Cerner Corporation
Second Quarter 2015
Earnings Conference Call
August 4, 2015

Moderator

Welcome to Cerner Corporation's second quarter 2015 conference call. Today's date is August 4, 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 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. Mike Nill, Executive Vice President and Chief Operating Officer, will discuss operations. Neal Patterson, our Chairman and CEO, will join us for Q&A.

Now I will turn to our results. Similar to last quarter, we delivered results that were mostly in line with our expectations with the exception of revenue. While we are disappointed that we were below our guided levels of revenue, our continued levels of strong bookings and positive outlook set up a good second half of the year.

Bookings, Backlog and Revenue

Our bookings revenue in Q2 was $1.29 billion, which is an all-time high and reflects 20% growth over Q214, including record amounts of new business activity.

Our revenue backlog ended the quarter at $13.3 billion, which is up from $9.7 billion a year ago and reflects the strong bookings in Q2 as well as the inclusion of backlog from Health Services.

Revenue in the quarter was $1.13 billion, which is up 32% over Q214 and includes approximately $260 million from Health Services. The total is approximately $50 million below our guidance range, with approximately $40 million of the shortfall related to core Cerner and $10 million attributable to Health Services.

On the Cerner side, the lower revenue and resulting low single-digit growth is related to several factors. Some are in-quarter dynamics, some are unique items in the prior-year period that drove 20% growth and created a tough comparable, and some are items that we didn’t accurately forecast.

- The first factor is lower growth in services, which is primarily because of a year-over-year decrease in third-party services. Recall that in Q214 we had a revenue over-attainment of more than $20 million that was largely related to higher third-party services and reimbursed travel. We are using less third-party services this year, and travel revenue excluding Health Services was down approximately 50% year-over-year. Just adjusting for these two items brings Cerner’s core growth from approximately 2% to 5%. As you know, third-party services are lower margin and reimbursed travel is zero margin, so this lower revenue had little impact on our profitability.

- Another factor that has impacted our services revenue is that we limited hiring in the months leading up to and the initial months after the close of our Health Services acquisition. Our forecasting model did not fully reflect this. We are now ramping up hiring to meet the strong demand reflected in year-to-date bookings and our forecast, which will drive stronger services revenue growth, but the impact of the additional resources, as well the impact of additional opportunities we see for the Works businesses, will primarily be toward the end of the year and in 2016.

- An additional factor impacting revenue is that our bookings this quarter included a higher percentage from long-term contracts resulting in a lower percentage of items that generated in-quarter revenue.

- Finally, Relative to Health Services, recurring revenue is tracking as we had forecasted, but non-recurring revenue came in lower than expected. While we are having ongoing success with converting Health Services clients to *Millennium*, there is a portion of their base that is sitting tight during the transition, which has impacted the rate at which they make add-on purchases for things like lower margin hardware. Otherwise, everything we are tracking for Health Services is at or ahead of our expectations.

Now I'll quickly go through the total revenue composition for Q2. Total System Sales revenue was $315 million, Support and Maintenance was $255 million, Services was $538 million, and Reimbursed Travel was $18 million.

System sales revenue reflects a 34% increase over Q214, 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 growth in Licensed Software.

Our System sales margin percent was 64.3%, which is down slightly from 65.3% in Q214 and 64.7% in Q1. The decline was driven by lower tech resale margins.

Moving to Services, total Services revenue, including professional and managed services, was up 30% compared to Q214, mainly driven by the addition of Health Services as well as growth in core Cerner Managed Services.

Support and Maintenance revenue increased 45% over Q214, reflecting solid growth in core support and maintenance and the addition of Health Services.

Looking at revenue by geographic segment, domestic revenue increased 30% over the year-ago quarter to $995 million, driven largely by the addition of Health Services, and Global revenue grew 54% to $131 million, with good growth in core Global revenue being augmented by the addition of Health Services.

Moving to gross margin. Our gross margin for Q2 was 82.9%, which is up from 80.9 % in Q214, with the improved margin reflecting the lower level of third-party services and reimbursed travel.

Operating Expense

Looking at operating spending, our second quarter non-GAAP operating expenses, which exclude share-based compensation expense, voluntary separation plan expense, and acquisition-related adjustments, were $661 million, which is up 37% compared to adjusted Q214 operating expenses. This growth was primarily driven by the addition of the Health Services business.

