Cerner Corporation
Third Quarter 2020
Earnings Conference Call
October 28, 2020

Moderator

Welcome to Cerner Corporation's third quarter 2020 conference call. Today's date is October 28, 2020, 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, and capital allocation plans; cost optimization and operational improvement initiatives; future business outlook; the expected benefits of our acquisitions, divestitures or other collaborations; and the expected impact of the COVID-19 pandemic. Actual results may differ materially from those indicated by the forward-looking statements. Please see Cerner's earnings release, which was furnished to the SEC today and posted to the investor section of cerner.com, and other filings with the SEC for information concerning factors that could cause actual results to differ materially from those in the forward-looking statements. A reconciliation of non-GAAP financial measures discussed in this earnings call can also be found in the Company's earnings release. 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

Good afternoon everyone, and thanks for joining the call.

I'll spend a few minutes providing some thoughts on the business and current environment, before handing the call over to CFO Marc Naughton, Chief Client & Services Officer John Peterzalek and President Don Trigg for more on the numbers and marketplace commentary.

As COVID continues to disrupt global health care, it's also underscoring the value of health care interoperability, interconnected information systems and access to timely population-level data and analysis.

For all the damage it has caused, the global pandemic has sharpened Cerner's intense focus on supporting our clients. Managing through COVID with our clients has enabled Cerner to strengthen and extend relationships and help our partners manage their response, plan their recovery, and re-imagine new business models that leverage emerging and comprehensive data and network strategies.

Earlier this month, we hosted our 35th annual Cerner Health Conference, which was also our first virtual CHC. It succeeded beyond our expectations: More than 22,000 registered for the event, client attendance was up 125% and participation from non-U.S. clients was up more than 330%.

A key topic at the conference was how Cerner clients are using data-driven insights to improve care quality and the experiences of clinicians and patients. Other themes included Cerner's commitment to **supporting** the clinical, operational and financial successes of our clients; **improving** our core products and platforms; and **eliminating** health care inequities around the world.

Another topic was the importance of interoperable health records and health information exchanges that seamlessly connect patients and their health care providers across geographies and the entire continuum of health care. Such connectivity enables patients and **all** of their providers to be aligned in support of a consistent health plan.

As John will discuss, we have made meaningful progress in our work with the Federal government, including expanding interoperability capabilities that are foundational to the success of the VA and DoD programs.

Using interoperability to close gaps in health care is **a goal of providers around the world.** In partnership with **One-London** – another of the world's largest health information exchanges – we built a **digital infrastructure** that covers **7 million Londoners** and – combined with Cerner's other British exchanges – **we now cover 20 million people** across England, **or 35%** of the country's entire population.

Also underscoring the importance of interoperability and data analytics was the announcement of two new brands: ***Cerner Unite*™** and ***Cerner Discover*™**.

Cerner ***Unite*** is our **portfolio of interoperability** products, and Cerner ***Discover*** is our **portfolio of intelligence**-integrated products. Together, ***Unite*** and ***Discover*** deliver the elements crucial to effective value-based care strategies, including: **improving** data quality; **simplifying data reconciliation; and seamlessly integrating** data-driven insights into workflows – on ***any*** **health platform**.

Before CHC, I was also pleased to announce the hiring of **Will Mintz** as our Chief Strategy Officer. Will brings a **strong entrepreneurial** background and **deep health care experience** to the role. His responsibilities include identifying and developing **new business** opportunities, coordinating **strategic planning** processes across multiple business units and overseeing Cerner's overall **corporate strategy**.

Now I'd like to recognize one of our longest-tenured associates who, as announced this afternoon, will be leaving the company in 2021.

As Chief Financial Officer, **Marc Naughton** has worked with many of you through the years. He joined Cerner in 1992 and soon assumed leadership of Cerner's mergers, acquisitions and finance activities. He served as the director of finance for two years before being promoted to CFO in 1995. Marc has been one of the key players in Cerner's legacy of success—supporting more than a 50-fold increase in revenue and earnings during his career. We are conducting a global search and Marc plans to stay engaged to ensure a smooth transition.

