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CERN - Q4 2013 Cerner Corporation Earnings Conference Call

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OVERVIEW:

CERN reported full-year 2013 revenues of $2.91b, adjusted net earnings of $497m, and adjusted EPS of $1.41. 4Q13 revenue was $795m and GAAP net earnings (including certain items) were $60m or $0.17 per diluted share. Expects full-year 2014 revenues to be $3.2-3.4b and adjusted EPS to be $1.62-1.67. Expects 1Q14 revenues to be $770-810m and adjusted EPS (before share-based compensation expense) to be $0.36-0.37.

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PRESENTATION

Operator

Welcome to the Cerner Corporation's fourth-quarter 2013 conference call. Today's date is February 4, 2014, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today by Cerner's management about future expectations, plans, perspectives, and prospects constitute forward-looking statements for the purpose of the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. 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 the heading risk factors under Item 1A in Cerner's Form 10-K, together with other reports that are furnished to or filed with the SEC.

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

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

Marc Naughton - *Cerner Corporation - EVP and CFO*

Thank you, Brianna. 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 the results highlights and marketplace trends.

Neal Patterson, our Chairman and CEO, will be available during Q&A. Mike Nill, Executive Vice President and Chief Operating Officer; and Jeff Townsend, Executive Vice President and Chief of Staff, are at client events but look forward to catching up with you at our investment community meeting on February 25.

Now I will turn to our results. We delivered very good results for the fourth quarter and for the full year of 2013. Our total bookings revenue in Q4 was $1.11 billion, which is an all-time high and reflects 9% growth over our previous record results in Q4 of 2012.

Bookings margin in Q4 was $975 million, or 88% of total bookings. For the full year, bookings revenue was $3.77 billion, up 20% over 2012. Our bookings performance drove a 23% increase in total backlog to $8.91 billion. Contract revenue backlog of $8.13 billion is 24% higher than a year ago. Support revenue backlog of $786 million is up 6% year over year.

Revenue in the quarter was $795 million, which is up 12% over Q4 of 2012. The revenue composition for Q4 was $246 million in system sales; $170 million in support and maintenance; $361 million in services; and $18 million in reimbursed travel. For the full year, revenue grew 9% to $2.91 billion over a tough comparable in 2012, when revenue grew 21%.

System sales revenue reflects a 2% drop from Q4 of 2012, which had grown 14% over the prior year; and a 6% decrease for the full year of 2013, due to continued declines in technology resale revenue. Q4 system sales margin dollars, however, still grew 13% over the year-ago period; and full-year system sales margin dollars grew 15%, reflecting continued strong levels of high-margin system sales components like software and subscriptions. We are now through our toughest comparable periods for technology resale, and we expect it to return to growth in 2014.

Moving to services, total services revenue was up 24% compared to Q4 of 2012 and 21% for the full year, with strong growth in managed services and professional services and continued increasing contributions from ITWorks and RevWorks. Support and maintenance revenue increased 11% over Q4 of 2012 and 10% for the full year.

Looking at revenue by geographic segment, domestic revenue increased 12% for the quarter and 9% for the full year. Global revenue was up 8% for the quarter and 11% for the full year.

As a preview to the annual update of our detailed business model that we will provide at our investment community meeting on February 25, I'd like to provide you with the total revenue and growth by business model for the full-year 2013.

Licensed software grew 12% to $388 million. Technology resale was down 33% to $263 million, but as previously discussed, this decline had little impact on our gross margin dollars.

Subscriptions and transactions increased 19% to $197 million. Professional services revenue grew 24% to $851 million. Managed services increased 15% to $479 million. Support and maintenance was up 10% to $662 million, and reimburse travel was $70 million, which is up 27%.

Moving to gross margin, our gross margin for Q4 was 82.1%, which is up from 78.4% in Q4 of 2012, reflecting record software levels and a lower mix of technology resale. For the full year gross margin was 82.3%, which is up 510 basis points compared to 77.2% in 2012, also reflecting record software and lower technology resale.

Gross margin dollar growth for the year was 16%, which compares to revenue growth of 9%, with the difference in growth rates reflecting the decline in low-margin technology resale. With the toughest comparable periods for technology resale behind us, we expect gross margin fluctuation to moderate as the technology resale resumes contributing to revenue growth. This should also result in our revenue gross margin dollar growth rates being more aligned.

Looking at operating spending, our fourth-quarter operating expenses were $450 million before share-based compensation expense and the settlement charge. This is a year-over-year increase of 16%, which is below the 17% growth of our gross margin dollars, reflecting ongoing leverage.

For the full year, operating expenses before share-based compensation expense and a settlement charge were up 15% to $1.66 billion. This compares to gross margin dollar growth for the year of 16%.

Sales and client service expenses increased 16% compared to Q4 of 2012 and 15% for the full year, driven by an increase in revenue-generating associates in our services businesses.

Our investment in software development was up 17% compared to Q4 of 2012 and 12% for the full year. As previously discussed, the growth in software development is due to increased focus on investing in growth initiatives. And we expect this growth to moderate later this year.

G&A expense increased 17% compared to Q4 of 2012 and 24% for the full year, driven by increased personnel expense related to our strong growth and higher amortization expense related to recent acquisitions and acquired intangibles. We expect growth in G&A expense to be more in line with overall growth in 2014.