The total year-over-year- growth for each expense category on a non-GAAP basis was: 32% for Sales and Client Service; 42% for Software Development, 61% for G&A, and a 3% decline in Amortization of acquisition-related intangibles, which is a new expense line we added this quarter. Note that this line is $25 million on our GAAP income statement and $3 million in our non-GAAP results since we are excluding amortization related to Health Services.

Operating Margins

Moving to operating margins. Our operating margin before share-based compensation expense, voluntary separation expense, and acquisition-related adjustments was 24.2% in Q2. This is essentially flat compared to Q214 and up 50 basis points from last quarter.

Similar to Q1, we achieved our second quarter earnings on lower revenue, resulting in a higher operating margin percent than we originally projected.   We expect this dynamic to continue for the rest of the year, with lower revenue being offset by lower expenses, resulting in no change to our earnings outlook and a higher operating margin percent than we originally projected. We now expect our non-GAAP operating margin for the year to be close to 2014 levels. This compares to an original expectation that it would go down approximately 200 basis points with the addition of Health Services.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q2 were $115 million, or 33 cents per diluted share. Adjusted net earnings were $183 million and adjusted EPS was 52 cents, which is up 30% compared to Q214.   Adjusted net earnings exclude share-based compensation expense, which had a net impact on GAAP earnings of $14 million, or $0.04 per diluted share; as well as the voluntary separation plan expense, which had a net impact on GAAP earnings of $28 million, or $0.08 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 $14 million and $0.04, respectively; other acquisition-related adjustments, which reduced GAAP net earnings and diluted earnings per share by $6 million and $0.01, respectively; and the acquisition-related deferred revenue adjustment, which is not included in GAAP net earnings, but increases adjusted net earnings and diluted earnings per share by $6 million and $0.02, respectively.

The Q2 tax rate for adjusted net earnings was 33%, which is in our expected range of 33-34%.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q2 with $857 million of total cash and investments, which is down slightly from $889 million in Q1 due to our negative free cash flow, which I'll discuss in a minute. Our total debt, including capital lease obligations, is $623 million.

Total receivables ended the quarter at $1.0 billion, which is up $63 million from Q1. Our Q2 DSO was 81 days compared to 79 days in Q1 and 66 days in the year-ago quarter. The higher DSO is primarily a function of the lower revenue in the quarter and some delayed billings for Health Services clients as we transition to our systems. As we move through the year, we expect DSO to come down as revenue increases and we get Health Services billings caught up.

Operating cash flow for the quarter was $109 million, down from $214M in Q1 due mainly to the voluntary separation plan expense and lower collections related to the delayed billings. Q2 capital expenditures were $85 million, and capitalized software was $70 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was negative $46 million for the quarter, driven by a combination of lower operating cash flow and higher capital spending.

Looking ahead, we expect operating cash flow to increase in coming quarters as voluntary separation plan and acquisition-related expenses decline and we improve DSO. Some of the increased operating cash flow will be offset by capital expenditures tied to construction of our new campus and Health Services capital expenditures, but we still expect free cash flow to improve meaningfully.

Guidance

Now I'll go through Q3 and full-year 2015 guidance.

- For Q3, we expect revenue between $1.15 and $1.2 billion, with the midpoint reflecting growth of 40% over Q314.
- For the full year, we expect revenue between $4.475 and $4.575 billion, with the midpoint reflecting 33% growth over last year. This is lower than our prior guidance due to the lower revenue in Q2 and also factors in the lower year-to-date run rate.
- As I indicated, the lower revenue is not expected to impact our earnings in Q3 or for the year. For Q3, we expect adjusted EPS before share-based compensation, voluntary separation plan expense, and acquisition-related adjustments to be 54 to 55 cents per share, with the midpoint reflecting 30% growth over Q314 adjusted EPS.
- For the full-year, we expect adjusted EPS before share based compensation, voluntary separation plan expense, and acquisition-related adjustments to be $2.09 to $2.15, which is up from our previous range of $2.07 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 Q3 and 14 to 15 cents for the full year.
- Moving to bookings guidance, we expect bookings revenue in Q3 of $1.35 billion to $1.45 billion, with the midpoint reflecting 27% growth over Q314.

In summary, while we are disappointed that revenue was below our guidance, we are very pleased with our bookings results and outlook. Importantly, we believe we have appropriately adjusted our revenue guidance to factor in the lower first half revenue and run rate.

