Cerner Corporation
First Quarter 2015
Earnings Conference Call
May 7, 2015

Moderator

Welcome to Cerner Corporation's first quarter 2015 conference call. Today's date is May 7, 2015, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today constitute forward-looking statements, including without limitation, those regarding projections of future revenues or earnings, operating margins, operating expenses, product development, new markets or prospects for the Company's solutions and plans and expectations related to the acquisition and integration of the Siemens Health Services business. Actual results may differ materially from those indicated by the forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements may be found under Item 1A in Cerner's Form 10-K together with the Company's other filings. A reconciliation of non-GAAP financial measures discussed in this earnings call can be found in the Company's earnings release, which was furnished to the SEC today and posted on the investor section of Cerner.com.

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

Marc Naughton

Thank you. Good afternoon everyone and welcome to the call.

I will lead off today with a review of the numbers. Zane Burke, our President, will follow me with results highlights and marketplace observations. Mike Nill, Executive Vice President and Chief Operating Officer, will discuss operations. And Neal Patterson, our Chairman and CEO, will join us for Q&A.

Now I will turn to our results. Overall, while revenue was below our expectations, we had a solid quarter highlighted by very strong bookings and our outlook remains positive.

Bookings, Backlog and Revenue

Our bookings revenue in Q1 was $1.2 billion, which is an all-time high and reflects 32% growth over Q114, driven by strong growth in traditional Cerner bookings with minimal bookings contribution from Health Services.

Our revenue backlog ended the quarter at $13.0 billion, which is up from $9.2 billion a year ago and reflects the strong bookings in Q1 and the inclusion of backlog from Health Services.

Revenue in the quarter was $996 million, which is up 27% over Q114. Total revenue for Cerner was approximately $820 million, with the remaining $176 million attributable to Health Services. The total is approximately $50 million below our guidance range, with the shortfall roughly equally split between Cerner and Health Services. On the Cerner side, the higher percentage of the record bookings that came from long term contracts meant a lower percentage of items that generated in-quarter revenue. Additionally, services and reimbursed travel was lower than expected. On the Health Services side, part of the shortfall was due to the $12.5 million adjustment to earnings for deferred revenue not being reflected in revenue, as we had assumed in our guidance. However, since we decided not to report a non-GAAP revenue metric, our top-line guidance was off by that amount. This difference in Health Services will continue and is factored into our new full-year revenue guidance along with a slightly lower run rate for total revenue that reflects the Q1 shortfall. It is important to note that our Q1 adjusted earnings results were not impacted by the lower revenue and our annual guidance for adjusted earnings remains the same.

The revenue composition for Q1 was $259 million in System Sales, $229 million in Support and Maintenance, $490 million in Services, and $18 million in Reimbursed Travel.

System sales revenue reflects a 26% increase over Q114, with the growth mainly driven by an increase in Subscriptions, which is where the addition of Health Services had the biggest impact.

Q1 System Sales margin dollars grew 19% over the year-ago period. Our System sales margin percent of 64.7% is down from 68.5% in Q114 and up from 63.6% in Q414. The decline year-over-year reflects lower tech resale margins.

Moving to Services, total Services revenue, including professional and managed services, was up 28% compared to Q114, with solid growth in Cerner services augmented by the addition of Health Services.

Support and Maintenance revenue increased 31% over Q114, reflecting solid growth in core support and maintenance and the addition of Health Services.

Looking at revenue by geographic segment, domestic revenue increased 25% over the year-ago quarter to $871 million and Global revenue grew 44% to $126 million, with both of the growth rates augmented by the addition of Health Services. Health Services had a slightly higher mix of Global revenue than Cerner's historical levels, so the addition of Health Services had a bigger impact on global revenue, but our existing global business also had strong performance.

Moving to gross margin. Our gross margin for Q1 was 83.1%, which is down slightly compared to 83.5 % in Q114, reflecting the lower technology resale margins and a slightly lower gross margin from Health Services.

Operating Expense

Looking at operating spending, our first quarter operating expenses before share-based compensation expense and acquisition-related adjustments were $591 million, which is up 28% compared to adjusted Q114 operating expenses. Since we have already integrated many components of Health Services, we don't have an exact breakout of operating expense between Cerner and Health Services, but we estimate that Cerner operating expenses grew in the mid-single-digit range and the rest of the growth is the addition of Health Services.

The total year-over-year- growth for each expense category was: 23% for Sales and Client Service; 41% for Software Development, and 33% for G&A.

Operating Margins

Moving to operating margins. Our operating margin before share-based compensation expense and acquisition-related adjustments was 23.7% in Q1. This is down 90 basis points compared to Q114, reflecting the incorporation of Health Services.