Moving to operating margins, our operating margin in Q4 was 25.6% before share-based compensation expense and a settlement charge and was up 160 basis points compared to Q4 of 2012. For the full year, operating margins increased 220 basis points to 25.1%. This was driven by combination of ongoing operating efficiencies; the decline in lower-margin technology revenue; and strength in software.

Going forward, our plan reflects continued margin expansion, albeit at lower levels than 2013, since we expect technology resale to resume growing. We expect approximately 100 basis points of margin expansion, with higher or lower levels possible, depending on mix. As in the past, we will focus on delivering predictable levels of gross margin and earnings growth, which is not materially impacted if we have fluctuations in technology resale.

Moving to net earnings and EPS, our GAAP net earnings in Q4 were $60 million or $0.17 per diluted share. GAAP net earnings include share-based compensation expense, which had an impact on earnings of $9 million or $0.03 per diluted share; and a settlement charge, which had a net impact of $68 million or $0.19.

Adjusted net earnings were $137 million, and adjusted EPS was $0.39, which is up 16% compared to Q4 of 2012. For the year, adjusted net earnings were $497 million. And adjusted EPS was $1.41, which is up 18% from 2012.

The Q4 tax rate for adjusted net earnings was 34%, which is in line with our expected effective tax rate. For 2014 we expect our effective tax rate to remain within 50 to 100 basis points of 34%.

Now I will move to our balance sheet. We ended Q4 with $1.43 billion of total cash and investments compared to $1.5 billion in Q3. Total cash and investments include $879 million of cash and short-term investments and $555 million of highly-rated corporate and government bonds with maturities less than 2 years. Our total debt, including capital lease obligations, is $166 million.

Total receivables ended the quarter at $583 million, which is up $54 million from Q3 and driven by strong sales in the quarter. Our DSO in Q4 was 67 days, which is similar to Q3 DSO of 66 days and down from 74 days in Q4 of 2012.

Operating cash flow for the quarter was $141 million. Q4 capital expenditures were $134 million, and capitalized software was $149 million.

Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was negative $42 million for the quarter, due to the settlement charge as well as continued higher capital expenditures, which included a $43 million land purchase that was announced during Q4.

For the full year, operating cash flow decreased 2% to $696 million, primarily due to the settlement charge. Free cash flow for the year was $168 million, with capital expenditures of $353 million and capitalized software of $175 million. Free cash flow was lower than 2012 due to higher capital investments tied to our cloud infrastructure; higher spending on land and facilities to support our growth; higher capitalized software related to investment in our growth initiatives; and a settlement charge.

Looking at capitalized software, the $49 million of capitalized software in Q4 represents 42% of the $116 million of total investment and development activities. Software amortization for the quarter was $25 million, resulting in a net capitalization of $23 million, or 20% of our total R&D investment.

For 2014 we expect stronger free cash flow, driven by growth in operating cash flow, a decline in capital expenditures, and flat to slightly higher capitalized software. For capital expenditures, we expect them to average $65 million to $70 million per quarter versus nearly $90 million in 2013.

For capitalized software, we expect it to be in the mid-$40 million range throughout the year, which will lead to it being flat or slightly higher than 2013. This reflects a reduction in the use of third-party developers, which will be slightly offset by an increase in our own developers.

I'd also like to note that we announced in December that our Board of Directors approved another stock repurchase program, authorizing the repurchase of up to $217 million of common stock. Like our last repurchase program, this one is targeted at offsetting dilution from options.

Now I will go through Q1 and full-year 2014 guidance. For Q1 we expect revenue between $770 million and $810 million, with the midpoint reflecting growth of 16% over Q1 of 2013. For the full year we expect revenue between $3.2 billion and $3.4 billion, reflecting 13% growth at the midpoint. We expect Q1 adjusted EPS before share-based compensation expense to be $0.36 to $0.37 per share, with the midpoint reflecting 11% growth over Q1 2013 reported adjusted EPS, and 14% growth when you consider the $0.01 benefit we had from lower taxes in Q1 of 2013.

This range is slightly lower than the Q1 consensus, which may have factored in growth off of Q1 2013 EPS that included the tax benefit. Consensus for the remaining quarters and the full year is within our full-year guidance.

Q1 guidance is based on total spending before share-based compensation expense of approximately $455 million to $465 million. For the full year we expect adjusted EPS between $1.62 and $1.67, with the midpoint reflecting 17% growth. Our estimate for the impact of share-based compensation expense is approximately $0.03 in Q1 and $0.11 to $0.12 for the full year.

Moving to bookings guidance, we expect bookings revenue in Q1 of $860 million to $930 million, with the midpoint reflecting 12% growth over our strong Q1 2013 bookings.

In summary, we are pleased with our results in 2013 which was the year in which we were able to deliver good results while also investing heavily in our future growth. With that, I will turn the call over to Zane.

Zane Burke - *Cerner Corporation - President*

Thanks, Marc. Good afternoon, everyone. Today I will provide Q4 and full-year result highlights and discuss marketplace trends, starting with our results.

Our bookings revenue in Q4 of $1.11 billion is an all-time high and reflects 9% growth over Q4 2012, which was our previous all-time high. Our full-year bookings of $3.77 billion reflect 20% growth over 2012. This is particularly impressive when you consider we achieved this growth despite the large decline in technology resale.

