Cerner Corporation
Fourth Quarter 2015
Earnings Conference Call
February 16, 2016

Moderator

Welcome to Cerner Corporation's fourth quarter 2015 conference call. Today's date is February 16, 2016, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today constitute forward-looking statements, including without limitation, those regarding projections of future revenues or earnings, operating margins, operating and capital expenses, product development, new markets or prospects for the Company's solutions and services and plans and expectations related to the Health Services business and other client achievements. 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, and then Jeff Townsend, EVP and Chief of Staff, will provide an update on Intermountain Healthcare and Cerner's innovation.

Now I will turn to our results. Q4 was a good finish to the year. Revenue, earnings, and cash flow, were all at or above targeted levels. Bookings were slightly below our guided levels, primarily because we didn't have a Works deal in the quarter, but full-year bookings were very strong.

Bookings, Backlog and Revenue

Our bookings revenue in Q4 was $1.35 billion, which reflects 16% growth over Q414. While that is a healthy growth rate, it is below our guided range. There was an ITWorks deal and a large professional services contract in our forecast that would have led to us comfortably achieving our guidance range. While they didn't close in Q4, we do expect them in future quarters. For the full year, our bookings revenue was $5.43 billion, which is 28% growth over 2014, and reflects more than $200 million of upside to the bookings guidance we provided throughout the year, including Q4.

Our revenue backlog ended the year at $14.2 billion, which is up from $10.6 billion a year ago.

Revenue in the quarter was $1.18 billion, which is up 27% over Q414 and in the middle of our guidance range. The revenue composition for Q4 was $382 million in System Sales, $247 million in Support and Maintenance, $528 million in Services, and $18 million in Reimbursed Travel.

Revenue in the quarter includes approximately $245 million from Health Services. This is down from approximately $250 million in Q3, but note that the deferred revenue adjustment was higher in Q4, so Health Services revenue was basically flat sequentially on an operational basis, which is in line with our expectations.

For the full year, revenue grew 30% over 2014 to $4.4 billion and includes approximately $930 million from Health Services.

System sales revenue reflects a 36% increase over Q414, with the growth mainly driven by an increase in Subscriptions, which is where the addition of Health Services has had the biggest impact, as well as strong growth in License Software. For the full year, system sales revenue grew by 36% over 2014.

Our System sales margin percent in Q4 was 68.4%, which is up from 67.5% in Q3 due to strong sequential growth in License Software. Full year system sales margin percent was 66.4%, which is basically flat compared to 2014.

Moving to Services, total Services revenue, including professional and managed services, was up 23% compared to Q414. Full-year Services revenue was up 28% over 2014.

Support and Maintenance revenue increased 25% over Q414 and 35% for the full year, with the lower growth in Q4 due to the extra week in Q4 of 2014.

Looking at revenue by geographic segment, domestic revenue increased 28% over the year-ago quarter to $1.04 billion and Global revenue grew 21% to $134 million, both driven largely by the addition of Health Services. For the full year, domestic revenue grew 29% and global grew 37%.

As a preview to the annual update of our detailed business model that we'll provide at our investment community meeting on March 2nd at HIMSS, I'd like to provide you with the total revenue and growth by business model for the full-year 2015.

- Licensed Software grew 24% to $564 million;
- Technology Resale grew 21% to $330 million;
- Subscriptions increased 76% to $388 million;
- Professional Services revenue grew 13% to $1.24 billion;
- Managed Services increased 56% to $858 million;
- Support & Maintenance was up 35% to $976 million, and
- Reimbursed Travel was $73 million, which is down 19%

Moving to gross margin. Our gross margin for Q4 was 83.0%, which is up from 81.3% in Q414, reflecting strong License Software growth. Full-year gross margin of 83.0% was up from 82.2% in 2014.

Operating Expense

Looking at operating spending, our fourth quarter non-GAAP operating expenses, which exclude share-based compensation expense, voluntary separation plan expense, and acquisition-related adjustments, were $686 million, which is up 31% compared to adjusted Q414 operating expenses. This growth was primarily driven by the addition of the Health Services business. For the full year, operating expenses before share-based compensation expense, voluntary separation plan expense, and acquisition-related adjustments were up 33% to $2.60 billion

The total year-over-year growth for each expense category in Q4 on a non-GAAP basis was: 26% for Sales and Client Service; 33% for Software Development, and 59% for G&A. Amortization of acquisition-related intangibles, the new line we added in Q2, was basically flat. For the full year, Sales and Client Service grew 29%, Software Development grew 38% and G&A grew 54%.

