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CERN - Q3 2016 Cerner Corp Earnings Call

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OVERVIEW:

Co. reported revenue of $1.185b and GAAP net earnings of $170m or $0.49 per diluted share. Expects 4Q16 revenue to be $1.225-1.300b and diluted EPS to be $0.60-0.62.

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PRESENTATION

Operator

Welcome to Cerner Corporation's third-quarter 2016 conference call. Today's date is November 1, 2016 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 limitations, those regarding projections of future revenues or earnings, operating margins, operating capital, expenses, product development, new product or prospects of the Company's solution and services, and plans and expectations, related to 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 the item 1A in Cerner's Form 10-K, together with the Company's other filings.

A reconciliation of non-GAAP financial measures discussed in the 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. Sir, please go ahead.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Thank you, Michele. This is Marc Naughton. Good afternoon, everyone, and welcome to the call. I'll lead off today with a review of the numbers. Zane Burke, our President, will follow me with results, highlights, and marketplace observations. And then Mike Nill, our Chief Operating Officer, will provide some operational highlights.

Now I will turn to our results. While solid overall, our results included bookings and revenues slightly below our guidance range, and earnings at the low end of our range. Starting with bookings, our bookings revenue in Q3 was $1.434 billion, which reflects a 10% decrease from the very difficult comparable in Q3 of 2015, when bookings were an all-time high and had grown 44% over the prior year.

Relative to our guidance, bookings were $16 million below the low end of our range, but Q3 was still our second-highest bookings quarter ever. Our revenue backlog ended the quarter at $15.471 billion, which is up 11% from $13.876 billion a year ago. Revenue in the quarter was $1.185 billion, which is up 5% over Q3 of 2015, but $15 million below the low end of our guidance range of $1.2 billion to $1.275 billion.

The revenue shortfall was mainly in system sales, and was a result of lower-than-expected technology resale and software bookings for the quarter. The revenue composition for Q3 was $301 million in system sales, $253 million in support and maintenance, $608 million in services, and $22 million in reimbursed travel.

System sales revenue for the quarter was down 7% compared to Q3 of 2015, with technology resale declining 21% and licensed software declining 12%, partially offset by 10% growth in subscriptions. System sales margin percent increased 150 basis points year-over-year to 69%, reflecting lower technology resale mix as well as lower commissions.

Moving to services, total services revenue, including professional and managed services, was up 13% compared to Q3 of 2015. This is in line with our expectations and continues to reflect good execution by our services organizations. Support and maintenance revenue increased 3% over Q3 of 2015, slightly below our expectation in mid-single-digit growth, due mostly to lower equipment maintenance revenue related to our lower technology resale.

Looking at revenue by geographic segment, domestic revenue increased 6% over the year-ago quarter to $1.06 billion, and non-US revenue was flat year-over-year at $130 million. Moving to gross margin, gross margin for Q3 was 84.6%, which is up from 83.1% in Q3 of 2015, due mostly to the lower mix of technology resale and better services margins versus the year-ago period.

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, Health Services acquisition-related amortization, acquisition-related deferred revenue and other acquisition-related adjustments, which are detailed and reconciled to GAAP in our earnings release.

Looking at operating spending, our third-quarter GAAP operating expenses were $759 million compared to $722 million in the year-ago period. Adjusted operating expenses were $713 million, which is up 8% compared to Q3 of 2015. This growth was primarily driven by growth in personnel expense related to revenue generating associates, which is reflected in the sales and client service expense line that increased 11%.

Software development increased 3%. G&A was basically flat, and amortization of acquisition-related intangibles was down 30%. But this represents only a $1 million decline from $3 million to $2 million, as this line excludes Health Services acquisition-related amortization in the non-GAAP view.

Moving to operating margins, our Q3 GAAP operating margin was 20.4% compared to 19.1% in the year-ago period. Our adjusted operating margin was 24.4% in Q3, which is essentially flat to the year-ago period. This is in line with our previous indication that we expect margin expansion to be limited in 2016, but we do continue to believe we can expand margins 50-plus basis points annually after 2016.

Moving to net earnings and EPS, our GAAP net earnings in Q3 were $170 million or $0.49 per diluted share. Adjusted net earnings were $203 million and adjusted diluted EPS was $0.59, which is up 9% compared to Q3 of 2015. Q3 tax rate was 30%, which is slightly below our expected rate. The benefit of this was largely offset by a $3.7 million write-off of a venture capital investment that is reflected in the Other Income line.

Now I'd like to preview an expense we expect to incur in Q4. We recently offered a new voluntary separation plan, or VSP, to eligible associates. Similar to our program in February of last year, the VSP was made available to US associates to meet a minimum level of combined age and tenure. The irrevocable acceptance period for most associates electing to participate in the VSP ends in December.

Based on the number of eligible associates and our estimate of participation, we expect the corresponding pretax charge in the fourth quarter of 2016 to be approximately $30 million. Similar to our last VSP, we believe we will be able to fill many of the positions vacated by participating associates with existing associates, which should create efficiencies in the future while also creating career growth opportunities for our associates.

This completely voluntary program will have a very small impact on our total headcount, as the number of eligible associates we expect to accept the offer represent less than 2% of our total associates. Also, this should not be viewed as a layoff or a sign we don't expect to grow. We've grown our headcount by over 2,000 people this year and expect to grow headcount next year as well.

Now, I'll move to our balance sheet. We ended Q3 with $837 million of total cash and investments, which is up from $720 million in Q2. We did not repurchase stock during the quarter, which means $100 million still remains available for repurchase under the stock repurchase program authorized in March of this year.