For the quarter we had 25 contracts over $5 million, including 16 over $10 million, driven by strength both inside and outside our installed base. For the year we had record levels of contracts in both categories, with 101 contracts over $5 million and 57 over $10 million.

The mix of long-term bookings was 29% in the quarter. For the year, 32% of our contracts were long term compared to 31% last year.

Looking at our pipeline, we had a double-digit increase in 2013, even with nearly $4 billion of bookings coming out of it during the year. This positions us well for continued bookings growth.

A major highlight of our quarter and year was our continued success at gaining market share. This is reflected in the 39% of bookings in the quarter and 31% for the whole year coming from outside our core Millennium installed base. For the year, our total bookings outside of our base grew 24% and exceeded $1 billion for the first time.

We continue to have significant opportunities to gain share, as I believe that at least half of the market will evaluate if they are going with the right supplier over the next several years. These decisions are disproportionately going to Cerner and our primary competitor. And we believe our position against them continues to improve. This is apparent with our win rate, which has doubled over the past three years.

A major highlight of our competitiveness in 2013 was Intermountain Healthcare's selection of Cerner. This selection and several other signature domestic and global wins over our primary competitor in 2013 have been noticed across the industry and are having a positive impact on our positioning.

It is clear that investments in physician experience and revenue cycle are paying off and allowing our leading capabilities and vision for population health to carry more weight in the selection process. Our modern architecture and commitment to being open is also contributing to our positive momentum.

Now I will cover some specific areas that contributed to our strong Q4 and full-year results. I will start with ITWorks, which had a great year, including a new contract in the fourth quarter.

Our new ITWorks client is a regional medical center with two hospitals that have gone live with over 50 solutions in 2012. The ITWorks alignment will focus on optimizing user experience and shifting routine, predictable work to Cerner centers in Kansas City to free the client to focus on providing care.

Financial results for ITWorks were excellent in 2013, with both bookings and revenue growing over 40%. With ongoing pressures on our client spending, our offering is very compelling, because we help them control spending while getting more done and achieving a higher level of quality.

This is evident in the fact that 100% of our ITWorks clients are referenceable; 100% have attested for meaningful use; and 80% are at HIMSS EMR adoption level 6 or 7. As a result of our value proposition and ongoing pressures on our clients, our pipeline is very strong. And I expect 2014 to be another great year.

Revenue Cycle also had a great year, with revenue growth of almost 50%, driven by Revenue Cycle solutions and services and full RevWorks services for both inpatient and outpatient venues. Our execution in Revenue Cycle is evident in progress made at our largest RevWorks client, Adventist Health, who recently reported initial improvements as a result of the implementation, including cash collections at 103% of target; a 5.5% decrease in accounts receivable; and a decline in accounts receivable aged over 90 days.

These are encouraging signs and further validation that the focus we have put into our Revenue Cycle solutions and services is paying off. The outlook for our Revenue Cycle business remains positive, as revenue and costs are top of mind for all providers, and the importance of Revenue Cycle being integrated with clinical solutions continue to increase as the industry shifts to at-risk models.

Another factor is that healthcare is the only major sector in our economy that doesn't have a true costing system, and we believe that our work with Intermountain Healthcare to build an activity-based costing system will further our differentiation.

Our Population Health organization also delivered strong results, with revenue growth of more than 20% driven by demand for HIE, enterprise data warehouse, and clinical process optimization. These solutions are foundational to our broader-population health strategy, which we are advancing through the buildout of our cloud-based Healthe Intent platform.

Our progress on this front was excellent. We achieved a major milestone last year by releasing our Healthe Intent Smart Registry solution just seven months from contract signing. Healthe Intent Smart Registry is a cloud-based EMR-agnostic solution that provides the capability to stratify patient populations based on risk, conditions, and attributed physicians. In addition, the registries enable care managers to quickly determine what key quality measures specific to the designated condition of the patient have been met.

Advocate Health went live with the solution in January, and everything is going well. We look forward to providing more details on this at our investment community meeting at HIMSS in Orlando.

Moving to the ambulatory spaces, where we had an outstanding Q4 and record year that included the following highlights: we had over 40% growth in bookings; 18 signature displacements of our key competitors; the signing of our largest ambulatory business office services contract; 5 new global footprints; and a total of more than 16,000 providers signed during the year. Clearly, it was a great year for our ambulatory business, and I attribute this to the investments we made in our solutions and the ongoing trend of our clients wanting an integrated inpatient and outpatient solution.

We also had a record year of success with smaller hospitals, adding 20 Community Works clients during the year, bringing our total to 66 clients. We are competing very effectively against the traditional suppliers in the small hospital space. And our recent recognition as best-in-class Community HIS validates the strength of our offering and positions us for ongoing success.

In other highlights, a highlight this year was the success at providing non-Cerner EMR clients solutions and services to help them with future stages of meaningful use in their Population Health strategies. In Q3 we were selected by a mid-sized health system with no existing Cerner solutions to provide them with health information exchange, Community Patient Index, Patient Portal, and enterprise Master Patient Index solutions to wrap multiple existing non-Cerner inpatient and outpatient solutions.

In Q4 the client added our enterprise data warehouse, and we expect them to add our new Healthe Intent Smart Registry solution soon.

We also sold HIE to a 600-bed hospital that uses our primary competitor's EMR, as they found that our primary competitor was unable to effectively connect to other systems. In addition, we sold our iBus connectivity platform to a client that uses our primary competitor's EMR. These examples are evidence that our strategy of building EMR-agnostic solution and device platforms is working and making our addressable market much bigger.