Operating Margins

Moving to operating margins. Our operating margin before share-based compensation expense, voluntary separation expense, and acquisition-related adjustments was 24.7% in Q4, which is flat to the year-ago period and up 20 basis points from Q315. Full-year operating margin came in at 24.3%, which is basically flat compared to last year.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q4 were $166 million, or 48 cents per diluted share. Adjusted net earnings were $212 million and adjusted diluted EPS was 61 cents, which is up 30% compared to Q414. Adjusted net earnings exclude share-based compensation expense, which had a net impact on GAAP earnings of $13 million, or $0.04 per diluted share; as well as the voluntary separation plan expense, which had a net impact on GAAP earnings of $861 thousand, or less than $0.01 per diluted share. Adjusted net earnings also reflect adjustments related to Cerner's acquisition of Health Services, including: Health Services acquisition-related amortization, which reduced GAAP net earnings and diluted earnings per share by $15 million and $0.04, respectively; other acquisition-related adjustments, which reduced GAAP net earnings and diluted earnings per share by $4 million and $0.01, respectively; and the acquisition-related deferred revenue adjustment, which is not included in GAAP net earnings, but increased adjusted net earnings and diluted earnings per share by $13 million and $0.04, respectively. For the full year, adjusted net earnings were $741 million and adjusted EPS was $2.11, which is up 28% from 2014.

The Q4 tax rate for adjusted net earnings was 27%, which is lower than our normal range primarily due to the R&D tax credit being reinstated in Q4. The R&D tax credit benefited EPS by approximately 4 cents, with about 3 cents related to the first three quarters before the reinstatement of the credit. Therefore, we view our normalized adjusted EPS for the quarter as 58 cents instead of 61 cents.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q4 with $686 million of total cash and investments, which is down from $766 million in Q3, primarily due to the use of cash for our stock repurchase program. During the quarter, we finished the remaining $145 million of stock repurchases authorized in September of this year, repurchasing 2.5 million shares at an average price of $58.40. For the year, we repurchased 5.7 million shares for $345 million, or an average price of $60.39.

Moving to debt, our total debt, including capital lease obligations, is $605 million, which is down slightly compared to Q3.

Total receivables ended the quarter at $1.03 billion, which is down $19 million from Q3. Our Q4 DSO was 80 days, which is an improvement of 5 days compared to Q3. We are targeting DSO in the 70s in 2016.

Operating cash flow for the quarter was extremely strong at $353 million, up from $272 million in Q3. Q4 capital expenditures were $107 million, and capitalized software was $60 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was $186 million for the quarter, driven by strong operating cash flow.

For the full year, operating cash flow was $948 million, and free cash flow was $321 million with capital expenditures of $362 million and capitalized software of $265 million.

As previously indicated, we expect capital expenditures to increase in 2016, primarily due to construction of a new campus. We still expect to generate solid free cash flow, with growth in operating cash flow offsetting most of the increase in capital expenditures.

Guidance

Now I'll go through Q1 and full-year 2016 guidance.

- For Q1, we expect revenue between $1.15 and $1.2 billion, with the midpoint reflecting growth of 18% over Q115.
- For the full year, we expect revenue between $4.9 and $5.1 billion, reflecting 13% growth over 2015 at the midpoint.
- We expect Q1 adjusted EPS before share-based compensation and acquisition-related adjustments to be 52 to 54 cents per share, with the midpoint reflecting 18% growth over Q115 adjusted EPS.
- For the full-year, we continue to expect adjusted EPS before share based compensation and acquisition related adjustments to be $2.30 to $2.40, as initially stated on our Q3 earnings call, with the midpoint reflecting 11% growth over 2015.
- Our estimate for the impact of share-based compensation expense is approximately 4 cents in Q1 and between 16 and 17 cents for the full year.
- Moving to bookings guidance, we expect bookings revenue in Q1 of $1.15 billion to $1.25 billion. The midpoint of this range is flat to Q115 bookings. Given the very tough comparable established in Q1 of last year with 32% bookings growth, and 28% growth for the full-year 2015, there will be some quarters this year with flat or low growth.

  We do expect growth for the year, but note that even flat bookings would lead to a 2-year CAGR of 13%. Also, given that nearly 80% of our guided revenue is scheduled to come out of backlog, we believe we can deliver our revenue and earnings guidance even if bookings are flat.

With that, I will turn the call over to Zane.

Zane Burke

Thanks Marc. Good afternoon everyone. Today I'll provide color on our results and make some marketplace observations.

