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# EDITED TRANSCRIPT

CERN - Q3 2015 Cerner Corp Earnings Call

EVENT DATE/TIME: NOVEMBER 03, 2015 / 9:30PM GMT

## OVERVIEW:

CERN reported 3Q15 revenue of \$1.13b and GAAP net earnings \$147m or \$0.42 per diluted share. Co. expects 4Q15 revenue to be \$1.15-1.20b and adjusted EPS to be \$0.56-0.58.



## CORPORATE PARTICIPANTS

**Marc Naughton** *Cerner Corporation - CFO*

**Zane Burke** *Cerner Corporation - President*

## CONFERENCE CALL PARTICIPANTS

**Dave Francis** *RBC Capital Markets - Analyst*

**Robert Jones** *Goldman Sachs - Analyst*

**Sean Weiland** *Piper Jaffray - Analyst*

**Eric Percher** *Barclays Capital - Analyst*

**David Larsen** *Leerink Partners - Analyst*

**Mohan Naidu** *Oppenheimer - Analyst*

**Jonathan Young** *UBS - Analyst*

**George Hill** *Deutsche Bank - Analyst*

**Zach Sopcak** *Morgan Stanley - Analyst*

**Steve Halper** *FBR - Analyst*

## PRESENTATION

### Operator

Welcome to Cerner Corporation's third-quarter 2015 conference call. Today's date is November 3, 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 investors section of Cerner.com.

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

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**Marc Naughton** - *Cerner Corporation - CFO*

Thank you, Bridget. 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. Neal Patterson, our Chairman and CEO, will be available for Q&A.

Now I will turn to our results. Similar to recent quarters, our great success in the marketplace is reflected in our record bookings, but we delivered revenue slightly below expectations. Today we will address the disconnect between our outstanding bookings in what remains a very strong marketplace and our near-term revenue shortfalls.



While we are disappointed about delivering slightly lower than expected revenue, our booking this year, coupled with our strong pipeline, sets us up for good revenue growth next year.

Our bookings revenue in Q3 was \$1.59 billion, which is an all-time high and reflects 44% growth over Q3 of 2014, including record amounts of new business activity. Our revenue backlog ended the quarter at \$13.9 billion, which is up from \$10.2 billion a year ago and reflects the strong bookings in Q3, as well as the inclusion of backlog from Health Services.

Revenue in the quarter was \$1.13 billion, which is up 34% over Q3 of 2014 and includes approximately \$250 million from Health Services. The total is about \$20 million below the low end of our guidance range, with approximately half of the shortfall related to core Cerner and half attributable to Health Services.

On the Cerner side, the shortfall is much lower than previous quarters, mainly because we appropriately adjusted our forecast for lower services revenue, which was the primary issue in prior quarters. This quarter, the lower-than-expected revenue is mostly a function of lower-than-usual levels of upfront software revenue on some of our larger contracts and technology resale being slightly below our expectations.

On the software portion, I would like to note that we had an all-time high level of software bookings, but a larger-than-normal portion of the contracts were structured in a manner that resulted in revenue being spread over a longer period. This is obviously good for future periods, but did impact our current-quarter revenue.

Relative to Health Services, the lower revenue was spread among a few areas, including software, technology, resale, and maintenance revenue, and also reflects that we are continuing to fine-tune our visibility in that space.

Another factor we have not discussed that has impacted revenue this year is foreign currency fluctuations. In Q3, revenue would have been \$20 million higher if you held exchange rates consistent with those in Q3 of 2014. While we have factored a portion of this into our guidance, it did have some impact beyond what we expected in Q3 and is also a contributor to the lower revenue for the year.

Now I will quickly go through the total revenue composition for Q3. Total system sales revenue was \$325 million. Support and maintenance was \$245 million. Services was \$539 million, and reimbursed travel was \$19 million. System sales revenue reflects a 45% increase over Q3 of 2014, 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 and tech resale.

Our software sales margin percent was 67.5%, which is up from 64.3% in Q2, due to a sequential decline in technology resale. The margin percentage is down year over year mainly because Q3 2014 had a very low mix of tech resale that resulted in an unusually high system sales margin percent.

Moving to services, total services revenue, including professional and managed services, was up 30% compared to Q3 of 2014, mainly driven by the addition of Health Services, as well as growth in core Cerner managed services. Support and maintenance revenue increased 38% over Q3 of 2014, reflecting growth in core support and maintenance and the addition of Health Services.

Looking at revenue by geographic segment, domestic revenue increased 35% over the year-ago quarter to \$998 million, and global revenue grew 32% to \$130 million, both driven largely by the addition of Health Services.

Moving to gross margin, our gross margin for Q3 was 83.1%, which is basically flat both year over year and sequentially.

Looking at operating spending, our third-quarter non-GAAP operating expenses, which excludes share-based compensation expense, voluntary separation plan expense, and acquisition-related adjustments, were \$661 million, which is up 36% compared to adjusted Q3 2014 operating expenses. This growth was primarily driven by the addition of 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, 37% for software development, and [62%] for G&A. Amortization of acquisition-related intangibles, which you will recall is a new expense line we added in Q2, was basically flat.

Note that, similar to last quarter, this line is \$25 million on our GAAP income statement and just \$3 million in our non-GAAP results, since we are excluding amortization related to Health Services.

Moving to operating margins, similar to the past two quarters, we delivered basically in-line earnings on lower revenue, resulting in a higher operating margin percent than we projected at the beginning of the year. Our operating margin before share-based compensation expenses, voluntary separation expense, and acquisition-related adjustments, was 24.5% in Q3. This is down 90 basis points year over year, due mostly to the very low tech resale in Q3 2014, and up 30 basis points from Q2 of 2015.

Moving to net earnings and EPS, our GAAP net earnings in Q3 were \$147 million or \$0.42 per diluted share. Adjusted net earnings were \$189 million, and adjusted EPS was \$0.54, which is up 29% compared to Q3 of 2014. 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 \$2.5 million or \$0.01 per diluted share.

