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CERN - Q1 2017 Cerner Corp Earnings Call

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OVERVIEW:

Co. reported 1Q17 revenues of $1.26b and GAAP net earnings of $173m or $0.52 per diluted share. Expects 2017 revenues to be $5.1-5.3b and adjusted diluted EPS to be $2.44-2.56. Also expects 2Q17 revenues to be $1.265-1.335b and adjusted diluted EPS to be $0.60-0.62.

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CORPORATE PARTICIPANTS

Marc G. Naughton *Cerner Corporation - CFO, EVP and Treasurer*

Michael R. Nill *Cerner Corporation - COO and EVP*

Zane M. Burke *Cerner Corporation - President*

CONFERENCE CALL PARTICIPANTS

Adam Chase Noble *Goldman Sachs Group Inc., Research Division - Research Analyst*

Alexander Yearley Draper *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Charles Rhyee *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

David M. Larsen *Leerink Partners LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Donald Houghton Hooker *KeyBanc Capital Markets Inc., Research Division - VP and Equity Research Analyst*

Eric R. Percher *Barclays PLC, Research Division - Senior Analyst*

Garen Sarafian *Citigroup Inc, Research Division - VP and Healthcare Technology and Distribution Analyst*

Jamie Stockton *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Jeffrey Robert Garro *William Blair & Company L.L.C., Research Division - Research Analyst*

Matthew Dale Gillmor *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Michael Aaron Cherny *UBS Investment Bank, Research Division - Executive Director and Healthcare Technology and Distribution Analyst*

Mohan A. Naidu *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Rivka Regina Goldwasser *Morgan Stanley, Research Division - MD*

Sean William Wieland *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

PRESENTATION

Operator

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 in 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 Investors section of cerner.com. Cerner assumes no obligation to update any forward-looking statements or information.

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

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Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

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

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

Starting with bookings. Our bookings in Q1 was $1.25 billion, which reflects a 7% increase over Q1 of '16. 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 $1.26 billion, which is up 11% over Q1 of '16, 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 Q1 of '16, then driven primarily by strong license 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 Q1 of '16 and 150 basis points over Q4 of '16.

Moving to services. Total services revenue, including professional and managed services, was up 11% compared to Q1 of '16. 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 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 Q4 of '16.

Now I'll 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 was 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's 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 do not adjust it out.

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 Q1 of '16. This growth was primarily driven by an increase in personnel expense related to revenue-generating associates, which is reflected in the sales and client service expense line that increased 12%. Software development increased 9%, driven by noncash items, as we had $4 million less capitalized software and $8 million more amortization in Q1 than '16. G&A expense was up 3%. Amortization of acquisition-related intangibles decreased by $1 million.

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.

Moving to net earnings and EPS. Our GAAP net earnings in Q1 were $173 million or $0.52 per diluted share. Adjusted net earnings were $198 million, and adjusted diluted EPS was $0.59, up 11% from $0.53 in Q1 of '16.

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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.

Now I'll move to our balance sheet. We ended Q1 with $609 million in 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 cost, 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 Q1 '17, 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 Q1 of '16 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.

Now I'll go through guidance. We expect revenue in Q2 to be between $1.265 billion and $1.335 billion, with the midpoint reflecting growth of 7% over Q2 of '16. For the full year, we continue to expect revenue between $5.1 billion and $5.3 billion, reflecting 8% growth over 2016 at the midpoint. We expect Q2 adjusted diluted EPS to be $0.60 to $0.62 per share, with the midpoint reflecting 5% growth over Q2 of '16. 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 $1.3 billion to $1.5 billion. The midpoint is basically flat compared to Q2 of '16, which is 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'll turn the call over to Zane.

Zane M. Burke - *Cerner Corporation - President*

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

I'll start with bookings. As Marc mentioned earlier, our Q1 bookings of $1.25 billion reflect 7% growth over Q1 of 2016. 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 Q1 of 2016 but below the 30% plus average for 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 Millennium install base. This included multiple head-to-head wins against our primary competitor. A noteworthy example is being selected by a top 100 health system located in the top 10 metropolitan area for a full suite of acute EHR ambulatory and revenue cycle solutions.

Additionally, we're selected by another organization in the Southeast as one of the largest publicly owned health systems in the U.S.

