Moderator

Welcome to Cerner Corporation’s fourth quarter 2019 conference call. Today’s date is February 4, 2020, 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, and capital allocation plans; cost optimization and operational improvement initiatives; future business outlook, including new markets or prospects for the Company’s solutions and services; and the expected benefits of certain of our acquisitions or other collaborations. 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 to the investor section of cerner.com, and other filings with the SEC for additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements. A reconciliation of non-GAAP financial measures discussed in this earnings call can also be found in the Company’s earnings release. 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 am joining the call from a client event, so I’ll start the call with a few comments then hand it over to the team in Kansas City, including our CFO, Marc Naughton; Chief Client Officer, John Peterzalek; and EVP of Strategic Growth, Don Trigg.

2019 was an important and productive year for Cerner. We began the year by introducing a new operating model to refine our organizational alignment, enhance our client focus, accelerate scalable innovation and make Cerner easier to do business with. We also initiated a company-wide transformation focused on operating efficiencies, business simplification, portfolio management, and refining our growth strategy to position Cerner for long-term, profitable growth. Further, we enhanced our governance through the addition of four strong board members, who, along with our existing members, have been invaluable as we work through our transformation.

Our 2019 progress is reflected in our fourth quarter results, which included good performance across all key metrics, including exceeding our adjusted operating margin target and delivering record free cash flow. We also returned $1.4 billion of capital to shareholders in 2019 through our share buyback program and our first two dividend payments, reflecting our commitment to delivering value to shareholders.

Also significant in 2019 was the announcement of our multi-faceted collaboration with AWS and Amazon. We view this relationship as an enabler to many of the growth strategies we’ve discussed on previous calls, including Cerner’s development of a cognitive platform and our evolution to becoming the Software-as-a-Service health care IT partner. Leveraging the powerful combination of Cerner technology, the AWS infrastructure, and their artificial intelligence and machine learning capabilities, we expect to create next-generation user experiences and innovations to deliver more predictive, patient-centric care.
Before turning the call over to Marc, I’d like to discuss Cerner’s position on the topic of interoperability, data security, and privacy. For several decades, Cerner has been a trusted steward of health information and a leader in the pursuit of data interoperability. We have been a vocal proponent of the 21st Century Cures Act, and we look forward to continuing our work with the ONC, clients, and other key stakeholders to ensure the secure flow of information across disparate systems and health care entities.

We do this because it’s the right thing to do. I started my career at Intermountain Healthcare where I am today for an event about the future of health and care. We talk a lot of about the fact that healthcare is too important to stay the same. I love the chance to collaborate with organizations like Intermountain working to “help people live the healthiest lives possible.”

We believe it is wrong to ask patients striving to get better to manage a collection of faxes, PDFs and paper-filled shopping bags. It is wrong to ask providers to leave their workflows to review and leverage relevant patient information. It is wrong to waste hundreds of billions of dollars on the highest administrative costs in the world when we are in the middle of an affordability crisis in U.S. healthcare.

We are going to continue being a positive voice for change in this industry. Access to the “right information at the right time in the right place” continues to drive our advocacy in Washington and the global markets we serve.

In summary, I’m very pleased with everything we accomplished in 2019. We consistently delivered against expectations we set while driving a significant amount of change throughout Cerner. This was hard work, and I appreciate all Cerner associates for their contributions to this progress. We have a lot more work to do in 2020, but we are off to a good start, and I am optimistic we’ll continue to advance our transformation. More importantly, I believe the work we are doing will position us to create meaningful value in health care while also driving good long-term growth for Cerner.

I’ll now hand the call over to Marc.
Marc Naughton

Thanks, Brent. Good afternoon everyone. I am going to cover our Q4 results and future period guidance.

This quarter we delivered all key metrics at or above our guidance.

**Bookings, Backlog and Revenue**

I will start with bookings, which were $1.665 billion in Q4, exceeding the high-end of our guidance. This is down from Q418, which was the second highest bookings quarter in our history. Full-year bookings were $5.990 billion, which is down from $6.721 billion in 2018. The decline in Q4 and for the year was primarily due to a decline in long-term bookings related to us being more selective on outsourcing contracts, as we have discussed throughout the year.

We ended the quarter with a revenue backlog of $13.71 billion, which is down 10% from a year ago primarily due to the termination of a RevWorks agreement that I discussed on our Q3 call. Also 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 nearly 85% over the next 12 months.

Revenue in the quarter was $1.442 billion, up 6% over Q418 and in line with our expectations. Total revenue for the year was $5.693 billion, reflecting growth of 6% over 2018.