Moving to debt, our total debt, including capital lease obligations, is $573 million, which is down slightly compared to Q2. Total receivables ended the quarter at $985 million, which is essentially flat to Q2. Our Q3 DSO was 76 days, which is down nine days from 85 in the year-ago period.

Operating cash flow for the quarter was $240 million, down from $272 million in Q3 of 2015. Year-to-date operating cash flow of $822 million still reflects strong growth over the $594 million of operating cash flow for the first three quarters of last year. We also expect strong Q4 cash flow.

Q3 capital expenditures were $110 million and capitalized software was $74 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $56 million for the quarter. This is flat compared to Q2 and down compared to Q3 of 2015.

Year-to-date, free cash flow of $266 million is nearly double the $134 million generated in the first three quarters of last year. Next year, we continue to expect a decline in capital expenditures, which we expect to drive stronger free cash flow.

Now I'll go through guidance. We expect revenue in Q4 to be between $1.225 billion and $1.3 billion, with the midpoint reflecting growth of 7% over Q4 of 2015. Our guidance reflects our expectation that system sales will increase sequentially compared to Q3, but will still be below our original target for the quarter, due to lower expected software and hardware.

We expect Q4 diluted EPS -- adjusted diluted EPS to be $0.60 to $0.62 per share, which is below our original expectations, due to the impact of the lower system sales. The midpoint of this range is flat compared to Q4 of 2015, but recall we had a $0.03 tax benefit last year.

Moving to bookings guidance, we expect bookings revenue in Q4 of $1.425 billion to $1.575 billion, and the midpoint reflects 11% growth over Q4 2015. When added to year-to-date actuals, the midpoint of our Q4 guidance implies the following expected full-year 2016 results: revenue of $4.8 billion compared to a guidance range of $4.9 billion to $5.0 billion; diluted -- adjusted diluted EPS of $2.31 compared to guidance of $2.30 to $2.40; and bookings of $5.5 billion compared to our stated target of exceeding 2015 bookings of $5.4 billion.

When compared to the guidance we provided a year ago, revenue is the only key metric projected to be below our previously guided range. Recall that I shared at our Investor Day in March approximately 79% of the $5 billion midpoint of our original revenue guidance was scheduled to come out of backlog that existed at the beginning of 2016.

This means that we expected about $4 billion of revenue to come from backlog that existed at the beginning of the year, and the remaining $1 billion to come from current year bookings. So far this year, our conversion of backlog has been almost right at target levels, and we expect that to continue.

Where we have missed has been on contribution of bookings to current-year revenue, which is reflected in the lower system sales. Fortunately, much more of this miss has been due to hardware than software, which is the main reason we still expect to be in our full-year adjusted diluted EPS guidance range. Also, while below our initial range, our 2016 revenue is still expected to be 8% to 9% higher than 2015, which is a very tough comparable, as it had grown 30% over 2014.

Now I'd like to provide initial expectations for 2017. We'll provide more formal guidance after we report Q4 results and finalize our 2017 plan. But based on the initial version of our plan, we currently expect 2017 revenue between $5.2 billion and $5.45 billion, reflecting 11% growth at the midpoint, and 2017 adjusted diluted EPS between $2.50 and $2.70, reflecting 13% growth at the midpoint. Current consensus estimates for both revenue and adjusted diluted EPS are at the high end of these guidance ranges, largely reflecting the fact that consensus was formed before our Q3 results and Q4 guidance.

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

Zane Burke - *Cerner Corporation - President*

Thanks, Marc. Good afternoon, everyone. Today I'll provide color on our results and make some marketplace observations. I'll start with bookings.

While our Q3 bookings were slightly below our guidance range, it was still the second highest level of bookings in our history -- second only to Q3 of 2015. In addition, we expect to return to strong bookings growth in Q4.

Looking at mix, 34% of bookings in the quarter were from long-term contracts, reflecting one new IT works client and strong managed services bookings. This is in a more normal range for long-term bookings, but our year-to-date mix is still lower than normal because of the lower long-term bookings in the first half of the year.

Bookings this quarter included several large contracts, with 35 contracts over $5 million, including 26 over $10 million. From a new client perspective, 34% of bookings this quarter came from outside our core millennium installed base. This high level of new business reflects our ongoing competitiveness and good market activity.

Looking ahead, we continue to believe the replacement market will remain active, given the high number of hospitals on legacy platforms, some that are being sunset, while yet others are preparing for future regulatory and payment models that many legacy platforms are not well-equipped to handle. As we have previously discussed, the timing of these contracts has proven to be less predictable, which I will discuss more in a minute.

First, I will provide some more highlights on the quarter. I'll start with revenue cycle, which continues to be a strong contributor to our results. The market remains very focused on clinically-driven revenue cycle, which is driving strong sales into our base, as well as inclusion in new EHR deals. We also had good contribution from RevWorks services in the quarter, with the expansion of an existing relationship, and good contribution from our acute and ambulatory revenue cycle services offerings.

Our competitiveness in revenue cycle continues to improve across both acute and ambulatory, and this is reflected in the fact that we have displaced more than 10 different competitors so far this year. Looking ahead, we remain optimistic that revenue cycle will continue to be a strong contributor to our growth. We still have significant whitespace on solution penetration, and opportunities for our consulting services remains high.

Now I'll shift to population health, where we continue to do very well. Our comprehensive approach to population health remains differentiated in the marketplace. The power of our platform and ability to integrate with EHR workflow remain key differentiators, but we also continue to strengthen our competitiveness against the niche competitors we face across different categories, such as registries, enterprise data warehouse, analytics, and Care Management.