Adjusted net earnings also reflect adjustments related to Cerner's acquisition of Health Services, including Health Services acquisition-related amortization, which reduced GAAP net earnings and diluted earnings per share by \$15 million and \$0.04, respectively, other acquisition-related adjustments, which reduced GAAP net earnings and diluted earnings per share by \$4 million or \$0.01, respectively, and the acquisition-related deferred revenue adjustment, which is not included in GAAP net earnings, but increased adjusted net earnings and diluted earnings per share by \$6 million and \$0.02, respectively.

The Q3 tax rate for adjusted net earnings was 32%, which is slightly below our expected range of 33% to 34%.

Now I will move to our balance sheet. We ended Q3 with \$766 million of total cash and investments, which is down from \$857 million in Q2, primarily due to the use of cash for our repurchase programs. During the quarter, we finished the remaining \$100 million of repurchases authorized in 2014 and purchased \$100 million of the \$245 million authorized in September of this year. In total, we repurchased 3.2 million shares at an average price of \$61.91.

Moving to debt, our total debt, including capital lease obligations, is \$631 million, which is basically flat compared to Q2. Total receivables ended the quarter at \$1.05 billion, which is up \$50 million from Q2. Our Q3 DSO was 85 days compared to 81 days in Q2 and 67 days in the year-ago quarter. The higher DSO is primarily a function of the lower revenue in the quarter, and we were also still working through some delayed billings for Health Services clients as part of the transition. We do expect DSO improvement in Q4.

Operating cash flow for the quarter was \$272 million, up from \$109 million in Q2. Q3 capital expenditures were \$88 million, and capitalized software was \$72 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was \$111 million for the quarter, driven by strong operating cash flow.

Now I will go through Q4 and full-year 2016 guidance. For Q4, we expect revenue between \$1.15 billion and \$1.2 billion, with the midpoint reflecting growth of 27% over Q4 of 2014. Our Q4 revenue guidance combined with year-to-date results put us slightly below the low end of previously provided full-year guidance, as we have factored in the lower results from Q3 and lowered Q4 to reflect a similar run rate.

So far this year, a favorable mix of revenue, lower expenses, and Health Services synergies have allowed us to deliver mostly in-line earnings despite our lower revenue.

Looking at Q4, we do expect the lower revenue to have some impact on earnings, mainly due to the continuing effect of lower services revenue and the impact of lower upfront software on some contracts. We expect Q4 adjusted EPS before share-based compensation, voluntary separation plan expense, and acquisition-related adjustments to be \$0.56 to \$0.58 per share, with the midpoint reflecting 21% growth over Q4 2014 adjusted EPS.

This range is below consensus estimates and slightly below our original plan, but it does get us to the low end of our most recently provided full-year guidance. Also, the Q4 guidance combined with year-to-date results still reflects strong growth of 26% for the full year.

Our estimate for the impact of share-based compensation expense is approximately \$0.03 to \$0.04 in Q4, which equates to \$0.14 to \$0.15 for the full year.

Moving to bookings guidance, we expect bookings revenue in Q4 of \$1.45 billion to \$1.55 billion, with the midpoint reflecting strong growth of 29% over Q4 of 2014 and 31% growth for the full year.

Now I would like to provide initial expectations for 2016. Note that these comments should be viewed as preliminary until we finalize our financial plan and provide more formal guidance when we report fourth-quarter results.

We currently expect 2016 revenue to be over \$5 billion, which equates to growth of at least 13% on top of what is projected to be approximately 30% growth in 2015. We realize that the growth this year benefited from our acquisition and has come in below our original targets, but growing 13% on top of a 30% growth year is still strong.

Our 13% target does include a benefit of having 12 months of Health Services revenue in 2016 compared to 11 months of 2015, but that only equates to about 2% of the growth for the year, so our full-year growth target is still double-digit even excluding the extra month.

While there are obviously many assumptions that go into projecting future revenue, we do feel positive about our ability to deliver good growth in 2016. A key element to our confidence in 2016 revenue is our backlog, which has grown significantly this year due to our record bookings and the addition of Health Services business. This larger backlog translates into better visibility for 2016.

As we look at the rollout of backlog in 2016, we currently expect approximately 75% of our revenue to come from backlog, which is higher than historical levels. Another key assumption is that we do believe the market opportunity remains strong, which Zane will discuss.

For earnings, we currently expect adjusted diluted earnings per share before share-based compensation and acquisition-related adjustments between \$2.30 and \$2.40 per share, with the midpoint reflecting 13% growth over 2015 expected results. This range is below the current consensus estimate of \$2.52, which was formed in the absence of Company guidance.

We believe the primary potential differences between our preliminary view and the consensus estimate may include higher noncash expenses and professional services contributions.

Regarding noncash expenses, our current estimates reflect an increase in depreciation and amortization of more than \$75 million in 2016, which equates to nearly \$0.15 of earnings per share. We believe consensus estimates have less than this for noncash expense impact. The large increase in amortization is tied to a significant amount of previously capitalized software expected to become generally available, and a large increase in depreciation is related to recent increased levels of capital spending.

Relative to services contribution, while we expect strong growth in services revenue and earnings contributions next year, the growth will be coming off of the lower 2015 levels we have discussed. We do not intend for these comments to precisely reconcile our preliminary view to analysts' estimates, but more to provide our thoughts on potential differences.

In summary, we realize this has been a challenging year relative to delivering against our revenue expectations. As I indicated, we believe revenue growth will be good next year, and we have visibility to this growth, partially driven from a backlog that has benefited from what has been by far the best year of bookings in the history of our Company.

With that, I will turn the call over to Zane, who can talk about why our bookings are so strong.

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**Zane Burke** - Cerner Corporation - President

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



I will start with our results. Our bookings revenue in Q3 of \$1.59 billion reflects strong growth of 44% over Q3 2014. Bookings this quarter included another all-time high level of large contracts, with 45 contracts over \$5 million, including 31 over \$10 million. For long-term bookings, we did have two ITWorks contracts, but the overall mix of long-term bookings was more in the normal range of 31%, which makes the strength of those bookings even more impressive because it wasn't driven by elevated levels of longer-term contracts.