I’ll now go through the business model detail and year-over-year growth compared to Q418 and full-year 2018.

- **Licensed Software** revenue in Q4 grew 5% over Q418 to $174 million, and full-year Licensed Software revenue grew 11% over 2018 to $681 million, both primarily due to strong growth in our SaaS offerings.

- **Technology Resale** of $60 million in Q4 increased 31% compared to a weak Q418. Full-year Technology Resale revenue was up 1% to $247 million.
• **Subscriptions** revenue grew 7% in Q4 to $93 million. Full-year Subscriptions revenue was $359 million, up 10% from $326 million in 2018.

• **Professional Services** revenue grew 9% in Q4 to $509 million, primarily driven by solid growth in implementation services and partially offset by approximately $23 million less revenue due to termination of the RevWorks agreement we previously discussed. Full-year Professional Services revenue grew 10% to $1.992 billion.

• **Managed Services** was up 3% in Q4 to $309 million. Full-year Managed Services revenue was $1.214 billion, an increase of 5% over 2018.

• **Support & Maintenance** was down 1% to $274 million for the quarter, which is in our expectation range and reflects the impact of some past attrition that we discussed last quarter. Full-year Support & Maintenance revenue was also down 1% from 2018 at $1.105 billion.

• And finally, **Reimbursed Travel** of $22 million was down 9% in Q4 and down 2% for the full-year at $95 million.

Looking at revenue by geographic segment, domestic revenue was up 6% from the year-ago quarter at $1.276 billion, and non-U.S. revenue of $166 million was up 3% from the year-ago quarter. For the full year, domestic revenue grew 7% and non-U.S. revenue grew 3%.

Moving to gross margin. Our gross margin for Q4 was 80.8%, down from 81.0% in Q319 and 82.6% year-over-year. Full-year gross margin of 81.2% is down from 82.5% in 2018. The declines in our quarterly and full-year gross margin are both driven by higher third-party services, largely related to our Federal business, and a lower margin mix within technology resale.

**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, acquisition-related adjustments, organizational restructuring and other expenses, and other adjustments that are detailed and reconciled to GAAP in our earnings release.
Operating Expense

Looking at our operating spending, our fourth quarter GAAP operating expenses of $982 million were up 2% compared to $965 million in the year-ago period. Full-year GAAP operating expenses were $4.021 billion, up 10% from $3.654 billion in 2018.

Our adjusted operating expenses were up 4% for the full year, with the fourth quarter essentially flat compared to Q418, reflecting good progress on our cost optimization efforts. Looking at the line items for Q4, Sales & Client Service expense increased 1% in Q4. Software development expense increased 4% over Q418, driven by a 1% increase in gross R&D, a 7% increase in amortization, and a 3% decrease in capitalized software. G&A expense was down 15%, driven by a decline in both personnel and non-personnel expenses. Amortization of Acquisition-related Intangibles decreased slightly year over year.

Operating Margins

Moving to operating margins. Our GAAP operating margin in Q4 was 12.7% compared to 12.0% in the year-ago period. Our Adjusted Operating Margin for the quarter was 20.3%, up from 18.7% in Q418 and 18.1% last quarter. Our Q4 Adjusted Operating Margin is in-line with our expectations and above the 20% Adjusted Operating Margin target for Q419 that we committed to last April. Our GAAP operating margin for full-year 2019 was 10.6% compared to 14.4% in 2018. Our full-year Adjusted Operating Margin was 18.5%, which is down slightly from 18.8% last year.

We believe our ongoing business optimization efforts keep us on track for delivering our targeted Q420 Adjusted Operating Margin of 22.5%. I’d note that some of the margin expansion is expected to be back-end loaded like last year due to the timing of our initiatives and some seasonality. However, our guidance, which I’ll discuss in a minute, does reflect a full-year Adjusted Operating Margin of approximately 21%, which is about 250 basis points higher than 2019 and reflects the cumulative impact of all of the optimization work we have done and expect to do this year. We also believe we can continue improving profitability beyond 2020 though ongoing optimization efforts and a longer-term opportunity to benefit from platform modernization.
As we’ve discussed, the benefits from platform modernization will be a multi-year process, particularly for Millennium®, and most near-term benefit is largely offset by modernization investment. However, we expect the lower operating costs associated with this move along with efficiencies and improvements we are driving in our development process to meaningfully contribute to our profitability while also helping us deliver a differentiated solution to our clients at a lower total cost of ownership.

