Cerner Corporation
First Quarter 2014
Earnings Conference Call
April 24, 2014

Moderator

Welcome to Cerner Corporation's first quarter 2014 conference call. Today's date is April 24, 2014, 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 expenses, product development and new markets or prospects for the Company's solutions. 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. Mike Nill, Executive Vice President and Chief Operating Officer, will discuss our imperatives. Then Jeff Townsend, Executive Vice President and Chief of Staff, will provide an update on our focus on innovation with Intermountain Healthcare. Neal Patterson, our Chairman and CEO, is with a client today.

Now I will turn to our results.

Bookings, Backlog and Revenue

Our total bookings revenue in Q1 was $910 million, which is an all-time high for a first quarter and reflects 14% growth over our previous Q1 record results in Q113. Bookings margin in Q1 was $824 million, or 91% of total bookings.

Our bookings performance drove a 22% increase in total backlog to $9.24 billion. Contract revenue backlog of $8.45 billion is 24% higher than a year ago. Support revenue backlog of $796 million is up 6%.

Revenue in the quarter was $785 million, which is up 15% over Q113. The revenue composition for Q1 was $207 million in System Sales, $175 million in Support and Maintenance, $382 million in Services, and $21 million in Reimbursed Travel.

System sales revenue reflects a 4% increase over Q113 due to growth in software and subscription revenue, which offset another decline in technology resale. The tech resale decline was in-part due to a tough comparable in our global business where we had a large hardware sale in the year-ago period, but the rest of tech resale was also below our expectations. Our forecast reflects growth in tech resale for the rest of the year.

Q1 System Sales margin dollars grew 21% over the year-ago period, driven by continued strong levels of the higher-margin system sales components of software and subscriptions.

Moving to Services, total Services revenue was up 25% compared to Q113, with strong growth in managed services and professional services and good contributions from ITWorks and RevWorks.

Support and Maintenance revenue increased 9% over Q113.

Looking at revenue by geographic segment, domestic revenue increased 21% for the quarter. Global revenue was down 16% from Q113, which, as I mentioned, was a tough comparable for global. Zane will discuss our global outlook for the rest of the year, which is very good.

Moving to gross margin. Our gross margin for Q1 was 83.5%, which is up from 81.3% in Q113, reflecting strong software and subscription levels and a lower mix of technology resale.

Operating Expense and Earnings

Looking at operating spending, our first quarter operating expenses were $463 million before share-based compensation expense. This is a year-over-year increase of 20%.

Sales and client service expenses increased 23% compared to Q113, driven by an increase in revenue generating associates in our services businesses and growth in depreciation.

Our investment in Software Development was up 12% compared to Q113. As previously discussed, the growth in software development is due to increased focus on investing in growth initiatives.

G&A expense increased 15% compared to Q113, driven by increased personnel expense related to our strong growth and higher amortization expense related to recent acquisitions and acquired intangibles.

Operating Margins

Moving to operating margins. Our operating margin in Q1 was 24.6% before share-based compensation expense. This is down 10 basis points compared to Q113, due to slightly higher growth in operating expenses. Our forecast for the rest of the year reflects approximately 100 basis points of margin expansion, with less than that next quarter and more in Q3 and Q4. As you know, this can vary based on our revenue mix and we will focus on delivering predictable levels of growth in gross margin and earnings dollars, which we did this quarter without margin expansion.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q1 were $119.5 million, or 34 cents per diluted share. GAAP net earnings include share-based compensation expense, which had a net impact on earnings of $9.6 million, or 3 cents per diluted share.

Adjusted net earnings were $129.1 million and adjusted EPS was 37 cents, which is up 11% compared to Q113. Recall that Q113 had a lower tax rate that benefited adjusted EPS by 1 cent. If you adjust Q113 for this, our normalized growth this quarter would be 14%.

The Q1 tax rate for adjusted net earnings was 34%, which is in line with our expected effective tax rate. For the remainder of 2014, we expect our effective tax rate to remain within 50 to 100 basis points of 34%.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q1 with $1.47 billion of total cash and investments, compared to $1.43 billion in Q4. Total cash and investments include $1.03 billion of cash and short-term investments and $437 million of highly rated corporate and government bonds with maturities less than 2 years. Our total debt, including capital lease obligations, is $160 million.

Total receivables ended the quarter at $564 million, which is down $19 million from Q4. Our DSO in Q1 was 66 days, which is down from the Q4 DSO of 67 days and down from 69 days in Q113.