A highlight of the quarter was that we again signed a record number of new footprints, with 39% of our bookings coming from outside our core Millennium installed base. So far this year, we have signed more new footprints, measured by dollars and count of sites, than any full year in our history. This success reflects our strong competitiveness and the continued large opportunity for competitive displacements.

Our success this quarter and the opportunities in our pipeline span many market segments, including IDNs, regional hospitals, children and community hospitals, state and federal, behavioral health, ambulatory surgery centers, and physician groups.

A particularly noteworthy area of success is large IDNs and investor-owned health systems. In addition to McLaren Health Care selecting Cerner for EHR, Revenue Cycle and Population Health, which they announced last quarter, we also gained another large investor-owned health system as a new client during the quarter.

In addition, one of our existing investor-owned clients chose to move forward with Cerner for an additional 24 sites. These are in addition to Baptist Health South Florida and the Department of Defense, which we talked about on our last call, but occurred during the third quarter.

As I've mentioned before, I believe a key element of our success is driven by our track record for delivering projects on time and on budget, as well as creating measurable value, which aligns well with our clients' focus on making ROI-based decisions. This ability to deliver value, along with predictable costs and timelines, serves as a differentiator relative to our primary competitor.

I believe their list of clients, where the significant costs of deploying and maintaining their system has been cited as a key reason for financial challenges, is starting to impact them in the marketplace. This not only differentiates us in the sales process, it has also contributed to some of their existing clients switching to Cerner, even after having spent \$100 million-plus on their system.

We are also continuing to sign Health Services clients to migrate to Millennium, including both IDNs and small hospitals. Overall, we remain pleased with our progress with Health Services' base, with migrations continuing at a good pace.

Now I would like to highlight an important announcement we made during the Cerner Health Conference that represents a major milestone for our Healthe Intent platform. During Neal's keynote address, we announced that Geisinger Health System, a national model for high-quality and high-value healthcare, decided to use our Healthe Intent population health platform to extend their data-driven population health capabilities. Cerner and Geisinger share a core belief that managing the health of populations requires access to information outside traditional healthcare domains, and we are excited to be a strategic part of Geisinger's ability to provide systems-level insight to manage population health at scale.

This relationship builds on a proof-of-concept project that started last year where Geisinger leveraged Healthe Intent, our system-agnostic near-real-time platform that normalizes data to aggregate clinical and financial data from its core EHR and other sources such as its insurance company. We believe this decision makes a clear statement to the market, as Geisinger uses our primary competitor for their core EHR and is one of their longest-duration and most significant clients. We believe this demonstrates that our capabilities could not be equaled by our competitor and that the Healthe Intent platform is the right platform to support Geisinger's quest for ongoing innovation.

I also think this makes clear that our investments in interoperability and open platforms that enable client and third-party innovation are paying off. This is a great example of why we believe Cerner is positioned to play a major role as healthcare continues to shift from a fee-for-service model to outcomes-based reimbursement models that incent keeping people healthy.

Moving to our Revenue Cycle business, we had a good third quarter. We continue to have a high take rate of Revenue Cycle in our new EHR footprint, which supports what we have been saying about the market looking to buy integrated systems.



A key element of our success in Revenue Cycle has been the increasing number of proof points with our clients. One quick example I'd like to share is something from a thank-you note a client CFO sent us recently. In the note, he indicated that in the past year, they had decreased AR days 19%, increased average daily revenue 22%, and reduced discharged, not final billed, days by 33%. These success stories are becoming more common and add to our momentum in the marketplace.

Moving to the ambulatory market, where we had an all-time high level of bookings in Q3, surpassing a record we just set in the last quarter, 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 the new business footprints.

In the ambulatory business office services, we had two displacements of a certain cloud competitor. Our opportunity to displace this competitor resulted from their lack of execution, failure to meet established objectives, rising costs after teaser rates, and a realization by the client that they ended up needing similar or more staff, even though they thought they had outsourced the function to our competitor, because they left much of the harder work and complex work to the client.

We also had a strong quarter in the small hospital market and passed the 100-client milestone with our cloud-based CommunityWorks offering. This quarter's success was again driven by a combination of traditional new footprints, extensions through our health system clients, and Health Services migrations. We expect the CommunityWorks offering to exceed 125 clients by year end.

In addition, CommunityWorks opened two new markets by completing multiple client conversions within stand-alone orthopedic surgical hospitals, along with a multisite clinically integrated network in the state of Iowa. We believe there is good market opportunity for Cerner in the small hospital market and are very pleased with our competitiveness in this market.

Outside of the US, we had a solid Q3, with revenue growth of 32% and good bookings in Australia, the United Kingdom, and the Middle East. We continue to make progress with integrating the global components of Health Services, which is augmenting our global presence and positioning us for good long-term contributions from our global business.

In summary, I am very pleased with the success we are having in the marketplace. We maintain a positive outlook because of our large pipeline, broad solution and services offering, and strong competitive position.

With that, I'd like to open the call for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Dave Francis, RBC Capital Markets.

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### Dave Francis - RBC Capital Markets - Analyst

Marc or Zane, can you help us understand a little bit more, as you talked about on the front end of the call, the difference between getting revenue booked and the backlog in bookings? If I understood from the last quarter, there were several contracts that had some meaningful revenue attached to them that didn't fall into the quarter. I'm just trying to true up the difference there so that we can better understand the cadence of bookings and how that translates to revenue in the short term.





**Marc Naughton** - *Cerner Corporation - CFO*

Sure. This is Marc. Relative to license revenue, as we've said, record bookings for licensed software in the quarter, we actually had record license revenue, very strong license revenue. However, it was lower than our projections, primarily because certain contracts have some provisions, especially as we start addressing the new markets, for new clients who are coming off of an unsatisfactory relationship, where they are looking to hold the new suppliers' feet to the fire a little bit. So we do have those contracts that will have some payments tied to milestones.

Traditionally, as we've talked to you all in the past, most of our payments for licensed software are date based and don't impact revenue recognition at all. We are now seeing some payments being tied to milestones, which is very reasonable for a client to do that in the current environment. That tie-in to a milestone defers that revenue until the milestone occurs. So that revenue goes into the backlog and comes out at a future point in time as part of the project that is getting done.