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Finally, we continue to see our large health system clients move more of their sites to Cerner, as they look to get off 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 we 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's ever been. We believe our primary competitor continues to be in a more 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 that our predictable total cost of ownership, contemporary architecture, ability to demonstrate value and solid and strong population health capabilities position us to continue having success against this competitor and others.

Beyond our strength in new business, we also had good contribution 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 a broader shift from fee-for-service to value-based care will occur, there continues to be a 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 HealtheIntent 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 our 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.

We also had a solid quarter in smaller venues with our ambulatory and CommunityWorks offerings. In ambulatory, we had success with 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 multiple -- beating multiple niche competitors. Activity remains high, and we have a very good outlook for the year.

Next, I'd like to provide a quick update on our project with the Department of Defense. As we have 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 we are very pleased with the early success, which is a 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 our clients and is leading to enhanced implementation processes, advancements in our 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.

Moving to our business outside 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 2

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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.

Now I'd like to provide some observations on the U.S. marketplace. As I've 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 to have a material impact on our results. I think it's 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 the 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 costs down and quality up.

From a policy standpoint, we believe that 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 the 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're seeing a predictable review. But most policymakers seem confident that MACRA and their overall shift to value-based reimbursement will continue. In our view, based on the forces and pressures that drive health care spending, it's 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'll turn the call over to Mike.

Michael R. Nill - *Cerner Corporation - COO and EVP*

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

Let's start with ITWorks. As Zane mentioned and has contemplated in our forecast, we didn't have a new ITWorks deal in Q1. However, 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 cost, achieve operational excellence and maintain security across the enterprise.

Looking ahead, we believe -- 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.

Now I'd like to briefly discuss 2 examples of initiatives focused on driving quality and efficiency. 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 create the ability to measure the EHR efficiency of each clinician and benchmark them against peers by specialty and venue. This is -- 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 and 500 organizations have leveraged this capability to advance certain organizations towards best practices that represent more effective and efficient utilization of our solutions.

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Another example of our focus is making our systems continuously available. One measure of this has been our ability to provide "4 nines" of ability to our leading hosting capabilities. Going beyond this, we are now able to achieve continuous availability even during the 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 toward 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 our ability to do this will become a competitive advantage.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Eric Percher of Barclays.

Eric R. Percher - *Barclays PLC, Research Division - Senior Analyst*

A question relative to cash. Strong cash flow this quarter. Cash building on the balance sheet, we didn't see you in the market, although we've seen you in prior Q1s. Was there anything in the market that precluded you from repurchasing shares? Or is there any thought on timing of repurchase and/or other cash activity this year?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, Eric, this is Marc. There wasn't anything in the market precluding from being in the market. The timing, and by the time we released Q1 and then we go into quiet period for the end of -- or when we release for the year and then go to a quiet period for Q1. It just made sense at this point to stay on the sidelines. We still have $100 million of capacity available to us, and we would expect that to be increased appropriately as we go forward by the board. We certainly, at a minimum, expect to continue buybacks at a level to reduce the dilution or eliminating dilution we get from issuing stock options. But there is nothing in the quarter other than just the timing of our quiet periods.

Eric R. Percher - *Barclays PLC, Research Division - Senior Analyst*

Very good. And one question on OpEx spend. The level of reduction you saw this quarter, is that deal sustainable throughout the year?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

I think -- I mean, I think OpEx expense is certainly consistent with the plan that we had. So I think our goal will be to continue to watch spending as we do and continue to make sure that we are managing expenses. So I don't think -- I think the future quarters will be fairly consistent.

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Operator

Our next question is from the line of Ricky Goldwasser of Morgan Stanley.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

If you can just give us a little bit more a bit detail, seeing on the prepared remarks, you talked about 37% of bookings outside core. So when you think about gaining share, is this mostly from some of your customers that have acquired other hospitals? Or is this just a new customer base? And also, if you can talk a little bit in more detail about where you're seeing the demand in ITWorks. I think you said that you expect it tick up in the second quarter. So if you could just provide a little bit more details on that.

