

**Cerner Corporation**  
**First Quarter 2017**  
**Earnings Conference Call**  
**April 27, 2017**

**Moderator**

Welcome to Cerner Corporation's first quarter 2017 conference call. Today's date is April 27, 2017, 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, solution development, and 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.

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

## **Marc Naughton**

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

I will lead off today with a review of the numbers. Zane Burke, our President, will follow me with results highlights and marketplace observations, and then Mike Nill, our Chief Operating Officer, will provide some operational highlights.

Now I will turn to our results. Q1 was a good start to 2017 with bookings, revenue and earnings all at the high-end of our guidance ranges.

### **Bookings, Backlog and Revenue**

Starting with bookings, our bookings in Q1 was \$1.250 billion, which reflects a 7% increase over Q116.

Our revenue backlog ended the quarter at \$16.098 billion, which is up 10% from \$14.615 billion a year ago.

Revenue in the quarter was \$1.260 billion, which is up 11% over Q116, driven by strong growth in System Sales and Services. The revenue composition for Q1 was \$320 million in System Sales, \$262 million in Support and Maintenance, \$656 million in Services, and \$22 million in Reimbursed Travel.

System sales revenue for the quarter was up 14% compared to Q116, driven primarily by strong licensed software growth as well as solid growth in technology resale. The higher level of software is reflected in the strong system sales margin percent of 68.6% which is up 50 basis points over Q116 and 150 basis point over Q416.

Moving to Services, total Services revenue, including professional and managed services, was up 11% compared to Q116.

Support and Maintenance revenue increased 4% for the quarter, which is in-line with our expectations.

Looking at revenue by geographic segment, domestic revenue increased 13% over the year-ago quarter to \$1.13 billion and non-U.S. revenue declined 3% to \$129 million. On the non-U.S. revenue decline, note that currency fluctuations impacted revenue by about 2%, so revenue is basically flat on a constant currency basis. In addition, the primary driver of the lack of growth was a decline in non-U.S. technology resale.

Moving to gross margin. Our gross margin for Q1 was 84.2% which is basically flat compared to a year ago and up 130 basis points compared to Q416.

## 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, Health Services acquisition-related amortization, acquisition related deferred revenue adjustments and other acquisition-related adjustments, which are detailed and reconciled to GAAP in our earnings release. The adjustment for share-based compensation permanent tax items is a new adjustment this year to incorporate a new accounting standard adopted in Q1, which is designed to simplify accounting for share-based compensation. There is more information in our release, but we are basically reducing our adjusted earnings by the amount of the permanent tax benefit so our results will be comparable to prior periods. In addition, not including this tax benefit should reduce significant swings in our adjusted tax rate that would occur if we didn't adjust it out.

## Operating Expense

Looking at operating spending, our first quarter GAAP operating expenses of \$817 million were up 9% compared to \$747 million in the year-ago period.

Adjusted operating expenses were \$773 million, which is up 10% compared to Q116. This growth was primarily driven by an increase in personnel expense related to revenue generating associates, which is reflected in the Sales & Client Service expense line that increased 12%. Software development increased 9%, driven by non-cash items as we had \$4 million less capitalized software and \$8 million more amortization than Q116. G&A expense was up 3%. Amortization of Acquisition-related Intangibles decreased by \$1 million.

## Operating Margins

Moving to operating margins. Our Q1 GAAP operating margin was 19.4% compared to 18.9% in the year-ago period. Our Adjusted Operating Margin was 22.9% in Q1, which is essentially flat to the year-ago period and in-line with previously communicated expectations.

## Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q1 were \$173 million, or 52 cents per diluted share. Adjusted Net Earnings were \$198 million and Adjusted Diluted EPS was 59 cents, up 11% from \$0.53 in Q116.

Our GAAP tax rate for the quarter was 29%. When excluding the share-based compensation permanent tax items, the Q1 tax rate was 31%, which is basically flat compared to a year ago. Note that we also had a \$3.3 million write-down of a venture capital investment that is reflected in the other income line.

## Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q1 with \$609 million of total cash and investments, which is up from \$466 million in Q4.

Moving to debt, our total debt, including capital lease obligations, was \$550 million, which is down slightly compared to Q4.

Total receivables ended the quarter at \$986 million, which is up from \$945 million in Q4. Our Q1 DSO was 71 days, which is up from 69 days in Q4 and down from 76 days in the year-ago period.

Operating cash flow for the quarter was \$304 million. Q1 capital expenditures were \$88 million, and capitalized software was \$71 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was \$144 million for the quarter.

Note that our operating cash flow reflects certain classification changes required by the previously mentioned new accounting standard adopted in Q1. For Q117, this impact resulted in approximately \$12 million more operating cash flow than under the prior accounting guidance. We have also recast 2016 cash flows to reflect this change, which resulted in Q116 operating cash flows increasing by \$9 million over what was previously reported.