Operating cash flow for the quarter was $156 million. Q1 capital expenditures were $70 million, and capitalized software was $45 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was $42 million for the quarter.

Looking at capitalized software, the $45 million of capitalized software in Q1 represents 40% of the $111 million of total investment in development activities. Software amortization for the quarter was $25 million, resulting in net capitalization of $19 million, or 18% of our total R&D investment.

Note that operating cash flow was impacted in Q1 by the timing of tax payments and other working capital elements, which reduced operating cash flow by over $80 million as compared to Q1 of 2013. I also wanted to point out that we received a $48 million cash grant in Q1 from the Kansas Department of Commerce in connection with the construction of our Continuous Campus. While this will show up in the Financing section of our cash flow, it is not really debt and I view it as another element of cash flow.

Looking at the rest of the year, we expect stronger operating cash flow, and as a result, stronger free cash flow.

Our outlook for capital expenditures and capitalized software remains the same as what we provided last quarter. We expect capital expenditures to be $260M to $280M for the year, which is down from $353M in 2013. We expect capitalized software to remain in the mid-forty million dollar range throughout the year, which will lead to it being flat or slightly higher than the $175M capitalized in 2013. This reflects a reduction in the use of 3rd party developers, which will be slightly offset by an increase in our own developers.

Regarding our share buy-back, we purchased 1.3 million shares for approximately $75 million during the quarter and now have $142 million remaining from the $217 million that was authorized in December.

Guidance

Now I'll go through Q2 and full-year 2014 guidance.

- For Q2, we expect revenue between $790 and $830 million, with the midpoint reflecting growth of 14% over Q213.

- For the full year, we expect revenue between $3.25 and $3.4 billion, reflecting 14% growth at the midpoint. This is up from our prior range of $3.2 to $3.4 billion.

- We expect Q2 adjusted EPS before share-based compensation expense to be 39 to 40 cents per share, with the midpoint reflecting 16% growth over Q213 adjusted EPS.

- Q2 guidance is based on total spending before share-based compensation expense of approximately $470 to $480 million.

- For the full-year, we expect adjusted EPS between $1.63 and $1.67, with the midpoint reflecting 17% growth. This is up slightly from our prior range of $1.62 to $1.67.

- Our estimate for the impact of share-based compensation expense is approximately 3 cents in Q2 and 11 to 12 cents for the full year.

- Moving to bookings guidance, we expect bookings revenue in Q2 of $1.0 billion to $1.06 billion, with the midpoint reflecting 10% growth over Q213, which is our toughest comparable of the year—having grown 33% over 2012.

In summary, we are pleased with our results in Q1 and believe we are positioned for good year.

With that I will turn the call over to Zane.

Zane Burke

Thanks Marc. Good afternoon everyone. Today I will provide Q1 highlights and discuss marketplace trends.

Results

Starting with our results, our bookings revenue in Q1 of $910 million reflects 14% growth over Q113 and is a record for a first quarter. This growth was achieved despite another weak quarter of technology resale. In addition, we had no new ITWorks or RevWorks deals in the quarter, but we did have contributions from scope expansions at existing ITWorks clients and good sales of revenue cycle solutions.

For the quarter, we had 23 contracts over $5 million, including 13 over $10 million.

The mix of long-term bookings was 28% in the quarter, which is lower than recent quarters because of less contribution from Works businesses. Note that our pipeline is strong for our Works businesses, and we still expect to have very good bookings this year.

25% of our bookings this quarter came from outside of our core Millennium installed base, reflecting ongoing competitiveness. As we highlighted at our recent investor day, we continue to have significant opportunities to gain share, as we believe we are in the early stages of another wave of EMR purchases that will disproportionately go to Cerner or our primary competitor. With our win rate against this competitor significantly improved, we are positioned for good share gains in coming years. The volume of potential new business was also very apparent at HIMSS this year where we interacted with more potential new clients than we ever have.

Revenue Cycle

Now I'll cover some of the specific areas that contributed to our Q1 results. I'll start with Revenue Cycle. While we didn't have a new RevWorks deal in Q1, contribution from revenue cycle was still good. This was driven by ongoing sales of our broad suite of revenue cycle solutions. Our forecast for the year calls for ongoing strength in solution sales and increased contribution from RevWorks.