Outside of the US, we had a solid quarter and year, with 8% growth in Q4 and 11% growth for the full year. This growth was driven by contributions from the Middle East, Canada, Australia, France, and Latin America.

Looking at 2014, we have a good outlook for all of these regions, in addition to strong pipeline in the UK.

In the Middle East we have made good progress on our work for the Saudi Ministry of Health. And we are on pace for a 500-bed pilot site to be our fastest-ever global go-live. We believe a successful go-live in record time will serve as a major proof point that will help position us for more business in Saudi and the entire region.

Now I will cover a few more marketplace observations. In the provider space, the focus remains on cost and quality in anticipation of an expected industry shift to an at-risk model that incents keeping people healthy. The financial pressures are coupled with a long list of priorities around meaningful use, ICD-10, healthcare reform, and value-based purchasing.

Specific areas of focus on our clients' radar in 2014 will be Revenue Cycle, HIE, analytics, and patient engagement. Our solutions and services are very well aligned with helping our clients address these immediate needs and their long-term challenges.

Another observation is that industry consolidation is continuing as providers look to obtain scale. This is a trend that favors Cerner, as our clients are the most active, and in my opinion, the best positioned to be successful over the long term.

Cerner clients accounted for 61% of the buying activity in 2013, and these acquisitions create more than 100 sites into which we can potentially extend our Cerner footprint. This is more than 4 times the number of sites acquired by clients of our primary competitor. Our Q4 bookings included an early return on this trend, as one of our large clients purchased solutions and services for hospitals they acquired earlier in the year.

In summary, 2013 was a great year that included strong growth and many records, and we are well positioned to continue delivering good results in 2014.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Dave Windley, Jefferies.

Dave Windley - *Jefferies & Company - Analyst*

I wanted to focus on the Advocate Population Health platform that you have been working on diligently this year. And what parts of that -- or to what extent do you believe you will be able to commercialize that to your broader client base as you move into 2014?

Zane Burke - *Cerner Corporation - President*

Dave, this is Zane. Thanks for the question. We feel very good that this solution is ready for the marketplace. And, in fact, we have quite a pipeline built for that as we look into 2014.

Dave Windley - *Jefferies & Company - Analyst*

Care to put a number on that?

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. We wouldn't quantify what that is. But clearly, we have already in 2013 sold some of the Smart Registries to not only Cerner clients, but not non-Cerner clients. So the strategy of having an agnostic platform that can go outside of our base is paying off.

And I think as Advocate starts generating results from their go-live in January, that the momentum for that solution is going to pick up. Keep in mind, this is just the first of our platform on which we will build a multitude of different solutions, Smart Registries being one of the first.

Dave Windley - *Jefferies & Company - Analyst*

Sure, thanks. Marc, if I could follow up on the CapEx: you talked last quarter and again in your prepared remarks today that investments are expected to go down. Can you help us from a free-cash-flow standpoint understand how long that lower level of investment can be sustained? In other words, the investment that you have made in 2013 can support growth for how long, i.e. beyond 2014?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I think certainly we doubled down in 2013 relative to capitalized software and relative to building CapEx and capital expenditures on our cloud platform and other initiatives. I think that the building CapEx obviously gives us a little bit of time to move forward. So when you look at 2014, that is an area that you will see a much lower number.

Keep in mind, in Q4 of 2013 we actually acquired a 230-acre tract that we will be able to grow as we need to grow additional buildings at a campus that is near our innovation campus. But that will be based on the need and timing. Kansas campus comes fully online the end of this month, so that should hold us for a little while. So you won't see us having to put a bunch of money into land or CapEx for buildings.

Our capital expenditures for the business will stay relatively flat year over year. And actually, our software we expect to be relatively flat.

So the big benefit will be a significant reduction in the building CapEx -- to the point where the free cash flow for 2014 should be significantly higher. I don't know that I would go so far as to say it is going to double, but it will be a significant increase over this year, just because of the increase in operating cash flow we expect and the decrease in building CapEx.

We can expect to continue to be able to ramp up in 2015, with a goal that as you look at the free cash flow as a percent of net income, that we can go from this year, which was certainly kind of in the mid-30s to getting between 50% and 60% next year. And then 70% in 2015, ideally continuing to ramp up to where we bring operating -- free cash flow up to the level of net income on an equal basis. And I think we do that without having to disrupt our growth and continue to invest in things we want to invest in.

Operator

David Larsen, Leerink.

David Larsen - *Leerink Partners - Analyst*

Zane, I think you mentioned at one point in your prepared comments that maybe up to 50% of hospitals could be seeking a new solution or potentially a new vendor. Can you just maybe give a little more color around that?

And then, also, congratulations on the Community Market. Is there a certain pricing mechanism you guys are using? How can these hospitals, these smaller hospitals, afford Cerner? Thanks.

Zane Burke - *Cerner Corporation - President*

Sure. I am going to do the second one first -- second question first around the Community Works model. We have been able to create a model which scales down to critical access in small hospitals by essentially delivering in a combined tenant domain.

And it is a prepackaged offering, full services offering that is off-the-shelf and gets great, robust functionality to a market that typically does not get the kind of robustness that we have. And so our offering is much richer and deeper than those can typically expect in that marketplace.