Zane M. Burke - *Cerner Corporation - President*

Sure. So thanks for the question. Thanks for the congratulations. The net new additions, the 37% reflects -- when we say outside our core Millennium install base, basically, is a new client setting. And a lot of the -- we saw a demand across all segments of our business. So I noted a large IDN. I noted a large public entity. I noted 2 outside the U.S. on a significant side, but we saw that across the community hospital marketplace, across the small marketplace. So there was -- and that's kind of been a trend we've seen for the last several quarters. It's been a very active replacement market for our solutions, and we've seen that in terms of that percentage. As it relates to the ITWorks opportunities, we are seeing more larger opportunities coming in the pipeline than we've seen historically speaking. So there's both a higher number of opportunity as well as larger opportunities moving forward. So we're seeing the success that we've had in ITWorks, from an execution perspective, now reflecting up -- going up market a bit in terms of the size of opportunity that we go -- we want to go -- that we're going after and that there's a good acceptance for. And so as we look forward into the back half of the year, we see a number of opportunities, and they're at a bigger size than what we've seen historically.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

So should we think about the back half really as kind of, like, an inflection point for ITWorks?

Zane M. Burke - *Cerner Corporation - President*

I think what we're saying is it's going to -- we think we're having the opportunity to have a record high for ITWorks, which means not only returning to our 2015 highs that we saw, but the opportunity to eclipse our 2015 bookings amounts, which would be a significant bump from where we were in 2016.

Operator

Our next question comes from the line of Charles Rhyee of Cowen and Company.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Just wanted to follow up on Ricky's question. In terms of this, in the ITWorks opportunities, Zane you talked about going up market to some bigger opportunities, what are clients using currently? Are they outsourcing to other more traditional tech companies? Can you give us a sense for that competitive landscape looks there?

Zane M. Burke - *Cerner Corporation - President*

Most of these are in-house situations. So they're not typically outsourced. But they're looking -- as I mentioned last year, they were not the same impetus in terms of the measures and mandates from a government perspective that were driving people to complete ITWorks business last year.

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We saw activity, we saw interest in what we're doing, but we're having a hard time moving things through the pipeline. But we're seeing, as we move through the cycle for 2017 and beyond, is a focus on organizations looking at how can they make an impact with their own associates on their core business operations, which are truly about delivering medical care. And they're looking at things like the IT shop as the way to enable that medical care, and not part of their core business model. And so it's both the opportunity to move faster. It's also the execution success we've had at our existing ITWorks clients in terms -- and our ability to actually move faster and get better outcomes as well as an unpredictable cost model in the future. We are able to bake in some of those kinds of assurances around what happens in your forward model. We've done hosting for quite some time, so you think about hosting and application management and some of the other Works businesses that we have and we've been doing that for a long time. ITWorks becomes an extension from which we're able to jump off of and take the rest of the clients' business in a bigger and broader space. And we've earned the confidence over time in those areas and that's allowing us to have a different dialogue. But I think the change from prior year to this year is we're seeing them -- we're seeing the activity move forward and you can see that they're getting closer in the close cycle. And I really think that's a reflection of people preparing for the future and some of these other measures and mandates beginning to pile up that they need help with.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

That's helpful. If I can just follow up on -- a question on RevWorks. So you guys talked a little bit about the sort of increased demand on different types of rev cycle management, and you mentioned outsourcing, sort of full outsourcing. What are some of the demand interest in that part of the market and sort of your receptivity? How much are you moving into that direction at this point?

Zane M. Burke - *Cerner Corporation - President*

We have a couple of full outsourced clients today. What we are seeing is, similar to the ITWorks space, people are looking for how do I, again, create scale, use Cerner's scale in a different way? How do I lock in some of the cost elements as I move forward? And how do I manage through some of the changing reimbursement side to this? And so we're actually seeing the activity pick up on the full outsourcing as we look forward as well. And so good activity through the pipeline is really building on the RevWorks side.

Operator

Our next question comes from the line of Robert Jones, Goldman Sachs.

Adam Chase Noble - *Goldman Sachs Group Inc., Research Division - Research Analyst*

This is Adam Noble in for Bob. I just wanted to ask around population health, if you have any updates around there on PMPM trends and some of the growth in risk-based lives in your platform. How have those trended? And thinking about the guidance, anything you could share around expectations for those for the course of the year?

Zane M. Burke - *Cerner Corporation - President*

I don't think we're releasing the PMPM elements at this point. What I would say, obviously, I noted double-digit, I would say those were significant double digits. So we had great, for Q1, increase over our Q1 of 2016. And we're looking -- for the year, we're looking at significant double digits for the year in terms of growth in that area.