It's good for the future, but when you go into a quarter and don't see those provisions up front as an expectation, but they are negotiated as we go forward, it does impact the amount of revenue we take in the initial quarter for particularly those new clients, is where we are seeing that.

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**Dave Francis** - *RBC Capital Markets - Analyst*

Let me ask it a different way, then. As you look at your initial guidance for 2016 and talking about conversion out of backlog into revenue and what have you, the visibility issues that you guys have had relative to this year, what changes over the next coming several quarters to give you the kind of confidence that the revenue level that you are looking at, up double digits year over year, are achievable relative to your ability to convert out of backlog? And I'll stop there. Thanks.

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes. No, the key for 2016, when I am looking at 2016, is the amount of backlog we have and the fact that I am having things such as licensed software rolling out, based on a projection of the projects, as I do ours to be done. Another key factor for 2016 is that really in the last half of 2015, particularly in Q3, we saw a strong increase in professional services implementation bookings. And we expect to see that in Q4. That strong increase in those specific bookings is feeding the backlog, and those projects will be started and underway in 2016.

Just from a number of bodies times number of hours perspective, we hired over 200 people into this professional services organization during Q3. So we ended Q3 with a larger workforce, which means we will be able to go work additional hours, drive additional revenue from that backlog that's there.

The 75% we referenced is coming as 2015 revenue being driven from the backlog, is the highest percent of revenue for a year that I've seen in my tenure here. Normally -- I think recently it has kind of been in the low 70s.

And all of that, at this point, should be predictive or that we can drive with available headcount. We are not going to be in an HS mode of trying to decide should we hire, should we not hire. We are back into our mode of seeing the work, hiring the people, getting them up to speed. Unfortunately for us in 2015, the impact of that is going to be in 2016.

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**Operator**

Robert Jones, Goldman Sachs.

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**Robert Jones** - *Goldman Sachs - Analyst*

I guess just one follow-up on that, Marc, just so I'm clear. I think the last few quarters, where the topline might have missed expectations, it was really more around services conversion obviously just being slower by nature and then also some weakness in tech resale. Am I understanding it





correctly that it's still a component of those two things, but now, in addition to that, there are some longer conversions around your more classic licensed software sales? Is that the message on this quarter's revenue shortfall?

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**Marc Naughton** - *Cerner Corporation - CFO*

No. Let me make sure I'm clear. This quarter, we actually delivered our services number. The number we had projected, we delivered that. The difference in the revenue from what we shared in our projections to what we delivered was really focused on two things, primarily licensed software from the Cerner side and from lower-than-expected tech resale.

We had a fairly significant, a couple of significant tech resale deals, primarily related to third-party -- the resale of third-party software that we expected to happen in the quarter, and they did not happen. So one of those actually was changed to be sold by the manufacturer. We will get some profitability out of that, but we won't get the revenue out of that. So that was the primary driver.

On the license side for center, why the license was less than we had projected, even though it was strong and at record levels, we had projected even higher levels. Those contracts from new clients, we had a few of those that were larger that included milestone-based payments. So the payments for the licenses are tied to milestones; we can't take the revenue for that licensed software until the milestone occurs.

Relative to the services businesses, we actually delivered the services number. That was a number we focused on internally, and we actually delivered that. But for Q3, the difference was half of it at HS, half of it at Cerner. And on the Cerner side, it was licensed software and those two tech resale deals that didn't materialize.

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**Robert Jones** - *Goldman Sachs - Analyst*

Got it. That's actually really helpful. And then I guess just some back-of-the-envelope math on the EPS guidance range for next year. Assuming your guidance of roughly around \$5 billion on the topline, it seems like it at least directionally would imply a tougher operating margin year than I think many were thinking. I guess first off, is that accurate? And then secondly, could you maybe just talk about the major components of what might be weighing on margins more than people expected?

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**Marc Naughton** - *Cerner Corporation - CFO*

Well, I think that if I do the quick math, I think it basically looks at flat operating margins. They will be around 25% if you use a revenue number that's around \$5 billion to get to the earnings. I think with HS expected not to grow quite as much on the operating margin side, we clearly, because of lower revenue this year, have actually gotten almost back to our prior operating margin levels.

Next year, it's really the impact of the noncash expenses. That's a \$75 million to \$80 million hit. That is going to impact my operating margins. It's not a cash hit, but it is additional expense.

So I think if you go map out the numbers, you will end up with about the same operating margins next year. Should be within 30, 40 basis points of what we would end up with this year, which is somewhere around 24.5%. So somewhere in the 24.5% to 25% range would be my rough math for 2016.

So we don't see a decrease. We do see, because of the higher noncash spending, challenging to grow above that. But I think, clearly, we are continuing to invest in the business and should be able to get to a level where we start getting the leverage back into the business as those increases moderate.

**Robert Jones** - *Goldman Sachs - Analyst*

Okay, thanks so much.

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**Operator**

Sean Weiland, Piper Jaffray.

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**Sean Weiland** - *Piper Jaffray - Analyst*

So first, to confirm, I didn't hear you mention any contribution from DoD in the quarter for 2015 or 2016. I want to confirm that that is the case.

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes. Once again, as we said, DoD will have certainly a slow impact on the bookings and a slower impact on the revenue that we recognize. We did have the first task order, task order number one. We got our group that's the Leidos Group. We got an order from that. But that number was less than 1% of my bookings for the quarter.

So, once again, those numbers will come in in smallish chunks on a just-in-time basis, to some extent. So no contribution in 2015 from DoD from either earnings or from material bookings. And in 2016, we're not relying on DoD to be anything that provides additional uplift over the other business.

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**Sean Weiland** - *Piper Jaffray - Analyst*

Okay. And then one other question, a follow-up to Dave's on these milestone payments. What kind of milestones are we talking about? Are we talking about a shipment of software, or are we talking about achieving certain savings metrics or clinical measures? Can you just tell us what kind of milestones you are baking into the contracts?

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**Zane Burke** - *Cerner Corporation - President*

Sure. Sean, this is Zane. I think it's more project-related items. So as you think about the projects and where these clients have come from, so they are -- I always describe it as they are getting divorced at the same time they are trying to get remarried. And their previous vendor has left them in a very challenging position and has basically failed them to deliver the kinds of solutions that they need long term.

