Cerner Corporation
Fourth Quarter 2013
Earnings Conference Call
February 4, 2014

Moderator

Welcome to 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 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 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 in the fourth quarter and for the full year 2013.

Bookings, Backlog and Revenue

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 Q412. 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 Q412. 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 Q412, which had grown 14% over the prior year, and a 6% decrease for the full year 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 higher-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 Q412 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 Q412 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'll provide at our investment community meeting on February 25th, 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 & Maintenance was up 10% to $662 million, and
- Reimbursed 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 Q412, reflecting record software levels and the 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 technology resale resumes contributing to revenue growth. This should also result in our revenue and gross margin dollar growth rates being more aligned.

Operating Expense and Earnings

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 the 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 Q412 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 Q412 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 Q412 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.

Operating Margins

Moving to operating margins. Our operating margin in Q4 was 25.6% before share-based compensation expense and the settlement charge and was up 160 basis points compared to Q412. For the full year, operating margins increased 220 basis points to 25.1%. This was driven by a 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.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q4 were $60 million, or 17 cents per diluted share. GAAP net earnings include share-based compensation expense, which had a net impact on earnings of $9 million, or 3 cents per diluted share, and the settlement charge, which had a net impact of $68 million, or 19 cents.

Adjusted net earnings were $137 million and adjusted EPS was 39 cents, which is up 16% compared to Q412. 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%.

Balance Sheet / Cash Flow

Now I'll 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 Q412.

Operating cash flow for the quarter was $141 million. Q4 capital expenditures were $134 million, and capitalized software was $49 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 is 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 the settlement charge.

Looking at capitalized software, the $49 million of capitalized software in Q4 represents 42% of the $116 million of total investment in development activities. Software amortization for the quarter was $25 million, resulting in 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-$70M per quarter versus nearly $90M in 2013. For capitalized software, we expect it to be in the mid-forty million dollar range throughout the year, which will lead to it being flat or slightly higher than 2013. This reflects a reduction in the use of 3rd 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.

Guidance

Now I'll go through Q1 and full-year 2014 guidance.

- For Q1, we expect revenue between $770 and $810 million, with the midpoint reflecting growth of 16% over Q113.

- For the full year, we expect revenue between $3.2 and $3.4 billion, reflecting 13% growth at the midpoint.

- We expect Q1 adjusted EPS before share-based compensation expense to be 36 to 37 cents per share, with the midpoint reflecting 11% growth over Q113 reported adjusted EPS, and 14% growth when you consider the 1 cent benefit we had from lower taxes in Q113. This range is slightly lower than Q1 consensus, which may have factored in growth off of the Q113 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 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 3 cents in Q1 and 11 to 12 cents for the full year.

- Moving to bookings guidance, we expect bookings revenue in Q1 of $860 to $930 million, with the midpoint reflecting 12% growth over our strong Q113 bookings.

In summary, we are pleased with our results in 2013, which was a 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

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

Results

Starting with our results, our bookings revenue in Q4 of $1.11 billion is an all-time high and reflects 9% growth over Q412, 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 inside and outside our installed base. For the year, we had record levels of contracts in both categories, with 101 over $5M and 57 over $10M.

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 2014, even with nearly $4B 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 of 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 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 in 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.

ITWorks

Now I'll cover some of the specific areas that contributed to our strong Q4 and full-year results. I'll 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 had 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 clients' 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 highly reference-able, 100% have attested for Meanignful 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

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 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. Another factor is that health care 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.

Population Health

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 build out of our cloud-based Healthe Intent platform. Our progress on this front was excellent, and 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 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 this solution in January and everything is going well. We look forward to providing more details on this at our investment community meeting.

Ambulatory / CommunityWorks

Moving to the ambulatory space, where we had an outstanding Q4 and record year that included the following highlights:

- Over 40% growth in bookings;
- 18 signature displacements of our key competitors;
- The signing of our largest ambulatory Business Office Services contract;
- Five 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've made in our solutions and the ongoing trend of our clients wanting an integrated inpatient/outpatient solution.

We also had a record year of success with smaller hospitals, adding 20 CommunityWorks 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 KLAS Community HIS validates the strength of our offering and positions us for ongoing success.

Other Highlights

Another highlight this year was success at providing non-Cerner EMR clients solutions and services to help them with future stages of Meaningful Use and with 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. Then 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 device connectively 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.

Global

Outside of the U.S., we had a solid quarter and year, with 8% revenue 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 a strong pipeline in the UK. In the Middle East, we have made good progress on work for the Saudi Ministry of Health, and we are on pace for the 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.

Marketplace Observations

Now I'll cover a few more marketplace observations.

In the provider space, the focus remains on costs 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, health care 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 attain 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 four 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'll turn the call over for questions.