Cerner Corporation
Fourth Quarter 2018
Earnings Conference Call
February 5, 2019

Moderator

Welcome to Cerner Corporation's fourth quarter 2018 conference call. Today's date is February 5, 2019, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today constitute forward-looking statements, including without limitation, those regarding projections of future revenues or earnings; operating margins; operating and capital expenses; bookings; new solution, services and offering development; capital allocation plans; and future business outlook, including new markets or prospects for the Company's solutions and services. Actual results may differ materially from those indicated by the forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements may be found under Item 1A in Cerner's Form 10-K together with the Company's other filings. A reconciliation of non-GAAP financial measures discussed in this earnings call can be found in the Company's earnings release, which was furnished to the SEC today and posted on the investor section of Cerner.com. Cerner assumes no obligation to update any forward-looking statements or information except as required by law.

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

Brent Shafer

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

Today I am going to provide reflections on my first year at Cerner and discuss steps we are taking to position ourselves for long-term profitable growth. I'll then have our Chief Financial Officer, Marc Naughton, cover the numbers, and John Peterzalek, our Chief Client Officer, provide marketplace observations.

I'd like to begin with some observations from my first year. This past Friday marked my one-year anniversary at Cerner. It's been an eventful and important 12 months. I have spent a great deal of time learning the business, talking to clients, partners, the financial community, and of course, Cerner associates. A clear takeaway from these conversations is the optimism around Cerner's role in having a positive impact on health care. Clients have been eager to give feedback on how Cerner solutions are advancing their businesses—along with urging us to go faster because of our importance to them; partners are pleased working with our platforms; and, the culture around the associate base is linked to relentless innovation. These assessments have bolstered my confidence that Cerner is well-positioned to deliver profitable growth. I fully expect Cerner to continue its legacy as a growth company and innovator in health care.

As an overall leadership team, we have also focused on assessing market opportunities, listening to clients, reviewing our internal processes, and evaluating our profitability and capital allocation strategy. You heard me on the last earnings call talk about four commitments that define our framework for delivering value. To reiterate, 1) We must relentlessly advance our clients' success; 2) imagine, design and implement intelligent health networks; 3) focus on better health care experiences and outcomes; and 4th), become the partner of choice for health care innovation.

In order to deliver on these commitments, I've worked with the team to create a better structure and improved processes. This work has led to a refined operating model that we'll discuss next week at HIMSS. It's my belief that we can reduce complexity for our clients and make it easier to do business with Cerner. I also believe we can innovate faster, and more efficiently so clients can quickly adopt new solutions. By aligning resources around client focus and efficient delivery of innovation, I expect the business to operate more cost-effectively, have more predictable results and improve profitability.

I want to highlight today's announcement that we plan to initiate a dividend. This decision is a significant milestone in Cerner's journey and illustrates our confidence in delivering strong operating performance and free cash flow generation. Marc will give the specifics, but this decision underscores our commitment to delivering shareholder value.

We had a solid 4th quarter with all key metrics within our guidance ranges except for revenue, which was slightly below guidance primarily due to lower than expected technology resale. Given the lower margin profile of technology resale, the quarterly revenue shortfall had very little impact on earnings, which were in-line with expectations. For all of 2018, our revenue and EPS were both in the full-year guidance ranges we provided on our Q1 earnings call, and we delivered solid bookings growth.

While we did deliver within our full-year guidance ranges, I am aware that our results included a decline in operating earnings. This is not something we expect to continue, and I believe the structure and process changes we are making will help make Cerner more focused and efficient, which should allow us to increase our predictability and profitability over time.

In summary, while we still have a lot to do, I am pleased with the progress we made as a leadership team in the past year. I believe we have the right mix of people, processes and strategies to drive long-term financial success.

I look forward to seeing many of you next week at HIMSS.

With that, I will turn the call to Marc.

Marc Naughton

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

Bookings, Backlog and Revenue

I will start with bookings, which were $1.960 billion in Q4. This is above the midpoint of our guidance range and is the second highest bookings quarter in our history behind $2.329 billion in Q417, which included several uniquely large contracts and had grown 62% over the prior 4th quarter. Full-year bookings were $6.721 billion, which is up 6% over $6.325 billion in 2017.