And so when you're in those kind of predicaments, it oftentimes happens that as their client is getting divorced from their former vendor and getting married to Cerner, they come in with a prenup that looks a little different than what you would typically see. And then, as we gain experience with that client and they gain the confidence in us to deliver, those kinds of things tend to go away in subsequent periods.

So when we have the high level of new business bookings that we had in the quarter, there is the higher susceptibility to some of those types of activities impacting our result at the end of the day.

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**Marc Naughton** - *Cerner Corporation - CFO*

And one milestone could be go-live. That's a pretty standard one that they put in, that we are saying we're going to get this done in this kind of timeframe. And they say, well, that's great. And let's tie a payment to us going live when we expect to go live.

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**Sean Weiland** - Piper Jaffray - Analyst

What about, like, performance, like AR days or things like that?

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**Marc Naughton** - Cerner Corporation - CFO

Yes. Those aren't milestones. In our view, milestones are really events that occur relative to some payments that are at risk in some form or fashion. We will have some of those in the contract on occasion. Usually it's upside to us. So we get our base pricing, but at the last minute there will be an element of shared savings that we will put into contracts because obviously the client wants to see us focused on making them successful. And the best way to do that is to have some at-risk element.

But that doesn't really affect my revenue recognition because any at-risk payment doesn't get recognized until we actually receive the payment. Not only do we deliver the action that should get the payment, but we take a conservative position that I've got to get the check in my hand before we take that revenue. But that's outside what I would call revenue recognition bumps.

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**Sean Weiland** - Piper Jaffray - Analyst

Okay, great. Thank you very much.

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**Zane Burke** - Cerner Corporation - President

And I wouldn't necessarily say this is a new trend. I think it's just one of those things that when you end up with a higher level of new business bookings, that that's something that is part of the process. And so I wouldn't necessarily say that that is a new trend element. I think the trend part is the significant bookings, our increase of number of new bookings, percentage of those new bookings, to our business.

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**Sean Weiland** - Piper Jaffray - Analyst

Thank you.

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**Operator**

Eric Percher, Barclays.

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**Eric Percher** - Barclays Capital - Analyst

I think I will come back to the margin question. As we look at this year, you have been able to reduce expenses tremendously. And I know that Health Services was a big part of that.

Can I ask you to just walk us through, as you look at the underlying business and maybe the mix shift -- it's really a mix question -- how into next year -- there's obviously some noncash elements. But do you expect that your mix continues to give you the opportunity to drive higher op margin? Or have we entered a period where op margin and earnings look much closer to the revenue growth number?

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**Marc Naughton** - Cerner Corporation - CFO

This is Marc. I don't think we are in a period where we would expect operating margins to stay at the same level. We continue to have opportunities certainly on the combined HS and Cerner organization to drive out additional synergies on the spend side, as well as the operating and the revenue side.

I think that what you will see us in 2016 offsetting the impact of significantly higher noncash expense, we will add resources at Cerner to the extent that they drive revenue. And that has been our philosophy at many points in time.

We've invested heavily in R&D and those types of areas more recently, but I don't think you are going to see a lot of needed additional investment in those areas. You'll see us hiring people to go work on projects, drive revenue out. You'll see us hire people from managed services, which drives revenue, some of the support organization, which drives revenue.

So that's really where we are going to focus our dollars on. I think once you get through a period of the software turning on and ramping up some of the software amortization, we should get back to a time when you will start seeing improvements in operating margin. There's no real change in the mix of the business. Software is still really strong. And that strength in software should logically, as you get through some of this noncash spending element, you should actually get to a point where operating margins can increase.

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**Eric Percher** - *Barclays Capital - Analyst*

That's helpful. And the services investments you've made, you talked about 200 additional team members. Does that same type of ramp occur in Q4?

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**Marc Naughton** - *Cerner Corporation - CFO*

We can give you the Q4 numbers once we have them. I think the hiring in Q2 or Q3 was related to the Q3 strong bookings that we expected. So I think we will be hiring based on our demand. I would expect to see that number go up.

I can't tell you; there's a little bit of hiring at the end of the year and timing and relative to when people graduate school and all this kind of stuff that impacts a lot of people we don't bring into January. So will we, at the end of Q4, have another 200 people? I can't address that, but I can indicate that we are back on track to increasing that workforce.

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**Eric Percher** - *Barclays Capital - Analyst*

Very good, thank you.

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**Operator**

David Larsen, Leerink Partners.

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**David Larsen** - *Leerink Partners - Analyst*

Can you talk about Siemens Health Services? I guess the revenue came in slightly below expectations. Was that from Siemens' hospitals buying other Siemens software solutions, or was it conversions over to Millennium that were slightly below expectations? Any more color around that would be helpful.

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**Marc Naughton** - *Cerner Corporation - CFO*

Sure, David. This is Marc. The HS was really not related to selling more Siemens software because we aren't expecting to sell a lot of additional Siemens software specifically. Migrations are doing well. But it's primarily just related to their business overall. Some maintenance contracts that people canceled was probably as big an impact on revenue as anything. Those are dependent on that client having certain equipment or keeping



that maintenance contract with Siemens, but didn't reflect really a major change. It's just the expiration of certain maintenance, and in some cases people just not renewing their maintenance contracts relative to the equipment that they had through Siemens.

The rest of it was just spread throughout the piece of the organization, but nothing that reflected a trend relative to their selling more of their Siemens software, which we didn't expect and they didn't do, or migrations, which are going well and once again fall into a bucket that is not necessarily -- we can't necessarily attribute it to Siemens, since we are selling the revenue.

But I think we are still working, obviously, through the visibility on the revenue side. But when we look at the net impact on Cerner, our overall accretion remains on track. It's primarily, at this point, just the topline forecasting element, timing we are trying to get through.

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**David Larsen** - *Leerink Partners - Analyst*

Okay. That's great; thanks very much. And then can you size how much bookings in the quarter came from the Siemens side of the house?

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**Marc Naughton** - *Cerner Corporation - CFO*

It would be minimal.