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 Q2 of $1.29 billion reflects strong growth of 20% over Q214.

Bookings this quarter included an all-time high level of large contracts, with 38 contracts over $5 million, including 23 over $10 million.

We also had strong contributions from long-term bookings, with a large ITWorks contract and an expansion of an existing ITWorks relationship. This led to long-term bookings making up 35% of total, which is a few percent higher than normal.

The main highlight of the quarter was that we signed a record number of new footprints both in terms of number and dollars. This resulted in 34% of our bookings coming from outside our core *Millennium®* installed base. This success reflects our strong competitiveness and the continued large opportunity for competitive displacements. Our wins spanned many market segments, including: IDNs, regional hospitals, Children's hospitals, Community hospitals, state behavioral health, ambulatory surgery centers, and physician groups.

We are also continuing to sign Health Services clients to migrate to *Millennium*. These clients range from community hospitals selecting our CommunityWorks offering to large IDNs and we continue to see cross sale activity for solutions like population health and ambulatory.

While not part of Q2, I'd like to highlight a significant win for Cerner that was announced today. We were recently selected by Baptist Health South Florida, a leading health care organization in the region, to implement *Cerner Millennium®* and *HealtheIntent™* across their 7 hospitals and over 50 outpatient facilities. Baptist Health is recognized as a national leader in quality, safety and patient satisfaction, and they are looking to Cerner's solutions to optimize the physician experience, improve quality of care, and support their efforts to improve patient experience. In addition, they expect to leverage our enterprise-wide solutions and *HealtheIntent* platform to advance their goal of improving care coordination and reducing the cost of care.

This recent win combined with our record level of new footprints in Q2 is evidence of strong momentum we have in the marketplace.

Looking forward, we believe we can build on this momentum, and we remain bullish on new footprint opportunities. Our positive outlook is based on a very large and active pipeline and all-time high levels of new business activity, such as demos, reference calls and visits, and Vision Center visits. We continue to believe we have a multi-year opportunity to expand our client base as about half the market is on a legacy system that we think will need to be replaced.

One observation about the buyer in today's market is that they are very focused on predictability of cost and transparency of the total cost of ownership, and we believe this is something that plays to our strength. We believe our ability to offer fixed fee pricing on implementations because of our automation tools and implementation methodologies is a competitive differentiator. We also differentiate in our ability to provide services ranging from remote hosting to taking over an entire IT department, which can make our client's total costs much more transparent and predictable.

In addition, I believe we have credibility in the industry because of our track record for delivering value, and this credibility is bolstered by our large presence in investor-owned systems that are known for making ROI-based decisions. These clients, along with many of our other large IDN clients, represent some of the largest health care IT deployments in the industry. I think it is also worth noting that our ability to deliver value, on-time and on-budget projects is a meaningful differentiator relative to our primary competitor, who has a long list of clients making headlines when the significant costs of deploying and maintaining their system is cited as a key reason for job loss, financial challenges and debt rating downgrades.

Another marketplace observation is that openness, interoperability and population health capabilities are becoming more important. This also benefits Cerner because of our long-time commitment to interoperability and open systems and our robust *HealtheIntent* cloud platform for population health. We continue to expand the presence of *HealtheIntent* across our client base and the number of opportunities outside of our base is growing.

Revenue Cycle

Moving to our revenue cycle business, we had a good second quarter. All of our new EMR footprints in Q2 included revenue cycle, which supports what we have been saying about the market looking to buy integrated systems. Revenue cycle is also an important component of almost all deals in our pipeline. In addition, we are gaining momentum in our existing installed base, with several clients selecting us to replace their legacy revenue cycle systems in favor of an integrated system. Based on these trends, and a growing pipeline for related services, I expect revenue cycle to continue contributing to our growth for years to come.

Ambulatory/CommunityWorks

Moving to the ambulatory market, where we had an all-time high level of bookings in Q2. The bookings were driven by success at displacing our key competitors both by expanding our solutions to the ambulatory venues of our acute care clients and as part of new business footprints. In addition, we are continuing to have success selling ambulatory solutions into the Health Services base. Finally, we continue to gain momentum in ambulatory business office services and expect there to be additional sites where we displace the cloud business office services offering of a certain cloud competitor because of our ability to demonstrate better service and value.

We also had a record bookings quarter in the small hospital market, driven by a combination of traditional new footprints, extensions through our health system clients, and Health Services migrations.

