THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

CERN - Q2 2018 Cerner Corp Earnings Call

EVENT DATE/TIME: AUGUST 02, 2018 / 8:30PM GMT

OVERVIEW:

Co. reported 2Q18 revenue of $1.368b and GAAP net earnings of $169m or $0.51 per diluted share. Expects 2018 revenue to be $5.325-5.450b and adjusted diluted EPS to be $2.45-2.55. Expects 3Q18 revenue to be $1.335-1.385b and adjusted diluted EPS to be $0.62-0.64.

THOMSON REUTERS

CORPORATE PARTICIPANTS

David Brent Shafer *Cerner Corporation - Chairman & CEO*

Marc G. Naughton *Cerner Corporation - Executive VP & CFO*

Zane M. Burke *Cerner Corporation - President*

CONFERENCE CALL PARTICIPANTS

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

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

Eric R. Percher *Nephron Research LLC - Research Analyst*

George Robert Hill *RBC Capital Markets, LLC, Research Division - Analyst*

James John Stockton *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

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

Lisa Christine Gill *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

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

Michael Aaron Cherny *BofA Merrill Lynch, Research Division - Director*

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

Robert Patrick Jones *Goldman Sachs Group Inc., Research Division - VP*

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

PRESENTATION

Operator

Welcome to Cerner Corporation's Second Quarter 2018 Conference Call. Today's date is August 2, 2018, 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, solution, services and new offering development and future business outlook, including new markets or prospects for the company's solution 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 except as required by law.

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

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Thank you, Shannon. Good afternoon, everyone, and welcome to the call. I'll start with a review of our numbers. Zane Burke, our President, will follow me with results highlights and marketplace observations. And then Brent Shafer, our Chairman and CEO, will provide closing remarks.

Turning to our results. Overall, we had a solid Q2, with all key metrics coming in at or above our expectations. Our bookings in Q2 were $1.775 billion, which reflects a 9% increase over $1.636 billion in Q2 of '17. This is well above the guided range we provided, largely due to the initial task orders for the Veterans Affairs contract that was announced in May. Note that while the total contract opportunity is $10 billion over 10 years, the impact to our bookings, revenue and earnings will be phased in over time as individual task orders are executed during the various phases of the project. With the initial task orders signed in Q2, we are positioned to achieve the expected contributions from the contract in the second half of the year that we discussed on our last call.

We ended the quarter with a revenue backlog of $14.79 billion. Recall from our Q1 earnings discussion that the backlog calculations changed with our adoption of the new revenue standard. So it is not comparable to prior year periods.

Revenue in the quarter was $1.368 billion, which is up 6% over Q2 of '17 and above the high end of our guidance range.

I'll now go through the business model detail and year-over-year growth compared to Q2 of '17. Licensed software revenue was $172 million, up 11%, primarily due to strong license software bookings in the quarter. Tech resale increased 3% to $75 million. Subscriptions revenue was $83 million in Q2 of '18, down from $119 million in Q2 of '17 but up 8% from $77 million in Q1 of '18. Recall that our comments last quarter that subscriptions were impacted by our adoption of the new revenue standard, which reduced subscription backlog and also led us to classifying a portion of subscription revenue as support.

Professional services revenue grew 13% to $447 million, driven largely by growth in our works businesses. Managed services increased 9% to $286 million. Support and maintenance was up 7% to $279 million, reflecting our expected low single-digit growth plus the previously discussed impact of the new revenue standard. And finally, reimbursed travel was $25 million, which is down 5%.

Looking at revenue by geographic segment. Domestic revenue was up 4% from the year ago quarter at $1.202 billion, and non-U.S. revenue of $166 million increased 22% from the year ago quarter.

Moving to gross margin. Our gross margin for Q2 was 82.5%, which is up from 82.1% in Q1 of '18, down slightly from 82.7% a year ago.

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, and acquisition-related adjustments, all as detailed and reconciled to GAAP in our earnings release.

Looking at operating spending. Our second quarter GAAP operating expenses of $921 million were up 12% compared to $820 million in the year ago period. Adjusted operating expenses were $873 million, which is up 13% compared to $771 million in Q2 of '17.

Looking at the line items. Sales and client service expense increased 14% over Q2 of '17. This increase was primarily driven by an increase in personnel expense related to our services businesses, including the hiring of Adventist Health revenue cycle staff and hiring additional revenue cycle staff in Kansas City. Software development expense increased 18%, driven by a 7% increase in gross R&D, a 26% increase in amortization and 4% less capitalized software. G&A expense was up 4%, and amortization of acquisition-related intangibles decreased 53% year-over-year.

