move. In fact, many of the benefits of SaaS, the currency elements, we can do today even running the Millennium in our data centers as we do. So it will be an evolution, picking the better parts of the SaaS model until we've really evolved over to, basically, a pure SaaS model, but it's not going to be something that's going to happen in the near term from an economic standpoint.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

Okay. And then maybe one quick one, Marc. The bookings number, the guidance for Q3, it's a nice step-up sequentially. Should we -- and if you commented about it, I apologize if I missed it. But should we read into that, that maybe the long-term deal flow does bounce back somewhat? And then John said that you guys weren't totally walking away from those businesses. Was there anything else like VA that we should think about as notably contributing to that number?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. There isn't anything large from a government's perspective that's impacting Q3. I think John talked to we've got a very strong pipeline. We continue to see a lot of business. And I think the Q3, while the seasonality tends to impact you a little bit, the opportunities are there, and that's why you're seeing us with the numbers we talked about. Once again, we still do our rigorous forecast. We've been -- this year, we've been pretty successful in having our results align with that forecast. So we are basically forecasting what we see on the horizon, what we see on our ability to deliver. So that's the basis for the number.

I think you're still going to see some of the little bit lower level of long term. We are being selective. We are looking at those deals, making sure they meet our margin targets. And that will result in some business that we don't do. In fact, in Q2, you could look at the number that we delivered at the top end of our guidance. There were opportunities that we had to sign business that didn't meet our targets, and we did not pursue that business. So that number could have been a higher long-term percentage and over the top end of our guidance, but we understood that we weren't going to do some of those. And that's why we ended up in our guidance range, albeit at the top end.

Operator

And our next question comes from Sean Wieland from Piper Jaffray.

Sean William Wieland - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

So when you talk about being a little more selective on your long-term contracts, can you give us a sense of what you mean? Are you looking at it from just a financial perspective? Are you looking at it from a strategic perspective, a client-specific perspective? What are the criteria that you're applying there?

John T. Peterzalek - *Cerner Corporation - Executive VP & Chief Client Officer*

This is John. And we look at all those aspects that you had mentioned. So we look at it from a client perspective to make sure that we're providing a service that is highly valued to the client, which, in essence, can drive higher margins for us. We look at it from a capability component and acquisition of either talent from the client and those type of things to not only meet margin targets but to meet strategic targets as it may relate to workforce and those type of things. And then absolutely, a lens we look at it as truly the margin target. And if we can't kind of -- if we don't provide a high value to the client, a return to Cerner within the margin parameters we like and it has some strategic benefit for actually Cerner and our clients, then we question whether we want to go forward on that. And for the ones that we do, when you get all 3 of those aligned, it works for everybody. It works for our clients, and it works for Cerner.

Sean William Wieland - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

So without, of course, naming names, I mean could you give us a sense of the kind of -- or profile of an opportunity that you would say no to now that you would have said yes to prior?

John T. Peterzalek - *Cerner Corporation - Executive VP & Chief Client Officer*

I would say that if we look at some of our acquired workforce space that bringing on a client's workforce just add a little margin to us is something that we would only do in the context of a very strategic relationship, not as looking at it from a revenue perspective but truly from a revenue and margin perspective. And we think of different ways to accomplish the same thing for our client without having to bring on a component that may be low margin for us may be one example. Our ability to leverage our varying degrees of works at -- our varying locations of workforce, whether it's U.S., domestic or some of our capabilities we have outside of the U.S., those type of things will play into what we look at to create both more margin and more value for our clients.

Operator

And our next question comes from Steve Halper with Cantor Fitzgerald.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

I don't know if you're willing to disclose this number, but when you're all said and done on the -- your cost-efficiency process, how much do you plan on taking out in terms of total costs? What do you think is possible? Or is it just ongoing?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. Steve, this is Marc. We're somewhat in specific relative total because, obviously, we are right in the process of finalizing and announcing and getting our associates' pace up to speed and understanding what the impacts are going to be. But clearly, I think if you look at the numbers, you can figure that it's in excess of $200 million, and I think that's pretty clear if you just look at the economics and the -- what's necessary to get to our targets, our operating margin targets. But I think it is a matter of picking those initiatives that aren't onetime. They have to be things that have continuing benefit because once I get that savings, that savings needs to continue forever, and that's the focus we're having right now.