I’m proud to call him a colleague, and I’m happy to turn the call over to Marc now to review our results.

Marc Naughton

Thanks, Brent. Good afternoon everyone. I am going to cover our Q3 results and future guidance.

This quarter we delivered all key metrics in line with our expectations.

Bookings, Backlog and Revenue

I will start with bookings, which were $1.47 billion, above the midpoint of our guidance range.

We ended the quarter with a revenue backlog of $13.01 billion, which is down 2% from a year ago due primarily to the impact of divestitures. Our backlog revenue, combined with other contracted revenue that is excluded from the ASC 606 backlog definition, still provides visibility to more than 85% of expected revenue over the next 12 months.

Revenue in the quarter of $1.37 billion was in our guidance range and reflects impacts from closing the divestitures of non-core assets in Germany and Spain, as well as the remainder of our commercial RevWorks services business. Revenue in Q3 related to the sale of the commercial RevWorks business was impacted more than expected as we closed the sale earlier in the quarter than anticipated and also had some revenue impact as we transitioned client contracts to R1. As a result of these two items, the RevWorks transaction had $10 million more impact on revenue in Q3 than we factored into our guidance—making the total impact on Q3 revenue about $20 million instead of $10 million.

I'll now go through the business model detail and year-over-year growth compared to Q319.

- **Licensed Software** revenue in Q3 was $172 million, up 11% year-over-year driven by strong growth in our SaaS offerings.
- **Technology Resale** in Q3 was down 33% year-over-year to $47 million, slightly lower than anticipated primarily driven by a tough overall environment for technology resale and a few anticipated deals pushing out of the quarter.
- **Subscriptions** revenue grew 2% in Q3 to $93 million, with growth in domestic subscriptions being partially offset by the portion of our global divestiture that was subscriptions.

- **Professional Services** revenue was down 5% in Q3 to $480 million, due primarily to the impact of the divestitures in Q3, the termination of our large RevWorks agreement in 2019, and lower third-party services. The declines driven by these factors were partially offset by continued strength in Federal professional services.
- **Managed Services** was up 3% in Q3 to $312 million.
- **Support & Maintenance** of $260 million was down 6% year-over-year due to the impact of divestitures, attrition and reduced hardware maintenance revenue.
- And finally, **Reimbursed Travel** of $5 million was down 82% in Q3 due to continued pandemic-driven travel restrictions.

Looking at revenue by geographic segment, domestic revenue was down 3% from the year-ago quarter at $1.23 billion, and non-U.S. revenue of $138 million was down 16% from the year-ago quarter, primarily due to the divestiture of assets in Germany and Spain.

Moving to gross margin. Our gross margin for Q3 was 83.1%. This is up about 200 basis points from a year ago, reflecting improved revenue mix due to less outsourcing services, technology resale and reimbursed travel.

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, acquisition-related adjustments, organizational restructuring and other expenses, COVID-19 related expense, gains on the sale of businesses and other adjustments that are detailed and reconciled to GAAP in our earnings release.

Operating Expense

Looking at our operating spending, our third quarter GAAP operating expenses of $942 million were down 12% compared to $1.07 billion in the year-ago period.

Our adjusted operating expenses were down 5% compared to Q319, primarily due to our continued cost optimization efforts, divestitures, and lower travel expense. Looking at the line items for Q3, Sales & Client Service expense decreased 5% year-over-year, driven by lower non-personnel expense and divestitures. Software development expense decreased 1% from Q319, with basically flat gross R&D and a slight increase in net capitalized software. G&A expense in Q3 was down 11%, driven by a decline in both personnel and non-personnel expenses.

Operating Margins

Moving to operating margins. Our GAAP operating margin in Q3 was 30.1% compared to 6.2% in the year-ago period as GAAP operating earnings included $217 million in gains on our divestitures, which you'll see we broke out on a separate line on our income statement. Our Adjusted Operating Margin for the quarter was 20.4%, up from 18.1% in Q319 and 18.4% last quarter, reflecting the impact of our cost optimization efforts and improved revenue mix.