We are very pleased with our overall progress in population health. Just 2.5 years after our first HealtheIntent Solution went live, we have now sold solutions to over 100 clients, and the HealtheIntent platform has over 300 data connections for more than 80 unique sources. As we have discussed, the scope of many initial population health contracts are small, because most clients are not at risk for large portions of their population.

But we expect that ongoing shifts in reimbursement will lead to broader risk assumption, which should lead to adoption of more solutions and more lives being managed on a per-member, per-month model. Additionally, we are discovering through the use of our solutions that access to more data will enhance our clients' fee-for-service models.

Also, our addressable market for population health goes beyond our traditional EHR clients to include ACOs, health plans, governments, and employers. In addition, the opportunity goes beyond modules on HealtheIntent platform, as there is a significant market to provide high-value services that complement our solution offerings. Mike will discuss an example of where we are doing this.

Moving to the ambulatory market, where we had another very good quarter. This quarter again included multiple competitive displacements and strong contributions from many -- from ambulatory EHR practice management and business office services. A noteworthy ambulatory win during the quarter was being selected to replace our primary cloud-based competitor for ambulatory EHR and business office services at a large investor-owned IDN that we believe is their largest client.

We signed for one market in Q3 and anticipate expanding it to other markets in the future. This was one of three displacements of this competitor in the quarter.

We also had a good quarter in the small hospital market. Our competitiveness in this market remains strong, and we are having success against all competitors. In Q3, we added eight community hospitals with head-to-head wins against five different competitors. Outside the US, our revenue was flat year-over-year. Non-US revenue represents about 11% of our total revenue, so the flat revenue in the quarter didn't really impact our total results.

Despite some kind macro headwinds, we do expect the non-US market to becoming a more meaningful contributor to our results over the long-term, given the relatively untapped EHR Solution and Services market. We also believe there will be a large market for our population health platform outside the US.

Now I'd like to provide some perspective on our results and observations on the marketplace. Despite what was in most ways a solid quarter, we are always disappointed when we don't deliver against the guidance we established. So I'd like to comment about what I think are some of the elements contributing to results being somewhat less predictable.

While our pipeline has continued to increase this year, and is at record levels, we are in a period where the timing of closing opportunities has been more challenging. In the EHR replacement market, there continues to be a significant number of replacement opportunities, and we continue to win a majority of them. However, the reduced number of hard deadlines tied to regulatory mandates has impacted the clients' sense of urgency.

As I indicated, I believe this is primarily a timing issue, as deals in our forecast are changing from a calendar perspective, but not being lost. We have also had less contribution from our ITWorks and RevWorks businesses this year, despite a strong pipeline of opportunities. These opportunities remain, and I believe we'll see much stronger contributions from these businesses in 2017.

Overall, I feel good about our ability to grow bookings in 2017, given the pipeline for larger Works contracts, ongoing EHR replacement opportunities, and an expected continuation in the ramp of contributions from population health. As Marc discussed, our initial view of 2017 reflects good top and bottom-line growth.

In summary, while our results were slightly below our guidance range for revenue and bookings, I still view results as solid, and a strong pipeline in place, and believe we remain well-positioned for growth going forward.

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

Mike Nill - *Cerner Corporation - EVP and COO*

Thanks, Zane. Good afternoon, everyone. Today I'm going to discuss ITWorks and service collaboration with a large employer and leading health system. I'll start with ITWorks.

We had a good quarter with one new ITWorks client and strong sales back into our client base. Our new client in the quarter was a community hospital that also has six clinics. Like most of our ITWorks clients, they added additional solutions to their roadmap as part of their agreement.

In this case, they will be adding critical care, oncology, and cardiology solutions. In addition, they are adding HealtheIntent population health solutions as well. As Zane mentioned, we've had less ITWorks activity so far this year than expected, but our pipeline remains strong and includes some clients that are much larger than any of our existing ITWorks clients, which is why we are confident about the growth in ITWorks bookings for 2017.

The value proposition to our clients remains very appealing, especially in an environment where they have pressure on operating costs, limited access to IT talent, and increasing pressures in light of the industry issues related to security.

Now I'd like to discuss a new partnership between Cerner, a large employer and Memorial Hermann. Together, the three of us have collaborated to create a high-performance health network for employers. Employers are looking for strategies to improve quality, cost, and experience. Leading health systems are creating and looking to grow their insurance offerings.

As this emerging market takes shape, Cerner is investing in new capabilities to address this market opportunity. We think the chance to positively disrupt and drive revenue is compelling.

Cerner and Houston-based Memorial Hermann have a long history of collaboration and innovation. In addition to broad adoption of Cerner Millennium Solutions, they are an early adopter of our initial HealtheIntent population health solution, and have been steadily adopting more solutions and replacing niche suppliers over the past three years.

This has contributed to their success at running one of the largest, best-performing ACOs in the country. Memorial Hermann also has its own health plan built around their vast provider network in Houston. Within their plan, they have created their own custom, fully-insured product for a Fortune 500 employer. As part of the overall approach, Cerner is providing a concierge member services that will be tightly integrated into the health plan and health system, helping members maximize their benefits.

We are also providing the technology for the consumer engagement platform, which brings disparate patient and member portals into an organized consolidated experience. As you know, we have administered our own health plan for the past decade, which has allowed us to reduce the growth in our healthcare costs, while also leading to a better health experience for our associates.

By leveraging this experience and partnering with an innovative world-class provider like Memorial Hermann -- a large-forward thinking employer -- we are building an approach to value-based care that can be a model for other markets. We believe large health systems are uniquely positioned to play a role in helping employers move toward value-based care. By offering performance networks -- high-performance networks comprised of high-quality doctors, they can provide plans that help employers bend the cost curve, while also providing a better overall experience and improving the health of their workforce.