And we're able to do that in a manner that is cost efficient for them and is profitable for us. So it has been very effective and worked out very well for all of us.

As it relates to the market comments, we see that there are a number of clients that continue to look at the marketplace. They may have made decisions in the past they are looking at in the future having to undo. And that really relates to all the measures and mandates that are coming at them and making sure that they have a platform that will scale to the future changes as they evolve.

And I have discussed this on calls for the last several quarters -- that we see that trend, and we see that continuing. As we look forward, we see a number of large opportunities in the pipeline that reflect that type of scenario.

David Larsen - *Leerink Partners - Analyst*

Great. Thanks very much. Congratulations on a good quarter.

Operator

Michael Cherny, ISI Group.

Michael Cherny - *ISI Group - Analyst*

I wanted to go back to the comment you guys made. It seems like the last couple of years, the competitive win rate you guys have had versus the other largest competitor that you have called out seems to be going up. You seem to be doing better specifically versus them in a head-to-head basis versus maybe the -- maybe the few years before that.

As you talked about how that competitive win rate has gone up, what's -- I guess versus them head-to-head, what have been the key differentiating factors? Has it been the robustness of Population Health management tools? Has it been some of the investments you have made in the software development, features and functionality? I guess maybe just give a better sense of why you are beating them more than you did in the past.

Zane Burke - *Cerner Corporation - President*

Sure. This is Zane. Our investments in physician usability; our focus on fast, easy, smart as it relates to the physician community in particular; our focus on Revenue Cycle solutions, and having clinically-driven Revenue Cycle, and having those proof points in the marketplace are coming together well for us.

And then it allows you to get to the dialog of the future vision pieces around -- first off, around the performance improvement that we can drive and deliver value today. And we will work with our clients to drive and deliver that value. And then look at their future around managing the Population Health and our vision around Population Health, and, frankly, our delivery in the short range of what we have been able to do in that space.

As well as the continuum of care and having solutions across all the continuum of care. And there's also a desire for a company that has an open, standards-based, and transparent approach. And Cerner has clearly differentiated itself as the open, transparent, and interoperable Company, where our principal competitor has -- is exactly the opposite of that. And there is a definite need for that in the marketplace and a desire for that.

Michael Cherny - *ISI Group - Analyst*

Thanks, Zane, that is helpful. And then one last quicker question. When you talked about the 61% of the M&A that was done over the last year involving Cerner customers, is there any way you could frame what the potential opportunity could be from those acquired hospitals, if you were to assume that they were all, over time, going to convert? Just give a sense of the magnitude of how big that could potentially be.

Zane Burke - *Cerner Corporation - President*

I don't have a number detail at this point. And I may be providing some additional color at the upcoming conference at HIMSS.

But what I can tell you is given that we are in 17 of the top 30 largest organizations as the principal EMR provider, we have significant opportunity in the whitespace in a number of those acquired spaces, as well as our solutions or whitespace around, in particular, ambulatory, Revenue Cycle, and Population Health. And so having those footprints are critically important. We may provide some additional color around that at HIMSS.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, this is Marc. I would just add that even as these acquisitions get made, it will vary as to whether the acquirer decides to quickly replace all of the hospital technology or takes the tack of: I want to do the larger hospitals, but I'm going to wait for some of the smaller hospitals and do them at a later date.

So it doesn't necessarily bring with it a large 12-month activity of new business. But clearly over time our expectation is that those clients will eventually move a significant portion of those acquired hospitals over to Cerner, which gives us a nice annuity, if you will, of potential future business.

Michael Cherny - *ISI Group - Analyst*

Thanks, guys, and see you in a couple of weeks.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

I guess, Zane, I will start with you. If we think about the Population Health management opportunity, two quick questions. Recognizing that it is early in this sales cycle, I will ask, is it -- are Population Health bookings and is Population Health business tracking to Cerner's expectations, kind of above or below?

And part B of that question is: from a functionality perspective, what hasn't Cerner developed? Or what don't you have in your bag yet that you would like to have in the bag?

Zane Burke - *Cerner Corporation - President*

I will start, George, with the first part. I would say it is tracking at our expectations. And we have, actually, in addition to Advocate, kicked off 3 other client projects in that area. And so we anticipate the uptick to go well as we see more and more proof points in that space.

There is a number of areas that you will see additional features and functions and major modules past the Smart Registries conversations. So whether it is the additional scorecards for payers; whether it is some of the additional Web services that we will add in that space; some of the quality measurements that we will be doing -- there's a number of things that you will see us rolling out. And those I mentioned will be in 2014.

And there's many, many things to go do in this space. So this is a multi-year rollout for Population Health.

George Hill - *Deutsche Bank - Analyst*

And then maybe a quick follow up for Marc. Just with respect to 2014, we talked about tech resale. Should we expect tech resale to reaccelerate or just be flat in 2014? And any chance you would give us the contribution from Intermountain to bookings in the quarter? I've got to ask, come on.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Addressing your technology resale question, our expectation is now that we've kind of -- the level is set, and gotten rid of the 2012 bolus, if you will, that we continue to introduce new devices and new connectivity, and continue to get uptake on those devices -- and especially the connectivity, even in shops that are automated with our biggest competitor.

They are buying our iBus and our connectivity engines, because they clearly see us as the way to go pull their device infrastructure together. And that capability doesn't exist on the other side.