Moving on to operating margins. Our GAAP operating margin was 15.2% compared to 19.3% in the year ago period, and our adjusted operating margin was 18.7%, down from 23%. The year-over-year decline in operating margin is consistent with our guidance, which reflects items we have discussed, including the higher growth of noncash expenses, investments in our works businesses and an increased mix of works revenue. We do continue to believe that many of these factors are temporary in nature, that we can begin to expand margins in 2019.

Moving to net earnings and EPS. Our GAAP net earnings in Q2 were $169 million or $0.51 per diluted share compared to $0.53 in Q2 of '17. Adjusted net earnings in Q2 were $207 million, and adjusted diluted EPS was $0.62 compared to $0.61 in Q2 of '17. Our GAAP tax rate for the quarter was 21%. Our non-GAAP tax rate was also 21%, which is slightly below our tax rate in Q1.

We'll move to our balance sheet. We ended Q2 with $1.004 billion of cash and investments, which is down from $1.093 billion in Q1 of '18, primarily due to use of cash for our stock repurchase program.

During the quarter, we repurchased 3.4 million shares of stock at an average price of $58.75 per share for a total of $200 million. We currently have $639 million of remaining authorization under our repurchase program after our board increased authorization amount by $500 million in May.

Moving to debt. Our total debt, including capital lease obligations, was $441 million, which is down from $446 million in Q1 of '18. Total receivables ended the quarter at $1.152 billion, up from $1.041 billion in Q1 of '18. Our Q2 DSO was 77 days, which is up from 73 days in both the year ago period and Q1 of '18.

Operating cash flow for the quarter was $300 million. Q2 capital expenditures were $109 million. Capitalized software was $69 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $121 million for the quarter.

We continue to expect strong operating cash flow for the year to more than offset the increase in capital expenditures, leading to another year of strong free cash flow.

Now I'll go through guidance. We expect revenue in Q3 to be between $1.335 billion and $1.385 billion, with $1.360 billion midpoint, reflecting growth of 7% over Q3 of '17. For the full year, we continue to expect revenue between $5.325 billion and $5.45 billion with the $5.388 billion midpoint, reflecting 5% growth over 2017. We expect Q3 adjusted diluted EPS to be $0.62 to $0.64 per share. The $0.63 midpoint is $0.02 higher than Q3 of '17. Note that while consensus EPS for the year is in line with our annual guidance midpoint, consensus estimates reflect a different quarterly ramp. So our Q3 guidance range is below the current Q3 consensus.

For the full year, we continue to expect adjusted diluted EPS to be $2.45 to $2.55 with a $2.50 midpoint reflecting 5% growth over 2017.

Moving to bookings guidance. We expect bookings revenue in Q3 of $1.45 billion to $1.65 billion. The $1.55 billion midpoint reflects a 40% increase compared to Q3 of '17, which was our lowest bookings quarter of 2017.

In summary, we are pleased with our solid performance in Q2 and our 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. Good afternoon, everyone. Today, I'll provide color on our results and make some marketplace observations.

I'll start with bookings, which grew 9% over a strong Q2 2017 and was well above our guidance range. In Q2, the percent of bookings from long-term contracts was in the normal range at 35%. Multiple large transactions contributed to our bookings this quarter with a record 7 contracts over $75 million. We're also pleased with the quarter from a new business standpoint, with 31% of bookings coming from outside our core Cerner Millennium installed base, including a noteworthy win at a large academic medical center. This quarter included broad contributions across several areas that reflect the diversity of our offerings and end markets. We had good results from almost all our solution and service categories, large and small clients, U.S. and non-U.S. geographies.

Starting with smaller venues of care. Our ambulatory business had a strong quarter, driven by ongoing penetration in the ambulatory settings of our large health system clients as well as adding a large independent provider. In the small hospital market, our CommunityWorks organization continues to execute well, adding multiple new footprints and delivering strong sales back into our base.

Moving to revenue cycle. We had a good quarter, driven by revenue cycle inclusion in many new EHR business and selling back into our base as our existing clients continue to migrate from legacy systems to Cerner Millennium. Operationally, we are seeing early returns on enhancements we have made to our revenue cycle implementation methodology. Our approach includes more upfront assessments to identify potential implementation challenges and enhanced pre-project design approach, conversion readiness assessments and post go-live monitoring and transition services.

We also had good contribution from Cerner ITWorks, including a new ITWorks client, scope expansion with existing clients and good sales back into our ITWorks base. We have a strong outlook for the rest of the year, with several more ITWorks contract forecasted.

Next, I'd like to provide an update on our federal business. Starting with the Department of Defense MHS GENESIS project. The optimization efforts we have discussed have led to many improvements in access and efficiency at our initial sites, and we remain on track to begin the next wave of implementation later this year. In addition, DoD announced last week that they are increasing the contract ceiling for MHS GENESIS by $1.2 billion to include the Coast Guard and expanded the scope of solutions and services.

