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CERN - Q3 2013 Cerner Corporation Earnings Conference Call

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OVERVIEW:

CERN reported 3Q13 revenues of $728m, GAAP net earnings of $115.3m or $0.33 per diluted share. Expects 4Q13 revenue to be $775-815m and adjusted EPS before share-based compensation expense to be $0.38-0.39.

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PRESENTATION

Operator

Welcome to Cerner Corporation's third-quarter 2013 conference call. Today's date is October 24, 2013, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today by Cerner's management about future expectations, plans, perspectives, and prospects constitute forward-looking statements for the purpose of the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. 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 heading risk factors under item 1a in Cerner's Form 10-K together with other reports that are furnished to or filed with the SEC. A reconciliation of non-GAAP financial measures discussed in this earnings call can be found in the Company's earnings release that 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.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Thank you, Philip. 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 sales highlights and marketplace trends. Mike Nill, Executive Vice President and Chief Operating Officer, will discuss our works businesses and R&D investments, and Jeff Townsend, Executive Vice President and Chief of Staff will discuss our new relationship with Intermountain Healthcare. Neal Patterson, our Chairman and CEO will be available during Q&A.

Now I will turn to our results. We delivered good results overall in Q3 with revenue again being an exception to the continued lower levels of technology we sell. We continued to increase gross margin dollars at a strong rate, which is evidence of ongoing strength in the higher-margin components of our business.

Our total bookings revenue in Q3 was $928 million, which is up 21% over Q3 of 2012 and is an all-time high for a third quarter. Bookings margin in Q3 was $831 million, or 90% of total bookings. Our bookings performance drove a 24% increase in total backlog over Q3 of 2012 to $8.4 billion. Contract revenue backlog of $7.63 billion is 26% higher than a year ago; support revenue backlog totaled $770 million, up 6% over the year ago.

Revenue in the quarter was $728 million, which is up 8% over Q3 of 2012. Similar to Q1 and Q2, lower technology sales impacted our revenue but had limited impact on earnings. Next quarter will be our last tough comparable for technology resale. We do expect it to contribute to growth next year.

The revenue composition for Q3 was $203 million in system sales, $166 million in support and maintenance, $342 million in services, and $17 million in reimbursed travel. Systems sales revenue reflects a 12% decline from Q3 of 2012 which had grown 22% over the prior year. The decline this quarter was again driven by a significant year-over-year decrease in technology resale. As with recent quarters, we continue to have strong levels of higher margin system sales components, including software and subscriptions, which is reflected in the 7% growth in system sales margin dollars even with the decline in system sales revenue.

Moving to services, total services revenue was up 23% compared to Q3 of 2012 with strong growth in both managed services and professional services and a continued increase in contribution from ITWorks and Revenue Cycle.

Support and maintenance revenue increased 8% over Q3 of 2012.

Moving to gross margin, our gross margin for Q3 was 83.6%, which is up from 82.2% in Q2 of 2013 and 77.9% in Q3 of 2012. The large year-over-year increase in gross margin percentage was driven by the lower mix of technology resale. This mix shift and the strength in higher margin business model is also reflected in strong year-over-year gross margin dollar growth of 15%, which is almost double the revenue growth rate in the quarter.

Looking at revenue by geographic segment, domestic revenue increase 8% compared to Q3 of last year, even with the decline in technology resale. Global revenue grew by 1% due largely to a tough comparable. We did have several positive developments in our global business, which Zane will discuss, but these did not have an immediate impact on our income statement.

Looking at operating spending, our third-quarter operating expenses were $426 million before share-based compensation expense of $13 million. This is a year-over-year increase of 15%.

Sales and client services expenses increased 17% compared to Q3 of 2012, driven by the continued increase in revenue-generating associates in our services business.

Our investment in software development was up 6% compared to Q3 of 2012 with the larger increase in gross spending being largely offset by an increase in capitalized software. As we have indicated, we expect gross spending and capitalized software to increase through the end of the year and should moderate at some point next year.

G&A expense increased 22% compared to Q3 of 2012, driven by increased personnel expense related to our strong growth and high amortization expense related to recent acquisitions and acquired intangibles.

Moving to operating margins, our operating margin in Q3 was 25.1% before share-based compensation expense and was up 180 basis points compared to Q3 of 2012. This was again driven by combination of ongoing operating efficiencies, the lower level of low-margin technology revenue, and strength in high-margin areas I have discussed.

Moving to net earnings and EPS, our GAAP net earnings in Q3 were $115.3 million, or $0.33 per diluted share. GAAP net earnings include share-based compensation expense, which had a net impact on earnings of $8.2 million, or $0.02 per diluted share. Adjusted net earnings were $123.6 million and adjusted EPS was $0.35, which is up 17% compared to Q3 of 2012.

The Q3 tax rate for adjusted net earnings was 34%, which is in line with our expected effective tax rate.

Now, I will move to our balance sheet. We ended Q3 with $1.5 billion of total cash and investments, which is flat compared to Q2. Total cash and investments include $922 million of cash and short-term investments and $577.5 million of highly rated corporate and government bonds with maturities less than two years. Our total debt, including capital lease obligations, is [$183 million].

Total receivables ended the quarter at $529 million, which is up $1 million from Q2. Our DSO in Q3 was 66 days, which is down from Q2 DSO of 68 days and 73 days in Q3 of 2012.

Operating cash flow for the quarter was $164 million. Q3 capital expenditures were $83 million and capitalized software was $48 million. Free cash flow, defined as operating cash flow less capital expenditures and capitalized software, was $33 million. As expected, free cash flow remains lower than recent levels due to higher CapEx, driven by investments in our cloud infrastructure, the build out of our new campus, and higher capitalized software. Operating cash flow was also slightly lower due primarily to timing of tax payments. We expect capital expenditures to remain high in coming quarters as we continue these important investments in our growth. Even at these levels of investment, we still expect to generate solid levels of free cash flow. We expect these investments to moderate by the second half of 2014 and for free cash flow to increase at that point.