Results/Marketplace

Starting with bookings, our bookings revenue in Q4 of $1.35 billion reflects 16% growth over Q414. As Marc mentioned, this is slightly lower than expected primarily due to less long-term bookings, but still a strong level of bookings that contributed to our excellent growth for the year of 28%.

Bookings this quarter included another all-time high level of large contracts, with 46 contracts over $5 million, including 29 over $10 million. For the year, we had 153 contracts over $5 million, with 102 of these being over $10 million. This reflects 37% growth in contracts over $5 million and 62% growth in contracts over $10 million.

For long-term bookings, we had a strong quarter for remote hosting, but did not have a new ITWorks or RevWorks deal, so the percent of bookings from long-term contracts was 27%, which is about 7% lower than the average of the first 3 quarters. For the year, long-term bookings were 32% of total bookings, which is 2% higher than last year, reflecting full-year strength in Works deals.

We continued our new business momentum in Q4, with 36% of our bookings coming from outside our core *Millennium*® installed base. 2015 was by far the best year in our history from a new business standpoint. During the year, we signed more than double the number of new footprints than any year in our history, which we believe is evidence of our strong competitiveness and the large opportunity for competitive displacements. Our success was very broad during the year, with new business coming from IDNs, regional hospitals, Children's hospitals, Community hospitals, state and federal, behavioral health, ambulatory surgery centers, and physician groups.

I believe 2015 was a breakthrough year from a competitiveness standpoint. I believe our success is driven by several factors:

- First, we are much better in key areas because of our R&D investments. In the past five years, we've invested more than $2 billion in R&D, with a focus on population health, physician and clinician experience, revenue cycle, consumer, interoperability, open platforms and mobility. These investments are leading to much better performance in traditional competitions for EHR and Revenue Cycle and further differentiation in areas like population health and open platform capabilities.
- We have also focused on predictable delivery capabilities, cost of ownership, and delivering measurable value, which is critical in an environment where ROI is increasingly important.
- Finally, the marketplace is becoming more aware of our primary competitor's higher cost of ownership, lack of system openness, and lack of investment in cloud-based systems to support population health. We believe this is leading to more success against our primary competitor in EHR procurements and opportunities in their installed base for population health.

Population Health

Turning to population health, 2015 was a great year. We had 30% bookings growth and we now have 85 clients that have chosen the *HealtheIntent™* platform to support their population health strategy. A highlight of 2015 was success outside of our EHR installed base, with one example being Geisinger Health System choosing *HealtheIntent* to extend their data-driven population health capabilities. This announcement made a clear statement to the market and has already added to our long list of opportunities outside of our EHR base. We currently have more than 20 opportunities outside of our installed base, most of which use our primary competitor's EHR. I believe this activity is validating the broad opportunity for *HealtheIntent* and the shortcomings of our primary competitor.

Another highlight was that we were recently selected to support the health insights of a statewide Medicaid population. The state will use *HealtheIntent's* enterprise data warehouse solution to gain insights and intelligence from claims and clinical information across the state's Medicaid population, which will enable them to manage outcomes at an optimal level. This is a new market entry point for Cerner and is an additional example how *HealtheIntent* expands Cerner's reach beyond our EHR base.

A key reason we are having so much success at selling *HealtheIntent* solutions is that clients who have already adopted them are getting great value and have become examples for the industry for how technology can enable a transition to quality- and value-based reimbursement. A good example of this was captured in a January feature in *Health Data Management* magazine. The article covered Advocate Health Care's success at using the *HealtheIntent* platform to gather more than 60 different clinical and transactional data sources and use predictive algorithms to predict risks, improve patient care and control costs.

Revenue Cycle

Moving to our revenue cycle business. We had a very good year, with bookings that were more than double 2014 levels and included several of our large clients choosing Cerner for revenue cycle. Operationally, we brought 39 acute care sites and 455 clinics live on *Millennium* revenue cycle, and we now have more than 1,800 live sites.

Our momentum in revenue cycle is also reflected in very strong organic revenue growth, with revenue cycle revenue nearly doubling in the past three years. We expect continued strong growth going forward, with many large clients forecasted to transition to Cerner revenue cycle and a large volume of RevWorks and Extended Business Office opportunities.

Ambulatory/CommunityWorks

Moving to the ambulatory market, where we had a strong Q4 and year. For the year, ambulatory bookings grew over 50% and included 38 displacements of our primary ambulatory competitors. This included some of our largest acute care clients choosing to replace their existing ambulatory supplier. We also had a strong start to penetrating the Health Services base, with 16 Health Services clients choosing Cerner ambulatory.

Our ambulatory business office services offering also had a strong year that included our two largest deals to date, both of which were displacements of a certain "cloud" competitor.