We look forward to sharing more about this collaboration as we move through the enrollment and launch this -- in the launch of this offering, and then expand these capabilities to other leading health systems, employers, and markets.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Garen Sarafian, Citi Research.

Garen Sarafian - *Citi Research - Analyst*

Thanks for taking the questions. Hey, Zane, could you just elaborate a little bit on what you're seeing in the market and some of the delays? Could you just maybe give a couple of examples? And then what gives you guys confidence that it's sort of just getting pushed over to a little bit farther down the road and not necessarily disappearing? Are they putting anything into their budgets for next year that gives you that confidence, or any other metrics that we can rely on?

Zane Burke - *Cerner Corporation - President*

Yes. Thank you. Garen, thanks for the question. So the -- in the new business marketplace, I'd say our metrics are at all-time highs. So the activity levels are incredibly good, and in fact, we had a very strong new business quarter overall. So we did very well. We just had anticipated doing slightly better. And there were a couple of opportunities that moved, and mostly from just a pure timing perspective.

So it's not a question of if they are going to do it; it's a when. And without the challenges of -- or without the regulatory elements behind it, the regulatory mandate times behind it, some of those clients are moving a little bit slower than they have in the past.

So the budgets are there. The activity is there, and we are -- we had a high-performance quarter in terms of numbers. We did not meet our expectations in what we anticipated to come through for the quarter. So, and as we look forward, we see our pipeline of activity and those that are in the pipe as very strong. And record levels of activity there.

And as those of you who have followed us for a long time know, we go through a rigorous process in terms of how we qualify those opportunities, how they run through the -- our forecasting process. And that's helped us to provide good predictability historically around the closing of those -- some of those -- of those opportunities.

In this case, as I have discussed previously, there are some timing gaps. So the activity remains strong. The ability to accurately predict within the number of weeks, days, et cetera, and how we close our business, was not where we have seen it previously.

So, does that make sense?

Garen Sarafian - *Citi Research - Analyst*

Okay. No, that -- yes. No, that's useful. And then as a follow-up maybe for Marc, in setting guidance for 2017, given just more uncertainty and sort of predictability in achieving these results, is the -- has the methodology in coming up with guidance any more conservative than in prior years? So, for example, what percent of the midpoint of next year's revenues come from backlog versus prior years? Or any other metric for that matter?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Hey, Garen. It's -- once again, it's early. What we are providing is our kind of view as of now. We don't have a 2017 plan completed. As we go through the process, the process will remain as it's always remained. We will look at the business. We won't make any assumptions that we are going to grow bookings. We will expect bookings to be relatively flat; a mix to be relatively similar.

And we will then look at our forecast that goes out four quarters to see if that forecast supports those assumptions. We'll do all the things we do relatively looking at spending and looking at opportunities. I would expect, while I don't have a number today, that a material component similar to what we saw coming into 2016, which was in the 80%, 79% range, that we would see that same contribution from backlog as we roll into next year.

I don't know that that -- what that number exactly is going to be, but I think we're going to have that visibility. Once again I think it will be a focus on the 20% that we've got to go drive, a lot of which comes through system sales, and that's going to be what we're going to focus on relative to our forecasting and our assumptions.

But my philosophy is, I'm going to do -- we are going to do all the work, and then we are going to provide you guidance based on our best work. So, we can't really -- as I said, we can't -- my planning process assumes certain things, one of which is flat bookings. I don't expect to have flat bookings next year. We are basically guiding today that we are going to be relatively flat for bookings.

But I think what, as we look next year, we would certainly expect to get back on an uptick after coming off a very challenging year with a significant increase in bookings. Last year, exceeding that very tough mark this year is actually a good accomplishment, but we'd expect to get back on track to growing bookings at a similar pace that we've seen in the past. So, once again, my comments on plan is we traditionally have always done from an actual expectation of bookings, the business expects to grow our bookings.

Especially as Zane talked about. In 2015, the Works businesses -- or 2016, the Works businesses weren't an integral part of a lot of our bookings numbers. We didn't do a lot of big ITWorks deals. In the pipeline, there are more opportunities in that space. And given that and the size of those bookings, gives us kind of a higher level of confidence that 2017 bookings are going to be stronger than 2016.

Garen Sarafian - *Citi Research - Analyst*

Okay, that's useful. Thanks for the questions.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Sure.

Operator

Robert Jones, Goldman Sachs.

Robert Jones - *Goldman Sachs - Analyst*

Thanks for the questions. Marc, I actually just wanted to follow-up on some of those bookings comments. Just to be clear, is the 2017 preliminary revenue outlook that you are providing tonight -- is that assume no bookings growth? And then I guess as I think about the short-term bookings, it does look like you are calling for a pickup in 4Q. I'm just curious, as you look out into next year, is it just a conservative assumption to assume you don't see bookings growth? Or are you actually baking in some as you think about 2017?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes. And let me be very clear. We expect bookings to grow in 2017. That is our expectations. The business is there. Everything we are seeing in our forecasting process, which goes out four quarters, so we actually have a view out that long as to what the opportunities are. And as Zane said, it's at record levels.

So we see bookings growing next year. My point is relative to us doing a plan, the question kind of came up, is there a level of conservatism? And for us, we don't expect -- we don't plan the bookings are going to grow. We expect them to grow, but by not building that into the plan, that gives us some degree of cushion should they not grow, to deliver the numbers that we provided in our guidance.