Given we achieved our earnings on lower revenue this quarter, the operating margin percent with Health Services incorporated into our results is higher than we originally projected. This is largely due to lower core Cerner expense growth offsetting the lower core revenue growth. We expect higher core Cerner revenue growth for the rest of the year, but still expect the full-year to be below original projections. This is expected to continue being offset by lower expense growth, so we still expect to drive the same level of earnings, with the combination of lower revenue and unchanged earnings leading to a higher core operating margin percent. In total, this means we expect our combined operating margin to only go down approximately 100-150 basis points for the year versus an original expectation that it would go down over 200 basis points with the addition of Health Services.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q1 were $111 million, or 32 cents per diluted share. Adjusted net earnings were $157 million and adjusted EPS was 45 cents, which is up 22% compared to Q114. Adjusted net earnings and diluted earnings per share exclude share-based compensation expense, which reduced first quarter 2015 net earnings and diluted earnings per share by $11 million and $0.03, respectively. Adjusted net earnings and diluted earnings per share also reflect adjustments related to the acquisition of Health Services, including: amortization of intangibles, which reduced net earnings and diluted earnings per share by $10 million and $0.03, respectively; a deferred revenue adjustment, which reduced net earnings and diluted earnings per share by $8 million and $0.02, respectively; and other acquisition-related adjustments, which reduced net earnings and diluted earnings per share by $17 million and $0.05, respectively.

The Q1 tax rate for adjusted net earnings was 33.6%, which is in line with our expected effective tax rate. For the remainder of 2015, we expect our effective tax rate to be in the 33% to 34% range.

Voluntary Separation Program

Now I'd like to preview a nonrecurring expense we expect to incur in Q2. We recently offered a voluntary separation plan, or VSP, to eligible associates. Generally, the VSP was made available to U.S. associates who meet a minimum level of combined age and tenure. The VSP was offered to both Cerner and Health Services associates and the percent accepting has been roughly equal across both groups. There were some positions, such as executive officers and certain critical roles that were excluded from being eligible for business continuity purposes.

Associates who elected to participate in the VSP will receive financial benefits commensurate with their tenure and position, along with vacation payout and medical benefits. The acceptance period for associates electing to participate in the VSP ends later this month. Based on levels of acceptance, we currently estimate a net of tax charge of approximately $35 million in Q2 for the VSP and related costs.

This completely voluntary program will have a small impact on our total headcount as the eligible associates that accepted the offer only represent about 2% of total associates. While a portion of these positions will be backfilled, we believe we will be able to fill many of the positions with existing associates, which should create efficiencies in the future while also creating career growth opportunities for our associates.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q1 with $889 million of total cash and investments, which is down $763 million from $1.65 billion in Q4, mainly driven by our $1.37 billion purchase of Siemens Health Services and partially offset by $500 million of debt that we issued earlier this year and added to cash and investments. Our total debt, including capital lease obligations, is $626 million, up from $130 million in Q4 due to the new debt.

Total receivables ended the quarter at $941 million, which is up $268 million from Q4 driven by strong sales in the quarter. Our DSO in Q1 was 79 days, which compares to DSO of 66 days in Q4 and 66 days in the year-ago quarter. The increase was driven by higher accounts receivable, which was largely due to adding Health Services, and the lower revenue this quarter. We expect DSO to be closer to historical levels in future quarters.

Operating cash flow for the quarter was $214 million. Q1 capital expenditures were $82 million, and capitalized software was $63 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was $69 million for the quarter.

Moving to capitalized software, the $63 million of capitalized software in Q1 represents 39% of the $161 million of total investment in development activities. Software amortization for the quarter was $29 million, resulting in net capitalization of $34 million, or 21% of our total R&D investment.

We still expect to continue generating solid free cash flow this year, with operating cash flow growth partially offsetting an expected increase in capital expenditures tied to beginning construction of a new campus and capital expenditures related to our Health Services business. Note that the cash flow impact of the VSP will primarily impact Q2 and reduce overall free cash flow for the year.

Guidance

Now I'll go through Q2 and full-year 2015 guidance.

- For Q2, we expect revenue between $1.175 and $1.225 billion, with the midpoint reflecting growth of 41% over Q214.

- For the full year, we expect revenue between $4.65 and $4.80 billion. This is lower than our prior guidance due to the lower revenue in Q1 and an expectation for about $1 billion of Health Services revenue for the year instead of our previous expectation of $1.1 billion, which is largely due to the deferred revenue adjustment not impacting the revenue line. This is still 39% growth at the midpoint and reflects an expectation for higher growth than Q1 from core Cerner for the rest of the year.

- The lower revenue is not expected to impact our earnings in Q2 or for the year. For Q2, we expect adjusted EPS before share-based compensation and acquisition-related adjustments to be 51 to 52 cents per share, with the midpoint reflecting 29% growth over Q214 adjusted EPS.