We ended the quarter with a revenue backlog of $15.25 billion, which is up from $14.70 billion in Q3. As we've indicated, our backlog calculation under the new revenue standard excludes revenue potentially impacted by contract termination clauses. In our experience, clients rarely exercise this option, so this doesn't change our total long-term revenue opportunity—it just reduces the calculation of backlog. You'll see in our 10-K filing that we've supplemented our backlog disclosure by adding the amount of revenue we expect from contracts that are not included in the backlog calculation. For 2019, when you combine the 29% of our backlog we expect to recognize with an additional $525 million expected from contracts not included in backlog, the total is approximately 85% of the midpoint of our revenue guidance.

Revenue in the quarter was $1.366 billion, up 4% over Q417 and, as I mentioned, just below our guidance range of $1.370 to $1.420 billion. The shortfall in Q4 was primarily due to lower than expected levels of technology resale, which was down 42% compared to Q417. Total revenue for the year was $5.366 billion, reflecting growth of 4% over 2017.

I'll now go through the business model detail and year-over-year growth compared to Q417 and full-year 2017.

- Licensed Software revenue in Q4 was $166 million, down 2%, against a solid Q417. Full-year Licensed Software revenue of $614 million was $2 million higher than 2017, or basically flat, with growth in SaaS offsetting declines in traditional software. As we've discussed, the smaller nature of the remaining EHR replacement market reduces our traditional software opportunity, but we do expect SaaS to continue growing and eventually become the majority of software revenue, which should reduce volatility over time.
- Technology Resale decreased 42% in Q4 to $46 million and was well below our forecast. Full-year Technology Resale revenue was $245 million, down 10% year-over-year. The weakness relative to our forecast in Q4 was largely due to transactions pushing. We are also beginning to see more of our third-party suppliers transition to subscription and SaaS models, which did impact the sublicensed software portion of technology resale revenue in 2018.
- Subscriptions revenue was $87 million in Q4, down from $115 million in Q417. As we have discussed throughout the year, subscriptions were impacted by our adoption of the new revenue standard, reducing subscription backlog and classifying a portion of subscription revenue as support. Full-year Subscriptions revenue was $326 million, down from $469 million in 2017. With a full-year of the transition to the new revenue standard behind us, we expect the subscription business model to return to solid growth in 2019.
- Professional Services revenue in Q4 grew 17% to $466 million, driven largely by growth in our Works businesses. Full-year Professional Services revenue grew 14% to $1.811 billion.
- Managed Services increased 14% to $299 million in Q4, driven by strong bookings throughout the year. Full-year Managed Services revenue was $1.155 billion, an increase of 10% over 2017.
- Support & Maintenance was up 6% to $277 million in Q4, and full-year revenue grew 7% to $1.118 billion, both reflecting our expected low-single-digit growth plus the previously discussed impact of the new revenue standard.
- And finally, Reimbursed Travel in Q4 was $24 million, down $4 million from the year-ago quarter. Full-year Reimbursed Travel revenue was $97 million, down 4% year-over-year.

Looking at revenue by geographic segment, domestic revenue was up 4% from the year-ago quarter at $1.205 billion, and non-U.S. revenue of $161 million was up $1 million from the year-ago quarter. For the full year, domestic revenue grew 3% and non-U.S. revenue grew 12%.

Moving to gross margin. Our gross margin for Q4 was 82.6%, down slightly from 82.8% in Q318 and flat year-over-year. Full-year gross margin of 82.5% is down from 83.4% in 2017, driven by higher 3rd party services costs.

Earnings

Now I will discuss spending, operating margin and net earnings. For these items, we provide both GAAP and "Adjusted," or Non-GAAP, results. The Adjusted results exclude share-based compensation expense, share-based compensation permanent tax items, acquisition-related adjustments, an allowance on a non-current asset, impact of U.S. tax reform, and other adjustments, all as detailed and reconciled to GAAP in our earnings release.

Operating Expense

Looking at operating spending, our fourth quarter GAAP operating expenses of $965 million were up 11% compared to $866 million in the year-ago period. Full-year GAAP operating expenses were $3.654 billion, up 10% from $3.328 billion in 2017. Note that in Q4, we recognized a pre-tax charge of $45 million to provide an allowance against a non-current receivable with Fujitsu Services Limited that is in Other Assets on our balance sheet. As some of you will recall, Fujitsu's contract as the prime contractor in the National Health Service initiative to automate clinical processes and digitize medical records in the Southern region of England was terminated in the second quarter of 2008 by the NHS. This led to our subcontract being terminated. We continue to be in dispute regarding the amounts due as a result of such termination, but we determined in the fourth quarter that our chances of a favorable resolution have been reduced based on the outcome of the alternative dispute resolution procedures provided for in our subcontract. Note that after our subcontract with Fujitsu was terminated, Cerner went on to successfully deliver in the Southern region, as well as the London region, with another prime contractor, and the U.K. remains a strong and active market for us today.