And so I think that's our expectation. I expect bookings to grow, Zane expect bookings to grow. The opportunities out there, so we will see higher bookings in 2017. But relative to giving you guidance, especially preliminary guidance, we're not going to go build growth and bookings into those preliminary numbers.

When we come back to you after Q4 ends with a completely built backlog and have our best view, then we'll certainly tie down those numbers. But at this point, based on our normal process, which we've done every year, we are comfortable with the guidance we're providing relative to a first look at 2017, and once again, realizing we've got to get to our planning process to tie it down.

Robert Jones - *Goldman Sachs - Analyst*

No, that's fair. I guess just one more specific follow-up around that. If I think about 2016 and maybe one of the things that was disappointing relative to your expectations coming into the year probably would be around the Works pipeline. It seems like the expectations for some of these large Works deals to be implemented is obviously moved throughout the year.

I guess the question is, what changes in 2017 -- as far as the system that you've been talking to around IT and ITWorks and RevWorks -- what changes that you see them actually moving forward with those contracts?

Zane Burke - *Cerner Corporation - President*

Robert, this is Zane. I think what we are seeing is moving -- some of those things moving through the pipeline a little bit faster in terms of -- not faster but just maturing more appropriately through there. And so what's really going on, when you make this move is, it's a combination of things. So, there's always a how to go faster.

And so when you look at MACRA and MIPS, our clients are going to have a need to be able to measure and monitor a number of different metrics and to begin to prepare for that. And when they look at what the pressure they are under for meaningful use, for MACRA, MIPS, those kinds of things are going to drive additional behavior around ITWorks.

In addition, the decreasing reimbursement environment creates a cost strain at a time when they need access to more data, they need more IT to actually be able to answer all these questions. So the combination of those regulatory elements and a capital and operating-constrained environment, at a point in time when they are trying to just flat-out execute, what we offer for our clients is provide that kind of leverage.

And I think what we saw in 2016 is, there was almost a catch-your-breath mentality in that we did not have any of those major elements around meaningful use in the current year. We didn't have the MACRA MIPS. And in addition, the bottom lines for our clients were still pretty strong. What you are seeing is you go to the back half of the year is a little bit of weakness with the bottom lines and that regulatory environment coming on, that's actually a really big positive for the IT, for the Works programs themselves, both revenue cycle and ITWorks.

And so in the conversations that we are having, they are continuing along. And I feel like those are going to mature in a good way in 2017 that we just didn't see in 2016, with that kind of catch-your-breath element in some of those areas.

Robert Jones - *Goldman Sachs - Analyst*

Got it. Thank you.

Operator

Steven Valiquette, Bank of America.

Steven Valiquette - *BofA Merrill Lynch - Analyst*

I guess I'm just curious on the -- just an update on the VA opportunity. There were some rumblings obviously a few months ago that the Vista system could potentially be replaced and potentially bidding to third parties. Just curious to get an update on what's going on there from your perspective. Thanks.

Zane Burke - *Cerner Corporation - President*

Thanks for the question. So, from a VA perspective, I think with the administration's changing and some of those elements, that there is a -- I don't think there is an expectation that that's going to be in the immediate horizon. But there is clearly a dialogue, and has been from them, around making a change out of Vista in the long run. And should we be called upon to respond to that and get asked, we would be excited to perform.

I think our best model is to continue to perform on the DOD, which we are performing very well on, and the follow-on opportunities for that are quite significant in and of themselves. So as you think about 2017 and 2018 in the future, we have a unique position, both from the DOD perspective, obviously the additional opportunities that are not yet booked as part of that opportunity, but also to set us up to be in good position to think about competing well around the VA.

And so our motto is to put our head down and be very successful with the DOD. That will yield a lot of positive results for 2017 in terms of system sales for Cerner Corporation that are unique to Cerner as well as physicians for the VA.

Steven Valiquette - *BofA Merrill Lynch - Analyst*

Okay. Just on the -- just based on that comment then, on the DOD part of that then, it sounded like maybe you were saying that could be a source of upside to bookings next year? Or is that going to be counted in the bookings already as far as the opportunity? Just wanted to get clarity on that comment you made around that.

Zane Burke - *Cerner Corporation - President*

The -- I would say part of those are in the bookings, and I'd say part of those could be upside to the bookings. So I think as we have visibility to what that looks like, we are anticipating where we are. We have not set any guidance at this point around bookings other than to say, as Marc has said, our anticipation is to grow for next year.

And we haven't -- again we haven't said that, I can't really tell you that piece. But in our forecasting process, we are forecasting opportunities around that, and I think it will be both provide some coverage for what we are doing from a guidance -- what we will do around guidance as well as provide some upside opportunity.

Steven Valiquette - *BofA Merrill Lynch - Analyst*

Okay, got it. Okay, thanks.

Operator

David Larsen, Leerink.

David Larsen - *Leerink Partners - Analyst*

How much did the DOD contribute to the quarter, if any, in terms of like bookings and revenue? And what would that contribution be next quarter, please?

Marc Naughton - *Cerner Corporation - EVP and CFO*

David, as we've said, that the bookings from DOD tend to be kind of steady and not significant in any one quarter. They weren't significant similarly -- there isn't a big impact in any one quarter. The revenue doesn't have a big impact in any one quarter, and it's not a number we are disclosing.

But it isn't -- if it was a big -- if it was something material and we were going to, then we'd talk about it, but it spreads out through multiple periods. And as Zane said, as we complete certain processes and elements of the project in 2017, that opens up additional past quarters for us to realize not one of which will be a giant booking in the quarter, but it will be definitely a strong support for overall bookings, as well as the potential to provide some guidance -- some upside to our guidance.