Regarding free cash flow, we still expect to increase our free cash flow by at least \$150 million under the prior classification method. It is also likely we'll drive a similar increase under the new method unless the tax impact of share-based compensation is materially lower in 2017. Either way, we expect strong free cash flow this year.

Finally, you will see that we added a cash flow statement to our press release schedules.

## Guidance

Now I'll go through guidance.

- We expect revenue in Q2 to be between \$1.265 and \$1.335 billion, with the midpoint reflecting growth of 7% over Q216.
- For the full year, we continue to expect revenue between \$5.1 and \$5.3 billion, reflecting 8% growth over 2016 at the midpoint.
- We expect Q2 Adjusted Diluted EPS to be 60 to 62 cents per share, with the midpoint reflecting 5% growth over Q216.
- For the full-year, we still expect Adjusted Diluted EPS to be \$2.44 to \$2.56, with the midpoint reflecting 9% growth over 2016.
- Moving to bookings guidance, we expect bookings revenue in Q2 of \$1.300 billion to \$1.500 billion. The midpoint is basically flat compared to Q216, which was our toughest comparable in 2016. We continue to expect bookings growth for the full year.

In summary, we feel like we started the year on a solid note, and we have a good outlook for the rest of the year.

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

## **Zane Burke**

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

### **Results/Marketplace**

I'll start with bookings. As Marc mentioned earlier, our Q1 bookings of \$1.25 billion reflects 7% growth over Q116. This growth was achieved without a new *Cerner ITWorks* contract, which we indicated was our expectation when we provided guidance. In total, 24% of bookings came from long-term contracts, which is flat compared to Q116 but below the 30%+ average the past several years. As Mike will discuss, we remain confident this will be a good year for Works bookings, with stronger contributions expected to begin next quarter.

The main highlight of the quarter was our competitiveness and volume of new footprints, as reflected in 37% of bookings coming from outside our core *Cerner Millennium*® installed base. This included multiple head-to-head wins against our primary competitor. A noteworthy example was being selected by a Top 100 health system located in a Top 10 metropolitan area for a full suite of acute EHR, ambulatory, and revenue cycle solutions. Additionally, we were selected by another organization in the southeast that is one of the largest publicly owned health systems in the U.S.

Finally, we continue to see our large health system clients move more of their sites to Cerner as they look to get off of legacy systems and standardize on Millennium. One client this quarter contracted to move 10 sites from a competitor's legacy system to Cerner Millennium, and they have many more sites that could be transitioned to Cerner in the future. As we have discussed, our health system clients still have a significant number of sites on competitors' legacy systems that represent future opportunities.

Overall, our competitiveness is as good as it has ever been. We believe our primary competitor continues to be in more of a defensive stance as a result of numerous factors, including cost overruns that have impacted their clients financially and become more widely known in the marketplace. We also believe our predictable total cost of ownership, contemporary architecture, ability to demonstrate value, and strong population health capabilities position us well to continue having success against this competitor and others.

### **Population Health / Revenue Cycle**

Beyond our strength in new business, we also had good contributions from other growth areas, such as population health and revenue cycle, with both positioned to deliver strong double-digit growth for the year.

In population health, despite the uncertainty of exactly when the broader shift from fee-for-service to value-based care will occur, there continues to be high interest in our population health solutions as providers realize they need to begin preparing for the shift long before it occurs. Further, we are able to demonstrate the ability of the *HealthIntent* platform to help our clients optimize performance in their fee-for-service business models while they are also preparing for new reimbursement models.

In revenue cycle, the strength continues to be driven by both new EHR clients including revenue cycle with their purchase as well as further penetrating our existing EHR base with our revenue cycle

solutions. We are also seeing increased demand for revenue cycle services, including targeted projects, transition services, business office management and full outsourcing.

### **Ambulatory/CommunityWorks**

We also had a solid quarter in smaller venues with our ambulatory and *CommunityWorks* offerings. In ambulatory, we had success at extending our solutions to the ambulatory facilities of our large health system clients, which led to the displacement of several different ambulatory competitors during the quarter. We also had another strong quarter in ambulatory business office services.

In *CommunityWorks*, we had a solid quarter that included beating multiple niche competitors. Activity remains high, and we have a very good outlook for the year.

### **Department of Defense**

Next, I'd like to provide a quick update on our project with the Department of Defense. As we've discussed, we had a successful first go live earlier this year, and we remain on track for additional go lives throughout the year. We are honored to be part of this project and are very pleased with the early success, which is the result of great effort by the Department of Defense, Cerner, Leidos, and other partners. This project is making Cerner better and I believe it ultimately benefits all of our clients as it is leading to enhanced implementation processes and advancements in cybersecurity and sometimes-connected technologies.