Moving to the Department of Veteran Affairs. As Marc mentioned, we signed a contract in May with the VA as the prime contractor to replace the VistA system, with one built off of the EHR we are deploying across the military health system. With VA managing one of the largest health care systems in the country, we believe there is great potential for broad industry impact. At the core of this project, Cerner will enable seamless care through a single system that links both veteran and military populations totaling more than 18 million people while also delivering national interoperability to the commercial market. This will allow patient data to be shared between VA, DoD and community providers through a secure system. We also expect to accelerate our efforts in population health, open platforms and telehealth, all of which have relevance to our commercial client base.

We view this opportunity as a great honor. And we believe we are well positioned to successfully deliver based on our experience with the Department of Defense project, our own delivery capabilities and capable partners.

Moving to our business outside the U.S. We had another strong quarter with 22% revenue growth. Bookings were also a highlight, with noteworthy contributions from the Middle East and U.K. Looking ahead, we can expect to have a good second half of the year, with Australia, Canada, Middle East and Europe, all forecasted to provide solid contributions to our growth.

The last topic I'd like to cover is population health and our recently announced collaboration with Lumeris. We had strong sales of HealtheIntent solutions to both new and existing clients in Q2. There continues to be steady progress towards value-based care models, which is a key driver of our population health sales. We also continue to have success at selling HealtheIntent to clients that aren't yet fully moving to the value-based care models because of the platform's ability to help clients optimize fee-for-service models while also preparing them for the shift to value-based payments.

Now I'd like to tell you a little bit more about what we're doing with Lumeris, which we believe will strengthen and expand the scope of our offerings and contribute be meaningfully to our longer-term growth. Lumeris is a John Doerr-backed company with a consistently highly rated Medicare Advantage plan, a proven methodology to help leading health systems advance value-based care strategies and the subject matter expertise required to support those efforts.

We are launching an EHR-agnostic offering with Lumeris called Maestro Advantage. That will be designed to help health systems set up and manage Medicare Advantage plans, provider-sponsored health plans and other risk-based arrangements. Additionally, Lumeris will adopt Cerner's HealtheIntent as the platform for its clinical methodology and advanced analytics, which will be the core to the operating model for Maestro Advantage to help drive better patient outcomes and lower cost of care.

We believe this offering, which will combine solutions and services from Cerner and Lumeris, will be differentiated in the market in several ways. We believe it will be the most comprehensive technology and service offering that leverages the experience of a proven 4.5-star Medicare Advantage plan. It will provide connectivity across the provider, health plan, and consumer and will be designed to improve outcomes and lower costs by embedding actionable insights inside provider workflow. It will include a unique, accountable care clinical model that supports a health system's development of a high-performing integrated delivery network and share savings with providers through value-based incentive alignment. And finally, this offering is differentiated by Lumeris' long-term strategic partnership with Mutual of Omaha to deploy Medicare Advantage plans nationally utilizing Lumeris' collaborative payer model and Mutual of Omaha's marketing distribution and funding.

While there's a lot of work ahead to realize the full potential of the Cerner-Lumeris collaboration, the value proposition at the outset is high. For Lumeris, that means aligning with an industry-leading technology partner that can bring national scale to their proven model. It also gives access to our leading health system client base, increasingly looking to Medicare Advantage as part of their value-based care strategies.

For Cerner, we gain a partner with a 4.5-star Medicare Advantage plan to build out the end-to-end capabilities required to run a provider-sponsored health plan within HealtheIntent, an opportunity to be a larger participant in the per-member-per-month economics within the provider-sponsored health plan space and a new point of market entry into non-Millennium leading health systems.

As most of you know, a major trend playing out on the provider supply side of health care is the creation of MSA-level health networks to advance existing and new business models. We believe Cerner is uniquely positioned to activate these intelligent health networks at a national level. With this collaboration, we are taking another step towards fulfilling Cerner's long-held desire to be a change agent within the traditional U.S. payment model, which we believe is filled with hundreds of billions of dollars of inefficiencies and massive consumer dissatisfaction. If we deliver on a better provider and consumer experience, we will disrupt a category in significant need of change.

Lastly, I wanted to highlight that this relationship also includes Cerner acquiring a minority interest in Lumeris' parent company, Essence Group Holdings Corporation, for $266 million. We believe this is a good use of capital as the relationship and investment speeds our entry into tech-enabled service related to the value-based care, broadens and strengthen our population health offering and increases our addressable market.

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

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

Thank you, Zane. Good afternoon. I'm going to offer some closing observations on the second quarter on Cerner as a whole, and on our recently announced collaboration and investment in the Medicare Advantage space.

Over the course of the last 90 days, I've had the opportunity to spend time with over 100 health system leaders, including many at our annual CEO event. It's been a chance to listen and learn.