**Net Earnings / EPS**
Moving to net earnings and EPS, our GAAP net earnings in Q4 were $154 million, or $0.49 per diluted share, which is up from $0.40 in Q418. For the full year, GAAP net earnings were $529 million, or $1.65 per diluted share. Adjusted Net Earnings in Q4 were $237 million and Adjusted Diluted EPS was $0.75, compared to $0.63 in Q418. For the full year, Adjusted Net Earnings were $862 million and Adjusted Diluted EPS was $2.68, up 9% from 2018.

Our GAAP tax rate was 19% for the quarter and year. Our non-GAAP tax rate was 20% for the quarter and year. For 2020, we expect our GAAP and non-GAAP tax rates to be between 20% and 22%

**Balance Sheet / Cash Flow**
Moving to our balance sheet, we ended Q4 with $542 million of cash and short-term investments, which is down from $633 million last quarter with our free cash flow being offset by our $75 million acquisition of AbleVets and $300 million of share repurchases in Q4. For the year, we repurchased 18.8 million shares for $1.3 billion, at an average price of $69.06, keeping us on track against our plan to repurchase $1.5 billion by the end of Q120.

Moving to debt, our total debt remained flat to last quarter at $1.038 billion.

Total receivables ended the quarter at $1.140 billion, down from $1.155 billion in Q319. Our Q4 DSO was 72 days, which is down from 74 days in Q319 and 79 days in the year-ago period.
Operating cash flow for the quarter was $438 million. Q4 capital expenditures were $83 million, and capitalized software was $63 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $292 million for the quarter.

For the full year, operating cash flow was $1.313 billion, capital expenditures were $472 million, and capitalized software was $274 million. Full-year free cash flow was $568 million, which is down $166 million from 2018, driven by higher capital expenditures and restructuring costs.

For 2020, we expect some level of restructuring costs to continue, but we still expect higher operating cash flow and lower capex to drive strong free cash flow growth.

**Capital Allocation**

Moving to capital allocation. As I indicated, we repurchased $1.3 billion of stock in 2019 and remain on track to meet our targeted level of $1.5 billion by the end of Q1. In December, we announced that our Board authorized the repurchase of an additional $1.5 billion of stock, bringing the total authorized amount available for repurchase up to $1.7 billion. We intend to continue funding these repurchases with a combination of cash from operations and debt, and the timing and amount of repurchases will depend on how much funding is used for other purposes, such as acquisitions or investments.

Moving to our dividend program, we paid our first three quarterly dividends of $0.18 per share on July 26th, October 9th and January 9th. Our quarterly dividend payments and the increased authorization in our share repurchase plan reflect our continued commitment to returning capital to shareholders and our belief in Cerner’s long-term potential.

I’d also note that we completed our acquisition of AbleVets in Q4 and have begun to integrate their service offerings into our portfolio to accelerate our success in the federal space.
As we’ve discussed, we expect to be more active in M&A as we believe there are opportunities that could be foundational to our growth in several of the markets our Strategic Growth organization is pursuing. I’d also note that our portfolio management efforts are expected to lead to some divestiture activity, as we look to create more focus in areas most aligned with our refined growth strategy.

**Guidance**

Now I’ll go through guidance.

- We expect revenue in Q1 to be between $1.415 and $1.465 billion. The midpoint of this range reflects growth of 4% over Q119.

- For the full year, we expect revenue between $5.725 and $5.975 billion, with the $5.850 billion midpoint reflecting 3% growth over 2019.
  - The midpoint of this range is slightly below consensus growth of 4%. We suspect this could be due to estimates not fully factoring in the impact of reduced levels of outsourcing bookings in 2019 and our continued approach of being more selective with those types of contracts.
  - Also, I’d like to walk you through an organic growth view for 2020. If you adjust for our exit from the Adventist Health contract by taking that revenue out of 2019, our 2020 growth would be over 5%. Adjusting out AbleVets revenue would bring pure organic growth back to 4%, but we don’t view all of the revenue from AbleVets as inorganic because we expect to leverage their associates in performing on the VA contract as it ramps up. This normally would have been done through organic hiring, but we believe there is value in leveraging their highly qualified workforce.
  - As we’ve discussed, there will likely be additional actions we take this year that could result in revenue reductions. There is also the potential that we do M&A, which could serve as an offset to divestiture activity. Overall, we do expect there to be several moving parts on the topline in 2020, but we believe the actions we take will set us up for solid and profitable growth.