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**David Larsen** - *Leerink Partners - Analyst*

Minimal? Okay, so that was all -- that's all mainly organic?

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**Zane Burke** - *Cerner Corporation - President*

This is Zane. We would have had a number of migrations that would impact the bookings, but the pure Health Services, purchasing Health Services solutions, would have been fairly minimal.

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes, Dave, we kind of get into the element that we have been talking to you about, is we are kind of one company now. So anything that we sell that's Cerner stuff we kind of think of as a Cerner booking. But even if it's a migration to Cerner from the Siemens client, the cross-sell on those elements are going to be coming through as Cerner bookings. The HS bookings for me is primarily things that they are selling, services or their own software. And as I said, we haven't really been focused on selling a lot of their own software this point.

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**David Larsen** - *Leerink Partners - Analyst*

Okay, that's great. And just one last one: I think you signed a couple large service engagements last quarter. Should we see the revenue flow through for those in 2016?

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes. Especially relative to our ITWorks business, we have actually had a very successful 2015. We signed two ITWorks deals each quarter in Q1, Q2, and Q3. So that's kind of the rhythm that I've always talked about us wanting to achieve. And once we get those signed, that revenue stream usually starts up very quickly because those associates get rebadged very close to the timing of the signing of the contract. So that revenue does kick in, and all six of those deals will be contributing to 2016 revenue.

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**David Larsen** - *Leerink Partners - Analyst*

Okay, great. Nice bookings quarter. Thanks a lot.

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**Operator**

Mohan Naidu, Oppenheimer.

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**Mohan Naidu** - *Oppenheimer - Analyst*

Thank you very much for taking my questions. Marc, maybe just want to go back to your bookings and revenue conversion one more time. With your new guidance, it looks like you are going to do 30%-plus growth for the full 2015. That's great, but your revenue guidance for next year points to low-teens growth. Can you help us understand what are the moving parts that translates from a 30% bookings growth to a teens revenue growth?

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**Marc Naughton** - *Cerner Corporation - CFO*

Well, certainly the elements of bookings growing significantly -- and keep in mind we've got a -- in 2015, we are growing revenue 30%, or growing earnings 26%. Obviously, you understand, there's an element from the acquisition that impacts that.

But when you look at our bookings, you've got the long-term component of them, which this quarter, even on the larger number, trended down, or trended to be more normal, like the 31% rather than the mid-30s that we have been seeing. Those longer-term bookings don't have an immediate effect. They spread out over a period of time. They will help 2016, but 1/10th of them help 2016.

Relative to current quarters, the item we were talking about primarily was the license component. And this is -- you are talking about \$10 million or \$15 million of licensed software when you are talking about that relative to the overall total revenue growth. So it's not a significant difference.

A lot of these contracts have significant amount of professional services in them. That rolls out over a period of time, sometimes multiyear period of time. They all have a hosting element to them, which falls into our long-term bookings percentage. So, really, the mix of the business is actually pretty much normalized in Q3.

The big difference is, even with strong license, based on that bigger number, we did not get as much revenue from the current quarter as we would have expected. That revenue flows forward.

But I think from a growth perspective, if you look at 13%-plus revenue growth in 2016 off of a number that grew 30% in 2015, we have got an extra \$1 billion or so of revenue that we are growing on top of. We've always targeted growing double digits, especially after a year where that was more challenging for us in 2015. We are actually feeling good about getting back to double-digit growth on a much higher base than we have had in the past.

So we actually think the growth in earnings and the growth in revenue being more aligned than normal is a matter of just not getting as much leverage in 2016 because of higher noncash expense. And I think that, as I said, moderates over time.

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**Mohan Naidu** - *Oppenheimer - Analyst*

Got it. That was very helpful. If I understand that correctly, if we take out the Health Services revenue out of your 2015 and keep the bookings the same, we could have seen 25%-plus revenue growth. Is that fair?



**Marc Naughton** - *Cerner Corporation - CFO*

You would certainly have seen in 2016 stronger revenue growth. Absolutely.

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**Mohan Naidu** - *Oppenheimer - Analyst*

Thanks a lot, Marc.

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**Operator**

Steven Valiquette, UBS.

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**Jonathan Young** - *UBS - Analyst*

This is Jonathan Young on for Steve today. Just a question, back on the margins. I get the noncash expense side of things. But I guess from the synergy targets that you originally laid out for the Siemens deal, of the \$175 million, are you guys still on track with that? Are you guys speeding up? Kind of just get a sense of where you guys are in terms of the synergy levels there.

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes. No, relative to Siemens, we are absolutely on track for 2015, delivering the synergies that we expected. We might be slightly ahead. But things are going well there. I think in 2016, we continue to expect to deliver the synergies we'd originally expected.

As we've indicated, the harder part for us now is, because of the coming together of the organizations and the fact that there is some spending on Cerner's side that relates to the HS business now, it is not cleaved cleanly that I could give you a P&L for HS. I don't have that visibility. I can't track the spending at that level. And so I can't specifically tell you exact numbers that it's driving out as a separate P&L.

But based on all the metrics that we track, based on their spend and based on our spend, we see that those synergies are coming through. And that is part of the benefit we get on the spend side in 2016. So it does help offset some of the noncash. But we are also growing -- we're continuing to invest in revenue-producing associates, which should drive revenue, but also is going to drive up spending as well.

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**Jonathan Young** - *UBS - Analyst*

Okay. And then just on the RevWorks side, since we are past ICD-10 now and hopefully things are good in the market there, have you guys heard any chatter about clients particularly looking at your RevWorks solution yet?

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**Zane Burke** - *Cerner Corporation - President*

This is Zane. I think we continue to see interest in Revenue Cycle, in particular. And then, obviously, the business office services perspective has been very strong on the physician side. So we continue to see good growth there.

I think you will see a return to that marketplace for broader RevWorks offerings there. And we continue to sell well as piece parts of that. But I do get a sense that that will return to the fold here as people get past ICD-10 and begin to think more long term about how to best handle their costs and the collections related to changing business models.

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**Marc Naughton** - *Cerner Corporation - CFO*

This is Marc. Keep in mind, ICD-10 wasn't just flip the switch and, okay, all the lights stayed green, so we are good. 30 days later, you are going to get -- it's when the payers come back and tell you that they agree with the claims. You're going to be tracking all the metrics you track.