Moving to capitalized software, the $48 million of capitalized software in Q3 represents 45% of the $107 million of total investment in development activities. Software amortization for the quarter was $24 million, resulting in a net capitalization of $24 million, or 22% of our total R&D investment.

As we have discussed, we expect capitalized software to remain high going into 2014, but then expect it to decline as we reduce the use of third-party developers throughout the year.

Regarding our share buyback, in Q3, we purchased $28 million worth of shares bringing year-to-date repurchases to $170 million and completing the share repurchase program that was authorized last December. In total, we purchased 3.6 million shares post-split in 2013.

Now I will go through Q4 guidance. For Q4, we expect revenue between $775 million and $815 million with the midpoint reflecting growth of 12% over Q4 of 2012. This revenue guidance range accounts for a wider range of results in technology resale and reflects expected ongoing strength in other areas. We expect Q4 adjusted EPS before share-based compensation expense to be $0.38 to $0.39 per share reflecting 15% growth over Q4 of 2012. Q4 guidance is based on total spending before share-based compensation expense of approximately $430 million to $440 million. Our estimate for the impact of share-based compensation expenses is approximately $0.02 to $0.03 in Q4.

Moving to bookings guidance, we expect bookings revenue of $1 billion to $1.1 billion, which is up compared to the all-time Q4 2012 bookings and leads to full-year bookings growth of 18% at the midpoint.

I would also like to provide our initial thoughts on 2014. The initial version of our 2014 plan supports the current 2014 analysts' estimates. As always, we will continue to update our outlook on future earnings calls.

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

Zane Burke - *Cerner Corporation - President*

Thanks, Marc. Good afternoon, everyone. Today I will provide sales highlights and discuss marketplace trends.

Starting with our results, our bookings revenue in Q3 of $928 million is an all-time high for a third quarter and reflects 21% growth over Q3 2012. Similar to the first two quarters of this year, our bookings included strength across all business models except for technology resale. While I am not pleased with the lower-than-expected system sales revenue resulting from the decline in technology resale, I am not concerned given the strength in our core higher-margin solution and services.

Looking at other bookings metrics, we had 23 contracts over $5 million including 11 over $10 million. The mix of long-term bookings was 32% in the quarter which is in line with historical levels. Our competitiveness in Q3 was very strong. 27% of a bookings came from out of our core Millennium installed base, and this does not include our very strategic wins against our primary competitor at Intermountain, which will contribute to Q4 bookings.

In addition to Intermountain, we had other domestic wins against our primary competitor and two noteworthy global wins, including Albert Einstein in Brazil and CHU de Nantes in France. Both of these hospitals are among the largest and most prestigious hospitals in their respective countries and we are very pleased to be working with them. This is our sixth French client and our first client in Brazil, which we view as a great emerging area of opportunity as they have over 7000 hospitals with limited EMR penetration.

The news of these wins created an immediate buzz across the industry, and I have already seen it have a positive impact on our momentum in both domestic and global opportunities. This success provides further evidence our investment in Physician Experience and Revenue Cycle are paying off and allowing our leading capabilities and vision for population health to carry more weight in the selection process. Our modern architecture and commitment to being open, which Jeff will discuss in more depth, is also contributing to our success.

Our momentum in the ambulatory space also continued as we had another strong quarter with several competitive displacements. Our success this year is evidenced by the fact that our ambulatory bookings for the first three quarters are already equal to the full-year 2012 bookings. We also had continued success with smaller hospitals, adding six CommunityWorks clients during the quarter.

Another highlight in Q3 was success with a new approach to providing non-Cerner EMR clients in solutions and services to help them with future stages of meaningful use and with the population health strategies. We are providing a mid-size health system with health information exchange, community patient index, patient portal, and enterprise master patient index solutions that wrap multiple existing non-Cerner inpatient and outpatient solutions. The client also plans to add our enterprise data warehouse and our just-released Healthe Intent Smart Registry solution in coming quarters. This new client relationship is significant because it demonstrates our ability to create a wrapper for non-Cerner systems with our cloud-based population health platform and expands on our addressable market for population health beyond our installed base. As we have discussed, our population health solutions are all EMR agnostic as we believe that by the end of that decade the EMR would just be one input into a broader cloud platform supporting population health, much like a lab system is viewed as one feed to an EMR.

Outside of the US, a highlight in addition to our strategic wins in Brazil and France was the signing of the contract for a pilot with the Saudi Ministry of Health. Recall that earlier this year, we were selected for the first pilot as a part of their national project that is expected to cover more than 200 public hospitals across the Kingdom of Saudi Arabia.

We are already working hard on this pilot and plan to deliver outstanding results to position ourselves for future opportunities.

Now I will cover a few marketplace observations.

The competitive landscape continues to reflect separation between the two most successful companies and the rest. And as I discussed, our momentum against our primary competitor is better than ever. In the provider space with noise around the shaky rollout of the exchanges in the background, providers continue to be focused on cost and quality in anticipation of an expected industry shift to a at-risk model that incents keeping people healthy. The financial pressures are real, and they are coupled with a long list of priorities around meaningful use, ICD-10, healthcare reform, and value-based purchasing.

While this is a challenging environment for our providers, it's a big opportunity for Cerner as our solutions and services are very well aligned with keeping our clients -- with helping our clients address these challenges. Our continued success in the marketplace reflects our differentiation as a supplier investing in a vision and one that partners with clients to navigate the changing environment versus just being an EMR company.