Our results and outlook keep us on track for our full-year Adjusted Operating Margin to be around 20%. This would be approximately 150 basis points of full-year margin expansion, which we view as impressive given the circumstances. For Q4, we still expect our operating margin to be within 50 to 100 basis points of our original 22.5% target. This would reflect strong margin expansion of more than 100 basis points compared to Q419.

We also believe the framework for ongoing margin expansion we shared at our investor day remains valid, and we expect to continue improving margins beyond this year as we implement additional optimization efforts and aim to realize a longer-term benefit from platform modernization.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q3 were $357 million, or $1.16 per diluted share, which is up from $0.26 in Q319 and reflects the impact of the gains from our divestitures in the quarter. Adjusted Net Earnings in Q3 were $222 million and Adjusted Diluted EPS was $0.72, up 9% compared to $0.66 in Q319.

Our GAAP tax rate for the quarter was 22% and our non-GAAP tax rate was 20%, with the higher GAAP rate reflecting the impact of higher taxes on the gains on our divestitures.

Balance Sheet / Cash Flow

Moving to our balance sheet, we remain in a solid position. We ended Q3 with $892 million of cash and short-term investments, driven by strong free cash flow, proceeds from our divestitures and the sale of an equity stake in a partner.

Our receivables ended the quarter at $1.22 billion, up $35 million from last quarter. Our Q3 DSO was 81 days, which is flat to Q220 and up from 74 days in the year-ago period. Looking forward, we expect DSO to return to the 70s in Q4 and beyond.

Operating cash flow in Q3 was strong at $382 million, capital expenditures were $72 million, and capitalized software was $73 million. Free cash flow was $237 million for the quarter.

Our debt remained at $1.34 billion at the end of Q3. Note that we recently increased the amount available under our Shelf Agreement by $750 million, bringing the total agreement from $1.1 billion to $1.8 billion of which only $300 million has been drawn. This, coupled with our strengthening free cash flow, positions us to execute our capital allocation strategy, including continuing our dividend, share repurchases, and M&A.

Guidance

Moving to guidance. As we've previously discussed, the uncertain progression of the pandemic makes it challenging to quantify the exact impact on our business, but we continue to feel it is important to provide investors with our current outlook for the business. Given the current environment, especially the uncertainty around how large of an impact colder weather and flu season will have on the pandemic, we continue to caution that our guidance remains subject to a higher than normal amount of risk.

Now I'll walk through the guidance for the fourth quarter:

- For Q4, we expect revenue to be between $1.365 and $1.415 billion. As a reminder, Q419 included about $60 million of revenue from our commercial RevWorks and global divested businesses, which is not included in Q420 revenue. The $1.390 billion midpoint of this range represents roughly 1% growth from Q419 after adjusting for divestitures and would bring full-year 2020 revenue to $5.501 billion, which is consistent with prior guidance and also reflects approximately 1% growth from 2019 after adjusting for divestitures. We continue to believe these portfolio management actions position us for solid growth when the pandemic impact subsides and the divested revenue is out of our comparable periods. The remaining headwind from the divestitures is approximately $40 million per quarter in Q1 and Q2 of 2021 and about $10 million in Q321.
- Moving to EPS, we expect Q4 Adjusted Diluted EPS to be 76 to 80 cents per share. The midpoint of this range represents 4% growth over Q419 and would bring full-year 2020 Adjusted Diluted EPS to $2.84, which is consistent with prior guidance and reflects 6% growth over 2019. The expected EPS growth in Q4 and for the full year continues to reflect our ability to offset the impact of lower revenues from COVID and the lost earnings from divested businesses through our cost optimization initiatives.
- Moving to bookings guidance, we expect bookings revenue in Q4 of $1.55 billion to $1.75 billion. The $1.65 billion midpoint of this range represents a nice sequential increase over Q3 and is consistent with our prior statements that we expect activity will continue to ramp as we move through the year. The Q4 midpoint would bring full-year 2020 bookings to $5.551 billion, down 7% from 2019, driven by the impact of the pandemic and divestitures.