- Moving to EPS, we expect Q1 Adjusted Diluted EPS to be 69 to 71 cents per share. The midpoint of this range is 15% higher than Q119.
• For the full year, we expect Adjusted Diluted EPS to be $3.09 to $3.19, with the $3.14 midpoint reflecting 17% growth over 2019.
  o Our Adjusted Diluted EPS guidance reflects a ramp up throughout the year that is similar to last year, with the biggest sequential increase in Q4. This reflects the expected timing of our ongoing efficiency and optimization efforts.
  o As I mentioned, we also expect our Adjusted Operating Margin to ramp during the year, with Q4 expected to be slightly higher than our 22.5% target due primarily to a lower mix of outsourcing revenue.
  o I’d also note that our expected full-year non-GAAP tax rate of approximately 21% is 1% higher than 2019, impacting EPS by about 4 cents.
• Moving to bookings guidance, we expect bookings revenue in Q1 of $1.100 billion to $1.300 billion. The midpoint of this range reflects a 3% decrease compared to the first quarter of 2019, driven by an expected decline in long-term bookings.

In summary, we are pleased with our strong results in the fourth quarter and believe we made a lot of good progress this year. There is a lot of hard work left to meet our profitability and growth targets, but we have a good plan in place and expect to execute against it in 2020 and beyond.

Before I wrap up, I’d like to remind you we will host our annual Investment Community Meeting at HIMSS on Tuesday, March 10th. If you plan to attend and have not registered, please do so through the link at the top of the investor section of Cerner.com. If you are unable to attend in person, there will also be a webcast available.

With that, I will turn the call over to John.
John Peterzalek
Thanks Marc. Good afternoon everyone. Today, I will provide results highlights and an update on our Federal business.

Results Summary
I’ll start with our bookings. As Marc mentioned, we delivered bookings ahead of our guidance range for the quarter, driven by strong contributions across multiple client segments, such as investor owned, academic, and IDNs. We also had good contributions from revenue cycle solutions and across our strategic growth businesses, which Don will discuss.

Consistent with recent quarters, we had a lower level of long-term bookings compared to last year, which drove the decline in overall bookings. For the quarter, the percent of bookings coming from long-term contracts was 29% compared to 38% in Q4 of last year. Long-term bookings for the year represented 28% of total bookings compared to 36% last year, with this decline in long-term bookings driving total bookings down for the year. Bookings excluding long-term contracts increased slightly for the full year.

Looking at the broader marketplace, many of the same trends continued to play out during 2019, with health care cost growth outpacing the economy; elevated levels of industry consolidation; rising consumer expectations around cost, convenience, and service; and the continued gradual evolution of reimbursement models adding to pressure on providers to lower costs and advance their risk-based strategies.

These forces are contributing to an overall challenging macro environment. Providers are simultaneously seeking to grow key service lines, drive operational efficiencies to make money at Medicare rates, and build out the competencies required to take and effectively manage risk and participate in value-based reimbursement models. Information technology is seen as an enabler of these efforts, which represents an opportunity for Cerner. At the same time, the low-margin nature of provider businesses can make it difficult to fund required investment, making it important for solutions and services to have a clear return on investment.
As we look at 2020, we see solid opportunity both in our installed base as well as continuing to gain new clients. This opportunity is reflected in our pipeline, which is up year over year for both new business and opportunities for sales back into our base. In our base, we are focused on getting our clients current while also filling out their Cerner solution suite, with a focus on increasing penetration of revenue cycle solutions, and solutions supported by our CareAware® and HealtheIntent® platforms. Our CommunityWorks pipeline remains strong and we have opportunities outside of our traditional provider base in areas such as state government, employer, and long-term, post-acute care. We also have opportunities to continue growing the presence of our EHR-agnostic CareAware and HealtheIntent solutions beyond our EHR base.

Moving to our Federal business, we continued to advance both our VA and DoD projects. On the VA project, Cerner along with the VA and our partners, remain focused on the Initial Operating Capability, or IOC, go live. We have completed initial integration validation and are doing a significant amount of training and site-preparation activities ahead of the scheduled go live in March. Looking beyond the initial go live, we also expect to go live at additional IOC sites in 2020 and continue to steadily scale our work to provide additional value and capabilities to the VA in upcoming quarters. As Marc mentioned, we expect to leverage the AbleVets team as these activities ramp throughout the year.

We are also making good progress on DoD. We successfully completed a code upgrade during the quarter and kicked off the Coast Guard project and two additional deployment waves. Go-lives for these waves are slated for late 2020.

With that, I’ll turn the call over to Don.
Don Trigg
Thanks, John. Good afternoon everyone.

Our Strategic Growth organization launched in 2019. Our strategic ambition was a simple one: scale a set of focused business units that position Cerner beyond the hospital, beyond our Cerner Millennium EMR and beyond the traditional fee-for-service payment model.