Another observation is the replacement market remains strong. We see a lot of opportunities where a supplier chosen in the past 10 years has not delivered as promised or the hospital has concerns about their ability to deliver future capabilities needed to keep up with industry shifts. Our proven ability to deliver the needs of today along with our platform to support clients in the population health era gives us an opportunity to reengage with many of these hospitals and health systems.

A good example of this occurred in Q3 when we displaced a best-of-breed roll up supplier at a 364-bed regional medical center in the Southeast. This client had selected a competitor's system over Cerner in the past 10 years. Since then, the competitor has been acquired and that client has dealt with missed promises around integration of merged companies and multiple suspended implementations. Frustration over these challenges and a desire to be on a platform that can support them well into the future led them to choosing Cerner.

Finally, industry consolidation is continuing. Two large examples announced this year include Tenet buying Vanguard Health and Community Health System announcing their purchase of HMA. This is a trend that favors Cerner. So far this year, Cerner clients have acquired six times more hospitals than our closest competitor's clients. As we have discussed, we also had a meaningful opportunity to our installed base, which includes seven of the top 10 US health systems. Just within these large health systems, there are more than 300 sites that currently don't have a Cerner EMR. This, combined with our clients leading the consolidation trend represents a substantial opportunity for Cerner.

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

Mike Nill - *Cerner Corporation - EVP and COO*

Thanks, Zane. Good afternoon, everyone. Today I'm going to discuss Revenue Cycle and ITWorks and provide an update on our R&D initiatives. I will start with ITWorks. Q3 was a great quarter for ITWorks as it included the addition of a prestigious client, Children's National Medical Center. As part of our expanded relationship with Children's National, we also formed the Bear Institute, which is the first pediatric health information technology institute in the country. Similar to our other institute relationships, the Bear Institute and ITWorks model makes a living lab for us to work together at the edge of healthcare delivery. And we believe we will be able to leverage this edge development and discovery to benefit other pediatric clients in the future.

Children's National will have a vision center on their campus which is located just two miles from the US capital and will serve as a showcase for clients, Washington dignitaries, and partner companies. It's worth noting that Children's National also became a Revenue Cycle client and will be displacing their existing revenue cycle supplier with both in-patient and ambulatory settings.

With that, I will transition to discussing our overall Revenue Cycle activity in the quarter. Children's national selection of our Revenue Cycle solutions contributed to a strong quarter for Cerner Revenue Cycle and provided yet another example of the momentum we have with our client base selecting Cerner's Revenue Cycle solutions. While we didn't have any new RevWorks clients in Q3, our strong level of bookings, including several competitive wins where Revenue Cycle was an important part of the selection process, reflecting our momentum in Revenue Cycle.

We also had an important Revenue Cycle -- many Revenue Cycle go-lives that reflect our ongoing execution. This progress was on display in a big way at the Cerner Health Conference where interest in Revenue Cycle was very strong. As a result, our pipeline for Revenue Cycle solutions and full RevWorks services is stronger than ever, and I expect Revenue Cycle to be a meaningful contributor to our growth for years to come.

Now, I like to provide a quick update on the progress we've made with our focused R&D investments. Starting with the Physician Experience, our physician solutions and overall mobility strategy was extremely well received at our Health Conference earlier this month. As we have indicated, PowerChart Touch, our native iPad application, is now generally available in the Apple Store and adoption is ramping quickly.

We further demonstrated our leadership in mobility and workflow with the recent announcement CareAware Connect. With CareAware Connect, our clients can use the iPhone to replace many disparate single-use devices such as pagers, barcode scanners, and voice-over-IP phones. The smartphone also allows us to rethink the workflow and provides the ability to integrate different platforms into a single experience. All of this is wrapped around new voice calling and a secured text messaging capability which utilizes the hospital's existing wireless infrastructure rather than requiring a cellular plan. CareAware Connect is another example of our ability to bring something from vision to reality very quickly as it was a concept that was shared with our clients at our Health Conference in 2012, and we announced two live client less than a year later.

Along with CareAware Connect, we also launched Skybox Mobility for mobile device management and Skybox network-assured services. I also wanted to note that Cerner has become an Apple authorized reseller for the iPhone, iPad, and all other Apple computing devices. We are the first noncarrier to be able to resell the iPhone which will allow us to resell the iPhone unlocked without a cellular plan, streamlining the purchasing, deployment, and staging of the device for our clients. Through this partnership and the rollout of Care Work Connect suite of solutions, we are meaningfully advancing our role in mobility and communications and further differentiating Cerner in the marketplace.

As you know, another key area of R&D investment has been population health. We recently achieved a major milestone in our population health development efforts. In September, Cerner and Advocate took a huge step forward in delivering our shared vision for population health when we released Healthe Intent Smart Registry solution to Advocate to seven months from contract signing. Healthe Intent Smart Registries provide the capabilities to stratify patient populations based upon risk, conditions, and attributed physicians. In addition, the registry enables care managers to quickly determine what key measures specific to the designated condition of the patient have been met. As Zane mentioned, we already have a non-Cerner EMR client lined up to buy our new Smart Registry solution, and there are several more interested in being early adopters.

I'd also like to mention another great accomplishment in the population health space. Earlier this month, CHIME presented the 2013 Collaboration Award to CHE Trinity Health and Cerner for our joint work on predicting and preventing sepsis. Trinity indicated they have saved more than 500 lives and $22 million over the last two years with Cerner's Lighthouse process improvement solutions being a key driver of the savings.

In summary, we continue to believe our approach to population health is differentiated in the marketplace. We believe many companies positioning themselves as suppliers of population health solution underestimate the complexity and none of them are addressing the population health opportunity with the comprehensive architectural approach that sets us apart. We also believe our ability to differentiate our capabilities will be enhanced by our relationship with Intermountain, which Jeff will discuss next.