We expect to provide our outlook for 2021 on our Q4 call. While there is some uncertainty about the duration of the pandemic's impact, we believe the framework we shared at our investor day for mid-single-digit revenue growth and an average of 100 basis points of margin expansion remains reasonable. Our outlook for next year will be dependent on how we finish this year and what our updated pipeline and backlog look like, but we think there is potential for us to drive more than 100 basis points of margin expansion in 2021.

In summary, we are pleased with our solid results in the third quarter given the circumstances, and we are focused on executing to finish 2020 on a strong note and building on that in 2021.

Departure News

Before turning the call over to John, I'd like to comment on the news about my departure. After 28 years at Cerner, I will be leaving next year. As Brent indicated, we are seeking a successor and considering internal and external candidates. Once we have named a successor, I plan to serve as an advisor to ensure a smooth transition.

It has been an incredible honor to be a part of Cerner during a time when we grew revenue from $100 million to over $5 billion—all while pursuing a noble mission that is personal to every Cerner associate. During this time, we have had countless reasons to celebrate, along with facing several challenges. This has definitely made for an exciting and fulfilling career.

The past few years have included important transformational work to position Cerner for our next wave of profitable growth. This has been both challenging and gratifying. We are delivering on margin expansion despite facing a 100-year pandemic; we have organized around creating client value and delivering on commitments; and we have created a more focused growth strategy to deliver on the opportunities we see in healthcare technology.

It was important to me to stay at Cerner while we advanced this transformational work and allowed new members of our leadership team to get acclimated. I believe Brent and the team are now well positioned to begin an era during which Cerner's impact on health care can be greater than ever.

Finally, I'd like to thank each of you in the investment community for your part in making my time as CFO a great experience. I have always appreciated your perspective and that you acknowledged our successes but also challenged us when we needed to do better. I look forward to catching up with many of you before I leave.

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

John Peterzalek

Thanks Marc. Good afternoon everyone. Today, I will provide results highlights and an update on our Federal business.

Results Summary/Marketplace

I'll start with bookings. We had another solid quarter in what remains a challenging environment, delivering bookings above the midpoint of our guidance range. The mix of bookings this quarter included 25% from long-term bookings compared to 29% a year ago.

Consistent with our plans and guidance, our Federal business had a very good quarter, with strong contributions to bookings and substantial operational progress, which I'll discuss in moment.

Beyond Federal, our ability to continue delivering solid bookings despite the challenges created by the pandemic is made possible by the strategic nature of our client relationships. Our clients remain focused on executing their strategic plans and *Cerner*® solutions and services are important elements of these plans. Cerner's ability to align strategically with our clients will allow us to expand our Strategic Growth offerings as well as other large addressable opportunities, such as Revenue Cycle.

The strong relationship alignment creates a receptive environment for advancing business through mostly virtual interactions for contracting activity, demos, open houses, and road-mapping sessions. Their willingness to engage virtually was also evident at our Cerner Health Conference, which had record client attendance as the virtual format enabled broader participation across our clients' teams.

Operationally, we made good progress in Q3. Our professional services organization delivered strong sequential growth in implementation revenue as they continued advancing projects with a hybrid model that uses limited onsite presence combined with a larger virtual workforce. Our clients remain open to this approach, and we believe elements of it will become standard beyond the pandemic which should benefit both Cerner and our clients.

While shifting to a hybrid implementation model, we have also made progress on a new implementation and training framework designed to deliver more predictable and higher quality activations. This framework applies to clinical and revenue cycle implementations and is an important part of our efforts to drive client success and improve satisfaction. Early indications are very positive, as we've seen 20% higher client satisfaction when comparing the new approach to our prior approach.

