Cerner Corporation
First Quarter 2019
Earnings Conference Call
April 25, 2019

Moderator

Welcome to Cerner Corporation's first quarter 2019 conference call. Today's date is April 25, 2019, 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; bookings; new solution, services and offering development; capital allocation plans; and future business outlook, including new markets or prospects for the Company's solutions and services. Actual results may differ materially from those indicated by the forward-looking statements. Please see Cerner's earnings release, which was furnished to the SEC today and posted on the investor section of cerner.com, and other filings with the SEC for information on the most significant factors that could cause actual results to differ materially from those in the forward-looking statements. Additionally, a reconciliation of non-GAAP financial measures discussed in this earnings call can also be found in the Company's earnings release available on Cerner.com. Cerner assumes no obligation to update any forward-looking statements or information except as required by law.

At this time, I'd like to turn the call over to Brent Shafer, Chairman and CEO of Cerner Corporation.

Brent Shafer

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

I'll spend the first few minutes providing some context for the quarter, then ask our CFO, Marc Naughton, to walk-through the results and then have Chief Client Officer, John Peterzalek provide additional highlights and marketplace observations.

Since our last earnings call, you've likely seen that Starboard acquired a position in Cerner and we announced a cooperation agreement with them. From the outset, we approached the conversations with Starboard in an open-minded fashion just like we do with any shareholder. Starboard's focus on operational improvements and board refreshment was consistent with our objectives and plans, and we had existing efforts underway in both areas. The cooperation agreement builds on and accelerates the work we've been doing and formalizes our commitment to improve operating performance, including specific targets that are aggressive but attainable. In addition, we added four outstanding new Board members, which we believe strengthens our governance. We strongly believe these operational and governance improvements are in the best interest of Cerner's clients, associates, and shareholders.

Since assuming the role of CEO in 2018, the entire Cerner leadership team and I have been reviewing all facets of our operations to improve financial performance and unlock the company's significant potential. As we discussed on our last earnings call and at HIMSS, we rolled out a new Operating Model to streamline operations, become more client centric, and enable improved focus on growth. We believe this work is foundational to our operational improvement commitments.

As a next step towards driving improvements in Cerner's operations and cost structure, we engaged AlixPartners, a leading outside consulting firm. Our goal is to uncover efficiencies without impacting important growth investments and commitments to Cerner clients. Key areas we expect to address include:

- Assess management span and layers
- Continue the portfolio management work we started in 2018

- Rationalize company facilities
- Review non-personnel expenses; and,
- Drive additional process improvements

The work is off to a good start. I have direct experience working with AlixPartners, and I am confident in their ability to help us become more efficient while we become more focused and better position ourselves for profitable growth. Marc will discuss our targets in more detail, but I want to make it clear they have been balanced against Cerner's growth investments and client commitments.

One of the other elements we evaluated last year was Cerner's capital allocation strategy. Based on the strength of our balance sheet, we wanted to enhance the return of capital to shareholders, which led to our announced quarterly dividend program and commitment to continue share repurchases. Given our expectation that we will create value as we deliver on our operational initiatives, we increased our share buyback authorization as part of our agreement with Starboard, resulting in $1.5 billion currently available for repurchase.

With respect to governance, we welcome John Greisch, Melinda Mount, George Riedel and Halsey Wise to Cerner's Board. These new members, along with our existing directors, bring invaluable counsel and insight. Our Board supports management's view that the actions we are taking can create shareholder value without putting the business at risk. To monitor the operational improvement efforts, a Finance and Strategy Committee has been established that will work closely with management to ensure execution against our operating targets.

Cerner operates in a highly competitive space and we will be measured in our approach with respect to client commitments, investments and considerations for our associate base. We believe the actions outlined help us become a much stronger and more focused company--well positioned for long-term profitable growth.

Now I'll turn it over to Marc.

Marc Naughton

Thanks, Brent. Good afternoon everyone. I am going to cover our Q1 results and future guidance.

Bookings, Backlog and Revenue

I will start with bookings, which were $1.242 billion in Q1. This is $42 million above the midpoint of our guidance range and, as anticipated, down from Q118 bookings of $1.398 billion which included much higher than normal levels of large, long-term bookings. As John will discuss, bookings excluding long-term contracts grew slightly over the year-ago period.