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

Thanks, Mike. Today I'm going to provide a perspective on our Intermountain Healthcare relationship; how it fits into our broader vision; and my role going forward.

Throughout Cerner's history, there have been moments in time that shape the next decade for both Cerner and for the industry. There are a few of us that have spent the last several months with the leadership from Intermountain sharing our collective thoughts around now and next. Listening to their approach around quality, cost, and new care models, it became more and more apparent another moment was in front of us to create something unique that could shape the future of the industry and Cerner's role in that future.

This is a much bigger thought than it may appear on the surface. I look at this as two organizations joining to disrupt the industry. I think there is an opportunity to accelerate clinical computing by a decade making it more open, aware, and intelligent. The resulting system could shift the current cost baselines by more than 20%. There is an urgency to accelerate the impact information technology can have on the macro health economy. The macroeconomic environment is approaching unsustainability. IT is the only remaining lever to pull that could change that current trajectory. Innovation won't come from the policymakers; their only lever is price and reduced services.

With the digitization that has occurred over the past several years, we are definitely in a better place today as an industry, but most of the targets have been IT oriented with little focus on quality, cost, efficiency and elimination of errors. As a result, we risk not getting value out of the investments that have been made if we stop here. Much of our industry is losing focus on the potential. Our primary competitor used their user conference to argue for a five-year delay in meaningful use, making the point that the industry needs to slow down versus speed up. Somehow they tried to connect safety and innovation as victims of pace.

There are surprising parallels if you study Kodak's history. They had the core technology used in digital cameras but didn't make the turn, spending most of their cycles optimizing the more profitable models of the past and attempting to delay the future versus speeding it up. We will have wasted a generational investment if we don't realize the true opportunity of digitizing an entire industry is as important each of us as healthcare.

This opportunity is playing out while the macro business model for care is shifting. Our clients are feeling the pressure to continue to do more for less. If we don't unlock the impact that IT can have on the system, it will become a cost center. Delay is not the answer as the industry is not standing still. Both technology and medicine innovate daily, if not hourly. We have to shift the impact of cost, quality, productivity, and throughput. Simply turning on systems and measuring process won't be enough. For Cerner, this is our pivot, our moment to prove that healthcare IT is more than storing the record, measurements, and getting paid. IT will disrupt the current state, bend the cost curve, and enable evidence being moved into practice overnight. It becomes a platform to discover, predict, and prevent, and enables a personalized experience for each of us.

Now, I would like to share how Intermountain fits into this pivot moment.

Two years ago, we introduced the PPR acronym for physician, population health, and revenue cycle. While Advocate and the Adventist Health System are leading the way on population health and revenue cycle respectively, the physician focus is spread across multiple relationships. Given the breadth and depth of Intermountain's system and their commitment to quality, evidence, and intelligence, it will be a comprehensive physician-proof point. We will deploy solutions at an accelerated rate to all clinics and practices in the first phase of the project. This also positions us to more quickly advance the CIM plus 1 initiatives we added last year to address continuum of care, intelligence, member engagement, and personalized medicine. All of this will happen in the context of the most sophisticated and complex computing environments I have seen in three decades. Parallel to the implementation project is a set of activities to align Intermountain's decades of clinical history, decision support, and knowledge repositories into the system as though it was always there from the beginning. Our early design discussions in this space, with their world-class informatics organization, has evolved into three major initiatives that will launch in parallel to the implementation.

Together, I believe they will evolve into game changers for the industry. The first is around Intermountain's care process models. These are summarized guides to clinical decision-making focused on both conditions and specific decision points within a care process. They are highly contextual, moment-in-time decisions that remove variance and produce the best outcome at the most appropriate costs in the context of the patient, provider, and venue. This will be a significant step forward in our intelligence journey. The ability to use a variety of trigger events, including risk or calculators from Cerner Math to push the decision moments face up in the conversation, makes the workflow dynamic and contextual. Think of it as a clinical navigation system. This broad capability sets up a second objective, open.

Most of the discussion today around interoperability is pretty basic and moving at a very slow pace. As part of our work together, we're taking on something more disruptive but also more impactful than the slowly evolving standards that exist today. We are going to make care process models EMR agnostic inside the workflow. This will enable a new standard of care where we create the moment-in-time experience to support the decision, and at the right moment in time, it will serve us contextually inside the workflow of the physician without upgrades, mapping of interfaces, or retraining of workforce.

We prototyped key pieces of this with real code during the selection process over the last few months. We are already very close.

This puts us on a path to accelerate a lot of the work done by the industry today embracing and advancing current standards much more quickly.

The third part of our alignment together is time-driven activity-based costing. It's somewhat simple that if you are going to bend the cost curve in an industry, you have to know your costs. Most EMRs of today will have to be significantly redesigned and rewritten to become a true resource management system that provides insights into activities, methods, and costs. I believe if we successfully blend executable content with more precision of activities inside an open EMR, my 20% estimate on bending the cost curve could be too low.

In closing, I want to share my perspective on how I view Intermountain and my role in the relationship. The Institute of Medicine published a series of books on the characteristics and journey of a learning healthcare system, the quick summary being a system that is continuously innovating and improving in its ability to deliver high value to patients through continuous learning, best care, and lower cost. Working with Intermountain over the last several months is the closest I have seen to having this concept embedded in the culture of everything they do. There is a quiet confidence that they will continue to get better, not only for themselves or the communities they serve, but as a model from the industry to learn from. This is inherent in their mission.

Alignment will be very natural for us. We share the same why; we're doing this because it is personal. As a result, the decision for me to move to Salt Lake City to focus on joint innovation was actually an easy one. It's tremendous opportunity for Cerner. We are setting the bar high as our goal is to literally transform the industry with a world-class partner. Note that I will still be maintaining my existing client relationships in my Chief of Staff responsibilities at Cerner. I look forward to providing you updates on future calls and investor days.