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Adam Chase Noble - *Goldman Sachs Group Inc., Research Division - Research Analyst*

That actually makes a lot of sense. And thinking about the margins, I think, Marc, you mentioned on last quarter's call that you expected operating margins to be roughly flat year-over-year in 2017. Thinking about what are kind of the main drivers from the 1Q baseline that you think will kind of push it back to that level as we go through the year?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Well, in Q1, we're basically flat year-over-year. And I think the biggest impact for us is the noncash spend that we're going to incur in 2017 and the $70 million or so uptick in that expense. So I think, as projected, we expect operating margins just to be relatively flat, and they were in Q1. We kind of expect that to continue this year. Obviously, we're pleased with the top line growth, which allows us to grow earnings even with not realizing a lot of leverage into this year. That being said, we are not expecting us to have flat margins for the longer term. The business is designed to create leverage. And once we kind of get through some of the headwinds relative to some of the amortization of software, we spend a lot of money on building new stuff, and as those come online and the net cap rate kind of declines, we should get to a point where we're back to looking at the 50 to 100 basis point growth. I'm not sure if we get to the top of that range in '18, but certainly, as we start rolling forward, there is -- the model has leverage in it, and we would expect to see margins grow. But in the near term, I think flat remains our expectation.

Operator

Our next question comes from the line of David Larsen of Leerink.

David M. Larsen - *Leerink Partners LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Can you talk a bit about the VA and also the DoD? How are things progressing, I guess, with the DoD? And any update on the VA's process?

Zane M. Burke - *Cerner Corporation - President*

Thanks, Dave. So I'll start with the DoD dialogue. Obviously, I mentioned in my prepared comments, we had the first go-live that's gone extremely well. The DoD has been a fantastic client to work with. And we are on track for the remaining 3 pilots as we come through this summer for the year, and that is the initial proof-of-concept element for the DoD. And our objective is, along with our partners, is to put our head down and deliver and have it continuing to go very well. And we think that positions us well for other opportunities as they come about. As you are likely aware, the VA has issued an RFI for -- to basically see what elements are out there in the commercial space. They have contracted with certain third parties to help do that review and really make a determination as to whether they look at a commercially available off-the-shelf system or COTS system or stay with their VISTA solution today. They could go back into -- so anything beyond that is speculation.

David M. Larsen - *Leerink Partners LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay, great. And then on the ambulatory side, who are you taking share from? Are you taking share? And how about like web-based vendors such as athena, I mean, do you take share from them? Just any thoughts around that?

Zane M. Burke - *Cerner Corporation - President*

So we're taking share from all competitors, and we had another strong ambulatory quarter, where we're taking share across all the competition.

Operator

And our next question comes from the line of Mohan Naidu of Oppenheimer.

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Mohan A. Naidu - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Marc, quickly on the tech resale. You noted that you saw a strong tech resale for this year. Any particular areas you're seeing the strength in? And also, do you see this becoming a tailwind in this year versus 2016, which, I think, was not such a great year?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes. I think, for the first time, tech resale feels like it's going to meet or, perhaps, slightly exceed our expectations and that certainly was some of the upside that we have in this quarter. It's really broadly both hardware and third-party software, which is the key components of the things that we resell. So both of those did well this quarter. It's, certainly, from my perspective, nice to have tech resale. As we talked about in the past, talked about continuing to kind of reduce our expectations of what we thought tech resale was going to do and the ability, this quarter, for them to come in at a number above what we were expecting hasn't happened for a while. So we'll definitely -- we're excited about that.

Mohan A. Naidu - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Got it. And maybe quickly on the bookings. So this quarter, without an ITWorks deal. You guys are pretty strong in bookings growth. I hear you guys talking about strength in ITWorks pipeline and confidence in closing them. Do you need some of these deals to close to get a bookings growth for the full year?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

I mean, when we do our forecasting and for the annual, we obviously take into account all of the transactions that are out there. For the most part, ITWorks, based on the difficulty and exactly forecasting the timing, are fairly risk weighted down. So I don't know that I would absolutely say we've got to go deliver a bunch of ITWorks deals in order to get growth. Clearly, this quarter, we should deliver growth with really not a lot of help from ITWorks. Q2, we're also not expecting a whole lot of help from ITWorks, with most of it coming kind of in the second half. So I think, as we go forward, I think that we certainly have some nice pipeline. We certainly expect that to contribute. But I think it's not dependent on delivering a bunch of ITWorks deals.