So even though people were post the technical ICD-10 go-live, there's still a good six months as people are going through and looking at making sure that they understand the impact of ICD-10, re-look at what their needs are in case the environment has changed.

So I think the demand is there, as Zane said. I don't think flipping that switch was going to trigger a bunch of demand. I think it will be something you see starting to hit us in 2016.

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**Jonathan Young** - *UBS - Analyst*

Okay, that's helpful. Thanks.

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**Operator**

George Hill, Deutsche Bank.

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**George Hill** - *Deutsche Bank - Analyst*

Thanks for taking the question. I guess Marc or Zane, can either of you guys tell us what -- I want to call it what like-for-like Cerner bookings are and what the growth has looked like year over year? Because I think there was probably some misunderstanding about the composition, how this year includes Siemens bookings and last year did not. So, like, real bookings growth year to date isn't actually 32%. What is the like-for-like Cerner bookings growth?

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes, this is Marc. Like-for-like actually is -- Siemens is negligibly impacting us. They are not selling a whole lot of stuff. They are not selling a lot of tech resale. From a bookings perspective, there's not a lot of -- they haven't had a lot of individual sales of what they offer separately. Almost anything that has been driven by that base has been migration-related.

So I think you might take a few percent out of it, to be -- if you want to, relative to that increase. But the vast majority, certainly 95%-plus, is related to Cerner and sale of our solutions and our services and our ITWorks and all of those things. So if you are really looking, if you are trying to figure out is this bookings increased reflective of Cerner's opportunity in the marketplace, it is almost entirely related to our opportunities. Zane?

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**Zane Burke** - *Cerner Corporation - President*

Yes, and I think the first place to start is by looking at the new business bookings. You had 39% new business booking for the quarter, which is all Cerner, Cerner, Cerner. And as Marc said, it's a few percentage points as it relates to the current-year impact of Health Services bookings on our total bookings. So it's very minimal.

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**George Hill** - *Deutsche Bank - Analyst*

Okay. Well, then I guess the follow-up question, then, becomes, it would seem that there has to be an elongation in the backlog to a revenue recognition conversion period. And we've talked about this before, and you've said there hasn't been a meaningful change there. I guess can you help us bridge the gap from 32% bookings growth year to date, likely to stay that number as we go into the end of the year, to the revenue guidance?



You talked about the milestone payment, but you wouldn't even think that that -- that hasn't been impacting the business long enough to explain the change in the bookings growth rate to the rev rec, to the delta in the rev rec growth rate. Or just what am I missing there?

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**Marc Naughton** - *Cerner Corporation - CFO*

Well, the milestones primarily impact current-quarter bookings near term. And it does feed the backlog. Keep in mind, George, this year we had significantly higher levels of long-term bookings. Right? First two quarters were 35%, 37%, whatever the percent was. It was very significantly higher relative to the bookings. Certainly, this quarter it's more like it's back into the 31% range, which is normal, on a much bigger number.

A lot of these new contracts that are getting signed by new clients have a significant amount of services and other items that roll into the backlog. So I'm not sure that's elongating the backlog, because things like software -- and some to your point, if I have day-based payments, the software really never hits the backlog. It gets recognized mostly in the quarter in which it's booked, and I don't have any future impact. I am now getting, for milestones for some other contract terms, I am getting backlog that is coming in from license. Now it's more of a two- to three-year timeframe, but it varies from day one to that. So from an elongated backlog, yes, it's slightly longer in some cases.

But it's not materially different relative to the business. So understand that the large bookings number coming through feels like it should contribute more to 2015. It does contribute more. I'm getting 75% of my revenue in 2015 out of that backlog, where in prior periods it would have been closer to 70%. So I am getting more revenue coming through there. But the mix is similar, except I have a lot more long term this year than I've had in prior years. And that is going to -- that's all 10-year stuff that is going to basically add to the overall average number of years it takes to drive the backlog out.

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**George Hill** - *Deutsche Bank - Analyst*

Okay. That's helpful. And then maybe one last quick question is, you referenced briefly the increased scale of the business now with the inclusion of Health Services. I guess should we be thinking of this 10% to 15% EPS growth as the new normal target range for the Company? Or is 15% to 20% closer to the right range? I guess I'm trying to think about what do we think is the sustainable number now, given the new size of the business and given the growth profile of the legacy Siemens business?

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes. I do not intend that the current -- the 2016 guidance, where revenue and margins and earnings are growing at the same rate, to be indicative of what we look to do in the future. We are a business that should have leverage. Keep in mind we are growing off of a 2015 that we put in Siemens. And so certainly that helped us. But now in 2016, we are growing on top of that. So we are having to go grow revenue on top of a 30% revenue growth business, I have to grow earnings on top of a 26% earnings growth business.

So it isn't illogical that in the year following that significant amount of growth, particularly a year I'm getting hit with these noncash expenses, that the growth might more track with revenue. I think over time, we would look to grow revenue double digit. And you would see us moving that earnings percentage growth up higher than our revenue growth. We will get leverage out.

The bigger a company we get, as a software company, as we get more efficient in our services businesses, as we continue to roll out the model system, which is an effective way to go implement our software, as we look to go make very quick migrations of Siemens clients, I think there's a lot of opportunities for us to certainly get efficiencies in the business. So, yes, I'm not calling this the new normal. There's upside to our growth percentages.

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**George Hill** - *Deutsche Bank - Analyst*

Okay, thanks for that.



**Operator**

Ricky Goldwasser, Morgan Stanley.

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**Zach Sopcak** - Morgan Stanley - Analyst

This is Zach for Ricky. I just wanted to ask a question, a bit of bookkeeping when thinking about bookings for 2016. Is the comp for 2016 bookings going to be tougher because the 2015 is going to include the migration of Health Services clients to Millennium?