Turning to adjusted operating expenses, they were up 7% compared to Q417, and 9% for the full year. Looking at the line items for Q4, Sales & Client Service expense increased 6% over Q417, primarily driven by an increase in personnel expense related to our services businesses. Software development expense increased 12% over Q417, driven by a 7% increase in gross R&D, a 17% increase in amortization, and flat capitalized software. G&A expense was up 5%, and Amortization of Acquisition-related Intangibles decreased $1 million year over year.

Operating Margins

Moving to operating margins. Our GAAP operating margin in Q4 was 12.0% compared to 16.7% in the year-ago period, largely due to the $45 million allowance I discussed. Our Adjusted Operating Margin for the quarter was 18.7%, down from 20.5% in Q417 and consistent with our guidance for the quarter.

Our GAAP operating margin for the full-year 2018 was 14.4% compared to 18.7% in 2017. Our full-year Adjusted Operating Margin was 18.8%, which is down from 22.4% last year. As we have discussed, 2018 was impacted by lower-than-anticipated Licensed Software revenue, higher growth of non-cash expenses, investments in our Works businesses and an increased mix of Works revenue.

We continue to believe that many of these factors are temporary in nature, and our 2019 guidance reflects our expectation that our operating margins stabilize at approximately 19%. This could vary based on revenue mix, but we do not expect margin compression like we have experienced the past few years. Longer term, we believe adjustments we are making to our operating model and a focus on profitable growth will position us for additional margin expansion.

Voluntary Separation Program

Now I'd like to preview an expense we expect to incur in Q2. As we discussed throughout 2018, we have been working to identify opportunities to operate more efficiently and innovate at scale. One outcome of that analysis was a recent announcement of a Voluntary Separation Plan, or VSP. Generally, the VSP is available to U.S. associates who meet a minimum level of combined age and tenure, with certain critical roles excluded for business continuity purposes.

Associates who elect to participate in the VSP will receive financial benefits commensurate with their tenure and position, along with vacation payout and medical benefits. At this point, we do not have a firm estimate for the charge because the acceptance period ends later this month, but we anticipate less than 3% of our total associates will separate as part of this program. While a portion of these positions will be backfilled, we believe we will be able to fill many of the positions with existing associates, which should create efficiencies in the future while also creating career growth opportunities for our associates.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q4 were $131 million, or $0.40 per diluted share, compared to $1.00 in Q417. For the full year, GAAP net earnings were $630 million, or $1.89 per diluted share. Adjusted Net Earnings in Q4 were $208 million and Adjusted Diluted EPS was $0.63, compared to $0.58 in Q417. For the full year, Adjusted Net Earnings were $819 million and Adjusted Diluted EPS was $2.45, up 3% from 2017.

Our GAAP tax rate was 24% for the quarter and 21% for the year. Our non-GAAP tax rate was 21%, for the quarter and year. For 2019, we expect our GAAP and non-GAAP tax rates to be closer to 22%.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q4 with $775 million of cash and short-term investments, which is down from $814 million in Q318, with our free cash flow being offset by $298 million of share repurchases. For the year, we repurchased 11.2 million shares for $644 million, at an average price of $57.65. We currently have $283 million of remaining authorization under our repurchase program.

Moving to debt, our total debt was up $3 million from last quarter to $444 million.

Total receivables ended the quarter at $1.183 billion, down from $1.211 billion in Q318. Our Q4 DSO was 79 days, which is down from 82 days in Q318 and up from 72 days in the year-ago period.

Operating cash flow for the quarter was $407 million. Q4 capital expenditures were $141 million, and capitalized software was $65 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $201 million for the quarter.

For the full year, operating cash flow was $1.454 billion, capital expenditures were $447 million, and capitalized software was $274 million. Full-year free cash flow was $733 million, which is $62 million higher than 2017.