So I think that we would expect it to grow -- for tech resale to grow, but kind of grow at a rate that our overall revenue is growing. And based on that overall revenue growth, I think it shouldn't, therefore, be skewing gross margins, operating margins, either way. Because as long as it is growing at the same level, I think that would be pretty effective.

I think on Intermountain, we haven't talked about the bookings levels. Obviously, our contracts are confidential. But I think I have seen analysts' estimates that put it kind of in the $100 million, $125 million, $135 million range. I think those are reasonable estimates for that base deal.

We certainly look forward to doing more things with Intermountain in the future, but I think that is a reasonable -- those are not unreasonable projections.

George Hill - *Deutsche Bank - Analyst*

Okay. Thank you very much. See you guys a couple of weeks.

Operator

Steve Halper, FBR.

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

One housekeeping question. Marc, what is the implied or assumed tax rate for 2014 in the guidance?

Marc Naughton - *Cerner Corporation - EVP and CFO*

A range of around 34%.

Operator

Eric Coldwell, Robert W. Baird.

Eric Coldwell - *Robert W. Baird & Company, Inc. - Analyst*

I was trying to come up with a new question, because George pretty much hit on mine with the tech resale. But I guess the main thing I am looking at is with that -- with those comments, are you seeing client purchasing orders picking up, or getting client commentary that lends you confidence? Or is it more just macro -- what you are seeing with the connectivity engines, and iBus, and things of that sort that you mentioned?

And then, perhaps as a follow-up to that, targeting operating margin expansion around 100 basis points: I'm curious what influence, if any, the RCM HIE analytics and patient engagement focus you talk about for 2014 has on that margin profile -- i.e., is it still in investment phase, so it is somewhat margin-dilutive? Or are those volumes in aggregate similar to the Firm averages?

Zane Burke - *Cerner Corporation - President*

Eric, this is Zane. I will comment on the technology resale in particular that you are speaking about, around the iBus connectivity in the CareAware. I think what we are saying is that continues -- we think will have continued uptick. The pure tech resale, the resale of low-margin devices and hardware, we think would be flat to slightly up in that space.

So we are seeing continued good activity. We have not seen any issues around any kind of negative elements around that.

On the business model side of that, the HIE, the patient engagement, and the enterprise data warehouse -- those are fairly high-margin business for us. So that is bundled typically in an ASP model, software-as-a-service model, all those types of offerings. And those carry a bundled high-margin rate that includes services, software, and hosting as one basic element.

Eric Coldwell - *Robert W. Baird & Company, Inc. - Analyst*

Got it. Perhaps as a follow-on -- that is very helpful. With those solutions you just referenced having a high-margin rate for a margin being up 100 bps, which is still admirable, are there other areas, legacy areas that perhaps you are seeing less margin expansion than perhaps in the past?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Eric, this is Marc. I don't know that there is anything -- I think across our business -- we'll certainly at the HIMSS meeting, investor meeting on February 25, go through and disclose all of the business model that we have briefly touched today and give you a sense of what those margins look like.

But we see good trends across all of those, even with the services business, which obviously is now a very big business -- but is able to, to the extent there is a low component element of some of the works businesses, still be able to cover that and continue to see growth in the overall margins of those businesses.

So I think that there is nothing that we are seeing -- the basic for us is the 100 bps is more a target. It certainly, if you look at our guidance, is kind of the answer you would get looking at our guidance.

We think there are still opportunities to get synergies and to get efficiencies in the business, but we are going to continue investing in R&D and other things that we're not going to get as much leverage as you might have seen us get in the past.

So that is probably the area that in the past you would have seen us getting more leverage. In this time period we're not getting the leverage from that. We're really getting the leverage from growing the business. And that is about 100 bps.

Operator

Robert Jones, Goldman Sachs.

Robert Jones - *Goldman Sachs - Analyst*

Actually, Marc, just to follow on, you just mentioned the R&D investments. Obviously, I think we are operating under the assumption that some of the R&D investments moderate in the back half of this year.

How should we be thinking about capital allocation? If I think about -- you mentioned the authorization being upped again. Just wondering, as we get into the back half of 2014, any comments you have around capital allocation would be helpful.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Relative to 2014 and our expectations for the year, we look to continue to spend about the same amount on R&D from a capitalized perspective as we did in 2013. It will be -- certainly our plan right now is very close to that.

We're going to see a tailing off of some of the third-party components of that as we go through the year and they complete their task. But we will also add some associates into that pool for continued long-term development.

So that will stay pretty flat. I think as we look out to 2015, you might see a slight reduction there, but pretty nominal. R&D is our lifeblood. There are a lot of opportunities ahead of us in healthcare, in Population Health.

And given the environment, given the lack of attractive targets from an acquisition standpoint, given that that is not really our strategy, we're going to invest in the business. And the way you are going to see us invest in the business is primarily going to be through that line. But it should remain a fairly constant number, certainly through 2014, with a slight reduction in 2015 on the R&D side.

Robert Jones - *Goldman Sachs - Analyst*

Got it. And this might be something we'll have to wait for HIMSS for, but of your core EMR clients, could you give us any sense on the penetration within that base as it relates to RevWorks and maybe ITWorks? And then on the back of that, any kind of run rate you would be willing to give us as far as what RevWorks and what ITWorks separately are generating at this point?