With that, I will open the lineup for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Robert Jones, Goldman Sachs.

Robert Jones - *Goldman Sachs - Analyst*

Zane, you mentioned a lot of buzz following the Intermountain win, and I was hoping you could maybe just give us an update on what you are seeing as far as the EMR replacement pipeline. Are you seeing actually more RFPs at this point in the wake of the Intermountain win? How should we be contemplating the pace of additional wins from here?

Zane Burke - *Cerner Corporation - President*

Robert, I think it's a little too early to say in terms of it is driving new RFPs in the door. What I would say is it enhances the whole competitive process. And our pipeline is at an all-time high so we are at an all-time high in that space. And the business feels very strong. I think it just solidifies what many of our clients and prospects are seeing is just the success we have had in the marketplace in both delivering and in preparing for the future.

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. Not just the new RFPs that could be impacted by this, but existing RFPs that we are in a process today almost to a client or potential client, that has made a big impression on those -- the people we're talking with as far as future clients of Cerner.

Robert Jones - *Goldman Sachs - Analyst*

That is helpful. And just my follow-up, just around Intermountain, could you guys give us any more of a sense of the breakdown between what percent of the bookings are EMR versus RevWorks? And then, I guess, just as we look forward, any guidance you can give us and how we should be thinking about revenue recognition around this win.

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. There is no RevWorks included in this --

Unidentified Company Representative

It has RevCycle.

Marc Naughton - *Cerner Corporation - EVP and CFO*

It has RevCycle but not RevWorks. From a size perspective we has seen analysts' estimates of $100 million to $125 million for this, the first deal that is contemplated. And those are probably in about the rate range. Relative to a breakout between all the different elements, it is really focused broadly across all of our suite of solutions currently but does not have a lot of other service offerings in it today.

Zane Burke - *Cerner Corporation - President*

This is Zane. Just as a reminder, none of that was in Q3; that would be a Q4 expectation.

Robert Jones - *Goldman Sachs - Analyst*

Got it. Thanks for the clarification. Appreciate it.

Operator

Richard Close, Avondale Partners.

Richard Close - *Avondale Partners - Analyst*

Marc, I was wondering if you could comment on a modeling question in terms of in the third quarter the sales and client services seem to take up quite a bit versus as a percentage of revenue. Can you just got into that of little bit for us?

Marc Naughton - *Cerner Corporation - EVP and CFO*

On a year-over-year basis?

Richard Close - *Avondale Partners - Analyst*

Well, I think it came in at around 42% of revenue if I am not mistaken. And it's up almost a couple of hundred basis points from the most recent quarter, second quarter.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, other than the continued strength in our services business, including the works businesses that have been added in for the quarter. I think if you really any time you're going to have a question on a percent of revenue, it is going to lead back to weak hardware in the lower amount of hardware that's coming through system sales. So it is naturally going to make everything else a higher percent of revenue than it was before.

Richard Close - *Avondale Partners - Analyst*

Okay. And then a follow-up on a different note. Can you guys talk a little bit about revenue cycle management in the physician segment where you are having success? Or are you having success there? And maybe the size of that business, if you could put any numbers in and around that.

Zane Burke - *Cerner Corporation - President*

This is Zane. I will defer on the numbers side, but what I will say is that business is growing exponentially for us, very fast growth. We have had a number of wins, including some of the known competitors out there in the space. I think there is a absolute desire for physicians to offload this work as they go into the ICD-10 era. So as they start to look at what it takes to actually operate in that era and the era beyond ICD-10, there is a desire by both the health systems and the physicians themselves to look to offload those services. That has been a significant growth area for us, and we're doing extremely well against our competitors in that space.

Richard Close - *Avondale Partners - Analyst*

Okay, thank you.

Operator

Sean Wieland, Piper Jaffray.

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

Another question on Intermountain Healthcare. Can you somehow quantify how this relationship accelerates your R&D timeline? Specifically in the answer what I am looking for is how long would it have taken for you to build these care process models on your own?

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

This is Jeff. I think the acceleration for us, we use the word intelligence to mean the -- you are moving from a workflow that is designed around data capture to a workflow that is guided filled with recommendations and insights. So, I don't know that from just a pure clinical evidence, that's not a core competency of Cerner historically to go out and look at clinical guidelines and directly develop those pieces of content.

The piece where we think it accelerates this is we are now building that in unison. So as the clinical evidence comes together, that is being built in unison with the workflow in the context of when those decisions are made. And that takes a lot of time in a traditional cycle where if we're doing that at the edge, is the term we use, we think it will speed things up significantly.

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

Okay, thanks. And then as you know, Intermountain has a history of chewing up and spitting out vendors. And just tell us, you have certainly made a huge commitment yourself personally. But tell us how you are in recognition of that, how you are going about servicing this customer.

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

I think the -- and this will be in my words -- but the difference here is, can we quickly put in core so that we can get to what I classify as the fun stuff, the intelligence. So if you want to go back and look at progress in activities over time, not just Intermountain but that other large organizations with strong internal IT or informatics, they end up spending a lot of time to get the core, to get to the fun stuff.

So we look at this as somewhat of a traditional, very accelerated though, implementation to get the basics in place so that we can harness their skills and talents for the really hard, sophisticated things that sit over the top.

So we are not concerned about any of the experiences of the past. We think this is a little bit different. We are not building from scratch.

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

Got it. Thanks so much.

Operator

Lisa Gill, JPMorgan.

