Moderator

Welcome to Cerner Corporation’s 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 investor 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.
Brent Shafer
Thank you. 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. 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 to it as Cerner.Next—a term that signifies to our associates that the future is now. We’ve spent the past four decades inventing, building, implementing and operating EHRs for clients around the world. Over that time, Cerner has helped digitize nearly 50% of health care in the U.S. and in the near term secured the two 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 healthcare costs, industry consolidation, payment reform pushing toward risk, the heightened impact of consumerism and the emerging role of Artificial Intelligence and Machine Learning. Cerner is 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 4Q19 and 4Q20.
As we embrace the macro trends affecting health care and our market position, we’ve refined our strategic framework around three 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 a SaaS approach should 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 network partner as Cerner pursues adjacent markets outside of 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 forces 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 this 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 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 the 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 Naughton
Thanks, Brent. Good afternoon everyone. I am going to cover our Q2 results and future guidance.

This quarter we delivered solid bookings, revenue and earnings.

**Bookings, Backlog and Revenue**
I will start with bookings, which were $1.432 billion in Q2 and near the high end of our guidance range. This is down from Q218 bookings of $1.775 billion, primarily due to a decline in long-term bookings, which we previewed last quarter. In addition, Q218 included the initial VA task orders, making it a tough comparable.

We ended the quarter with a 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 Q218 and in line with our expectations.

I’ll now go through the business model detail and year-over-year growth compared to Q218.

- **Licensed Software** revenue in Q2 was $197 million, up 14% over Q218 driven by strong bookings, and good growth in both SaaS offerings and traditional software.
- **Technology Resale** of $61 million decreased 19% compared to Q218, which was the strongest quarter of last year, and up 9 percent 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 & Maintenance** was basically flat, which is in-line with our expectations.
- And finally, **Reimbursed Travel** was down 5% from Q218, and essentially 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 was 81.2%, down from 81.8% in Q119 and 82.5% year-over-year driven by higher third-party services.

**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, share-based compensation permanent tax items, acquisition-related adjustments, VSP and other organizational restructuring expenses, and other adjustments that I’ll discuss in moment and are also detailed and reconciled to GAAP in our earnings release.

**Operating Expense**

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 a $20 million charge related to a client dispute that have been excluded from our adjusted results. Note that we also had a $16 million non-operating 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 Q218. Looking at the line items for Q2, Sales & Client Service expense increased 4% year-over-year, primarily driven by an increase in personnel expense related to our services businesses. Software development expense increased 9% over Q218, driven by a 5% increase in gross R&D, a 7% increase in amortization, and flat capitalized software. G&A expense was down 8%, driven in part by lower personnel expense. Amortization of Acquisition-related Intangibles decreased slightly year over year.
Operating Margins

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 Q218, 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 targeted 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 three waves, with initial benefits expected in Q419, followed by a second wave of benefits by the middle of 2020, then a third wave that is 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 Q419 and Q420 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 COO Mike Nill, our Chief of Staff Kimberly Gerard, and two 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 bi-weekly 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 can deliver ongoing profitable growth while also accelerating value creation for our clients.

**Net Earnings / EPS**

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 Q218. Adjusted Net Earnings in Q2 were $215 million and Adjusted Diluted EPS was $0.66, compared to $0.62 in Q218.

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

**Balance Sheet / Cash Flow**

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 ended the quarter at $1.229 billion, up from $1.159 billion in Q119. Our Q2 DSO was 78 days, which is up from 76 days in Q119 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 expenses 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 call last quarter.

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.

Capital Allocation
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 the 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.
Guidance

Now I’ll go through guidance.

- We expect revenue in Q3 to be between $1.405 and $1.455 billion. The midpoint of this range reflects growth of 7% over Q318.
- For the full year, we continue to expect revenue between $5.650 and $5.850 billion, with the $5.750 billion midpoint reflecting 7% growth over 2018.
- We expect Q3 Adjusted Diluted EPS to be 65 to 67 cents per share. The midpoint of this range is 5% higher than Q318.
- 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 $1.500 billion to $1.700 billion. The midpoint of this range reflects a 1% increase compared to the third quarter of 2018, which had increased 43% over the prior 3rd 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 will turn the call over to John.
John Peterzalek
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.

Results Summary
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 and 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 free-standing emergency departments.

In the Federal space, 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 lives 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 back over to Don.
Don Trigg

Thanks, John. Good afternoon everyone.

Brent spoke at the outset of the call about our strategic push to enable health systems to build out provider networks to win the zip codes in which they operate. This is core to our multi-year growth strategy and solid progress was made in the second quarter to advance it.

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

Enterprise security was a bright spot in the 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 multi-factor authentication for medication 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. We had more than 25 discrete contracts driving over 30% bookings growth, with 70% of the signed business occurring outside our Millennium client base. The post-acute sales trend positions us well on several fronts including our naviHealth partnership focused on the Bundled Payment and Care Improvement (Advanced) program.

Brent also discussed our strategic ambition to grow our curated data services assets. Cerner’s global market share, clinical research practice and overall platform leverage provide natural points of differentiation in a segment with a significant $60 billion total addressable market.
As part of our push into data services, Art Glasgow has joined Cerner within the Strategic Growth organization to lead our efforts. Art not only is the former CIO of Duke University Health System, he also served as the Chief Product Officer at Optum.

The early returns have been positive. We have made progress in the pharma and life sciences space leveraging our HealtheIntent DataLabs asset and our collaboration with the Duke Clinical Research Institute (DCRI). There also is good traction in our HealtheHistorySM business, which provides record retrieval for life insurance, legal and other administrative use cases.

Our health network businesses and 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 our portfolio management review relates to product areas we have targeted for an alternative go-to-market strategy. An example of this is an agreement we recently signed with GetWellNetwork. As part of the relationship, we will 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 constantly strive to embody the same entrepreneurial speed that we used to build the company. Our team always is impatient to go faster. 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 around company-level portfolio management.

With that, I will turn the call back over to Brent.
Brent Shafer

As you heard from Marc, John and Don, we are making good progress on several fronts.

- We have established a rigor around our cost optimization and process improvement efforts that I believe will not only will help us deliver our near-term targeted financial results but also position us for high-quality growth going forward.
- We have demonstrated good execution in our core markets, including solid bookings 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 are making good progress at creating growth from emerging market opportunities that will be important to Cerner’s long-term growth.

I am pleased with the team’s execution during a time with significant change occurring both inside and outside of Cerner.

Now I’ll turn the call over to the operator for questions.