Federal

Moving to a Federal update. Despite the challenges presented by the pandemic, we continue to make significant progress on both the VA and DoD.

On August 24th, the VA announced the successful go-live of their new Centralized Scheduling Solution at the VA Central Ohio Healthcare System in Columbus, replacing Epic's Scheduling System.

In September, the DOD and the Leidos Partnership for Defense Health, of which Cerner is a core partner, deployed MHS GENESIS to 10 additional sites as part of WAVE NELLIS, bringing the total number of DOD sites to 18. The U.S. Coast Guard had a successful go-live of MHS GENESIS to 4 sites. WAVE PENDLETON, which includes an additional 4 sites in Alaska and California, is scheduled to begin on October 31.

On October 13th, the Federal Electronic Health Record Modernization Office announced that DOD, VA and the U.S. Coast Guard have joined CommonWell Health Alliance, adding an additional 15,000+ private sector providers into the Joint Health Information Exchange that was launched in April.

In preparation for our first VA EHR go-live at Mann-Grandstaff, we successfully migrated clinical and demographic health information data for approximately 88,000 Veterans and tested the 73 interfaces required for system integration for our first set of capabilities.

Finally, the VA recently announced the historic and successful deployment of the new EHR at Mann-Grandstaff VA Medical Center and its four community-based outpatient clinics across Montana, Idaho, and Washington as well as the West Consolidated Patient Account Center, a VA business operations facility in Las Vegas.

This is a significant milestone and it positions us to proceed with the broader deployment plans as we head into next year.

In summary, I am pleased with our execution in the third quarter, and I believe we are well positioned for a solid finish to the year.

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

Don Trigg

Thanks, John.

There is no better leading indicator of where provider health care is headed than our annual Cerner Health Conference (CHC). The event celebrated its 35th anniversary in recent days with over 20,000 registered attendees. It is the coming together, I would contend, of the most entrepreneurial and innovative provider client base in the world.

As our leaders engaged in virtual education sessions and online client dialogue, three macro trends of our times were clear.

First, within the hospital, clients are looking for technology-enabled strategies to tackle unit costs and drive down Total Cost of Care. Our Real-Time Health System capabilities have been essential to COVID surge response, U.S. provider revenue recovery and now the strategic rethink around what it looks like to make money at government rates.

Second, outside the hospital, the pandemic is driving providers to think beyond the scope of their traditional brick-and-mortar Enterprise. Clients are striving to deliver clinical, operational and financial excellence at the Health Network level. The business models of these Health Networks center on managing outcomes. They necessitate core capabilities and data competencies that can span physical and digital venues, diverse payer types and heterogenous IT systems.

As the shift to value-based payment advances, we expect these Health Network strategies to take on heightened strategic urgency. As Rick Pollack from the American Hospital Association noted in a 2020 Election panel that I moderated, value-based payment will be a growing piece of provider economics in the decade ahead. I believe the shift away from Fee-For-Service is set to accelerate in the coming 117th Congress and next presidential term.

Finally, perhaps no area of emphasis received more positive client reactions than our data strategies. When you digitize the content of an industry, it has big second and third order impacts. And while we are at the “end of the beginning” of this early market bell curve, Cerner is clear-eyed about the organic and inorganic strategies needed for us to meaningfully disrupt and innovate in the quarters to come.

In the opening keynote, Dr. Eric Peterson from Duke challenged the Cerner client base to be part of a collective strategy to fundamentally accelerate the pace, and reduce the cost, of drug discovery. His comments were followed over the next two days with a collection of educational sessions featuring a set of almost 50 Cerner clients working to rethink clinical trial candidate identification and participation. The entrepreneurial opportunity surrounding our Learning Health Network is a massive one.

In addition to allowing our clients to learn best practices and understand emerging trends, Cerner Health Conference (CHC) also is an opportunity for clients to hear from us. The event has a rich history as a launch point for new products and partnerships. 2020 was no exception.