While health system CEOs are all dealing with unique issues in their respective markets and organizations, there are definitely some common themes. They are looking to grow key service lines, drive operational efficiencies on the expense line in order to make money at Medicare rates and to navigate the uncertainties of risk-based contracting. They believe technology and data-driven process change are critical to success factors, and they see Cerner as a critical partner for success.

While I don't have all the answers 2 quarters into my tenure, there is a set of things I know will be core to Cerner's success in the years to come. We are going to be obsessively focused on our clients' success. We will develop solutions that deliver the best possible experiences and outcomes. We will continue to be a transformative growth company focused on delivering on the top and bottom line.

Our leadership team isn't content with where health care is today, and we see opportunities for Cerner to make it better. We have a growing, diverse client base. We have a suite of technologies and services to solve provider business challenges. We have an amazing culture filled with tens of thousands of talented associates with ambitions to take Cerner well beyond the scope of where our business is today.

In my conversations over the last several weeks, I've been struck by the number of CEOs that have mentioned our collaboration and investment in Lumeris. They're excited to see us partner with an organization that has a 4.5-star Medicare Advantage plan. They're pleased our HealtheIntent platform will be core to the operating model for the combined market offering, and they're excited about the leverage they will get from their existing Millennium investment as they build out their value-based care strategies.

We are in an enviable position with a balance sheet that allows us to invest for success in the current EHR market while also investing in new markets beyond it. Based on the ongoing work we've been doing as a leadership team to assess the marketplace and growth opportunities, I believe we will identify other opportunities to deploy capital in ways that support our growth strategies. I believe this deployment of capital, along with our ongoing share repurchase program, represents a balanced approach to capital deployment that supports our long-term growth while also returning value to shareholders in the near term.

And I want to congratulate our team on a solid second quarter. And I'll now turn the call over to Marc and the moderator.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

I think we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Robert Jones with Goldman Sachs.

Robert Patrick Jones - *Goldman Sachs Group Inc., Research Division - VP*

Marc, you mentioned the bookings coming largely above the guidance range, driven from the VA. Can you maybe just share a little bit more context on how the bookings fared outside the VA? Just curious maybe where you saw traction away from that key client.

Zane M. Burke - *Cerner Corporation - President*

Robert, this is Zane. I'll take it and let Marc clean up my story here. But what I'll first say is without the VA, we finished just above the highest end of our guidance range without the VA. So we saw incredibly strong growth across global, across our population health solutions and our core market -- EHR marketplace, both with a significant win at the academic site, as I mentioned in my prepared comments, as well as in our community offerings. So broad-based with that, we had our ITWorks clients that did well, this client as well as additional rev cycle, and the RevWorks business. So we saw kind of broad-based elements both globally and here at home in the U.S.

Operator

Our next question comes from Matthew Gillmor with Robert Baird.

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

I wanted to ask about the margin outlook in some of the comments Marc made. And I was hoping you could get us oriented for '19. With the headwinds impacting the margins this year, is there an opportunity for you to be above the high end of the 30 to 60 bps range? Or would you encourage us to stay within that range?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Well, I think -- this is Marc. Obviously, for 2019, we're kind of just starting the planning process for that year. So it's a little early to provide anything that's more granular relative to that. I think we've talked about the ability, that once we get through this significant investment year, to be able to look at 30 to 60 basis points growth beginning in 2019 while certainly our starting point through that growth is going to be a little lower than it was in the beginning of the year, that's our best view. Obviously, we'll update that in the Q3 call when we start getting the kind of the first returns on our 2019 plan. But at this point, I would kind of still hold it in the 30 to 60 range until we can give you a little bit more visibility.

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

Got it. And one quick follow-up. When do you expect the next task order for either the VA or the DoD? Just trying to understand when that will hit bookings next.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

We'll try and give you some visibility to the extent we can, but those task order, we got to -- the first set of task order that usually carries you forward for a little while. So it will be dependent on the projects and when the next set of services and solutions need to be delivered. So that's kind of -- that's about all we can provide from a view on that.

Operator

Our next question comes from Lisa Gill with JPMorgan.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

Just going back to your comments around the relationship with Lumeris. How do we think about that overall size of that market opportunity? Is it -- we think about it, HealtheIntent, we think about it, the new Maestro Advantage EHR? Or do we think about you taking on risk over time as we think about value-based care? Just trying to get my arms around how to think about and size that market opportunity for Cerner specifically.