But I think -- so we'll provide more updates as we get further along. But I think, in general, that over $200 million at least is -- gives a ballpark that's consistent with what our guidance is. And once again, as I said in my comments, we don't expect the benefits to stop at the end of 2020. We expect them to continue to be able to harvest some of the benefits that we're going to get especially from process improvements into 2021 and beyond.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

Sure. And one other follow-up. Just on the new debt that you put on the balance sheet to facilitate share repurchase. What's the interest rate on that debt?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

It is -- it's a variable debt that we -- rate swaps, 3.06%.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

That's what you're paying right now?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. And that's what we will pay over the life of the debt because of the swap.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

Yes, with the swaps. Great. That's attractive capital.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Thank you.

Operator

And our next question comes from Eric Percher with Nephron Research.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

A process question for you. You mentioned that wave 1 this year versus wave 2 and 3 next year. Can you give us a little bit of a feel for what activities will be targeted as you progress through those waves and your thoughts on how you take on SG&A relative to R&D over time?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Sure. This is Marc. I think the reasoning for some of the ways will certainly be based on how quickly we can get to the benefits, right? Certain things such as third-party suppliers, such as T&E, those types of things, we can get to really quickly. I think the things that require process improvements, the things that require investment and tools, those types of things, those are the things that tend to be more in the wave 2 and 3. So I think that's -- they're all kind of targeted based on the ability to put in place whatever needs to happen in order to drive those benefits.

I think you'll see us certainly work very hard to look at accelerating anything that's in wave 2 or wave 3, look at ways that we can pull maybe a portion of those benefits forward because we certainly are aware that the dollars saved today are -- definitely have more value than waiting to -- for 1.5 years or whatever it is to save it. So -- but that's generally the difference between the wave 2 and wave 3, is the investment or the actions that have to be in place before we can go execute on those initiatives.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

And when you think about what Alix is doing with you internally, how do you think about what capabilities you want to build? And it sounds like the group with Mike and Kim is to internalize some of those responsibilities. How are you thinking about how the organization needs to change?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. I mean obviously, the transformation management office is key. We don't expect or want AlixPartners to be here forever, right? We want them to help us through and using their expertise on these initiatives on what they've learned over their history. But we want to set up the ability to manage change, and we want to set up the lean capabilities, all of those elements that will help our business as we go forward. I don't know that the transformation management office that certainly has an end date. I mean I think there's always going to be areas that we can benefit from those types of services, and we're creating an internal capability that can do those types of things that we really didn't have before. But we're doing that in context and working with Alix, but once their work is done, we will still have that capability and we'll be able to lever that going forward.

Operator

And our next question comes from Matthew Gillmor with Baird.

Matthew Dale Gillmor - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Maybe asking about the client base. You talked about getting clients on a current version of Millennium in some of the strategies. Can you give us some sort of sense for what portion you have classified as being on sort of newer software versions? And then what are the things you can do to encourage clients to migrate?

John T. Peterzalek - *Cerner Corporation - Executive VP & Chief Client Officer*

Yes. This is John. So as we're working through this year and going into early part of next year, we have some regulatory components that are actually driving the need to upgrade and be current. So with our most recent release, we should be -- have the vast majority of our client base on a current release by mid next year. So using the opportunity of the certified release structure that we have, that we have to follow right now with U.S.

regulations, that's a great opportunity to help our clients remain -- have a motivation to be current, remain current and stay current. So by the end of mid next year, the vast majority of our clients should be on the most current release.

Matthew Dale Gillmor - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Got it. And then one follow-up probably for Marc. The managed service revenue line, that looks like it ticked down a little sequentially in the second quarter relative to the first quarter. I guess I normally think of that line as being flat to up. Was there anything to call out either that was in this quarter or last quarter that caused that sequential decline?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

There wasn't anything material during that period. That business can have some impact based on new signings that occur depending on various elements. So in essence, it was pretty flat and like down to a few million dollars but nothing that was consequential or is creating a trend. We expect it to get back on a slight increase year-over-year -- quarter-over-quarter, year-over-year as we go.

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

This is what we're updating. Prior to going into the next question, I just want to circle back around capabilities and where we are with our processes.