Gabin Oysen - *JPMorgan Chase & Co. - Analyst*

This is [Gabin Oysen] for Lisa. First, Marc, if I think I heard you correctly, you mentioned that this is the last quarter of the tech resale comp. So how should we think about the impact to margins going forward from the lapsing of that comp?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, this is -- last year we had the comp to most of the year. So basically Q4 will be the last quarter that is in front of us where we have a tougher comp. After that as we move into 2014, the numbers, given the things that Mike talked about -- the additional device offerings, the Care Work Connect, all of these new exciting things that we are bringing to market and selling to our clients -- those will gradually start to increase that technology resale bucket as we go forward.

So we had a bolus in 2012; 2013 we have that put behind us, and starting in 2014, we should start seeing year-over-year incremental growth in that space as opposed to the decline that we have been experiencing.

So, going forward in 2014, it should not be a drag on my revenue growth. It should actually be contributing to my revenue growth.

Gabin Oysen - *JPMorgan Chase & Co. - Analyst*

But we should expect some impact to margins from that revenue growth.

Marc Naughton - *Cerner Corporation - EVP and CFO*

You will get some impact, but to the extent that it grows at a normalized rate relative to the growth of the rest of the Company, it should have a relatively neutral impact, also depending on specific margin for the technology resale. Once again we talk about technology resale being either low-margin hardware, medium-margin hardware. There are higher margin elements of it as well, so there's a different mix. But it likely doesn't change the overall margin view significantly because we expect it to grow at the rate of the rest of revenue.

Gabin Oysen - *JPMorgan Chase & Co. - Analyst*

Okay that's helpful. Thank you very much.

Operator

Donald Hooker, GMAC.

Ricky Goldwasser, Morgan Stanley.

Saurabh Singh - *Morgan Stanley - Analyst*

This is actually [Saurabh Singh] for Ricky Goldwasser. I just had a question about as we look at your contract backlog and year bookings, how should we think about the time horizon for how they convert into revenues and whether that still consistent with a high-single-digit revenue growth rate?

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. I think the mix with about 30% of our bookings on average being on long term extends the overall backlog length slightly. But there is two components of that backlog. I think a bunch of the backlog does rollout in the next year. The remainder comes out over the next 2.5 years. So the contribution from backlog, given a lot of the things that we have been booking have that longer-term, smoothing of the revenue, it should continue to help grow our bookings. Obviously, any year in which we have significant booking successes as we have so far this year feeding our backlog, that is going to contribute significantly into next year's revenue. We would expect when we start next year that we would have 75% of that year's revenue basically in backlog or things that are easily converted to revenue. So we should be in the same shape as we have been the last year.

Saurabh Singh - *Morgan Stanley - Analyst*

Thank you. And then one more question if I may, what is your view on hospital healthcare IT CapEx budgets over the next year? Do you see them as increasing?

Zane Burke - *Cerner Corporation - President*

This is Zane. I wouldn't necessarily say they I see them as increasing. But I think what you see is there is absolute understanding they've got to use IT as a lever to affect the cost and quality in their organization. And so I think that allocation of capital towards of those initiatives will continue to be very strong.

Saurabh Singh - *Morgan Stanley - Analyst*

Thank you. I will get back in line.

Operator

George Hill, Deutsche Bank.

George Hill - *Citigroup - Analyst*

I've got one strategic first thing and then I've got a couple of housekeeping for Marc.

Zane, on the Intermountain win, could you give us a quick 30 seconds or minute on how the competitive process on this shook down between you and your closest competitor? And then what has been the reaction from prospects like after this win and is it something that you guys can market to go win more business? Because it has been a while since you guys have picked up a client that looks like Intermountain.

Zane Burke - *Cerner Corporation - President*

George, I am going to answer actually the second part of your question, and then I'm going to try back to Jeff for his specific commentary around Intermountain, given his direct involvement there.

As it relates to the total marketplace, it has certainly emboldened our existing client base that they are on the right path, that they have chosen the right partner, and through all of the success that we've had, the win here is just yet another piece of validation that they are on the right path as they look towards the future. So there is the existing client base, which is incredibly important, because we have a lot of work still to go do together with our existing clients.

On the new business side, it has -- I think it's a validation of what prospects are seeing when they take a look at Cerner. So when they look at us, they see all these great things in terms of both what we do from a -- what we can do today and what we're planning to do in the future era. And having the validation of someone like an Intermountain, where the world is moving to cost and quality and they are the low-cost, high-quality provider and that is with the marketplace needs to go after, absolutely validates us. It validates what they are already seeing when they look at us. They already see those things when they look at us and it validates what they see.

So, I think it is incredibly impactful as we think -- move forward because it is a validation of what they are seeing as they take a look at us through the process.

And Jeff, I will let you comment on the Intermountain specifics.

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

Yes, I would say it was a more sophisticated process than typical. So there is the traditional RFP-scripted demos, site visit type thing that would be very EMR specific. But then in parallel to that was a much deeper look at architecture, future proofing, and as Zane outlined, where do we go from here. So a commitment to be open; a commitment to have cost and quality as a core premise; and then most importantly in the readiness for population health -- are you really going to be able to not only bend of the cost curve but ultimately impact the health status of those communities?

Because in their case, they are further along than most in that they also have a health plan. And so there is a closed loop environment there not only for research and for cost but on bending the total cost curve of the entire dollar, not just the portion that the provider gets.

So, all of that came together in a 9- to 12-month process to go really deep. And they look at a much like we do. This is not a project. This is a decade if not a two-decade type relationship between two organizations.

George Hill - *Citigroup - Analyst*

Okay. And then Marc -- Jeff, I appreciate that -- the quick housekeeping questions. I will say one is you guys have about $1.5 billion in cash on the balance sheet, uses of cash.

And then the second part is I wanted to follow-up on Richard's question about the growth in sales and client service. You referred to them as revenue generating sales in client services, client service people. You saw support and maintenance revenue grow 17% and change; you saw the growth in sales and client service. Expenses grow 17%-ish. Should we expect those two line items to track closely together with respect to growth rates with maybe just a touch of margin in the near term?