Zane M. Burke - *Cerner Corporation - President*

Lisa, this is Zane. So first off, I think what you would say is, yes to obviously it's a HealtheIntent play. But really, the broad elements of this are, this is a higher PMPM marketplace that allows us to move from where we've been just a technology only play in the $1 to $5 PMPM on an aspirational basis to play more in the nature of being upwards of $100 PMPM. Now we'll share that Lumeris, at this point, has the largest bulk of the offerings and the services that will be provided in that area but allows us to play at a much higher PMPM basis, bring all the attributes of what we do from a HealtheIntent perspective, bring the things to bear that Lumeris has, and then we'll go create some new offerings together.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes, and this is Marc. I think, financially, you look at kind of going from, as Zane said, $1 to $4 PMPM for technology to probably $15 to $20 PMPM would be kind of what we would work to develop as we deliver on these clients. Anything relative to a success factor or fee would be on top of that. So we're not going at risk from a negative standpoint. We are putting some of the economics at risk that we will deliver. Certain performance, and that performance will then be additive to a $15 to $20 PMPM once we get fully ramped up. So you know, you can gauge the market however many million PMPMs you wanted to use, but it's obviously significant. When we look at, going forward, kind of on our 10-year model, if you will, and kind of $1.8 billion that we're looking at, the key is that it's not additive. This is part of the strategy for that $1.8 billion. This business by itself would be 25% to 30% of that number by the time we get to that point. (inaudible) for us what we think the ability to deliver an impact on our financials is.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

And then, Marc, just so I understand, as Brent made a comment that as you think about your balance sheet and supporting your growth strategies, do you have what you need today to be able to support this growth that you talk about over the 10 years? Or do we think about internal investments? Or is it more M&A activity that you'll have to go out and procure certain products to be able to deliver on this?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. No, I think the Lumeris investment is a great example of taking technology we've created, skill sets we're developing, but then finding a partner where we can go faster with the development. We can go faster to the marketplace. We can get to those revenue dollars over a time frame. I think that applies to the other businesses as well. So you'll see us both investing internally, as always, it has been our history. But you'll also see us identify areas that could grow to be $100 million businesses. And maybe there's an opportunity to do an acquisition that gives us started doing that business and gets us to that $100 million level in a shorter period of time. So I think we're not -- certainly not going away from investing internally. That's our key strategy, and that will continue to be our key strategy. But we have a strong balance sheet, and I think Lumeris investment shows that we're willing to use it to support our growth strategy.

Operator

Our next question comes from Charles Rhyee with Cowen.

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

Just want to follow up -- continue on Lumeris here. Can you -- in their current MA plans that they're offering, can you remind us how many lives they're currently managing? And then also -- this is kind of moving you further up the sort of the value chain here. Certainly, a little bit of the departure from your legacy business. But as you think about longer term, as we move to value-based share, does this make you kind of think about maybe what the next generation of Millennium looks like? How do you see the EHR itself having to be redesigned as you think about more of an outcomes-based model of care?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Well, that was a simple question, Charles. I think the -- certainly, from a Lumeris standpoint, obviously they run a health plan that's -- today, and in -- you can certainly kind of get the sense of how big that health plan is. The opportunity here is really to go help our clients and nonclients who are going down the path certainly on -- in the medicare advantage space, prepare themselves for value-based care and ultimately, for taking risk. And I think this -- we see that market coming. It hasn't come as fast as we originally thought. And I think for most people in the selling population health solutions. But I think this will get us -- allow us to be ready when that market hits to have the premier solution that's available in the marketplace. I think from a -- how does this relate to our traditional EHR business? It obviously is key to what we're going to do with Lumeris. It's gathering the data from a variety of different EHR. So the interoperability we built into the Millennium and is into -- built into HealtheIntent, the ability to pull data from Millennium, the ability to push alerts and information back into electronic medical record that can impact the care that the patient is -- and the person is receiving while they're in front of their physician rather than getting a text message or an e-mail later. All of that is contextual to really being able to move the meter on the health of the population. So (technical difficulty) intertwine, Millennium, as it is today, is a perfect conduit for us to leverage in those in that HealtheIntent, as we've discussed, lays over-the-top of not only Millennium, but any EHR. And that's the part of the strategy is that's kind of a cloud-based option today is -- Using that should pull all the data from all those different solutions.

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

And if I could just follow up. From an accounting standpoint, from a reporting standpoint, are you consolidating all the premiums and then you take back out? Or like can you talk about sort of the order substructure? How this joint venture will look like? Is it going to -- are they going to be booking the -- all the revenues and you're just going to be getting sort of a minor interest? How should we think about the bookkeeping of it?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. Let me -- just to break into 2 parts, we made investment in Lumeris that's less than 20%. So that will have no impact on our income statement. To the extent we go to market, how it gets reflected in our income statement will depend on how the -- whose -- is it -- are we basically the prime, is Lumeris the prime? Are we -- is it all running through us? Is it all running through Lumeris? All of that will determine kind of where the revenue sits. But certainly, initially, a lot of the work there is going to be things that are components of the project because we're talking with an aspiration to get to 20% of those dollars. Initially, we start -- we're not going to be at that level. I'd also remind you that the ramp-up here -- when you're talking about creating and helping people create plans, that's a very cyclical business. It really hits at the back half of the year. So a plan can be stood up and operate the following year. So really until we get to 2020, 2021, you're not going to see a material impact on the financial statements for this. This is a longer-term investment. But when it hits, it's going to be significant.