We also had a strong year in the small hospital market with our cloud-based CommunityWorks offering where we ended the year with more than 130 clients. This year's success was driven by a combination of traditional new footprints, extensions through our health system clients, and Health Services migrations. One highlight for the year was Great Plains Health Alliance selecting Cerner CommunityWorks for their 25 critical access hospitals across Nebraska and Kansas. Looking ahead, the small hospital market remains very active, and I expect 2016 to be another good year.

DoD

Now I'd like to provide an update on the Department of Defense project. I am pleased with the work accomplished by the Leidos Partnership for Defense Health over the past several months as we prepare for pilot site rollouts. Next month at HIMSS, the partnership will highlight many of the solutions that will be used in the implementation, including some military-specific workflows, first responder applications, mass vaccinations, and theater synchronizations.

Our collaborative effort has led to solution enhancements and data portability that are essential to achieving the free flow of information across all venues of care and creating a system that works for health care organizations working to improve the well-being of individuals and communities. I believe this work can benefit the entire Cerner client base and the broader health care industry.

Health Services

Moving to Health Services, we had a good first year at signing Health Services clients to migrate to *Millennium*. During the year, over 40 sites signed to migrate, including both IDNs and small hospitals. Operationally, I am very pleased with how the Cerner and Health Services teams have come together in the past year. Health Services associates have proven to be highly talented and are adding value in many key areas of our business.

Global

Outside of the U.S., we had a solid year. Full-year non-U.S. revenue growth was 37%, with most of this driven by the addition of Health Services as organic revenue growth was limited to low-single digit due to the extra week in 2014, the impact of currency fluctuations, and lower activity in some markets where the economies are struggling. Even though our non-U.S. results tend to be lumpier, we continue to believe global markets represent a large growth opportunity for both EHR and population health. And Cerner is well positioned for this opportunity with associates or offices in more than 25 countries and a strong market position in many of them.

Marketplace Observations

Now I'd like to provide several marketplace observations.

1. The first is that health systems are increasingly being asked to live in two worlds – A future state driven by reimbursement models aligned to risk and quality outcomes and a current state where FFS is still the predominant model. To bridge the gap between the present and the future, health systems need to solve the same problem – How to effectively manage and make disparate data meaningful and drive appropriate action from it. Solving current state problems such as proactively identifying reimbursement opportunities, driving efficiency across venue specific workflows, and true visibility into the quality of care being delivered are critical to enable health systems to outperform their peers in an increasingly competitive

healthcare market. To make the pivot, health systems will compete by proactively identifying populations at risk, redefining clinical engagement to pre-empt problems, and enabling the person to be a more active member of the care team. We believe clients are looking for a platform to help bridge these worlds: compete more effectively on quality and efficiency in today's environment and more actively engage and manage populations in the future state, and *HealtheIntent* is a perfect fit for satisfying these needs.

2. Second, the EHR replacement market remains very active. While regulatory pressures and solutions being sunset by competitors continue to drive opportunities, we are also seeing more purchasing behavior driven by value and vision, which is positive for Cerner. Almost all EHR replacements also represent a revenue cycle opportunity as providers prefer integrated clinical, ambulatory and revenue cycle systems.
3. Third, consolidation in the hospital market has remained active and this is creating opportunities for Cerner. In the past 3 years, Cerner clients accounted for nearly 50% of hospital buying activity, creating an opportunity for more than 100 new footprints. Consolidation is not isolated to the provider market, with payers and HCIT suppliers also actively merging in attempt to attain scale to compete in the evolving health care market.
4. Fourth, we believe the EHR will evolve from a transactional system to an intelligent, activity-based system that will enable faster adoption of best practices, reduced variance, personalized care, improved outcomes, and the ability to identify unit costs, which will be critical as reimbursement shifts to outcomes-based and bundled payments. This is consistent with the direction Cerner has been headed and has been a focus of our efforts with Intermountain Healthcare.
5. Finally, we believe openness and interoperability continue to become increasingly important. This benefits Cerner because of our long-time commitment to interoperability and open systems. This commitment was recently advanced by our launch of the Cerner Open Developer Experience, which is an open site designed to enhance collaboration with third-party and client developers with SMART® on FHIR® applications. We believe this open platform has the potential to unlock future cutting-edge solutions that could benefit not only our entire client base, but the industry.

In summary, there is a significant amount of change occurring in health care. We believe more will change in the next five years than the last several decades, and Cerner is very well positioned to benefit from these changes.

With that I will turn the call over to Jeff.