Operator

Our next question comes from the line of Michael Cherny of UBS.

Michael Aaron Cherny - *UBS Investment Bank, Research Division - Executive Director and Healthcare Technology and Distribution Analyst*

I want to echo the congratulations on nice start to the year. Thinking more about the competitive dynamic in hospital. Really strong performance outside your core base. As you think about the discussions that you had, I know you talked about DC, but relative to what hospitals are going through and to the uncertainty of ACA, relative to also just general financial pressures, how do the discussions change when you go into those large repair and replaces about ROI? Are you -- what ROI are you able to show these customers that can prove that they can take whatever their tens, hundreds of millions of dollars that now looks like it's wasted and move your way? I'm just trying to see how the discussion shifts in an environment where they don't have funding backing them up, and it's all based primarily on value proposition, and if they asked for anything else from you?

Zane M. Burke - *Cerner Corporation - President*

Great question. So it's interesting. Each client has its own unique elements. So there's -- it's not a total way -- simple way to overly generalize. But I'll give you an example. One, we highlighted was the client that added the 10 additional sites. So they added Cerner in a reasonably sized chunk

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of their business, and they were looking to add to the portfolio. And what they're doing there, the justification is, actually, we can consolidate our business for them, consolidate on a single platform, and there's more things to do. But they're actually seeing a hard ROI around the Cerner Solutions set and the capabilities that we have. And so we have implemented a number of value creation, their offices or opportunities with our clients. And almost every new business opportunity has an ROI analysis around it, and that's part of our charter that we work together with the clients around that ROI. And really, what clients are trying to do, in the case that I mentioned of the 10 space, that's one where they're trying to standardize their operations and reduce costs. Overall, at the same time, they're having revenue enhancements from the software that we provide. So that's a double positive for them. In a core -- if you just think about a standalone organization, it's really -- or they're trying to do twofold. They're trying to prepare for the future, so they need a solid foundational system that will allow them to be flexible as they move forward and give them as much comfort about the systems they're on because, as I mentioned previously, over half of the systems out there are not on a currently marketed solution. And so you have a lot of legacy cleanup that needs to occur. In addition to that, the ROI that we're able to provide, based on the Cerner solutions and it's unique to what we do, helps those business cases move forward. So it's kind of -- the conversation is really about the foundational elements as you move forward as well as the ability to pay for it along the way.

Operator

Our next question comes from the line of Garen Sarafian of Citigroup.

Garen Sarafian - *Citigroup Inc, Research Division - VP and Healthcare Technology and Distribution Analyst*

Maybe specifically one on RevWorks. You made some favorable comments in the prepared remarks, Zane, but you guys have been very confident on the ITWorks portion of the business. So could you remind us what the assumptions were for RevWorks deals for this year? And just a little bit more detail as to what it needs -- what it needs to pick RevWorks up in the back half of the year as well.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

This is Marc. RevWorks, being the all-encompassing, all-outsourcing element, we haven't really made any overly strong expectations of that for 2017. What we're seeing some good strength in is our back office -- or business office services, our back office, all of the incremental services that we provide for the revenue function isn't full outsourcing. There's a lot of interest in that. That business is actually doing very well. So in that environment, we're not -- we're certainly working with clients as they work their way into deciding whether they want to fully outsource on the revenue cycle. But I think, certainly, the interim services that we are doing is a little bit like the hosting business for an ITWorks client. It gives them some familiarity with how we do things and comfort level on our skill sets. And I think that's what we're focusing on for the most part on the revenue cycle. Once again, working with one of our premier clients is of significant size and delivering a great experience and an example through them that we can then take to the industry. But I think, certainly, as we look at our bookings opportunities, ITWorks and the number and size of opportunities is a much closer opportunity to us than in RevWorks. Zane?

Zane M. Burke - *Cerner Corporation - President*

One element that we have seen, which is what I referenced in the prepared comments, is the pipeline for full outsourcing is something that we are seeing. We are seeing an activity and interest in the pipeline. And so I would look at that as not necessarily a significant element to contribute to 2017, but as we move beyond that time period, and over the long term, I think it provides some really great long-term opportunities. Some things that we've done on an individual basis is every new business opportunity that sells revenue cycle today has some portion of a revenue -- of a RevWorks services offering. So we get people started on our offerings. And I think that's proving to be a really great model for creation of businesses in the future, and we're seeing some of that play through in the pipeline.