Operator

Our next question comes from James Stockton with Wells Fargo.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

I guess maybe the first one, Marc, real quick. The strong license revenue during the quarter, was there anything notable from the VA in that number?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

No. No. It was -- once again, the expectation was that the VA wouldn't have a big impact on the quarter. And we delivered on that expectation.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

All right. That's great. The sales and client service expense did ramp pretty notably sequentially. And I caught your -- I think it was your comment that you guys -- you're hiring up in the Works business in general, but you also were taking on Adventist employees. Can you talk about whether there's been a really tight match of when you've taken on -- maybe specifically the Adventist contract, when you've been taking on the expenses versus when the revenues really flowing through -- and maybe outside of this, the rest of the Works business, what your expectations are there? Because it seemed like there was a big step-up in expenses this quarter, but not necessarily a big step-up in revenue. So, I'm kind of curious like has the revenue step-up already happened? Or are we going to see it in the future? Any color around that would be great.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes, Jamie. Good question. Last -- in Q1, basically, we were in the -- we were running Adventist revenue cycle. So all that activity was already occurring. Under the 605 of the older rev rec rule, all we could recognize is the net margin that we would received on that. Under 606, since we are controlling -- the employees that were doing the work, the revenue actually flowed into the top line of our income statement. But the cost went into the cost of goods sold. This quarter, the revenue is still in the main number, but now the costs have moved down to the expense line. So that that's -- the vast majority of the expense increase you saw is basically just moving that expense out of cost of goods sold and down to that line. And you see that in -- when you look at the -- some of the -- a little bit of the impact on gross margins. Clearly, on the expense side, we did have -- we are investing in RevWorks in the Kansas City billing office as I think we're up to 400 associates now that we brought on board to work in that space. We had some expenses related to the VA as we talked about in Q1. Q2, we're not getting paid for those either, but they're -- but we have those expenses. And even when you look at the net -- the software cap, the net software cap rate was 9% versus 13%. So that going down and amortization impact had an impact on expenses as well, which we've kind of talked about before. But the biggest impact was the moving of the Adventist people down to be our associates and the expense -- operating expense as opposed to being cost of goods sold.

Operator

Our next question comes from Mohan Naidu with Oppenheimer.

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

Zane, Marc, on the nonfederal business. If you can parse out the upsell between -- to your existing customers versus new market share gains, what are you seeing that excites you in both these segments? And is there a worry for potential slowing of spending within hospitals as they try to figure out what they need to do for these value-based models?

Zane M. Burke - *Cerner Corporation - President*

Yes. So Mohan, this is Zane. I think what we're excited about is, first off, that we actually had such strength across all the bookings elements. And I think what we're seeing in the U.S., in particular, is there is still a need for efficiencies and scale and for -- that drives a lot of our Works offerings, so both our ITWorks, RevWorks. So those pieces of our business, we're seeing good growth in that space. New marketplace, it was -- it's continuing strength in the community hospital marketplace. But we had a -- we sprinkled in a very significant, large academic medical center. And so we're seeing our competitiveness be very good in the replacement EHR market. So there's still a strength. There's still quite a bit of activity in the replacement EHR market. And many of those are community hospitals, so they tend to be a little bit smaller. But the activity levels are still very high. And while we had our highest Q2 in the history of the company for bookings, we also had a growth at the bottom line at the same time. So we're seeing continued strength in the business across kind of all metrics at this point. And I think success is really in the execution and driving value for our clients. And so ultimately, we feel like the closer we're tied to the outcomes of our clients and -- the more that we continue to drive towards helping them scale and to succeed and thrive in the future that we see continued growth opportunities. And I think that's reflected in our results and reflected in our pipeline and the activities as we move forward.

Operator

Our next question comes from George Hill with RBC.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

I guess, Zane, my first question would be around the deals over $75 million in the quarter. They're pretty large there, I guess. Is there a characterization of what those customers typically tend to buy or what they look like? Or is it spanning the range from kind of new footprints to Works' deals to -- I would just kind of love to hear about what's going on in the big check size category.