- For the full-year, we expect adjusted EPS before share based compensation and acquisition-related adjustments to be $2.07 to $2.15, which is up from our previous range of $2.05 to $2.15 and reflects 28% growth at the midpoint.

- Our estimate for the impact of share-based compensation expense is approximately 3 to 4 cents in Q2 and 14 to 16 cents for the full year.

- Moving to bookings guidance, we expect bookings revenue in Q2 of $1.2 billion to $1.3 billion, with the midpoint reflecting 16% growth over Q214. We expect our strong Q1 bookings and Q2 outlook to contribute to better core top-line growth as we move through the year, but keep in mind that Q4 has a tough comparable due to the extra week in Q414.

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

I'll start with our results. Our bookings revenue in Q1 of $1.2 billion reflects very strong growth of 32% over Q114.

Booking this quarter included a high level of large contracts, with 24 contracts over $5 million, including 19 over $10 million.

We also had strong contribution from long-term bookings, with an ITWorks contract and an expansion of an existing RevWorks relationship. This led to long-term bookings making up 37% of total, which is approximately 5% higher than normal. Even adjusting out the higher long-term bookings contribution, our bookings were very strong and bookings would still be at the high-end of our guidance. As Marc discussed, our strong bookings didn't convert to higher revenue this quarter, but it does position us for higher future growth.

A highlight of the quarter was strong competitiveness, which resulted in 34% of our bookings coming from outside of our core Millennium installed base. As I discussed during our Investment Community Meeting at HIMSS, our pipeline is very strong and we are well positioned for new business this year and beyond.

I believe we still have a multi-year period ahead of us where there will be opportunities to win new footprints as organizations look to replace legacy systems and align with a strategic supplier. There is also a meaningful opportunity to expand our footprints within our client base, as many of our large clients still have several non-Cerner facilities and are looking to consolidate on a single system. The ongoing acquisition activity in the marketplace plays to our advantage as well because it is being led by our clients. And, as we discussed at HIMSS, we are already off to a good start with migrating Health Services clients to Millennium, and this activity is bringing along sales of other solutions, such as population health and ambulatory.

My view of our opportunities was reinforced at HIMSS, where we interacted with more than $5 billion of pipeline, including many new EMR replacement opportunities. In addition to strong new business activity, the dominant themes at HIMSS aligned very well with Cerner's strengths. Our complete vision and strong capabilities in population health coupled with our commitment to interoperability and open EMR were clearly on display and well received. Regarding interoperability, we were pleased with the level of progress that was on display during the conference, most notably including CommonWell member expansion to 70% of the acute EMR market being represented.

Population Health

Now I'll briefly discuss a few key areas of our business, starting with Population Health. Our population health organization had a strong start to the year. We continue to have success with selling population health solutions to clients ranging from small hospitals, to IDNs, to counties and states. Population health solutions are now part of most new EMR contracts, and as I mentioned, have been added to migration contracts for Health Services clients converting to Millennium.

Overall, I believe our differentiation in population health is becoming clearer, and this differentiation was evident at HIMSS. We are quickly separating ourselves from other offerings with our ability to aggregate and normalize clinical, claims and financial data across multiple systems and bring near real-time information into the workflow.

Another key differentiator is results. Our early adopter clients, such as Advocate Health Care, are getting value out of the system and are vocal about the fact they view *HealtheIntent™* as a platform that improves their ability to operate in an environment in which they are taking more risk.

Revenue Cycle

Moving to our revenue cycle business, we had a good first quarter and have a strong outlook for the year. Revenue cycle continues to be an important component of EMR replacement opportunities, and the strength of our integrated revenue cycle offering is contributing to our success at gaining new footprints.

We are also continuing to increase penetration of our revenue cycle solutions in our client base in both acute and ambulatory venues as our clients look to move to a single platform. We are still early in this opportunity, and I expect many more of our large clients to move to our revenue cycle solutions now that we have more proof points among our large clients.

On the RevWorks services side of our business, we expanded our relationship with an existing RevWorks client based on success we've had so far. I am pleased with how we have executed on our initial RevWorks relationships, and we are achieving results that I believe will be compelling to other prospects. For example, Adventist Health's Northern California region has achieved a $27 million increase in revenue, a 21% decrease in A/R days, and all sites are over 100% of cash targets. These types of results reflect the strength of both our revenue cycle solutions and our RevWorks services offerings, and create compelling reasons for new prospects to consider our revenue cycle solutions and services.