We ended the quarter with a revenue backlog of $14.87 billion, which is up 2% over a year ago. Recall that our backlog calculation under the new revenue standard excludes revenue from contracts with termination clauses, even though such clauses are rarely exercised. When you combine the expected revenue from our backlog and the additional revenue expected from contracts not included in backlog, our revenue visibility remains at approximately 85% over the next 12 months.

Revenue in the quarter was $1.390 billion, up 8% over Q118 and at the midpoint of our guidance range.

I'll now go through the business model detail and year-over-year growth compared to Q118.

- Licensed Software revenue in Q1 was $154 million, up 15% over Q118 with good growth in both traditional software and SaaS offerings. The growth in traditional software benefited from a low comparable level in Q118, which was the lowest software quarter of the year.
- Technology Resale decreased 12% in Q1 to $56 million, but was up sequentially as we expected.
- Subscriptions revenue grew 10% to $84 million in Q1, in-line with our expectations that the subscriptions business model would return to solid growth after being impacted in 2018 by the adoption of Topic 606.
- Professional Services revenue in Q1 grew 11% to $490 million, driven by solid growth in both implementation services and our Works businesses.

- Managed Services increased 13% to $304 million in Q1, primarily driven by robust bookings in 2018.
- Support & Maintenance was down 3% compared to Q118, with solid growth in *Cerner Millennium®* support not quite offsetting declines in legacy support and hardware maintenance. Note that support and maintenance was flat sequentially and has easier comparable periods going forward, so we expect year-over-year growth to be flat to low single digit for the remainder of the year.
- And finally, Reimbursed Travel in the first quarter was flat to both Q118 and last quarter at $24 million.

Looking at revenue by geographic segment, domestic revenue was up 8% from the year-ago quarter at $1.231 billion, and international revenue of $159 million was up $1 million from the year-ago quarter. Note that our non-U.S. revenue growth was impacted by foreign currency rates and would have been mid-single-digit on a constant currency basis.

Moving to gross margin. Our gross margin for Q1 was 81.8%, down from 82.6% in Q418 and 82.1% year-over-year due to a slightly higher mix of third-party services.

Earnings

Now I will discuss spending, operating margin and net earnings. For these items, we provide both GAAP and "Adjusted," or Non-GAAP, results. The Adjusted results exclude share-based compensation expense, share-based compensation permanent tax items, acquisition-related adjustments, organizational restructuring expenses, and other adjustments, all as detailed and reconciled to GAAP in our earnings release.

Operating Expense

Looking at operating spending, our first quarter GAAP operating expenses of $939 million were up 8% compared to $866 million in the year-ago period.

Our adjusted operating expenses were up 9% compared to Q118. Looking at the line items for Q1, Sales & Client Service expense increased 9% year-over-year, primarily driven by an increase in personnel expense related to our services businesses. Software development expense increased 12% over Q118, driven by a 7% increase in gross R&D, a 12% increase in amortization, and flat capitalized software. G&A expense was up 5%, and Amortization of Acquisition-related Intangibles decreased slightly year over year.

Operating Margins

Moving to operating margins. Our GAAP operating margin in Q1 was 14.2% compared to 15.1% in the year-ago period. Our Adjusted Operating Margin for the quarter was 17.5%, down from 18.8% in Q118 and 18.7% last quarter.

As Brent discussed, we are taking steps to improve our operating performance, with a focus on costs optimization, process improvement and portfolio management. We expect these efforts to begin positively impacting our results in the second half of the year. We are working with AlixPartners to refine our list of optimization and process improvement opportunities and build a more detailed timeline. We expect to be done with this work by the time we report our second quarter, but based on our preliminary work we remain confident in our ability to meet previously announced targets for Q419 and Q420 Adjusted Operating Margins of 20% and 22.5%, respectively.