Overall, the outlook for our revenue cycle business remains positive, as revenue and cost are top of mind for all providers, and the importance of revenue cycle being integrated with clinical solutions continues to increase as the industry shifts to at-risk models. The opportunity is significant in our installed base as many of our large clients are still on antiquated revenue cycle solutions. Revenue cycle is also part of almost every opportunity for business outside of our base, and the improvements we have made in recent years have been an important part of our increased competitiveness. In addition, we think the delay in ICD-10 will be a slight positive to our revenue cycle business because we had some prospects that were going to wait until after the deadline to install new solutions that can now consider installing them before the new deadline.

Population Health

Our population health organization also delivered strong results, driven by demand for HIE, patient portal, enterprise data warehouse, and clinical process optimization. In addition, we had

additional sales of our new *Healthe Intent Smart Registries™* solution, and have a strong pipeline for the year.

Ambulatory / CommunityWorks

Moving to the ambulatory space, where we had a strong Q1, with our clients continuing to favor our integrated offering over standalone solutions. We had 6 significant displacements of our key competitors and two strategic Business Office Services deals during the quarter.

We also had a very good quarter in the small hospitals market, adding 5 new CommunityWorks clients, bringing 8 clients live, and hosting a record level of prospective clients in our Vision Center.

Global

Outside of the U.S., we had a strong quarter from a bookings standpoint, driven by contributions from the Middle East, Canada, Australia, Ireland and England. However, revenue declined by 16% largely due to a tough comparable related to technology resale. For the year, we still expect double digit revenue growth outside of the U.S., driven by the strong bookings in Q1, a good bookings forecast, and easier comparable periods the rest of the year.

In the Middle East, we brought our pilot site live for the Ministry of Health in Saudi Arabia in just 9 months, which is a record for a global go-live. This was no small feat, as it is a 500-bed hospital where we automated inpatient and outpatient physician and nursing workflows across the emergency, surgery, laboratory, pharmacy, and medical records departments.

We also had six more hospitals in the Middle East achieve HIMSS EMR Adoption Stage 6, giving us 13 total compared to just one for all competitors combined.

We believe this success positions us for more business in the region.

Marketplace Observations

Now I'll cover a couple more marketplace observations. Health care providers remain focused on controlling costs and increasing quality while also juggling requirements for Meaningful Use, health care reform, Value-Based Purchasing, and ICD-10. We believe IT is the biggest lever to help providers navigate these changes and facilitate a transition to an at-risk model that incents keeping people healthy.

We also expect that as providers focus on controlling costs, they will continue to look at acquisitions to attain scale. As we've mentioned, this trend has benefited Cerner because our clients have been the most active acquirers, and we expect this to continue. Each of the last two quarters have included bookings contributions from clients buying solutions for acquired hospitals.

In summary, Q1 was a solid start to the year, and I feel good about having a highly successful 2014.

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

Mike Nill

Thanks Zane. Good afternoon everyone. Today I am going to provide a quick update on our imperatives.

Imperatives – PPR CIM+1

Recall that our imperatives are captured in the long acronym PPR CIM+1, with the PPR representing our focus on Physician, Population Health, and Revenue Cycle, and the CIM+1 representing Continuum of Care, Intelligence, Member Engagement and Personalized Medicine.

PPR

I'll start with **Physician Experience**. With physician productivity being key to a clinical enterprise and Meaningful Use accelerating physician adoption, having solutions that optimize the physician experience is critical. As a result, we have invested and continue to invest heavily in physician experience and productivity. The record results for our physician solutions that we have experienced over the past two years are evidence that these investments are paying off. We are also investing to support the evolution to a population health model, in which the physician is going to be on a team managing thousands of people that are on registries.

This brings me to **Population Health**. As you know, one of our development partners for population health is Advocate Health, who has over 500,000 lives for which they are financially at risk, so they are incented to keep people healthy. We achieved a major milestone last year by releasing our Heathe Intent Smart Registries™ solution just 7 months from contract signing. Healthe Intent Smart Registries is part of our Healthe Intent cloud-based platform, which is a multipurpose programmable platform that aggregates, normalizes and standardizes clinical, financial and broader population data.

While it is still early in the development of our population health solutions and the evolution of the market, we are very pleased with our progress and believe we have the most comprehensive approach. Third-party validation of this came in a Chilmark Research report about their experience at HIMSS, where they asked multiple purported population health solution providers to explain their process map for enabling a client to effectively move to a population health model of care. They indicated that Cerner was the only supplier able to articulate such a process map.