As Marc was addressing this around the transformation ops, I just want to point we did announce since we talked last a new CHRO, Tracy Platt, joining us from Medtronic. Part of her charter is to really help us work through our strategic workforce planning and ensure that the capabilities in our workforce and leadership are in line with our strategy and direction and where we're going.

So it's -- I thought I was just important to tie that back. That's part of the work we are doing now. She'd just been on board a week, and we're glad to have her joining the team.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. This is Marc. I think we'll look for an opportunity to introduce Tracy to our investors because I think she's -- we certainly appreciate everything Julie Wilson did for the company in her role as leader of HR. Tracy brings a lot of skills, a lot of experience in the transformation efforts we're undergoing, including lean and all those other things that we're going to focus on. So I think bringing her in, she's also got a very business focus as well. So she wants to be a partner with the business and help us drive -- and help us understand the business. And I'm sure she's listening to the call today. So Tracy, welcome to Cerner. Next question?

Operator

Our next question comes from Jeff Garro with William Blair.

Jeffrey Robert Garro - *William Blair & Company L.L.C., Research Division - Research Analyst*

Yes. I want to ask about the strategic growth area that Brent discussed. It seems like there's a bit of a mix of both of near- and long-term opportunities there. So I was hoping you could provide a little more detail saying expectations for specific opportunities on timing of when those areas will contribute to growth.

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

I'm going to ask Don to address that. That's kind of his area. Don, do you want to...

Donald D. Trigg - *Cerner Corporation - EVP of Strategic Growth*

Yes. I'd be happy to. We spent some time and energy walking through a high-level view of some of the projections on a 5-year basis at HIMSS, really kind of laying out the core pop health business and what it would look like to have sustained 25% growth rates in that space as we work our way towards 2023. And then coupled with that, as we think about what high single-digit to a double-digit growth looks like, the need for us to think about a combination of organic, inorganic and partner-based revenue to over attain against those targets. So we haven't deviated from that kind of broad view that we put forth in Q1. As I said in my section of the script, I think we've made some good progress in several areas, and we're keen to see all of the market segments that we've identified for growth consistently begin to deliver in excess of 25% CAGRs. And that's what I'm spending time and energy with the team working on.

Jeffrey Robert Garro - *William Blair & Company L.L.C., Research Division - Research Analyst*

Great. That helps. Maybe as a follow-up to that. Thinking high level on revenue mix and those strategic areas and other growth initiatives, maybe a little bit more targeted towards higher-margin areas. So wanted to get thoughts on the evolution of the revenue mix over time and how that can impact gross margins.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. This is Marc. I mean clearly, as we move forward, I think especially as we focus on selectively pursuing certain service opportunities, that's going to help us from a mix standpoint with higher-margin services revenue compared to what we might have in the business today. Certainly, many of the things in the strategic growth area are dependent on HealtheIntent platform, which is a Software as a Service. So it has strong margins that are an integral part in what that business is going to rely on. So part of our focus is kind of replacing over time some of the traditional software with some of that SaaS-based software, especially with the HealtheIntent platform because, once again, that's not the Millennium converting to a SaaS approach and then eventually converting to a SaaS business model. HealtheIntent is a SaaS business model in many respects today and supports a lot of these businesses that we're talking about.

So from a margin perspective, all of those elements should have a positive impact on overall margins. And given that most of the costs related to driving the top line that go into the cost of goods sold are service and third-party related, that can be a positive impact to gross margin. This is certainly a positive impact to operating margins.

Donald D. Trigg - *Cerner Corporation - EVP of Strategic Growth*

Yes. And just to amplify on that. From my perspective, if you look at several of the businesses in that space which represent interesting nonprovider adjacencies for us, such as the work we're doing in the state Medicaid space specific to MMIS or the work we're doing in the employer services space, again, to Marc's good point, using HealtheIntent as the enabling technology strategy for both of those go-to-market efforts with not only a growth strategy but we also think of a margin profile that's attractive.

Operator

And our next question comes from Robert Jones with Goldman Sachs.