Garen Sarafian - *Citigroup Inc, Research Division - VP and Healthcare Technology and Distribution Analyst*

Got it. So but for 2017, it's meeting your modest expectations to-date, 3 quarters in?

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Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, it's doing well on the business office services level, and we don't have any big expectations for the bigger (inaudible)

Zane M. Burke - *Cerner Corporation - President*

I would say it's an upside opportunity for us as we move forward.

Garen Sarafian - *Citigroup Inc, Research Division - VP and Healthcare Technology and Distribution Analyst*

Okay, that's very helpful. And then a quick follow-up was, at Investor Day, I thought that there was some commentary on selecting a CRM partner. This is -- I think it was a variety of front end activities and some patient outreach, I think. So could you elaborate on where you are in that process? And I guess, more importantly, what will that allow you to do or do better? And where would we see the impact of that partnership in the financials?

Zane M. Burke - *Cerner Corporation - President*

So this is Zane. I think there's nothing really to discuss at this point in time. And so when there is, we'll let people know on that side. And I think that -- I think your question will -- we can address that more appropriately when we get to that point.

Operator

Our next question comes from the line of Sandy Draper of SunTrust.

Alexander Yearley Draper - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Just a quick question. I'm not sure, Marc, if you have a way of sort of encapsulating this. But I'm just thinking about the bookings revenue than versus really more on the software side. Thinking about the mix between recurring software and onetime software. Is that coming in fairly consistent? I can't remember off the top of my head what you talked about in terms of that at Investor Day in '16. But just how to think about sort of are we continuing to see the shift and how dramatic is the shift going towards recurring software versus the onetime software? Any commentary or color around that would be really appreciated.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, I think we talked about of our licensed software, about 30% of it is SaaS. So I think that's a data point relative to the licensed software. I'd also point out that it's not really a shift. We continue to sell onetime software, continue to sell licenses. That's actually -- that's the bulk of our business, doing that. But what we are seeing is that the additive developments of our business, the IP that we are selling as-a-service or on a subscription basis is continuing to ramp up. That number, as a revenue number, continues to be strong. And a percent of that from -- that's recurring in nature we expect that to continue to ramp up as well. So I think that's, for us, broadly, you got the Millennium's license. HealtheIntent is primarily the SaaS-based, along with some of the Cerner Works and the ambulatory, cloud solutions that we offer. But key for us is it's great business, but it isn't -- we're not shifting models. It's additive to our business.

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Alexander Yearley Draper - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay, that's really helpful. So just to sort of summarize it, you're growing that, but you're not -- there's not a focus on transitioning it, and you're not thinking of each year growing the SaaS and shrinking the other personally. It's just how things shaped out. And right now, it looks to be fairly consistent because you're doing well on the onetime software side.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Correct.

Operator

Our next question comes from the line of Jamie Stockton of Wells Fargo.

Jamie Stockton - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Maybe a couple of quick ones for Zane, as a follow-up to, I think, Ricky's questions earlier. Could you just give us a ballpark for the number of facilities that are not on Millennium that your existing clients currently own today? I think, in the past, you've drawn out a number around 300. Is it still around there? And then the second one, international, yes, FX was a headwind during the quarter. It sounds like maybe tech resale was weak there. But can you just kind of paint a picture for us of what you think that international business is going to do over the next 2 or 3 years? Can we see it reaccelerate to maybe a mid-teens growth rate? Because it seems like it's still a relatively small piece of your business.

Zane M. Burke - *Cerner Corporation - President*

Right. So Jamie, I'll start with the first piece. The number of, actually, opportunities has actually grown because we continue to add more clients. And so we have more clients as part -- so even though we've taken elements out like the 10 sites this quarter, we continue to add additional clients, and we've added more clients in the last 8 quarters than at any time in history of the company. And so you look at a couple of -- we have some really significant opportunities with many of our largest clients in that side, and that's -- and they've been nothing but net acquirers also over this time. So when we talked about the 300, I would just tell you it's an excess of that number at this point in time, and it actually continued to grow as an opportunity size for us. On the international business, we believe that, that business will grow, that has -- there's been a slow economic recovery, and we're encouraged actually by the bookings results. It hasn't necessarily shown up on the income statement yet to date. And so I think there's a good opportunity. I spend a fair amount of my time in the global market outside the U.S. And I think it's a -- it represents a growth opportunity for us over the mid- and long-range term. And I think you're going to -- the front early indicator of that is both, obviously, the pipeline is very strong and so our global pipeline is at an all-time high. Our bookings were very solid for the quarter, from global. It just didn't translate to the income statement at this point.