Jeff Townsend

Thanks Zane. Today I am going to provide an update on our collaboration with Intermountain Healthcare and what they refer to as their iCentra project, and how it is advancing Cerner's methodologies and our pace of innovation. After completing a second regional deployment in Q4 of 2015, we are now heads down deploying an ever improving Model System design across Intermountain in 2016 while continuing to innovate and improve in parallel.

Agile / Model System

A component of how we're doing both at the same time will be a topic that Marc Probst, the CIO at Intermountain Healthcare, and I will be co-presenting at a HIMSS education session titled, "What IT takes for Success", sharing our joint experiences and approaches to shift traditional Information Technology to Improvement Technology to better align with Intermountain's journey to a Learning Healthcare System. By applying a hybrid of agile development concepts with continuous quality improvement it has significantly changed the pace of both innovation and adoption. As a by-product of this work, the models and methods have continued to shape Cerner's next generation of continuous improvement methodologies, which are represented with our Model System framework. The library of process models, workflows, configuration and best practices are all part of a comprehensive "kit", that is applicable and measureable across our client base to speed our life cycle from innovation to adoption, at scale.

As this foundation of techniques, tools and measurements are utilized across multiple organizations, Cerner has continued to build on our ability to measure the experience of an end user as they navigate through our applications. This suite of analytics is called Cerner Advance, which includes a set of solutions that has leveraged our learning in the population health space. The difference is that the population is clinicians and the health status is how effectively they're utilizing the features and preferences of the system within their workflow. It allows us to identify and personalize improvement interactions at the individual user level, just like you would with care management for patients. We all learn at a different pace, in different ways. This applies an Amazon like consumer profiling for clinicians, which we think is a key component of accelerating adoption.

CareDecisions / Model Practice

As I've shared before, a core component of our relationship with Intermountain has been the ability to advance innovation of clinical computing models more quickly. Within Cerner, we have started to use the term Model Practice to represent the focus on contextual, clinical decision making within the workflow, as a seamless by-product of patient care. In the case of Intermountain, this is where their Care Process Models surface naturally. As Zane outlined, the shift in reimbursement models is increasing the demand to remove unnecessary variance in both costs and outcomes, which is shifting the focus to greater predictability and intelligence within the EMR experience.

We are now far enough along in our journey together that we have represented the breadth of structured care models from the simple to complex, and have extended the platform capabilities with a small set of Cerner clients to cover the continuum of care models, guidelines, pathways and predictive scoring. This suite of clinical decision support solutions is called CareDecisions, which covers a continuum of capabilities that can range from highly contextual point in time decisions like a patient with pneumonia presenting in the ED for treatment, to a series of nested pathways that would cover chronic conditions or diseases across several years. The architecture of this platform is based on Open principles allowing for both portability of predictive models that run from the cloud across clinical data sets that span enterprises, to something we call a SmartZone which is face up within the physician workflow and contextual to the moment. It's through this coordinated set of CareDecision capabilities that we think we can deliver intelligence that would create what Clayton Christensen refers to as a Facilitated Network in his book, The Innovator's Prescription. We anticipate this configuration and collection of open system solutions will make up the Model Practice layer of our Model efforts and enable clinical evidence to be sharable, portable and programmable across both Cerner clients and the industry.

Finally, I wanted to briefly share the growing capabilities of advancing an activity centered design within the EMR. We have found that the ability to link measurements from Application Experiences, Process Variation, Clinical Evidence and Outcomes provides significant new insights into our ability to achieve business and clinical objectives. This too is becoming part of the evolution towards a Learning Healthcare System with priorities being established based on desired outcomes versus implementation of technology. In many cases, this inverts the model that most have chased in the era of meaningful use. What we've found is that while independently a workflow may be followed, it may not be timely, which in turn impacts the effectiveness of adopting clinical evidence. This in turn produces a suboptimal outcome…even though several of the process centered metrics may have indicated a good result. This concept is shaping a new understanding of critical thinking and how clinical integration evolves in an environment where everything is connected and instantaneously aware with a depth and breadth of data that is significantly larger. As the boundaries move from patient centered "visits", to the continuous engagement of population health, there is no question it will require this next layer of intelligence, in context. Our ability to predict and dynamically adapt the health care ecosystem based on activities in context is what we think drives the next tier of outcome improvement.

Close

Before handing the call over to questions, I wanted to provide a brief Neal update. His initial treatments have gone well and he is progressing as expected. He is very appreciative of all the well wishes he has received from associates, clients and investors and pleased with the excellent care he has received. At Cerner, we have no doubt that his experience will further fuel his desire to continue to improve the system.

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