For 2019, we expect limited growth in our operating cash flow because we benefited in 2018 from a tax refund that offset most of our cash tax payments. This year, we expect to have more cash outflows for taxes, and our cash flow will also be impacted by our VSP payouts. On the capital side, we expect an increase in capital expenditures of more than $75 million in 2019, primarily to support our facilities requirements, including the peak year of spend on a phase at our Innovations Campus. Due to a combination of these two factors, we expect free cash flow to decline in 2019, but we still expect it to be solid. In 2020, we expect a return to normal operating cash flow growth and a meaningful decline in capital expenditures to lead to strong free cash flow.

Capital Allocation

Now I'd like to discuss capital allocation. As noted in our press release, subject to declaration by our Board, we plan to initiate a $0.15 cent per share quarterly cash dividend, with the first payment expected sometime in the third quarter. On an annualized basis, this represents a yield of just over 1% based on our current stock price and a payout ratio of 24% of 2018 Adjusted Net Earnings.

As you know, investing in innovation to fuel growth has been Cerner's core strategy since inception. This will not change, and we are confident that meaningful growth opportunities exist and that we are making the right investments to deliver good long-term growth. We are now at a point where we believe we can invest in this growth while also enhancing shareholder value with a dividend and continued share repurchases.

We have several objectives we are looking to accomplish with our broader capital allocation strategy. First, we want to provide current income to existing shareholders while also increasing the attractiveness of Cerner to a wider investor base. Second, we expect to continue using free cash flow for share repurchases to offset dilution from equity compensation and do additional repurchases as deemed appropriate. Third, we want to have flexibility to make other investments in growth, including relationships like Lumeris or strategic acquisitions that complement our organic growth investments.

Given our very strong balance sheet and expected strong cash flow, we believe we are in a comfortable position to do all these things with free cash flow, while still maintaining flexibility to use debt for larger strategic opportunities.

We also believe adding a dividend to our capital allocation approach will create discipline and focus on free cash flow generation, which is something we also plan to incorporate into our variable compensation plans as part of broader changes that we believe will increase alignment with shareholders.

In summary, we have put a lot of thought into our capital allocation approach and listened to feedback from many of you, and we believe this approach is in the best interest of our shareholders.

Guidance

Now I'll go through guidance.

- We expect revenue in Q1 to be between $1.365 and $1.415 billion. The midpoint of this range reflects growth of 8% over Q118.
- For the full year, we expect revenue between $5.650 and $5.850 billion, with the $5.750 billion midpoint reflecting 7% growth over 2018.
- We expect Q1 Adjusted Diluted EPS to be 60 to 62 cents per share. The midpoint of this range is 5% higher than Q118.
- For the full year, we expect Adjusted Diluted EPS to be $2.57 to $2.67, with the $2.62 midpoint reflecting 7% growth over 2018.
    - The midpoint of this range is 6 cents below consensus. We suspect about half of this is that consensus had a tax rate closer to our 2018 tax rate of 21%, and we expect a rate around 22%, with the rest likely being a slight difference in margins.
- Moving to bookings guidance, we expect bookings revenue in Q1 of $1.100 billion to $1.300 billion. The midpoint of this range reflects a 14% decrease compared to the first quarter of 2018.
    - Note that the first quarter of 2018 had a much higher than normal level of large, long-term bookings and we expect a much lower level in Q1 of this year. The combination of these two factors is the driver of the expected year-over-year decline in bookings, as the midpoint of our guidance range would reflect growth in bookings if you exclude the long-term portion. There are several large longer-term deals forecasted throughout the year and we expect the mix to normalize as the year progresses.

Before I wrap up, I'd like to remind you about our annual Investment Community Meeting at HIMSS next Wednesday, February 13th. If you plan to attend and have not registered, please do so through the link at the top of the investor section of Cerner.com. If you are unable to attend in person, there will also be a webcast available at the same location both live and archived.

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

John Peterzalek

Thanks Marc. Good afternoon everyone. Today, I'll cover Q4 and full-year results and discuss the marketplace.

Results Summary

I'll start with our bookings results. As Marc mentioned, Q4 bookings did decline compared to the all-time high in Q417, but they were still our second highest level ever. Multiple large transactions contributed to the strength of our bookings, including 6 contracts that were greater than $75 million. These large contracts included significant solution and services expansions with existing clients and new *Cerner Millennium®* footprints in both U.S. and non-U.S. markets. In addition to the contributions from larger hospitals, our CommunityWorks and ambulatory businesses both had record full-year bookings.