Zane M. Burke - *Cerner Corporation - President*

I mean, it's a great question, George. And it actually is a full box of chocolates and it's a -- and they're all very desirable. And so when I'd look at them and say, what you saw -- obviously, our federal business is very strong in the quarter. But you saw our IDN business where -- major IDN who's looking to scale and grow in their markets, investing, doubling down on Cerner in the future, you see an investment by clients that are new ITWorks client in that space, you see that new academic medical center in that space. So again, it was quite a very strong quarter from a diversity of what was driving those activities. Most all of those are around how do I grow and scale into the future. And I think that's really how you have to think about it.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay. And then maybe a quick follow-up. I'm going to ask one more on Lumeris. I guess how do we think about how that relationship fits into, I guess, your other relationships? And I'm thinking competitively, Centene and Ascension announced a partnership this week on -- you guys are working with Lumeris. Do you envision it where you and Lumeris eventually wind up competing against the likes of Centene Ascension? Or you guys in the back end -- and building -- helping build out Cerner Ascension? I'm just -- I'm trying to figure out like how you guys think of the pieces put together.

Zane M. Burke - *Cerner Corporation - President*

Yes. So here's how I'd look at it this way, George, we see that there's an opportunity for growth across multiple service lines, across multiple areas. And I'd probably add just to -- I'm not going to compare and contrast what Centene is doing with what we're doing. But what I'd say is our relationship with Salesforce, for example, there's some significant business needs to accomplish that for our clients and to help them succeed as world changes and as we'd all work to empower the consumer of the future and that we're going to partner with certain organizations to create that experience where we help them empower health care in a different way. We're, in this case, partnering with Lumeris to deliver our services offering that's based off our technology and their market-leading services and their Medicare Advantage plans. And I think you're going to continue to see us do that type of activity where we bring the biggest scale and really use Cerner's platform moving forward to be the world's most innovative platform -- health care platform. And that's really the way that we think about it. And we'll have to get into the competitive environment of each one of those scenarios as we move forward. And we're thinking about those thoughts very carefully. We don't want to be on the opposite side of our clients. We want to be on the same side as our clients as we move forward.

Operator

Our next question comes from Michael Cherny with Bank of America Merrill Lynch.

Michael Aaron Cherny - *BofA Merrill Lynch, Research Division - Director*

Diving back into the margin question, some of the direct service costs. As you get more experience in some of the large works and large consulting contracts, how do you think about any of the leverage if you can get it on the back-end costs, whether you can spread more of it over the RevWorks side or the ITWorks or whatever it might be so that going forward, there is a little more predictability in some of those margin targets I know, Marc, you want to hit?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes, Michael. Clearly, the concept on the Works businesses is to get scale and then to drive efficiencies into those businesses. One of the things you're already seeing as we were investing this year in creating a 600-person Kansas City-based business office that we'll run at a much lower cost than some of the regional -- business locations that were already using the support clients. So that's why -- what we can look at bringing costs down. Certainly, we're going to look at any of our option. We have a large India presence. So there's a chance to be able to leverage some of those people that we have in some of the businesses as well. So it's -- the whole focus of these businesses from a service component is how do I get leverage? How do I -- in RevWorks, it's how do I get lower costs humans, and the second set is how do I take this technology we've created and clinically driven revenue cycle and use automation, adding in AI, to be able to significantly reduce the amount of human touches that are required to actually get paid in this environment. So I think all of those things are future opportunities for efficiencies. We're at a point where we're trying to grow these businesses. We're trying to capture that business. These are dollars that they're spending today that we're trying to have them redirect to us. Once we get those captured, then we'll start worrying about them becoming more efficient at it. And that's not any different from our hosting business, when we started that out, we were at single-digit mark. And now we're well over 30%. So I think it's a similar thought. Maybe it doesn't get to over 30%, but that's the same goal that we're striving for.

Operator

Our next question comes from Jeff Garrow with William Blair and Company.

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

I want to ask about Adventist. Marc talked about the bookkeeping a little bit there, but maybe more of a substance hit. Thinking about how the progress is going against the plan for the year and just let -- the impact of them being a RevWorks and a partial ITWorks client, and then how do -- we can start to think about that impacting the more fully outsourced RevWorks pipeline.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Well, you broke up a little bit on the question, but I think it was basically how is that an Adventist impacting the year. Clearly, we anticipated the impact of 606 coming in the year, we knew that we would recognize the revenue from that client fully in our revenue and then have the costs coming in either cost of goods sold or now in our expense line. It hasn't changed our revenue guidance. It's not -- it was all baked into our original guidance. So I think that's pretty consistent with the numbers we've been sharing as how it's going to impact this year. The good news is it's going to continue to impact future years as a recurring level of revenue that is going to be underneath a very long-term contract. So it will continue for some time.

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

Great. And then the follow-up. I was actually hoping for also a little bit more on the substance of the relationship and achieving greater value for that, where you're progressing there. And then how we can think about that relationship impacting the more fully outsourced RevWorks pipeline.