David Larsen - *Leerink Partners - Analyst*

Okay. That's helpful and then, Zane, just one more question talking about like pipeline activity and new sales efforts, are there any metrics you can provide, like, for example, number of leads, how that is trending on a year-over-year basis? Or can you give any more sort of detailed color around which segments of the market you're seeing greater activity from? Is it community hospitals, physician offices, large hospitals? Thanks.

Zane Burke - *Cerner Corporation - President*

Sure. Happy to help with some of those pieces. There are some things that we do not provide numbers around, but those are proprietary for us. What I will say is in terms of absolute dollars across all segments, our pipeline is at the highest level in the history of the Company.

So, that's kind of the ultimate metric in terms of what we are looking for. And that's after we took the second highest level of bookings in the history of the Company out of the pipeline. So I think that's an important element to think of first when you are thinking about the health of where we are.

As far as certain areas of strength in the marketplace, certainly you look at community hospitals. That's a very strong marketplace for us. The small hospital marketplace is very strong. Some places where we uniquely compete around investor-owned segment, around the government, both from a federal and a state and local perspective, those are pretty -- those are very active parts of the marketplace, as well as our population health solution set. So, there are just a number of areas that we are very strong and continue to be very active.

David Larsen - *Leerink Partners - Analyst*

Great. Thanks very much.

Zane Burke - *Cerner Corporation - President*

Pleasure.

Operator

Sean Wieland, Piper Jaffray.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

So, a year ago, you said that you were comfortable with revenues in excess of $5 billion, and so we are about $200 million or so short of that. Can you, just looking back at -- over the past 12 months, what areas of product or market or services could you account for that $200 million?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I think you can just -- even looking at the last two quarters, there's $150 million that's come out of our revenue guidance. Half of that came out this quarter as a result of lower system sales. Right? We did not contemplate hardware decreasing 21%. We didn't contemplate software decreasing.

The business is out there. As Zane has talked, it's primarily a timing issues. But once those things hit a quarter -- so you are down half of that $150 million you are out this quarter, that's going to have a carryover effect. So even in our Q4 guidance, where we expect system sales to rebound and get back to good levels, you've got the follow-on's impact of that.

So that is going to impact basically take you down to $150 million just in the last half of the year. So I think that's the material amount. Obviously, when we were giving guidance, we were looking for a pretty significant uptick as we went through. And if you look at our Q4 guidance, I mean we are looking at a $78 million uptick at the midpoint of our revenue guidance range.

So we are still looking to get a significant bump in revenue to get to Q4. So I think relative to what we saw at the beginning of the year, the backlog has played out just like we expected it to. It's the system sales and some of the other things that are signed during the year that impact us.

But Zane, do you have any thoughts on that?

Zane Burke - *Cerner Corporation - President*

Yes, I think the other thing I would add is that the big difference is, as Marc discussed first off, low margin, tech resell, and frankly low-margin ITWorks bookings that we would have anticipated would have been in the numbers. They don't significantly add to the bottom line overall, but would have added to the top line in a revenue perspective.

And if you look at the first half of our ITWorks bookings, they led to lower second half revenue results. So, I think the combination of both the tech resell, as Marc mentioned, as well as the ITWorks pieces, both low-margin businesses for us. And both things that now -- and particularly the ITWorks side, as we look forward, having opportunity to pick back up, we should -- we feel better about that as we move forward.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

Okay, thank you. And then you mentioned that you replaced your large -- your cloud-based competitor at an investor-owned side. Is that a full rollout of -- and is that -- and when is that scheduled to go live?

Zane Burke - *Cerner Corporation - President*

It's a single region. So we look at it as opportunity to grow from that piece, but it's a single region of that one particular organization. And there will be a go-live in the 2017 period.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

Okay. And one last quick one. Do you have any thoughts on free cash flow for 2017?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, this is Marc. Clearly, we've talked about the CapEx we're spending on our new campus for Mike Nill. We expect that spending will moderate significantly when we head into 2017, so we expect CapEx to be $100 million less next year. So, if you look at the $100 million less of CapEx overall, and you look at kind of some level of increase in -- just in operating cash flow that flows down through, I think you'll see a pretty strong increase in free cash flow as you look to model what that looks like next year.

Sean Wieland - *Piper Jaffray & Co. - Analyst*

Okay, thanks so much.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Sure.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Thanks for taking the question. I guess Zane or Marc, just first, if we assume that bookings are flat in 2017, would it be right to assume that the mix of business that comes from installed clients versus new clients shifts more towards the installed clients, as it's largely cross-sell and renewal as opposed to new business -- is kind of question one.

And then question two for Zane, if we think about books of business that would not have been impacted by the lapping of stimulus spend, I guess maybe can you talk about what you're seeing in the international markets and government markets? Thanks.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Let me just take the mix of business, because we're talking hypothetically if we are talking flat bookings. Because bookings will grow next year. And so what reality is going to show in that growth is that our expectation is a similar mix between new and existing clients, as we continue -- as we move forward.

Relative to our assumptions, we are going to assume a similar mix -- relative to our planned assumption of flat bookings. Zane, I'll let you take the second half of that question.

Zane Burke - *Cerner Corporation - President*

Thanks, Marc. The -- around the international marketplaces, there are a few markets that feel very positive as we look at it. There are some who are investing more in healthcare IT, like Belgium, like Sweden, and you see that -- like Australia. And then there's some interesting ones where you look at a country like the UK, which is under incredible cost pressure, and that pressure really forces the change and forces the need for more IT, frankly.