We remain very focused on continuing to deliver for the Department of Defense, which we believe will help prepare and position us for other opportunities.

### **Non-U.S.**

Moving to our business outside of the U.S., despite the flat revenue Marc mentioned, we had a strong start to the year from a bookings standpoint. The strength of bookings was broad-based, with over 20% bookings growth in Canada, Australia, Germany, Belgium, and the U.K. Of note were two significant academic systems, including our first large client in Belgium and a very significant academic system in Australia. Both were won after rigorous and highly-competitive selection processes that included our primary competitor.

### **Marketplace / Closing**

Now I'd like to provide some observations on the U.S. marketplace. As I discussed last quarter, while there are unknowns about the future of Obamacare and the timing of the shift to value-based care, we are not seeing this have a material impact on our results.

I think it is important to step back from the noise and consider that the dialogue around Obamacare and its Republican alternatives is mainly focused on access and insurance reform, not care delivery reform. There isn't much of a discussion around cost of care delivery. If not addressed, the cost implications of the baby boomers hitting retirement, increases in chronic conditions, and reimbursement being tied to volume, will lead to our health care costs continuing to grow as a percent of GDP at an unsustainable rate. We continue to believe information technology is the single biggest lever to drive cost down and quality up.

From a policy standpoint, we believe the Medicare Access and CHIP Reauthorization Act of 2015, or “MACRA”, is an important step in the right direction. Unlike Meaningful Use, which mandated EHR adoption without requiring proof of better outcomes, MACRA rewards providers who achieve better outcomes and penalizes providers who do not. As the payer for roughly 50% of care in the U.S., the Federal government can use their leverage to push towards value-based care. And now that the core system is mostly digital, they can demand the measurements needed to do this.

With the change in the administration, we are seeing a predictable review, but most policymakers seem confident that MACRA and the overall shift to value-based reimbursement will continue. In our view, based on the forces and pressures that drive health care spending, it is hard to imagine ignoring the power of shifting from fee-for-service to a value-based system inside a competitive marketplace. And we clearly believe Cerner can play an important role in this shift.

In summary, we believe we are well positioned in an active marketplace with both near-term and long-term drivers of business opportunity for Cerner.

With that I will turn the call over to Mike.

## **Mike Nill**

Thanks Zane. Good afternoon everyone. Today I am going to discuss *ITWorks* and some initiatives that are focused on driving operational efficiencies while also improving our quality.

### ***ITWorks***

I'll start with *ITWorks*. As Zane mentioned and as contemplated in our forecast, we didn't have a new *ITWorks* deal in Q1. We did have an existing client expand and extend their *ITWorks* contract. We also had good sales back into our *ITWorks* base, which is an important part of our *ITWorks* model.

Despite a lack of recent new deals, the *ITWorks* value proposition is resonating with many of our clients as they look to control costs, achieve operational excellence, and maintain security across the enterprise.

Looking ahead, we still believe several of the opportunities we contemplated in 2016 will be closed in 2017, and we continue to add opportunities to our pipeline. In total, we believe 2017 could be a record year for *ITWorks* bookings.

### ***Efficiency/Quality Initiatives***

Now I'd like to briefly discuss two examples of initiatives focused on driving quality and efficiency.

#### **Cerner Advance**

The first example is our focus on clinician productivity and satisfaction. One of Cerner's unique competitive advantages is our ability to leverage analytics to understand the user experience within our solutions. With a tool called Cerner Advance, we've created the ability to measure the EHR efficiency of each clinician and benchmark them against peers by specialty and venue. This unparalleled ability allows us to proactively identify areas of opportunity, engage with our clients to create data-driven plans for improvement, and measure the impact of these changes. Over 8,000 users across 500 organizations have leveraged this capability to advance their organizations towards best practices that represent more effective and efficient utilization of our solutions.

#### **Continuous Availability**

Another example is our focus on making our systems continuously available. One measure of this has been our ability to provide '4 nines' of system availability through our leading hosting capabilities. Going beyond this, we are now able to achieve continuous availability even during a Millennium release upgrade. This is a significant achievement and we have already performed many release upgrades without incurring downtime. This accomplishment takes us a step closer to our goal of continuous delivery, which I discussed at our HIMSS investor meeting. Through continuous delivery, we expect to enable automatic deployment of updates and new innovations, which should significantly increase the rate of adoption, lower cost of ownership and improve our speed to market.

In summary, we believe these advancements will create significant value for our clients and drive tremendous productivity increases throughout Cerner. We also believe the ability to quickly deliver solutions at a lower cost will become more important as the financial pressures increase for our clients and that our ability to do this will become a competitive advantage.

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