Marc Naughton - *Cerner Corporation - EVP and CFO*

I would have to think about that one for a second, George. You are so much smarter than I am. I'll have to get my pencil out and do that one. But maybe I can get back to you on that one.

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George Hill - *Citigroup - Analyst*

Okay, how about just the cash?

Marc Naughton - *Cerner Corporation - EVP and CFO*

The cash. Still have $1.5 billion. We have actually been investing a significant component of our free cash flow, as you have all seen, invested both in development and looking at certainly strategic acquisitions which we have done this year. And I think a major component is that we have returned $170 million to shareholders this year. So, I think relative to the near-term use of that cash, I think we are trying to hit all the bases that we think. The opportunities for this Company are huge. The momentum shift we had with Intermountain and Einstein is dramatically opening up doors that some people would of thought weren't going to be available for us. So we're investing. We're putting some of the smartest guys we have, Jeff Townsend, with Intermountain to drive that faster, to create more intelligence that we can make available to our other clients.

So, we're going to keep investing. We think it's a good idea to invest internally rather than to try and go buy companies because there really isn't a company out there that does the kind of stuff we do. We will buy some things around the edges.

So, I think going forward we're going to continue to invest internally through certainly the first half 2014. We're going to certainly consider whether another stock buyback program is appropriate next year, and we will continue to make small, strategic acquisitions that fit into this overall architecture as we go forward.

George Hill - *Citigroup - Analyst*

Okay, great color. Thanks, Marc.

Operator

Jeff Garro, William Blair & Company.

Jeff Garro - *William Blair & Company - Analyst*

So, I wanted to ask about the data warehouse platform and the Healthe Intent registry system. I want to get a sense of the amount of development work that still needs to be done there in terms of building out different predictive modeling scenarios, how far along are you and at what point do need to get to to really scale this out to the larger client base?

Zane Burke - *Cerner Corporation - President*

I will take that. I think on the smart registries we look at that as the entry set of modules. I would say there's somewhere around 15 to 20 of those focused around the most common conditions and diagnoses. What you will see as the next wave of solutions moves beyond the warehousing reporting analytics level to a tighter, what we call closed-loop engagement.

So if you have identified all the individuals based on their conditions and needs, you have matched them to the providers, then there is another wave of applications that will be a hybrid of EMR and what we call new workforce. So care managers, utilization, not so much utilization review but more utilization management from a demand perspective. So, we think we can more efficiently match supply and demand across the population into those lower-cost venues and still achieve better outcomes. So, the registry piece is wave one from a market perspective. We think that offering is ahead of the majority of what's out there in the market as both proven by Advocate's selection, but they recently about the same time we had our conference, they have a symposium they do that has participants from across the country. So that is the stage most are in. We are now moving ahead to how do you now action that data and move away from just quality scores and actually impact that. So that is -- the majority of the 2014 focus is to make that actionable to where you now engage both the individual patient as well as the provider.

Marc Naughton - *Cerner Corporation - EVP and CFO*

This is Marc. Just to provide a little color, in Q3, we actually sold to a brand-new non-Cerner client HIE, various elements of the Patient Portal, that qualified as one of our deals over $5 million. And we expect actually to complete some of the solutions in the pop health space to that client in Q4 as an additional sale that will be of similar size.

So, when you start looking at the marketplace that is outside of Cerner's existing client base or includes people outside our existing client base and that just today selling it as a software ASP-type solution, you can have $10 million opportunity; multiply that times all the other opportunities we think are out there. And even what we have today is a significant revenue opportunity, let alone what Jeff is going to be creating.

Jeff Garro - *William Blair & Company - Analyst*

That's great. And then just a quick follow up there. Marc seemed to start to touch on some of this. But with this evolving and hybrid model that you are moving to in terms of the revenue model and the sales process, how should we think about this product set differently than your core offerings?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Well, I think -- this is Marc -- from going to market, certainly there's a little bit of a different sell; you're selling potentially to different people inside the organization. But it's not a whole lot different than what we do with all the variety of solutions that we have. Each of our solutions groups can be sold to different organization or different focus within an organization.

So, there is nothing new. We know how to sell things. We have a very informed client organization that does of a very good job of that. In addition to the one I mentioned, I'm aware of at least three or four more in the pipeline that have similar characteristics. This is just something -- this is inherent into what Cerner does. It's just a natural extension of what we have been working on for 30 years. There's -- I don't know, Jeff, you have any comment?

Jeff Townsend - *Cerner Corporation - EVP and Chief of Staff*

Well, I think the -- you will see from a business model perspective you'll see all the same similar capabilities -- licenses, subscriptions, technology -- the mix of that may be a little bit different, and the throttle will definitely be different. So instead of number of physicians our users or beds, you are going to see things being more PMPM or size of population. But it will have -- the component parts underneath there will look very much the same.

Jeff Garro - *William Blair & Company - Analyst*

Great. Thanks for the questions, guys.

Operator

Jamie Stockton.

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

Maybe the first one, Mike or Zane, I don't know who wants to take it, it's on Revenue Cycle software. There were a lot of standing room only meetings at your user conference talking about your Revenue Cycle software, so there's obviously a lot of interests. On the other hand we have these deadlines that are looming in 2014 for ICD-10. So, I'm just curious, internally when you guys think about the conversations that you are having around leveraging your clinical footprint to sell more Revenue Cycle software, how do you think the deadlines are going to impact those conversations? Will they accelerate them? Will there be a point sometime next year where things start to settle down? Any thoughts on that would be great.