The six business units that make up Strategic Growth each target large addressable markets in excess of $3 billion, and we believe we have a path to meaningful market share in each market. They gain significant leverage from existing Cerner assets ranging from the industry-leading data processing and aggregation capabilities of HealtheIntent to our subject matter expertise around the last-mile EMR workflow. Regulatory requirements are understood, surmountable and offer opportunities for differentiation. All six businesses overweight on recurring revenue and have high gross margin potential. Finally, Strategic Growth leaders focus squarely on speed-to-revenue as they pursue their larger category-leading positions.

For full year 2019, our Strategic Growth businesses generated $520 million in revenue, representing 22% growth year-over-year. We believe we can deliver similar growth in 2020 and look forward to our Investor Day at HIMSS in Orlando which will afford us an opportunity to review the long-term targets for each business.

As we look at areas of particular strength in 2019, cybersecurity frames our strategic approach. U.S. health care is seeing data breaches at a rate of one per day. Our technologies are core to how CIOs and CSIOs are building out their enterprise strategies. Cyber is an area of growing internal competence driven, in part, by our critical work to support our armed services and veterans. As a result, our security revenue from health systems grew nearly 40% in 2019.

Our provider communication business, leveraging our EMR-agnostic CareAware platform, also benefited from strong market tailwinds and delivered record bookings in 2019. We also continued to drive CareAware Connect solution adoption with an over 100% year-over-year increase in utilization to almost 75,000 monthly users.
We also were pleased with the full year progress in the Long Term and Post-Acute Care (LTPAC) market with 23% year-over-year growth. Our Behavioral Health solution, within our LTPAC solution suite, was a particular bright spot. It delivered almost forty new footprints with 80% of total bookings revenue coming from outside our Millennium base.

Our unified Behavioral Health solution is not only strongly differentiated in the market, it also was announced Friday as the 2019 Best-in-KLAS category leader. For individuals and families that seek help, our unified Cerner® solution strives to make it easier for providers to deliver the integrated care that successful treatment demands.

While LTPAC is an area where we sell at the point solution level, it also fits solidly into our larger strategic push to build out Health Network strategies across every Metropolitan Statistical Area in the U.S. and all 5 of our focused global regions.

At the technical platform level, our HealtheIntent platform is a strategic linchpin of our Health Network efforts. Our market-facing push to drive adoption of HealtheIntent continued to progress in 2019 bringing us to 175 HealtheIntent clients worldwide including the addition of leading health providers like Prospect Health and Davita Health.

As Brent noted in describing our AWS partnership, HealtheIntent was built as a native cloud platform, is EMR-agnostic and has been recognized by industry analysts like Chillmark as having the best product capabilities in the category. It also has been at the heart of our work with AWS.

As we move nearly all of our non-federal HealtheIntent clients to the AWS public cloud in the first half of 2020, it will establish the clear value proposition of the cloud technology approach for provider healthcare. We also see it as a key enabler of our Health Network strategy in focused global markets, such as England as the NHS accelerates its push to advance Integrated Care Systems (ICS).
Finally, with the content of health care digitized, we also are advancing a set of strategies around data services. Art Glasgow and team launched our Learning Health Network to make it easier for patients to be identified and participate in clinical trials. The Duke Clinical Research Institute (DCRI) partnership announced in 2019 played a central role in generating research opportunities for Cerner clients. We are excited that top health systems, such as Medstar Health announced yesterday, are helping us activate a network we believe can make it less expensive to create the next-generation of life-saving therapeutics.

Across all six business units, our efforts to drive strategic growth fit into an emerging enterprise discipline around portfolio management across Cerner. In 2019, we were as intentional about the things we decided not to do as the things we decided to do.

Several important Strategic Growth partnerships tell this story. Our partnership with ResMed offers new revenue-generating opportunities in the post-acute care and also advanced analytics around sleep and respiratory. It also featured a decision to make ResMed’s Brightree home health offering our preferred go-to-market solution. Similarly, our partnership with GetWellNetwork embedded their HealthLoop asset into our Wellbeing application framework. It also came with a portfolio decision to not invest further in our MyStation patient engagement solution in favor of GetWell’s industry-leading offering.

We believe a combination of thoughtful build, buy, partner assessment will bring us closer to our longstanding vision to build a system of health and care with the individual at the center. It is a system where consumers not only have a right to their data, but also have the ability to mobilize it in pursuit of better health.

We believe the entrepreneurial opportunities at the intersection of health care and technology have never been greater. We are excited about what 2020—and the 2020s—hold for a set of emerging areas of strategic growth for Cerner. 2019 performance laid a solid foundation for moving further, faster in the quarters to come.

With that, let me turn the call over to the operator for questions.