Moving to **Revenue Cycle**, we continue to have outstanding results that I believe are directly attributable to the large investments we have been making. While we have not added full RevWorks clients in recent quarters, our pipeline remains strong, and we expect 2014 to be another strong year for revenue cycle as a whole. We also remain excited about the potential of our work with Intermountain Healthcare to build an activity-based costing system, which will further our differentiation.

CIM+1

Now I'll quickly cover the CIM+1 part of our imperatives. The first is **Continuum of Care**, which reflects our view that you have to include the entire continuum of care in any complete population health model. It is not just the doctor's office or hospital. Cerner has the broadest suite of

solutions across the continuum, including solutions for home care, long-term care, skilled-nursing facilities, behavioral health, rehabilitation facilities, and employers. In addition, we are proving the ability to connect to non-Cerner solutions across the continuum through our work with Advocate, where we are connecting approximately 70 data sources. Our ability to aggregate the information across the continuum, perform analytics, and put the relevant information back into the workflow, is a big differentiator.

Moving on to **Intelligence**. Through work with client partners, we have created industry-leading predictive capabilities for sepsis and re-admissions that show our ability to embed intelligence in information technology. In the case of re-admissions, the predictive algorithm we worked with Advocate to refine performs 20% better than the industry average and has been deployed at 120 non-Advocate sites. Intelligence is also a large focus of our work with Intermountain Healthcare, where we have a huge opportunity to positively impact health care by embedding their care process models into our EMR-agnostic Healthe Intent platform.

Now I'll cover the **Member Engagement**. As organizations become accountable for not only the care but also the health of their patients, the way they connect to them will change. No longer are people just patients. Each person is now an important member of a client's population with whom they must engage and help manage their health and care needs. In 2013, we enhanced our member engagement capabilities with the addition of PureWellness, a comprehensive wellness portal that reaches millions of members through employer, health plan, and health system clients.

Finally, the **+1** represents **Personalized Medicine** and the inclusion of the genome in diagnosis and treatment. Cerner has been focused on the power of genomics and its impact to clinical processes dating back more than a decade when we released Millennium Helix®. With the cost of genetic testing coming down, we are starting to see more opportunities in this area. For example, we announced in late 2013 that we are working with Claritas Genomics to advance personalized medicine by building tools to integrate ordering of genomic sequencing tests, laboratory processing, results interpretation, and incorporation of the result in the EMR.

In summary, we are making great progress on our imperatives. This year we expect to continue advancing these imperatives as we focus on helping our clients use our intellectual property as a lever to improve quality and safety while controlling cost.

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

Jeff Townsend

Thanks Mike.

As Mike shared, we have been accelerating our innovation and market validation with strategic partnerships. This is more than just traditional alpha site deployments; these are highly aligned engagements that enable us to work at the "edge" in a living lab environment that provides immediate feedback, with short cycle times. As we highlighted with multiple client presentations during our investor event at HIMSS, we have been given the opportunity to work side by side with these organizations as they transform towards a future state. For Cerner, this creates an environment where ideas and concepts can more quickly evolve into real world production solutions. The bi-products of these relationships are much more than software or solutions, it's about embedding a systemic framework for change…enabling what the Institute of Medicine calls a Learning Health System. To go a little deeper on what this looks like in practice, I am going to provide an overview of what we are working on with Intermountain Healthcare.

Intermountain Healthcare

When we announced the partnership, one of my early quotes was that this partnership could accelerate clinical computing by at least a decade. I still believe that. There are several areas of innovation that will contribute to this, and over a few short months of engagement the opportunity list continues to grow.

The first is around Intermountain's Care Process Models. These are summarized guides to clinical decision making, focused on both conditions and specific decision points within a care process. They are highly contextual, moment in time decisions that remove variance and produce the best outcome at the most appropriate cost—all in the context of the patient, provider and venue. The system awareness of context is the most important part; it's what removes the clutter and noise. When done well, the system anticipates the next move. The ability to use a variety of trigger events to push the decision moments face up in the conversation makes the workflow dynamic — think of it as a clinical navigation system, a GPS for medicine.