Global

Outside of the U.S., we had a good Q2 with total revenue growth of 54%, consisting of good organic growth and the addition of Health Services. The organic growth was primarily driven by strength in the UK and Middle East. We are also off to a good start at integrating the global components of Health Services. We now have a presence in more than 30 countries, and believe we are well positioned for our global business to be a good contributor to our growth over the next decade.

DHMSM

Before turning the call over to Mike, I'd like to comment on the recent announcement on the Defense Healthcare Management System Modernization project, referred to as dim sum (DHMSM). We are pleased that last week the Department of Defense announced its decision to award the contract to Leidos, Inc. As you know, the Leidos Partnership for Defense Health includes Cerner as the core EHR supplier. We are honored, humbled, and excited to be a part of the team that won what we believe was the most objective and comprehensive evaluation of technology platforms and solutions ever conducted. We now have the opportunity for Cerner's suite of integrated solutions to replace the DoD's legacy health IT system in its 55 hospitals and more than 350 clinics worldwide, as well as in ships, submarines and other locations in the theater of military operations.

We're pleased to be partners with Leidos, Accenture, Henry Schein and a number of small business partners in making this important transition for our military health system and its 9.6 million beneficiaries. Intermountain Healthcare is also a strategic partner and is providing clinical governance of solutions and workflow.

The Partnership is fully prepared to meet the staffing requirements of DHMSM, and our globally deployed team stands ready to support the DoD and the DHMSM Mission. We believe this is a positive development for our clients, and they should have confidence that Cerner will continue to execute to meet all of our current and future commitments.

As many of you saw in the announcement, Leidos was awarded a contract for $4.3 billion over 10 years, consisting of a 2-year initial ordering period, two 3-year option periods, and another 2-year option period. We are not able to comment on Cerner's portion of this, but note that we do not expect this to have a material impact on bookings, revenue, or earnings in the near term since the project will have several phases and will start with a small initial rollout. I know many of you also saw an $11 billion figure cited in regard to the contract before it was announced. As noted in the DoD's press release this estimate is now approximately $9 billion and represents the total estimated program costs over 18 years, not the value of the contract awarded.

In summary, we believe this selection by the Defense Department reflects positively on the achievements of Cerner, our partners, and all of our clients. The Department of Defense is already in the Cerner family as a lab client, and we're excited to expand our relationship.

With that I will turn the call over to Mike.

Mike Nill

Thanks Zane. Good afternoon everyone. Today I am going to discuss ITWorks and provide an update on our relationship with University of Missouri.

In the second quarter, we established a new ITWorks relationship and also expanded an existing ITWorks relationship. Our new ITWorks client is Catholic Health Initiatives and this relationship was announced in July. CHI selected ITWorks to improve continuity of care across 47 hospitals and multiple clinical settings, and Cerner will assume operational and administrative responsibilities for CHI's IT at its facilities in multiple states that use *Cerner Millennium*®. This will include current and future implementations, upgrades, enhancements, optimization, application and operational management and support of the system, and clinical service desk support.

CHI has been a client for more than 12 years, and this will tighten our alignment and support CHI's vision of pioneering models to enhance patient care, safety and clinical outcomes. The tighter alignment will also help accelerate the implementation of the latest technology advances available.

The second ITWorks agreement I'd like to discuss is the expansion of our relationship with University of Missouri Health Care. MU has been a Cerner client since 1996 and we formed the Tiger Institute for Health Innovation with them in 2009. The Tiger Institute has produced a number of innovations to transform the delivery of care. Examples include e-visit technology, integrating calculators into the EHR, and developing a consumer facing mental health app. This year, the Tiger Institute launched OpenNotes, a function that gives patients access to their clinic notes through the MU Healthe patient portal.

MU Health has also achieved multiple health care IT successes, including HIMSS Stage 7, being the first Academic Medical Center to meet Meaningful Use Stage 2, and being designated "Most Wired" by AHA each of the past four years.

Going forward, the Tiger Institute will focus on: redefining patient engagement through mobile health care; developing a population health strategy and network to better position MU Health Care to lower costs while improving the health of Missourians, increasing the role of health care IT in academic medical research, helping transition to value-based payment models, and developing a Tiger Institute Value Creation Office to identify cost-saving opportunities.

University of Missouri was one of our first ITWorks clients and Institute relationships, and we are very pleased with what we have accomplished together as it demonstrates the power of close alignment with our clients.

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