Robert Patrick Jones - *Goldman Sachs Group Inc., Research Division - VP*

I guess just 2 generally around margins. I guess one in the quarter, you guys saw some nice strength in the licensed software area. I'm wondering how much of that came from the 7-hospital win that you mentioned during the prepared remarks. And then just obviously related to that, margins ticked up sequentially but not that much given what seemed like pretty strong growth in that area. And then Marc, I guess just as it relates to the expectation for kind of sequential flat margins into 3Q and then a pretty healthy step-up into 4Q. I know there's a lot of areas behind that. Just wondering if you can maybe just highlight some of the specific areas, line of sight, as we think about that, what seems to be probably around the 200 basis point step-up from 3Q to 4Q.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Sure. Yes, I think from a mix element, certainly, the software in Q3 was a strong point. It was strong across various areas, including SaaS and traditional software. So it did not -- the single transaction you indicated contributed but not in a significant manner.

I think we're starting to see some of the seasonality that we used to see in the business. So you see Q2 having some strengths. You see Q4 having some strength with Q3 a little bit lighter on the software revenue. So I think that's the -- that's a little bit of what you are seeing relative to why margins look a little bit flattish as you go into Q3. Clearly, as we've talked, we're not going to start seeing the real benefits from the operating -- from the expense side and some of the optimization efforts really until Q4. And therefore, that's -- Q3, given that you're not really moving the meter on the revenue mix significantly, that's going to basically be relatively flat.

When it comes to Q4, we start to see in our forecast in our pipeline some -- once again, some strengths in the software side. We see the benefits from cost optimization. So those are the things that give us some confidence in looking at the ability to ramp up to that 20% in Q4. And I think that's -- as we go look at -- that's all within the expectation we have. Obviously, the full year numbers we've talked about are still intact, still in place. But the ramp-up is going to be stronger in Q4. But because of the seasonality and the other elements of the business, it's actually pretty logical to me that, that's a quarter we're going to go hit that.

Operator

And our next question comes from Rivka Goldwasser from Morgan Stanley.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

Yes. Marc, going back to your comments about contract, the long-term benefit that should have an impact on 2021 for margins. Do you mean that we should take in effect the 4Q '20 run rate and extrapolate it to 2021? Or are you guiding to another margin step-up from 4Q '20 level into 2021 period?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. I'm doing anything but guiding to anything to 2021 at this point. But the logic is that if I'm increasing and end up with a higher margin in Q4 of 2020 than I did in the other quarters with the way I'm approaching it, that should be a sustainable element. And there will be things that are driven in 2020 that don't have a full year benefit. And so as I capture that full year benefit in 2021, it's logical that I should be able to have full year margins that increment up from what I have for full year 2020.

Relative to Q4 of 2020 versus full year 2021, we'll have to get closer to that for me to be able to give you a better view of that. But certainly, as we roll forward, we do expect full year benefits that aren't going to be fully hit in 2020 to fully hit 2021. So without putting any solid numbers around it, so for a year, yes, I think 2021 full year operating margin will be higher than 2020.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

Okay. And then you highlighted in the press release and on the call that the voluntary separation plan had an impact on the cash flows. Can you quantify for it what it is as a percent of just the total workforce?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

From a percent of total workforce, it's a pretty small amount. I think the total impact from that item is probably $40 million, some place in that, and from a salary perspective, then that's a $650 million personnel number. So once again, it was voluntary with people that were qualified to be in it, which meant you had to have a certain level of tenure with the company. So it's very successful, but I think it's -- certainly, we're pleased to have gone through that. We're pleased to start getting the benefits of that. But we're -- certainly, we're more excited about the benefits we'll get from our additional optimization work.

Operator

And our next question comes from Richard Close with Canaccord Genuity.

Richard Collamer Close - *Canaccord Genuity Corp., Research Division - MD & Senior Analyst*

Great. Just maybe to drill down on Jamie's question from earlier on the Software as a Service and possibly transition there. Thinking about it from the data center aspect, is there the opportunity to move stuff to AWS or Azure going forward? Just curious your thoughts on that potential and how big of an impact would that be for you.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. This is Marc. Certainly, as we go and look at our capital structure and return on invested capital, that's one of the things that we'll look at. I think that's -- as we move to a model that's more CommunityWorks release or a very limited number of releases that are being used by our clients, it would fit well with a third-party hosting. But clearly, that's something that we still have to decide and still have to move forward on. But the good news for our clients is basically, nothing that they're -- something that wouldn't really impact them significantly. They already have it hosted in an off-site data center. And I think that's -- for them, it's not going to impact the service that they get from us or the value that they get from it. But for us, certainly, we're doing an analysis based on the cost to determine what the best approach for us as we move forward on this new SaaS approach to the business, not necessarily the business model but the overall approach that SaaS represents and looking at all our options.