And we were -- you may be aware, we were awarded six of the 13 -- our clients were awarded six of the 13 challenge grants around innovation. So a GBP10 billion innovation grants by which they are charged with figuring out ways to use IT to lower costs and improve efficiencies in the UK. And so I look at a couple of markets where there's recognition for -- they are doing well economically, and they want to go invest in healthcare structures like Belgium, like Sweden, or they are struggling and it's going to force the change, like the UK.

And I think we are well-positioned in those marketplaces to have some good success. I also think Canada has the opportunity in 2017 and 2018 to be a very strong marketplace, as they look at some more provincially-wide procurements. And those tend to take time and are very challenging in which to predict how those will come to closure. But there is -- I feel very good about how we are positioned in many of those strong marketplaces.

George Hill - *Deutsche Bank - Analyst*

Okay. I appreciate the color. And Marc, I'll hold you to a barbecue dinner on that one.

Marc Naughton - *Cerner Corporation - EVP and CFO*

You got it.

Operator

Eric Percher, Barclays.

Eric Percher - *Barclays Capital - Analyst*

I'd like to go back to the discussion of the replacement market. And I know you talked about some delays across the book, but within the replacement market, what are hospitals coming to you for today? What is able to drive through some of those delays? Is it integration? Is it specific products around ambulatory rev cycle? Can you tell us what is reverberating?

Zane Burke - *Cerner Corporation - President*

Yes, I want to be clear. It's not -- all of these organizations are making a decision they need to change. And so, the delays don't have anything to do with the -- from a solution perspective or anything like that. It is truly a process and a need to -- these are significant purchases for these hospitals.

It's literally a -- do I want to buy a new EHR? -- which they know they have to, to compete for the future; or am I going to go invest in some sort of -- the other pieces on the existing client, the ROI around some of the connectivity pieces to other parts of the business, whether that's device connectivity, whether that's their ambulatory marketplace, whether it's efficiencies, there is a focus around -- on return on investments, which breaks through the pause, if you will, or the kind of breathing, the sigh of breathing for 2016.

Those kind of projects gain traction in this environment where you're competing for capital. So it's kind of the hard ROI elements, our staff schedule, our staff acuity solution set. Having a clinically integrated revenue cycle has been a very strong element. Again, it's bringing things together. Same things that drive actually the new marketplace.

How do I go round out my solution set such that I have a fully integrated solution capability and I've got data liquidity across my enterprise? and ROI doesn't hurt anything in terms of getting it moving forward. So, thanks for the question.

Eric Percher - *Barclays Capital - Analyst*

How do you measure ROI among those different products? And how difficult is that in the sale prices?

Zane Burke - *Cerner Corporation - President*

It's a good question. Each -- we have a set of tools by which we work with our clients on their specific data, and knowing how our solutions work and spend time in their processes, and we run those against our models and determine the -- along with the client, what that return on investment should be.

Eric Percher - *Barclays Capital - Analyst*

Thank you.

Operator

Michael Cherny, UBS.

Michael Cherny - *UBS - Analyst*

Good afternoon, guys, and thanks for all the details so far. So, I'll just keep this kind of quick, and I apologize if some of this has been answered, but I want to ask it a bit of a different way.

Marc, historically, you hadn't broken down the system sales as closely as you did today, and I know typically the tech resell has been something that's been very hard to predict, obviously noncore. I don't recall a license software number coming down at that pacing, obviously offset by subscription. As you think about on a go-forward basis -- I'm not specifically talking about this quarter, but maybe if you want to give any color -- how should we think about the long-term mix of subscription versus license software relative to your business?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I think clearly license software or subscription is just two ways of selling intangible intellectual property. Right? So, from our view, Q3 was a little bit of a unique circumstance in that, as Zane talked about, there was a lot of business in the quarter and a lot of software opportunities that, because of this -- the timing issues that we are seeing, didn't get done in Q3.

But we see that rebounding in Q4 and expect to get back kind of to more traditional levels. The reason you haven't heard us talk about software before is it really hasn't been different enough to highlight. The tech resell has been different enough that it's been a cause of the difference. So that's one reason.

The variance between subscription and license -- it really just depends on how we are selling it and how the clients buy it. We will -- as we go to market, we'll go to market in a variety of ways. They want to buy the software, they want to buy it as a time -- term license that's more of a subscription. If they want on the top health side, a lot of these -- much of it is bought per member per month. So it's much -- more like an ASP or subscription basis.

So I don't know that that mix is relevant to our business as a Q3, where some of those opportunities -- some of them of size have moved to a different period. But I think overall, we are a software company. We expect that to rebound. Our pipeline is strong and we have the opportunity to go sell software. People are still buying software in this marketplace.

So I think that our opportunities are there, and we've just got to get to the point where we can -- and we are at that point, where we can effectively deliver, on a fixed fee basis, the technology they need. Zane made a really good point earlier about MACRA and the impact that has on just the general desire for technology.

I think, as he was talking about the existing client base, what they are needing, some of that is going to be driven by their desire to have all of the data that's going to be required under MACRA, and make sure that they have a single point of truth to go get that data, and to be able to get all the data they need. So, yes, I don't know how we sell it makes much difference. We still sell it.

Q3, I think was a low number. We've highlighted it because that's -- we wanted to be transparent. Q4, we don't think that's going to be an issue.

Michael Cherny - *UBS - Analyst*

Okay, thanks, Marc.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Sure.

Operator

Jamie Stockton, Wells Fargo.