This will be hard work, particularly with the backdrop of a challenging core market environment, but it is necessary to make these changes to enhance efficiency and focus as we position ourselves for ongoing profitable growth. I want to be clear that we do still believe we have good long-term growth opportunities, driven by our Federal business, opportunities within our large health system base, and our strategic growth initiatives that address adjacent markets. As we work through our operational improvement efforts, we will look to protect the investments necessary to drive this growth. The changes we expect to make revolve around focus—we are doing too many things, and we believe we can do better if we target our attention on areas that represent the largest and most profitable growth opportunities and drive client satisfaction and retention.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q1 were $166 million, or $0.51 per diluted share, which is up 6% compared to GAAP EPS in Q118. Adjusted Net Earnings in Q1 were $199 million and Adjusted Diluted EPS was $0.61, compared to $0.58 in Q118.

Our GAAP tax rate was 19.5% for the quarter. Our non-GAAP tax rate was 21%. We expect our non-GAAP tax rate to be closer to 22% for the remainder of 2019.

Balance Sheet / Cash Flow

Moving to our balance sheet, we ended Q1 with $904 million of cash and short-term investments, which is up from $775 million in Q418. Our total debt was down $5 million from last quarter to $439 million.

Total receivables ended the quarter at $1.159 billion, down from $1.183 billion in Q418. Our Q1 DSO was 76 days, which is down from 79 days in Q418 and up from 73 days in the year-ago period.

Operating cash flow for the quarter was $317 million. Q1 capital expenditures were $119 million, and capitalized software was $75 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $123 million for the quarter.

For 2019, we continue to expect our operating cash flow to be impacted by higher cash outflows for taxes, our Voluntary Separation Plan payouts, and other expenses related to our organizational restructuring. On the capital side, we expect an increase in capital expenditures primarily driven by work on a phase of construction at our Innovations Campus, which should be completed in the first half of 2020. Due to a combination of these two factors, we expect free cash flow to decline in 2019. In 2020, we expect a return to normal operating cash flow growth and a meaningful decline in capital expenditures to lead to strong free cash flow. In addition, note that our capital spending is included in our operational review, and we expect to identify opportunities to reduce capital spending going forward.

Capital Allocation

Moving to capital allocation. As we recently announced, we increased our share buyback authorization to $1.5 billion. We expect to execute the majority of the repurchase authorization in the next 12 months, subject to market conditions and other factors. We intend to fund this with cash from operations and debt, with the amount of debt depending on the timing of our repurchases and whether we use cash for other purposes, such as M&A.

Regarding the dividend program we announced in February, we still expect to initiate a $0.15 cent per share quarterly cash dividend, with the first payment expected early in the third quarter. We expect the Board to officially declare the dividend at our May shareholder meeting.

Our expected initiation of a dividend combined with our significantly increased share repurchase authorization reflects our commitment to returning capital to shareholders and our belief in Cerner's long-term potential.

Guidance

Now I'll go through guidance.

- We expect revenue in Q2 to be between $1.410 and $1.460 billion. The midpoint of this range reflects growth of 5% over Q218.
- For the full year, we continue to expect revenue between $5.650 and $5.850 billion, with the $5.750 billion midpoint reflecting 7% growth over 2018.

- We expect Q2 Adjusted Diluted EPS to be 63 to 65 cents per share. The midpoint of this range is 3% higher than Q218.
- For full-year Adjusted Diluted Earnings Per Share, we expect to benefit from the recently announced operational improvement initiatives and expanded share repurchase program. The amount of the benefit will depend on the timing of operational improvements and share buybacks, but based on preliminary estimates, we now expect Adjusted Diluted EPS to be between $2.64 and $2.72, which reflects 9% growth at the midpoint and is above our previous guidance range of $2.57 to $2.67.
- Moving to bookings guidance, we expect bookings revenue in Q2 of $1.250 billion to $1.450 billion. The midpoint of this range reflects a 24% decrease compared to the second quarter of 2018, which included the initial task order for the VA. As John will discuss, a primary reason for the projected year-over-year decline is that we expect lower levels of long-term bookings.

In summary, we are pleased with our solid results in the first quarter, and we remain focused on delivering improved operating performance and creating shareholder value as we position Cerner for long-term profitable growth.

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

John Peterzalek

Thanks Marc. Good afternoon everyone. Today, I'll cover our top-line results and discuss the marketplace.