Zane Burke - *Cerner Corporation - President*

Jamie, this is Zane. I would share that what -- I agree with what you saw, which is there's a lot of interest in our Revenue Cycle solutions by our clients, both acute and ambulatory. And the success that we're having in a number of clients is bringing that to light. Most clients have a plan for ICD-10 today. So they've got a plan; they are now preparing for the future, much like I have discussed before, which is our clients are buying for the future. They are buying for the changes that are going to occur both for a regulatory perspectives and a reimbursement perspective. And they know that they are going to have to need to contemporarize their Revenue Cycle solutions and really get closer to a clinically-driven revenue cycle. And hence, it is a combination of our maturity coming together at a time when they are going to be preparing themselves for what some of those future revenue cycle needs that they have and the changes in business model. And so, I would anticipate that we will continue to see significant increase in the Revenue Cycle solutions going forward.

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

Okay. And then maybe Marc on the capitalized R&D, you talked about how the capitalization rates or level should start to come down maybe after 2014. You've already seen amortization start to creep up some. Are there any dates out there that we should be keeping in mind or any time frames around when what you have been capitalizing might be triggering from an amortization standpoint around a major software release or anything like that?

Marc Naughton - *Cerner Corporation - EVP and CFO*

Most of the work is spread along -- around a bunch of different solutions. So there's not any one single package that goes [GA] that is going to trigger a bunch of amortization. We will have things that are going to go [GA] in Q1 that will start triggering the amortization and will continue on through 2014 and into 2015. So, it should be more of a steady addition, and obviously, you have stuff that is going to roll off as well. But there is no single release trigger that is going to start pulling a lot of the amortization in. As we get closer to those occurring we will try to give his visibility relative to that, but today I don't expect there to be any unique or single quarter where we have a big hit in that.

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

That is great. Thank you.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Sure. Why don't we do one more question.

Operator

Donald Hooker, GMAC.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

I got cut off. Sorry about that. A lot of people have asked a lot of good questions, but maybe going on a different direction here, you won that deal down in Brazil which is kind of interesting. It's a new country for you. I don't know too much about the Brazilian health care [T-market]. I mean, there's 7000 hospitals there. Can you talk a little bit about them? I'm sure those hospitals are a lot different than the hospitals up here. Can you talk about the opportunity in Brazil, kind of the competitive landscape? And then maybe talk about some of the other opportunities outside the US. You won a few on France and elsewhere maybe in Asia?

Zane Burke - *Cerner Corporation - President*

Sure, Donald, this is Zane. So in Brazil there is a two-tier system. So you've got a for-profit and a not-for-profit environment, and the for-profit environment has more additional funding than perhaps the not-for-profit side of that. And so, we think there's a pretty good addressable market in that space with the kind of capital necessary to implement systems like Cerner. We are -- we thought this one was incredibly important from a launch perspective given this is the most prestigious organization within Latin America. And having this as our launch into that. And given that the competitive landscape from the other HIT suppliers is pretty -- is a little bit more limited. We felt this was an important one. So we're very excited about that, given that Brazil is also the fifth-largest economy in the world and one of the fastest growing as well. We see that is a great growth opportunity for us.

As we have discussed previously, Australia, Canada, the Middle East have been very strong marketplaces for us, and we continue to see those as strong markets. We anticipate that the UK will be a good rebound -- will come off of a rebound and be very strong as well. And if we can get contribution secreted from France, those are bonuses. But the French market has not really turned yet to date. But we would anticipate continued strength in those other core market places as well as a resurgence coming on in the UK over time.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Got you, and I think one of the secret (multiple speakers). Go ahead.

Marc Naughton - *Cerner Corporation - EVP and CFO*

You go ahead.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

I was curious in terms of in the US, some of the managed services and hosting services you provide hospitals, where are you strong there internationally as well, because I would assume that would be one of the drivers of your success over the years in the US in terms of replicating that overseas?

Zane Burke - *Cerner Corporation - President*

Donald, that does represent a great opportunity for us in those other market places, and we have invested in datacenters in a few of those market places and will continue to evaluate that. But obviously, our business model plays well in the continued services. And the need for those kind of services are not just unique to the US marketplace. They are absolutely applicable in the global market.

Marc Naughton - *Cerner Corporation - EVP and CFO*

Yes, and Don, this is Marc. Relative to what Zane said about investing in data centers globally, our approach globally is a little bit different than the US where you build and own datacenters. Globally, we intend to co-locate an appropriate location so that we minimize the initial capital investment we have to do in those places. But, certainly, it plays as well or if not better than it does in the US.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Got you. Thank you so much for squeezing me on.

Neal Patterson - *Cerner Corporation - Chairman and CEO*

Okay, with that, this is Neal. I guess to somewhat prove that I am here. But there isn't a question you all asked that the team didn't do a better job than I would have answering it. So appreciate everybody's time here this afternoon, your interest in our Company. We certainly wake up every morning at the intersection of healthcare and IT, and we do it worldwide. There's a huge amount of opportunity in front of us. We had an extraordinarily productive -- we have been highly productive in making a lot of progress in the Company for some period here. This summer was a very fun [cumulation] of a number of different initiatives that came together and, I think, propel us forward here. So our clients, and it's really our clients worldwide, basically have to focus in today's world around the cost of how they deliver care and the measurable quality of care that they deliver.

Certainly in the United States, there is the tomorrow side of what they think they have to be able to do is be much more responsive from the health of a population. So, the investments that we have accelerated here over the last couple years really are focusing on both the current, the now side of what our clients need, and what we think the next side.

So we've got a very good team. We are at a good place. I will though, my final comment is one that many of you've heard from me many times. What we do though is hard, is complex, and even on the best of days there's a level of ambiguity as to what the right answer is. But we are doing well. We are going to continue working our rears off here and serving our clients and expanding -- growing this Company.

Thank you. Have a great afternoon.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation and you may now disconnect. Have a great day.