At Cerner, our product and larger platform vision always begins with the person. The pandemic has accelerated the shift toward whole person capabilities in their always changing role as patient, member, caregiver or consumer. Our Consumer business has benefitted with booked revenue expected to double on a full year basis.

At the center of our Digital Front Door strategy is our Consumer Framework. It allows providers to combine natively developed functionality and 3rd party partner capabilities in one seamless experience. A good example of this is our new collaboration with Tonic to enable virtual intake and check-in which signed its first client in the third quarter and is seeing material sales momentum.

A unified communication strategy also is an essential building block to consumer engagement. We announced our new Unified Communications offering at our Cerner Consumer Forum earlier today. The pre-release client feedback has been exceptional as providers look to reduce delayed emails, hold queues and missed calls. It gives the Consumer team confidence that their 2020 business momentum will continue in 2021.

At the Enterprise level, our Real-Time Health System strategy also was a significant area of client excitement. The market trend toward near real-time data insights that can trigger caregiver action for high quality, low cost care is clear. It can be seen in RTHS booked revenue growth of almost 40% year-over year and compelling stories such as Adventist Health. Amid COVID, wildfires and rolling blackouts, Adventist deployed our Capacity Management solution enterprise-wide in just two weeks to better direct intra-health system patient management and accelerate their hospital-at-home strategies.

Our clients also heard about advancements in our ongoing push to deliver a unified inpatient and outpatient provider experience. Our latest functional capabilities are designed to make the provider workflow more natural and predictable. We are pushing to make documentation easier and also simpler to absorb by other care team members to include the patient. The momentum of our Chart Assist solution tells a piece of the story, leveraging Cerner's Natural Language Processing (NLP) to facilitate administrative requirements and deliver the potential of millions of dollars of annualized enterprise savings to our large IDN clients.

In addition, we also updated clients on important progress on Revenue Cycle Management. Clients detailed their improved experience with our hardened implementation methodologies and solid financial returns from the adoption of best-practice optimization in areas such as denial reduction and AR improvement.

Clients also heard from partners such as Baptist Health South Florida about our new registration and scheduling offering, "Engage and Access." It includes advancements such as our enhanced financial clearance workflows with Auto-Plan assignment. It also reflects our view that there is strategic leverage in the revenue cycle front end as clients look to decrease downstream cost-to-collect.

At the Health Network level, our EMR-agnostic *HealtheIntent®* continues to be at the center of our push for active Health Network strategies in every MSA. Geisinger Health told the story of *HealtheIntent* as their foundational 'first mile' data platform across their owned and affiliated assets. They also framed our efforts to push contextual insights back into the 'last-mile' workflow at the right time and the right place to drive the right outcome.

HealtheIntent's data aggregation and normalization strengths also are powering Customer Relationship Management (CRM) campaigns across our client base. The tool set allows for a data-driven approach to connect health systems with their customers in areas ranging from elective surgery rescheduling to Gaps in Care closure. We announced new *HealtheCRM*[SM] scope to include first-class Cerner EMR workflow integrations. It gives users both a complete network-level consumer profile and essential last-mile integration in areas such as scheduling, provider messaging and prescription refill.

In the coming quarters, we believe the solutions with the greatest market traction will deliver financial and operational returns for Fee-For-Service and Fee-For-Value. Our just launched *HealtheReferrals*[SM] solution perfectly reflects that value proposition. *HealtheReferrals* allows providers to manage their referrals at the Health Network level as they seek to better align consumer demand with their provider supply.

At the Cerner Health Conference executive session, I framed the idea the last decade saw three major forces of change: an ongoing demographic shift as the first boomers turned 65, the passage of Democratic reform as the Affordable Care Act (ACA) set the policy foundation for the decade ahead and, most importantly, the first-digitization of healthcare.

As the COVID pandemic plays forward, the 2020s are setting up to be equally dynamic. And as our clients deal with these accelerating forces of change, their collective voice in recent days was clear. We are counting on Cerner to help us navigate the business model shifts to come across person, enterprise and health network. We are counting on Cerner to define and lead the decade ahead.

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