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**Marc Naughton** - Cerner Corporation - CFO

The bookings comp, since HS doesn't have a whole lot of impact, pure HS, on the bookings, it won't really be a reason. But given, as we've talked earlier, that overall bookings are growing 30%, I'd call that a pretty reasonable comp to grow above. But yes, no, it's a tough comp. But I think that's the -- keep in mind that most of the growth this year was pretty much organic. It wasn't impact a lot by HS on the bookings side. Certainly on the earnings and revenue side it was impacted. But on the bookings side it wasn't.

So we grew 30% relatively organically on the bookings side. We see a very active marketplace. So our goal is to grow on top of that 30% uptick in bookings we saw in 2015.

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**Zach Sopcak** - Morgan Stanley - Analyst

Got you. And just quickly on the contracts, so you mentioned the strong growth in large contracts. And looks like contract over \$10 million have already exceeded 2014. Can you give us just a little bit more color on what's driving those and how that compared to your expectations going into the year?

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**Zane Burke** - Cerner Corporation - President

This is Zane. I think what you are seeing is we had a large number of big systems making purchases. So we talked about our competitiveness in the IDN marketplace and the investor-owned marketplace. And so just some pure very large new business and current clients that are out procuring solutions to standardize their businesses, they moved forward on a standard platform and using Cerner to help drive costs down and create leverage for their organizations.

And I think some of those larger contracts, they're all about actually creating leverage in their organization. So whether it's ITWorks type situations where our clients are utilizing our scale to help drive costs appropriately on their side and prepare for the future elements. So I think some of those larger elements are reflective of a broad base to the business because we hit on pretty much every large contract in that space -- big IDNs, investor-owned, our ITWorks businesses, our regional and community hospital marketplace. They are going to drive significant, large upfront bookings.

So I think it's a combination of things. And it's really about our clients are preparing for the future of healthcare. And that's what we are helping to provide them, to help drive their costs down and to improve the quality of care.

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**Zach Sopcak** - Morgan Stanley - Analyst

Great, thank you.

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**Marc Naughton** - *Cerner Corporation - CFO*

Thanks. Why don't we take one more question.

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**Operator**

Steve Halper, FBR.

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**Steve Halper** - *FBR - Analyst*

Could you just run through for me one more time the factors behind the reduction in the fourth-quarter guidance? And also, as a follow-up, what are the cash flow expectations for 2016, now that you have set the stage for the income statement?

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**Marc Naughton** - *Cerner Corporation - CFO*

Sure. Well, relative to Q4, I think that we continue to see lower revenue for Q4. I'm not looking to go -- we hit services revenue in Q3. We had probably expected Q4 to grow a little bit from that number. I think our current projections, based on the timing of hiring new people and based on the work, is that Q4 would be relatively flat on the services side to Q3. So we're not looking to go increase that a significant amount.

And I think we will still see some of the impact of those milestone-based payments on contracts. It's going to have an impact on the timing of revenue recognition. So those are elements, as we look forward to the revenue coming out of Q4, that we expected to probably be about \$50 million lower, probably, from the midpoint as to what has previously been out there.

Half of that is probably -- is HS continuing to be lower than we've projected. And the other half is basically Cerner Professional Services and some of those Q3 elements rolling into Q4. So that's a primary difference you are going to see relative to the Q4 number.

On the cash flow side, we think -- in Q4 we would expect -- we have some larger cash CapEx items related to building that will hit us in Q4. So we would expect to end the year at about -- I think \$475 million, \$470 million of total CapEx, including software CapEx. Next year, we would probably have a -- be a little bit of an uptick on that as we finish out our trails building.

One of the key things in 2015 is we are purchasing our leased Summit Data Center Building. We currently lease that. And given all the data center activity that we have there, we want to own our future there. We don't want to be subject to the vagaries of a landlord, which has been a very good landlord to us, but we want to own that facility.

So I think we've got -- as you look at this year, we end up with about \$405 million of CapEx, about \$275 million of software CapEx. And those probably increment up a little bit as we go into 2016.

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**Steve Halper** - *FBR - Analyst*

So just to clarify, the building purchase for the leased Summit Data Center, that's going to be 2015?

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**Marc Naughton** - *Cerner Corporation - CFO*

That will be Q4. That will be this quarter, Q4 of 2015.

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**Steve Halper** - *FBR - Analyst*

So all in, CapEx and your software, capitalized software, is \$475 million this year?

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**Marc Naughton** - *Cerner Corporation - CFO*

All in, it would be \$675 million.

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**Steve Halper** - *FBR - Analyst*

\$675 million? Okay.

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**Marc Naughton** - *Cerner Corporation - CFO*

Yes, so about \$400 million CapEx and \$275 million of software CapEx.

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**Steve Halper** - *FBR - Analyst*

Got it. And then a little uptick from that next year?

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**Marc Naughton** - *Cerner Corporation - CFO*

Correct.

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**Steve Halper** - *FBR - Analyst*

Great, thank you.

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**Marc Naughton** - *Cerner Corporation - CFO*

Certainly, Steve. Well, with that, I'd like to close. I'd like to maybe just step back a little bit to provide a little perspective.

We certainly understand our accountability to deliver against all our metrics. But Zane's commentary around our bookings and our current position in the marketplace gives us confidence regarding our success in that marketplace. We've been at this a very long time. And one thing we've always been driven by is delivering on the bigger vision. We are focused on long-term value, but also have been pretty good about delivering against near-term expectations.

I think we are incredibly well positioned to become a large company. It's not going to be a really perfectly straight path, but where we are situated between healthcare and IT, I think, gives us a lot of opportunities.

We are investing \$700 million a year in R&D to address those opportunities. And I think that level of investment, especially when you look at it in the context of other people trying to buy things that they are going to put together, is impressive and will generate a long-term benefit and advantage for us.

Many of you had a chance to attend our healthcare conference, where we had 14,000 attendees focused on solving major issues in healthcare. It's hard to come out of that conference not being energized with the belief that we are on the right track. We are actually now just getting to some

of the fun stuff with the base level of digitalization in healthcare, using data, predictive analytics. We think this can have a real disruptive impact on quality outcomes and payment models. And we expect to be right in the middle of that disruption.

What we do is hard, and it's complex. But we think we are well positioned, and certainly I wouldn't trade our position for anybody else's.

Thanks for listening, and have a good evening.

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## Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.

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