Richard Collamer Close - *Canaccord Genuity Corp., Research Division - MD & Senior Analyst*

Okay. And then I was interested in the GetWellNetwork commentary and that being one of the 165 opportunities that you see. If you look at the 165, how large is the opportunities, I guess, with maybe moving people off certain of your products or capabilities to other partners?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

This is Marc. Just to clarify that the partnering strategy is not one of the 165 initiatives to a great extent, right? Those are targeted on an optimization basis. That's additional top line growth alternatives potentially part of portfolio management. But I'd be happy -- Don, if you want to comment a little bit on the benefits of GetWell and kind of our...

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

Maybe just bridging comment, if I can. So This is Brent, and this is back to our discussions last quarter about an active portfolio management process and really looking at where does it make sense to build versus partner or buy. And as Don referred to, that's an example of -- as we looked at it, there's a desirable solution. It's well-accepted in the model. It's a win. It makes sense. And Don, you want to maybe describe a little.

Donald D. Trigg - *Cerner Corporation - EVP of Strategic Growth*

No, I think GetWell was one of a set of partnerships that I alluded to or have cited specifically in my section of the script. So GetWell would fit that, the work we're doing with Salesforce from a CRM perspective. I mentioned naviHealth in the bundled payments space; certainly, the work you're doing with Lumeris as it relates to provider-sponsored plan and MA. So we have some very strategic partnerships that we've entered into that we expect to make meaningful contributions to revenue as we work into 2020. And as part of that, we want to think about when does it make sense in this case to move away from to the myStation solution, engage in a partnership strategy that is highly penetrated today in our client base and also create some opportunities for us around their loop asset to begin to really build out our Consumer Framework and drive some net new revenue growth relative to that piece of our business.

So I think it's emblematic of something that's been part of a multi-quarter trend, and I think we'll continue to update you guys on what that partnership contribution looks like for those tier 1 relationships as we move into the back half of the year and the first half of 2020.

Operator

And our final question comes from Ross Muken with Evercore ISI.

Unidentified Analyst

It's Susie on for Ross. My questions around margins have all been answered, so thank you for all the detail. I guess I'll ask, with the organization's initiatives of driving cost cuts for margin expansion fully in motion now, is there any color you can provide on feedback you've been receiving from your clients? Or maybe have you gotten any sense that your competition may be transforming its strategy or maybe becoming more aggressive with these strategies in the face of the organizational changes?

John T. Peterzalek - *Cerner Corporation - Executive VP & Chief Client Officer*

Yes. This is John. From a client perspective, we hit this a little bit last -- the last call that we had, is that one of our key premises as we work through our efficiency efforts is that we do not impact our clients. We do not impact the commitments to them or, strategically, where they're going. And all of the initiatives that we're looking at, we're looking at through that lens.

The majority of our clients that I've talked to and we've talked to feel very comfortable from the fact that the things that we can do around the efficiency, the things that we can do around portfolio management is a benefit to them. It gets new innovations to the market quicker. It allows them to plan for things a little better because they are much more aware of when things would be coming to the market and those types of things. So in general, that as long as we don't -- that we continue to fulfill our commitments that we currently have and that we -- that we are more focused on what we're doing in the future, we should be fine with our clients. And I think they understand that, and they are looking forward to the benefits of this opposed to worrying about what some of the negative impacts may be.

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

Yes. This is Brent. I would just add that, of course, in health care delivery, the large providers, almost every one of them, has some sort of initiative like this going themselves. So in the executive suite, it's very familiar, and they understand it and they know it's part of doing business in health care. So it is familiar.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Thank you, everyone, for being on the call. We look forward to talking to you soon. Take care.

Donald D. Trigg - *Cerner Corporation - EVP of Strategic Growth*

Thank you, all.

Operator

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