Operator

Our next question comes from the line of Sean Wieland of Piper Jaffray.

Sean William Wieland - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

So just to follow up on Jamie's question. I don't think I heard the answer that, can you quantify the opportunity that you've got of health system customers that still have a significant number of sites on legacy systems? Is there a dollar value you can assign to that?

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Michael R. Nill - *Cerner Corporation - COO and EVP*

Yes, Sean, we're not going to assign a dollar value for it. It's a variety of sizes and places and a variety of things that go into it. But the fact that an existing client that already has our footprint and we have that number of facilities to which we have the opportunity to extend, it's part of our normal business. It's not -- we don't see that as an upside to the business. So that's part of our normal approach and normal view of the wolf as we're looking to do our forecasting. But we can't really give you a dollar number as to what that means. Sorry.

Sean William Wieland - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Okay. No problem. How about on ITWorks? So what I'm hearing is that it seems like the dry spell is coming to an end, maybe not by the second quarter, but certainly into that second half. But what I haven't heard is some specific factors, either internal to Cerner or external in the market, that's going to cause this what appears to be healthy pipeline of ITWorks deals convert into -- or prospects convert into deals.

Zane M. Burke - *Cerner Corporation - President*

Yes. So I may not have eloquently said it, but what I would tell you is that the factors that are changing is a little bit of the unsettledness around what happens in the future actually helps us in this space as well as some of the government regulations that were on pause for 2016, which come into play in 2017. There's a number of factors that really impact what I think was kind of a pause for 2016. So I think, really, the factors that were there previously, that had fueled good growth in the ITWorks business, I think, is really more of a return to the pre-2016 era of you have measures and mandates from the government. You've got increased concern over costs. You have increased focus on I need -- I should focus my associates on things that matter. So as a health system, I'm going to focus my people on the pieces that really matter, which is providing care and thinking about how I make money in the future of health care in that environment. I really think 2016 was a bit of a pause because margins were actually pretty good across our client base. There was no measures and mandates, no Meaningful Use element in 2016. And so you just didn't have those the same factors, that we're kind of back to where we were in 2015 from that perspective. So I really look at it and say, "2017 is more of the normal where we thought we would be." What we missed was 2016 being a pause.

Operator

Our next question comes from the line of Matthew Gillmor of Robert Baird.

Matthew Dale Gillmor - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

I wanted to ask a follow-up on the revenue performance. It seems like license software was the other key driver relative to expectations. Just curious if there was any additional commentary you could provide. Were there any particularly large deals that came through? Was it more broad-based? And then also, from a product mix standpoint in license software, was there more contribution from the rev cycle software or more on the EHR?

Zane M. Burke - *Cerner Corporation - President*

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This is Zane. So I think it's a broad-based element. So we didn't have any single transaction that drove license software in a significant way. It was actually the volume of transactions. The amount of new business wins were significant. Revenue cycle was significant in all of those elements of both from an install base as well as our new business opportunity. But I would actually say we got a little bit of bump on our new business side from a licensed software perspective. And having some of those larger opportunities and winning at those larger opportunities, you tend to have a little bit bigger software pieces. So the ones that I mentioned were more significant, but I think that's reflective of what we see in the marketplace. But there was not any single transaction that made a big difference there.

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Michael R. Nill - *Cerner Corporation - COO and EVP*

That's still broad-based. Still significant sales back into the base. But really no one solution or no specific group of solutions were notably bigger than the others.

Operator

Our next question comes from the line of Jeff Garro of William Blair & Company.

Jeffrey Robert Garro - *William Blair & Company L.L.C., Research Division - Research Analyst*

I wanted to touch on Mike's discussion on Cerner Advance and continuous availability. If I'm interpreting that correctly, it seems tied to cloud capabilities or remote hosting. So maybe you could update us on the overall penetration of hosting services and how we should think about whether clients are adopting hosting so they can take advantage of these additional capabilities or if they're adopting hosting on a standalone value proposition and then discovering everything else that they can do to their benefit.