Looking at the mix of new business, 30% of bookings in Q4 came from outside our core *Cerner Millennium®* installed base. The percent of bookings coming from long-term contracts in the quarter was 38% and included the addition of a *Cerner ITWorks*SM client and a *RevWorks*SM expansion. As Marc discussed, we are expecting a lower level of long-term deals in Q1, but we have a solid forecast for the year and the overall market remains active. This activity is reflected in our strong pipeline, which is at near-record levels.

2018 was also a strong year for our key growth areas, with Revenue Cycle, *HealtheIntent* Population Health solutions, and *Cerner ITWorks*SM all growing revenue more than 20%.

In Population Health, we are continuing to make early progress in our launch of our EHR-agnostic offering with Lumeris called *Maestro Advantage*TM. *Maestro Advantage* is designed to help health systems set up and manage provider sponsored Medicare Advantage Plans and enable population health service organizations to manage a portfolio of value-based reimbursement arrangements. We've continued to have strong interest in the offering.

In addition, we had a joint client go live at the beginning of this year that is a long-time *HealtheIntent* client that chose Lumeris because of our plans to operate as an integrated offering. This client launched a Medicare Advantage plan in 2019 with first year enrollment exceeding client target expectations. For their initial launch, they are using the Lumeris platform for their new MA plan benefits administration and leveraging *HealtheIntent* for their population health management and provider performance technology platform, with complete migration to *HealtheIntent* for the combined *Maestro Advantage* platform when it is available.

Further, we expect to sign a client outside of our EHR installed base for Maestro Advantage in the first half of this year.

Federal Business

Next, I'd like to provide an update on our federal business. Starting with the Department of Defense MHS Genesis project, we are continuing our work on the second wave of sites, and the projects are going as planned.

Similarly, our work with the Department of Veterans Affairs has continued as planned since signing the initial contract in Q2 and additional task orders in Q3. We remain on track to steadily ramp our work on the project as we go through the year. The first major project milestone will be in 2020 when initial sites are scheduled to go live.

As a related note, the Government shutdown didn't have a material impact on our DoD or VA projects.

Non-U.S.

Moving to our business outside of the U.S., our revenue for the quarter was flat versus a tough comparable in Q417, but up 12% for the full year. From a bookings standpoint, the highlight of the fourth quarter was winning our second major region in Sweden after signing our first region in Q118. Both of these were competitive wins against our primary competitor.

Marketplace

Now I'd like to discuss the marketplace and our approach to aligning with the shifts that are occurring. There are several macro drivers that are shaping the way we align with our clients and think about our long-term growth.

- First, provider consolidation continues to increase, with transacted deal revenue doubling on a year-over-year basis and primary and specialty practices owned by health systems nearing 50% for key service lines.
- This consolidation, focused within discrete metropolitan areas, has driven high levels of technology variance, with some health systems having 10+ disparate EMRs across its owned and affiliated assets.
- As the size and scale of these health networks grows, consolidators are looking for technology and services to increase near term Fee-For-Service revenue and enable emerging Fee-For-Value opportunities to include Episode Management and Provider-Sponsored Plans.

To better align with these trends, we made some adjustments in 2018 in how we align with the marketplace. This included creating a separate group focused on large clients that are driving much of the industry consolidation. Our focus is making sure these clients have the best of Cerner and to enable them to pursue their growth strategies. In some cases, this means we help them rapidly deploy Cerner's EHR across acquired sites that are using another EHR. For others, a strategy of using *HealtheIntent* as a single source of truth across a system with multiple EHRs may make more sense.

We are also making more changes this year as part of the adjustments to our operating model Brent discussed. The changes primarily revolve around streamlining how we sell to different solution categories and client types to make it easier for existing clients to work with us and create more focus on opportunities outside of Cerner's core EHR installed base.

Before turning the call over to questions, I wanted to highlight an industry milestone that Cerner played a role in through our membership in CommonWell Health Alliance. Recall that CommonWell is an open, not-for-profit industry consortium that we co-founded with other health care IT firms to enable secure nationwide interoperability. In November of 2018, CommonWell announced general availability of its connection to CareQuality, another national interoperability framework. This connection allows CommonWell and CareQuality enabled health care providers to connect and bilaterally exchange health data to improve care coordination and delivery. This is a significant milestone on the path to achieving true nationwide interoperability and making health data available to individuals and providers regardless of where care occurs. We are proud to have played a role in this accomplishment, and we plan to remain a leading advocate for interoperability because it is very important to health care.

With that, I will turn the call over to the moderator for questions.