Jamie Stockton - *Wells Fargo Securities, LLC - Analyst*

Marc, just on the expense trends that are backing up to the 2017 view that you guys have given, and I understand that the budget is not fully baked at this point, but specifically, as we think about R&D expense and what flows through the income statement, you guys have a relatively large gap between how much R&D you are capitalizing right now and how much you are amortizing. Can you give us a feel for how much of that gap is going to close next year? What the cadence over the next two or three years might be for that gap closing?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, obviously we continue to spend a significant amount of our R&D on new IP and new items that capitalize and that then go GA at some future point. We talk coming into this year that we'd expected to have non-cash expenses on some of the amortization on that, hitting us in 2016.

It has hit us. It didn't -- it has not hit us as much as we had originally expected. So I think you will see some carryover impact on the 2017 R&D expenses as that amortization starts -- ramps up early next year. We're continuing to deliver on the code. We're doing it on a timely basis. In some cases to get to GA, we acquire some testing by our client partners. And sometimes that timing gets -- is not exactly within our schedule that we would do amortization.

So, I think you'll see next year, similar level of capitalization, because we are still working on new stuff. The overall expense might take a slight hit from the amortization element of being slightly higher for the amount that didn't get hit into the number this year. So R&D expense basically is likely, as we look at it, goes up a little bit as we head into 2017, but it's not a significant adjustment. But once again, what we didn't see in 2016 will come to roost in 2017.

Jamie Stockton - *Wells Fargo Securities, LLC - Analyst*

When you -- just as a follow-up, when you think about the gross R&D spend, I mean, I know when you guys announced the Siemens transaction, one of the major bullet points was the amount of kind of combined R&D spend between the two organizations and the likelihood that there wouldn't need to be significant growth for a number of years in kind of that gross R&D spend.

If we think about the gross amount, I think this year it's probably going to be somewhere around $710 million or $715 million. You know, is that a number that we shouldn't expect to see grow materially over the next couple of years?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes. No, I think that's definitely part of our plan, that you're going to -- you know, the goal was around $700 million, that that should be enough for us to go deliver on what we are trying to do. At the very worst, any gross changes should be kind of low single-digit, so definitely growing at a rate lower than our revenue is growing.

But I think long-term, if you're just looking at kind of ordinary increases, kind of mid-single-digit growth would be something that would be along the lines of our expectation. We are -- we still have opportunities. We are still using some of the acquired resources to work and get to a point on some of the HS solutions. And so those people will become available as we roll forward.

And we are investing heavily in our India campuses. So our expectation there is that we will be bringing online more IP resources in that environment, which, from a headcount perspective, will increase; but from a cost perspective, will fit in with that single -- mid-single-digit future growth.

Jamie Stockton - *Wells Fargo Securities, LLC - Analyst*

Okay, thank you.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Why don't we take one more question?

Operator

Ricky Goldwasser, Morgan Stanley.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Thank you for getting me on. So, a couple of questions here. So, first of all when we look at the contract history, right, it seems that this quarter, the percent of contracts that are long-term in nature is the highest it's been since Q2. So shouldn't we think about this as a leading indicator for just again the step-down in booking conversion into 2017? I know that you talked about in the call about MACRA and meaningful use.

But it seems that the size of contracts -- the bigger the contract is seems to me it's more complicated and therefore slower to convert. That's question one.

And then second of all, if you can give us some sense of off-booking growth, what percent came from pop health and what percent from these big international contracts that you've talked about?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Let me just address the bookings. I think the comment kind of revolves around the long-term element of the bookings. Keep in mind that if you look at year-to-date, in 2015, long-term bookings were 34% of our total bookings. If you look at this year, it's been about 29%.

So, actually for us to be relatively flat and looking to be slightly up over a year where we are actually not getting the support from the long-term bookings, which we talked about from the Works deals, I think that's actually a point that shouldn't go unnoticed. But I think from relative to the overall contracts, every contract has some degree of -- these aren't simple, but they aren't -- they are not rocket science, right?

They want to buy stuff, but we want to sell stuff, there's a lot of parameters around that, but there are a lot of -- we have a lot of experience. They have a lot of experience. They also have a sell that helps them put the contract together. So I don't think the complexity of the contracts is delaying the signing of the contracts. I think the delay -- I think that is just more a matter of the organization's timing and focus and strategic planning, and they don't have an outside regulatory timeline that they have to go meet for some of these things.

MACRA could change that. MACRA may make them be more focused on making sure they have these solutions throughout all of their departments, so that they can get the data they need to do that reporting. So I think the -- so I don't think the complexity -- these have always been somewhat complex. It's just a matter of the timing of the client to do that.

The money is there, as Zane says. They are in our pipeline. It's just timing -- time down the 90-day period at which it's going to actually sign. It is a little bit more traditional than what it was prior to having meaningful use in all of these regulatory things that occur.

Ricky Goldwasser - *Morgan Stanley - Analyst*

And then on the booking growth and from pop health, what percent is pop health and what percent is international?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Pop health is very little piece of bookings growth at this point. I mean, it's -- we have some -- today, with the pilot version of pop health, a $5 million booking is a good-sized population health booking. So it's not moving to meet our $1 billion bookings number. And relative to global, those bookings have been basically relatively flat, if not a little bit lower.

Over the last year, as Zane said, there's some opportunities going forward, especially in Canada and some other countries, that look like demand is beginning to pick up. So we think that will help the global side. But most of the bookings and most of the stuff, the growth you are seeing is not pop health, not international. It is our core businesses that we've always been in.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay, thank you.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I want to thank everybody for their time. I think you know we are still on pace to grow bookings and revenue this year over a very tough comp. And I think we're all absolutely on path to grow revenue and earnings double-digit in 2017. So I think, based on our pipeline, based on the ITWorks opportunities we have, we do continue to expect to grow bookings year-over-year in 2017.

With that, I will thank you for your attendance and bid you good day.

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.