Michael R. Nill - *Cerner Corporation - COO and EVP*

This is Mike. Actually, they are related topics, but there are some distinctions between the 2 as well. Cerner Advance was really developed to allow us to capture data at a very granular level about the use of our system. And then through our analytics, we can then drive back across the entire client base, recommendations for improving the use and effectiveness of our solutions. Now if you tie that to -- and that advantage can be realized, whether you're hosting, whether we are hosting the system for them or not. But if we look at our hosting capabilities today, probably 75% to 80% of our clients run out of our data center, and all new deals are within that model. And you are correct that we do have an advantage when we run those systems. We have the ability to keep our clients current, refresh their software more easily with less effort and allow them to drive the value more quickly. So it doesn't necessarily have to be cloud-based. It's just the fact that by operating it within our environment, we can do things that maybe wouldn't be -- they couldn't do on their own. So it is a huge advantage that we leverage significantly.

Jeffrey Robert Garro - *William Blair & Company L.L.C., Research Division - Research Analyst*

Great. And if I can squeeze one in for Marc. Wanted to ask if there's any update to metrics you've given before on revenue visibility like the percentage growth needed from bookings for the year or amount of revenue for the remainder of the year coming from backlog that enhances your visibility on the forward outlook.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, usually, that's -- those are data points, Jeff, that we provide at the beginning of the year to kind of give you a sense when we're providing an annual guidance. We don't update those throughout the year. Obviously, when you get -- go from 12-month view to a 90-day view, the visibility is a higher percent than what we have talked about coming from backlog earlier. But we do not update those during the year.

Operator

Our next question comes from the line of Donald Hooker of KeyBanc.

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Donald Houghton Hooker - *KeyBanc Capital Markets Inc., Research Division - VP and Equity Research Analyst*

I was curious, when you talk about large ITWorks in the pipeline, if you could help kind of size what that means. And in terms of -- this might be a tough question to answer, but -- because I know it will range widely, but what is a typical run rate, revenue run rate of a "large ITWorks contract"?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

This is Marc. It's really hard to give you an average because we have 25 clients now, and they even range within that -- within their universe. And that is probably 25 clients that are kind of at the lower, lower end. I mean, if you're looking kind of what a current client in that current range is, it's probably $20 million a year, which includes not only their ITWorks components but all the revenue coming from that client, which would be licensed software support all of the elements. So we combine all those. Once an ITWorks deal is done, the ITWorks team owns that client regardless where the revenue is coming from. So that gives you -- that kind of gives you a sense of what's in the current base. As we look forward, you have some that were that size, you have some that could be 5x that size. So the opportunity -- when we talk about bigger ones, we're talking about multiple opportunities that could be multiple, bigger from an annual revenue standpoint when you do this all-inclusive view. So that's -- for us, that's kind of the next step once we've gotten the standalone or smaller clients, trying to move it up scale. And as Zane said, the current environment of people focusing on cost is making them consider doing an outsourcing where they might not have before, once again, why the industry really doesn't have a history of outsourcing. We're not going to compete against an existing outsourcer.

Donald Houghton Hooker - *KeyBanc Capital Markets Inc., Research Division - VP and Equity Research Analyst*

And when you win these deals, it takes time for that revenue to kick in, I understand. How late this year is sort of the cutoff for a deal sort of impacting 2018 as we start thinking about ITWorks possibly rebounding in '18?

Zane M. Burke - *Cerner Corporation - President*

This is Zane. I'd say there are implications in the current quarter of signing. So you do see positive earnings and revenues from ITWorks in the quarter to sign. It obviously, depends on what point in the quarter that does happen. But it's more of a run rate that's begun once that opportunity is completed.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Usually, these deals, you sign and re-badge simultaneously because it's all part of the communication process. So really, the month you sign it is the first month that, that sequential revenue comes. So you can, if you sign stuff in Q2 and Q3, it will have a fairly full Q impact beginning in the next quarter.

I want to thank everyone for being on the call today. Appreciate it. I know you guys got lots to do, so I will let you go. Have a good day. Bye.

Operator

Ladies and gentlemen, thank you for participating in today's conference. That does conclude today's program. You may all now disconnect. Everyone, have a great day.

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