A big next step is making Intermountain's Care Process Models EMR agnostic, yet still inside the workflow. This will enable a new standard of care, where we create the moment in time experience to support the decision, and at the right moment in time, it will surface contextually, inside the workflow of the physician without upgrades, mapping of interfaces, or retraining of a workforce. This puts us on a path to accelerate a lot of the work done by the industry today by embracing and advancing current work more quickly. We think these models have the potential to be the next generation of workflow, completely self-contained diagnostic, treatment, outcome and reimbursement containers. It could easily become the "new transaction" that replaces the claim in the fee for service world.

A key enabler of much of what we are doing is our commitment to having the most Open and interoperable EMR platform on the market. Most of the discussion today around interoperability is pretty basic and moving at a very slow pace. At HIMSS, Cerner and Intermountain showed the power of blending an emerging set of standards we have tagged SmartOnFHIR. Using the SMART

standard to provide plug-in web experiences within the workflow, and HL-7s Fast Health Interoperable Resources, commonly referred to as 'Fire'. We showed the ability to plug non-Cerner and non-Intermountain applications into the workflow contextually. One example was showing a consumer friendly growth chart app developed at Boston Children's, spanning both Intermountain's existing clinical system and Cerner Millennium to create a continuous story. This allows us to more rapidly unlock the same potential for Open platform development that has been experienced in other industries…which we believe will disrupt the current paradigm of how an EMR is used in the delivery of healthcare.

What we are doing with Intermountain and what we have already done with Advocate around interoperability and real-time analytics is a big differentiator for Cerner. Many of you probably saw dozens of booths at HIMSS highlighting a data warehouse, showing elegant graphs that purport to provide great insight into the data. However, if you can't get that insight back into the workflow when the physician is making the decision at what I call at the moment of relevance, then you are just reporting the news, versus making the news.

Another focus of our innovation with Intermountain is with their transformation lab, where multiple technologies and partners come together to innovate in a startup style environment. One of the examples I talked about at HIMSS was advancing past device integration and interoperability to environment orchestration with our CareAware platform. For example, with the ability to continuously stream vitals off of devices, the physician's order for IV meds can be placed to give a medication until a vital, such as heart rate, reaches a specific range, and once it gets into that zone then taper back or stop the medication. The ability to coordinate devices to create an outcomes-based ordering capability is very plausible, and will have a predictable impact on quality, cost and outcomes.

The last area of innovation I'd like to cover is what we're calling an activity-based EMR. The core component here is to dissect all the activities of medicine into Lego-like components so that you snap them together around a purpose. Dr. Brent James at Intermountain has done a lot of work in this space and has componentized a large number of procedures and activities, including 800 different risks which are drivers for clinical care. This ability to group things together into components and have the option to now snap together workflows and drive that change rapidly into the clinical process while knowing cost, measures and outcomes is very powerful. What is unique about the approach we're taking together is the inclusion of goals and outcomes associated to the activities. If you looked at just a costing, with a pure resource or consumption-based model, you miss the fact that the activities were aligned to an expected outcome. In some cases, those outcomes are events or risks you're attempting to avoid. While the cost of a manual capture of vital signs and a wearable continuous device will be very different, the ability to constantly monitor the patient's status continuously changes the outcome risks…well beyond the comparable resource costs of collecting the data. If you're going to attempt to impact appropriateness, costs and quality at the same time, you have to include expected and actual outcomes in the equation.

Summary/Close

In summary, the most exciting part of this partnership isn't the individual innovations or the potential impact they can have, it's the next generation of Cerner's consulting methodology rooted in agile development techniques, being applied to support both the implementation of core solutions, and the continuous overlay of new solutions and decision support capabilities. A key objective is to move away from the traditional waterfall IT approach of static, one size fits all projects, to a more nimble, continuous innovation environment that anticipates and embraces change. In the case of Intermountain, we are running on 6 week Model System Release cycles, producing workflows, content, solutions and education materials that come together into a comprehensive "release". This approach creates a culture of continuous improvement versus a one-time conversion mentality. The emerging toolkit from the methodology, combined with activity-centric design and componentized care decisions on top of an Open platform, are the foundational building blocks of the next generation of clinical computing.

This is very important work, and we have a sense of urgency driven by entrepreneurial impatience, a sense of responsibility to improve the overall system, and competitiveness. This urgency also comes from our belief that the rest of this decade will include more changes in health care than what has occurred in the last six decades combined. The solutions will need to keep up; IT organizations will have to re-invent their methods, and provider organizations will demand a more dynamic and contextual experience. Our role has always been to anticipate the future of health care and create solutions to meet those needs, and now is the window to accelerate.

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