Ambulatory

Moving to the ambulatory market, where we also had a strong Q1. Noteworthy activity in Q1 included:

- Continued displacements of key competitors, including the displacement of the ambulatory solutions of our primary competitor at 29 ambulatory facilities.
- A strong start at selling ambulatory solutions into the Health Services base, including stand-alone sales and being included as part of acute care migrations to Millennium; and
- Continued strength in our ambulatory business office services.

Regarding business office services, I'd like to highlight that business because I think our success there is not widely known. We have ambulatory business office services clients across 45 specialties and 39 states. Our clients range from single physician practices up to large IDNs where we have RevWorks relationships that include ambulatory Business Office Services.

As we have gained traction in this space, we are identifying more opportunities to displace a competitor's cloud business office services offering by proving our offering is more effective. For example, we are able to show in many cases that our business office services are more than 20% less than our competitors cloud offering primarily because they require the client to maintain a staff approximately 3 times what our offering requires. In addition, many of these larger and more sophisticated clients are facing several challenges with our competitor's solution, such as having 50-60% of claims require manual intervention because they don't fit the 'cloud configuration'.

I believe we will keep doing well in the business office services space as we continue to gain positive proof points with our clients and as awareness broadens about the true cost and challenges associated with our 'cloud' competitor.

Global

Outside of the U.S., we had a strong Q1. Total revenue growth was 44%, consisting of strong organic growth and the addition of Health Services. Strong performance in the UK was a big driver of our organic growth as we continued to have success gaining new footprints and expanding relationships with clients as they transition out of the national program. One of the reasons we continue to do well in the market is that our clients are getting value out of our solutions. A great example of this was documented when the Health and Social Care Information Centre did a benefits deep dive of the Cerner Millennium implementation at Barts Health NHS Trust, which is one of the largest hospital groups in the UK. In this review, they concluded Barts is achieving significant clinical and operational benefits in areas Cerner Millennium is installed. This and other proof points we have in the UK market position us very well relative to our less established competitors.

Broadly, we remain optimistic about our ability to get good contributions from global for the rest of the decade. And this opportunity is enhanced by the complementary global business of Health Services.

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

Mike Nill

Thanks Zane. Good afternoon everyone. Today I am going to discuss ITWorks and provide some comments on our initial go lives with Intermountain Healthcare.

ITWorks

I'll start with ITWorks. In the first quarter, we established a new ITWorks relationship and also expanded an existing ITWorks relationship. Our new ITWorks client is a 410-bed community hospital with 29 ambulatory locations. Similar to many of our ITWorks clients, taking over IT operations is only part of the new contract. For example, as Zane discussed, we will be displacing our primary competitor in the ambulatory facilities. We will also be doing an optimization project for the client's Millennium system at the hospital and implementing population health and revenue cycle solutions.

In a memo to all health system employees, the CEO of our client highlighted the strategic nature of ITWorks by saying, "We believe it is the best approach to ensure we meet the long-term strategic objectives of our organization while continuing to provide the highest level of care to our patients in an era of incredibly fast-moving changes in health care information technology and increasing regulatory requirements."

As I indicated on our last call, our ITWorks pipeline is strong as many provider organizations face pressures to control costs, improve quality, and keep up with regulatory requirements. Our Q1 results are a good start, and I expect continued success throughout the year.

iCentra

Now I'd like to make a few comments about our initial go lives at two Intermountain Healthcare hospitals and 24 clinics. The go lives occurred just 15 months after we signed the contract, which is extremely fast when you consider the majority of projects of similar scope take more than twice as long. When fully deployed, project iCentra will be at 22 hospitals and more than 180 clinics. It will include nearly 80 solutions across EHR, practice management and revenue cycle, and the system will have over 320 role profiles, 354 clinical workflow models, and 372 financial workflow models.

This is the first Cerner project to make use of our new Agile Deployment Methodology, a model that represents a departure from the industry-standard waterfall implementation process. In the Agile model, physicians and other end users participate in the system build and design, and never go more than six weeks without the opportunity to see, use and give feedback on the system prior to go-live. This approach has been a big success, and we believe there are benefits that will extend beyond the go-live. It has the potential to support elements of a learning health system—something that has been elusive in health care.

Another key element of this project is the incorporation of Intermountain's Care Process Models and Clinical Process Guidelines, which have helped its clinicians achieve high quality care and low overall cost for many years. Before iCentra, these were mostly paper documents. Now they are part of digital workflows that are used every day.

In summary, we believe our work with Intermountain, combined with work we are doing with other strategic client partners, is resulting in a new generation of systems. We are leading the transition in the industry away from systems that are simply transactional or used just for the purpose of meeting regulatory requirements. We are creating intelligent systems designed to meet the complex needs of providers across the spectrum of health care; coordinate care any time, any place; use intelligence to inform decisions by the highest standards; and connecting all of the individuals they serve seamlessly into the process.

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