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. Given that we have barely double digit and ITWorks and less than double digit in RevWorks, and we certainly have probably 350 places that we could go talk to, and certainly at least over 200 conversations of people that probably would be interested in these services -- not to mention going into the ambulatory business office side, which is a great business that we have made great inroads into -- I think there is a lot of whitespace for us.

I think we have talked about getting to a point where we can get a rhythm of certainly doing an ITWorks every quarter; doing a RevWorks every other quarter; and then, over time, perhaps getting to the point where we can do 6 to 8 ITWorks a year, with RevWorks coming 1 a quarter.

And I think we certainly see the opportunity out there. The need is out there. Healthcare is focused on reducing operating expenses. These Works businesses over time will certainly contain those expenses. And they all have efficiency targets on how we can -- that we can drive down over their operating costs as they move forward.

Everything we see would indicate that our clients are going to want to take up those offerings. And we're very happy with where we are at. We would argue that we are ahead of where we thought we would be on ITWorks, on launching of these types of businesses. And we think that it's just a matter of time before they become somewhat like our hosting business, where you have a vast majority of your client base taking it up.

Operator

Ryan Daniels, William Blair.

Ryan Daniels - *William Blair & Company - Analyst*

Zane, a quick one for you. One of the numbers that stood out in your commentary was the 39% of bookings in Q4 coming from outside of the core Millennium base. I think that is a record for percentage in absolute dollars. So hoping you can shine a little more color on what is driving that -- if it is truly just competitive replacements, rip and replace; or if it is really more of these EHR overlays that you are talking about, with data warehousing and some of the other initiatives, like HIEs?

Zane Burke - *Cerner Corporation - President*

It is absolutely the EHR rip-and-replace platform. So the HIE and some of the other pieces on a percentage basis are fairly nominal at this particular point.

Ryan Daniels - *William Blair & Company - Analyst*

And then a lot of discussion on Population Health. And I am curious if, when you look at that market and the opportunities you are seeing today, is it really true greenfield opportunities, where they haven't made investments? Or is it going out there and seeing entities that have invested a lot in these point solutions that have been on the market for a number of years and wanted to do a more integrated or comprehensive solution with you?

Zane Burke - *Cerner Corporation - President*

Well, I think, Ryan, you have gone to where it will go to and is going to, which is: people are looking at and are beginning to say there were piece parts, much like the old days of the niche markets, when people would buy best of breed. So I think there has been a historic best-of-breed for certain functions within organizations, but clients are beginning to think -- are just beginning to think more holistically about what the future looks like in that space.

So I would say it is still a niche buyer. From a buyer perspective, it is still a niche market. But the more progressive clients are beginning to think about what this will evolve to.

And so in some cases it is a greenfield, and in some cases it is a replacement of some of those niche providers. So it just depends upon the maturity level and how far along the organization's journey is on Population Health.

Operator

Sean Wieland, Piper Jaffray.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

I would like to know how the ICD-10 go-live October 1 is factored into your outlook for the year. Do you think it is a headwind or tailwind? And specifically when you are in your Revenue Cycle business, when are we so close to that date that hospitals go into lockdown mode and don't want to touch anything?

Zane Burke - *Cerner Corporation - President*

Sean, I think I would tell you it is probably a no-wind at this point. It is neither a headwind nor a tailwind at this point. While I think it is going to be a significant event from an execution perspective from our clients, which we have been preparing our clients for for the last year-plus to get ready -- and I do think there will be a lot of execution work -- it does not appear to be having any impact on our clients' buying cycles and is not reflecting itself in any of our forecasts or pipelines at this point.

We do see a fair amount of activity in the Revenue Cycle space, as clients begin to look past the ICD-10 cutover and begin to think about their futures and what they need to go do in that space. So I would say it is beginning to be -- almost be -- it will be back to normal, if you will.

So whatever -- if there was a headwind, it was buried in the last time periods; and we didn't really see that in our results. I would look at it and say, that is really beginning to remove itself as clients begin to think past that in their strategic planning and begin to plan for the future.

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. It is not unusual for our clients to have projects in front of them, especially on the Rev Cycle side, after ICD-10 is highlighting their current state of solutions in that space. And for them to start on the next track of, okay, what is -- when I get through ICD-10 cutover, I need to go and do something on my Rev Cycle solution. So I am actually going to get into a buying mode currently as opposed to waiting until my projects are done.

Most of the people we are dealing with in the C-suite are -- that is just work to go do for them. Sure, it is work. It is very hard work, and our clients are going to be very focused on it. We don't underestimate the impact.

But from a purchasing side, we have been querying our teams and our sales executives: do they see anything where ICD-10 is interfering in any of their ongoing pipeline discussions? And the answer was no. Because we had the same question. Is that going to impact 2014? And at this point we don't see any impact.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

Thank you. And unrelated follow-up: last quarter you talked about mobile and an agreement you put in place with Apple. Any update there on how you are leveraging mobile to enhance physician experience?

Zane Burke - *Cerner Corporation - President*

We continue to roll out to some of our early adopters some of the technology. And we continue to see good progress on that side.

But no other substantive rollout. So continued progress. We should be able to update you some in that area, as well, at the HIMSS.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, Sean. Clearly, it gives us an advantage to be able to sell the device direct, without the cost of connecting to a network. But once again, it follows our strategy of -- we're going to connect to the device that is most often used by the healthcare provider.

And this just gives us one more avenue to that. We're very pleased with our position. We are having active discussions. But obviously, it is still a fairly new agreement.