Results Summary

I'll start with our bookings, which were in line with our projections, with growth in non-long-term bookings being offset by a decline in long-term bookings, which we previewed last quarter. The percent of bookings coming from long-term contracts in the quarter was 30% compared to 40% in Q1 of last year. When you exclude the long-term component, bookings grew 3% compared to the year-ago quarter.

As Marc mentioned, this dynamic is expected to continue in Q2 with another expected decline in long-term bookings, and the impact is amplified by the fact that Q2 of last year represents a tough comparable as it was near an all-time high and included our initial VA booking.

The lower level of long-term bookings in our forecast is in part driven by our decision to be more selective as we consider certain low-margin, long-term contract opportunities given the current operational review and our focus on higher-margin growth. This is not expected to have a material impact on near-term revenue or earnings, but we do expect the mix of long-term bookings to be lower for the year. Our pipeline remains strong, and we are well positioned to deliver good long-term growth, but we want to make sure we pursue high-quality business that aligns with our focus on profitable growth.

Moving to new business mix, we had a solid quarter with 32% of bookings coming from outside our core *Cerner Millennium*® installed base.

In the Federal space, our projects with the DoD and VA are both progressing as planned. For DoD, we are continuing our work on the second wave of sites, with go lives on track for this Fall. Similarly, our work with the VA has continued as planned and we remain on track to steadily ramp our work on the project as we go through the year and into next year, with the initial sites still expected to go live in 2020.

Q1 was also a solid quarter for other key growth areas, such as Revenue Cycle and Population Health.

We also see material growth opportunities beyond the hospital. As the shift continues towards at-risk, value-based pay arrangements, providers will need better data and analytics to improve their economics. Cerner expects to help provider clients increase their topline revenue and "win their zip code" by providing the "big data" and predictive tools to support better health care experiences and outcomes.

A few weeks ago, we announced an expanded partnership with naviHealth, a pioneer in post-acute patient management. We have worked with naviHealth for the past five years to streamline workflows for post-acute discharge. We are expanding the relationship to create a new, EHR-agnostic offering that drives improved clinical outcomes and financial results, with a focus on addressing the latest Bundled Payments model from CMS, known as Bundled Payments for Care Improvement Advanced.

As we build out our health network strategy, we will selectively add "at-risk" capabilities with key partners. naviHealth, for example, will leverage Cerner's *HealtheIntent*^{SM} platform and allow us to drive higher dollar, higher margin economics around the provider health network. Because health systems leverage a portfolio of value-based risk models, the naviHealth relationship is highly complementary to our work with Lumeris and an important strategy for advancing our post-acute line of business.

Marketplace

Now I'll provide brief observations on the marketplace. While our core EHR market is mature, opportunities remain to replace legacy suppliers and cross sell additional solutions, such as revenue cycle and ambulatory, into our existing client base. We believe we are well positioned to act as a partner to our clients because we have capabilities beyond the EHR that align with their imperatives, which generally include optimizing revenue in both fee-for-service and value-based models, improving the health of populations, enhancing quality and outcomes, and creating operational efficiencies.

In summary, we believe we are aligned with our clients' needs and well positioned to enable them to pursue their growth strategies and deliver against their imperatives.

With that, I'll turn the call back over to Brent for closing comments.

Brent Shafer

Thanks, John.

As you've heard from us today, we are undergoing a lot of change. We have embraced the cooperation agreement as an opportunity to build on work we've done over the past year and move at a fast pace to make needed improvements to our operating performance. We are very committed to delivering against the targets we have established, and we are confident in our ability to execute.

One thing that will not change is our commitment to clients and innovation. We're focused on supporting our clients by aligning around the following priorities:

1. **Intelligent innovation**, which means delivering on our commitment to leverage the power of data to create contextual, intelligent experiences, new evidence-based insights and workflow interventions.
2. **Better experiences and outcomes**, which includes intelligent health networks and relentlessly advancing client successes.
3. **Open and connected health care**, which reflects our commitment to investing in rapid technology advancements to deliver tangible value to every patient, clinician, technologist and administrator. We believe open platforms that allow clients, partners and developers to innovate with us will allow us to solve health care's most complex challenges.

In summary, we believe we are making Cerner a stronger, more focused, company positioned to have a positive impact on health care.

I will now turn the call over to the moderator for questions.