Operator

Lisa Gill, JPMorgan.

Lisa Gill - *JPMorgan - Analyst*

Zane, I think I heard you say that there was strong growth in the ambulatory bookings in the fourth quarter, with 18 signature accounts that were displacements. Can you help us to understand if these were driven more by docs wanting to choose a new EMR? Or was this more of the hospital client driving affiliated physician decisions?

Zane Burke - *Cerner Corporation - President*

Lisa, it is a mixture of both. So it is both of those scenarios. But in many cases, it is the organizations wanting an integrated solution. And then our solution is very appealing and is second to none in the ambulatory marketplace. So it is the driver of the business. And so you are seeing a combination of both.

Lisa Gill - *JPMorgan - Analyst*

Is there a way to quantify how big that opportunity is? Clearly, you have a lot of very large hospital systems that are buying physician practices and driving what their decision is going to be around EMR. Is there any number we can put around that from an opportunity perspective?

Zane Burke - *Cerner Corporation - President*

Well, it is tricky, because I can tell you that about 70% of our clients have some sort of Cerner ambulatory footprint; but the number of physicians in each one of those organizations -- there's a lot of whitespace as it relates to those organizations that we have a singular footprint, because they will have many other connections with, perhaps, existing EMRs today.

So I don't have a ready number for that type of model. What is positive is the progress we have made in terms of the number of clients that have created a Cerner ambulatory footprint has grown dramatically. And so that gives us a good foothold. And our success in there, in that space, will give us lots of opportunity to continue to grow.

Lisa Gill - *JPMorgan - Analyst*

Okay, great. And then my second question would be around -- would be for Marc. In the bookings in the first quarter, just looking at 7% to 16% growth, can you maybe just talk about the variables on each end? What would cause it to be on the lower end versus on the upper end? Is it single deals that you see in the marketplace? And how much comfort you have, especially at the upper end of that range.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Lisa, normally, and as we always have, we go through our forecasting process where we review all the deals; and we get our best view of what the opportunities look like. And that is what we certainly base our forecast on.

Whether -- being at one end of the range or the other likely means, did a deal grow larger as we were moving forward? Did we risk down a couple of deals, and then both of them come through in that same quarter? Do we have a Works deal that comes in that quarter that we might not have expected, that we had at a different time?

So there is a variety of things. We are signing thousands of contracts in a quarter anymore. So there is nothing -- our range that we provide is our best estimate based on the information we have.

And it's a range, because it is as much art as it is science. So I think that is the best answer I can give.

I can't tell you which end of the range is more likely at this time. We are working through the quarter as we always work. And our goal is to provide you a range that we think the bookings are going to be in. And when we exceed that top of that range, that means some things came into the quarter that either got bigger -- or in this environment, there are things that come in very quickly, and the business gets done with a very short cycle, especially with existing clients. So, unfortunately, that is about the best I can do on commentary.

Lisa Gill - *JPMorgan - Analyst*

And I appreciate that. Thank you.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Why don't we take one more call?

Operator

Donald Hooker, KeyBanc.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

I wanted to ask you about the managed services line, which is something that has been a big driver for you guys for many years. And it looks like it is continuing to be a double-digit driver.

What keeps that growing? And what percentage of that is international at this point? I think you said -- it looks like it's about 15% growth year over year in managed services.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, this is Marc. The international component today is fairly small. It is just getting to get some traction. We collocate data centers in-country for hosting in the various countries, because a lot of them don't let their data go across their boundaries. But there is a much lower level of infrastructure investment than there is in the US.

A lot of the uptake is many of the new clients that get signed opt to do managed services with their initial contract. So there is that component. As our existing clients that are hosted do have acquisitions and expand their scope, that scope expansion not only applies to software, and implementation services, and all those other elements; it applies to their hosting infrastructure, as well.

So very few of our clients are just staying static and not growing. So that the business naturally grows. And then, obviously, the new clients that opt to do managed services immediately add to that number as well. So that is why we are able to see growth, both in the base and with new clients there.

Neal Patterson - *Cerner Corporation - Chairman, CEO, and Co-Founder*

This is Neal. Why don't I just wrap up here?

So 2013 we just basically wrapped that. It was a good year. So as an entrepreneur, and where this started at the kitchen table, having $1 billion of bookings in one quarter is certainly impresses me.

You all know what we do is very hard, complex, and at times can be very ambiguous. Your questions support that.

I think we all know that we have -- Cerner has plenty of things to improve. And while we are doing very good, we could be doing better. And I assure you, as a team we are focused very much on being better.

We are also, though, focused on -- whereas we focus on being better in the present, we also instinctively want to basically skate to where the puck is going. The Population Health investments that we are making -- we do certainly believe that that we'll be, by the end of the decade, a lot of healthcare organizations being responsible for the health of their population, and their business models will have changed.

I don't think we are quite at that trigger point. When the US figures out an alternative to fee for service, that will be -- the market will move in a fairly significant way, and it will be a major market at that point. So we expect to help facilitate that move and be there when it happens.

So broadly, we think healthcare will change significantly over the rest of this decade. We think information technology is the biggest lever to implement change in healthcare. And we think we can -- we will be involved in significantly redefining how healthcare works.

So we're going to continue to be bold. We will see you at HIMSS in the very near future. Thank you very much. Have a good evening.