Zane M. Burke - *Cerner Corporation - President*

Sure. This is Zane. So the projects have been going extremely well. We've been delivering against our objectives. It's -- I think that's Marc's view of performing against plan. So I'd just say it's gone very well. I think we have -- from a value creation office, we've been hitting several tens of millions in the value-creation office in terms of our value that we're driving together on an annual basis. And so the management team on that side is very happy with where we are. And I think that will lend itself to additional opportunity. There's not a hard code in for hit this objective and then it creates the next trigger event. But success here will help us beget more success, both with Adventist as well as obviously throughout the marketplace because this is central to how we're thinking about -- of the entire marketplace, which is add -- create value together with our goal to be closer to the strategies of our clients overall. And Adventist is a really good example of one where we're driving value together. And we've seen continued growth and trust placed in Cerner to perform and execute on the services side of that. And I would anticipate that will help us both with Adventist as it relates to additional services offerings as well as other clients who we're closely watching to see what happens here and how we perform over time.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. Jeff, this is Marc. We talked about them being kind of our cornerstone client for this business. The fact that they rebadged all their associates to Cerner in Q2 is a big statement by them on -- in their trust on us to deliver. We're focused on reducing their costs to collect. We need some -- get some time and delivery on those targets to be able to prove to people that we can do this at a large scale. So we're in that process. It's going well, but it's going to take -- it takes some time. Rebadging was a big milestone for us.

Operator

Our next question comes from Eric Percher with Nephron Research.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

So Lumeris, and your willingness to deploy capital for growth opportunities, seems very significant. I understand Lumeris -- the agreement with Lumeris occurred over a very long -- or a fairly long period. I'd welcome perspective on how that -- how the transaction came to be and whether you think that's a path you should typically follow or if Brent's comments around using the balance sheet suggests a increased awareness of other potential opportunities to put capital to work?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Yes. I mean, I think from my perspective, Lumeris was a little bit unique, right? We started working with them figuring out -- hey, this is pretty cool. We like -- we want to be in this Medicare space, and we think it's a sweet spot as people start going to take risk, and we went around and said, "who's the best?" In our opinion, it's -- Lumeris having the services component and actually running a 4.5-star plan, which is kind of a big deal, caught our attention. So we spent a lot of time just kind of meeting with the people, understanding what it would take, how would we leverage our technology and our service offerings to be effective in that space. And as all those conversations kept going, it kind of evolved from, "Hey, we should work together," to, "Hey, maybe we could use some of your tools." And that's why that one took quite a while. I think if we look at other maybe smaller levels of capital deployment to help us jump-start the growth in an area that we think is a potential for growth, I think those can occur more quickly. But I think we're still a company that likes to invest internally. But I think it's also -- we are also -- we're looking at our balance sheet saying, we ought to -- to the extent we have 7 really good areas of growth, is there some subset of that that we could fully invest in capital and get us there -- get us started faster and therefore, get us to kind of that $100 million-plus business faster.

Zane M. Burke - *Cerner Corporation - President*

And -- this is Zane, if I may. Just -- and Marc talked about our ability for speed but -- which I couldn't agree more with. The flip side of that is we're being incredibly thoughtful about who we partner with and who we bring into our clients and what that means when we do that. And so I would just say this is -- these are very long-term plays. So we're being -- the Lumeris conversation, I think it's appropriate that we spent a lot of time on how will this work and how can we deliver real value. Our Salesforce arrangement is of a similar variety. We spent 2 years in the making to make that really come to life in the proper way because these are incredibly strategic decisions we're making to broaden the suite of solutions. But in our view, these are people we're bringing into our clients, and we need to make sure that we fully vet the long-term feeling of that as well as the impact on Cerner over the long haul. And I think what -- I think we're being appropriately judicious about how we look at these. But if there's a need for speed, I'm glad to hear Marc's ready to go with it.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

That's helpful to hear. And unrelated follow-up. It's been a year since we spent some time talking about LifePoint and obviously, they were in the news lately. Could we just get a bit of a progress report there?

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Sure. The LifePoint engagement is progressing very well. We -- I think we have our go-live coming up here in the very near term, before the end of the year. And they're very pleased and we -- they've been a great partner for us. And so we would anticipate that it will be beneficial for both organizations as we move forward, an opportunity to expand. So we're excited about what they're doing and we think that's a great team. And I don't anticipate that their capital structure really changed the game here as it relates to what we're doing with them.

Operator

Our next question comes from Sean Wieland with Piper Jaffray.

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

First, a quick one on revenue cycle. The activity that you cited in the quarter, are you selling the Millennium revenue cycle or Soarian revenue cycle or a mix of the 2?

Zane M. Burke - *Cerner Corporation - President*

Well -- this is Zane again. Yes, we market both solutions. But principally, it's Millennium revenue cycle solution set. Most organizations are buying an integrated ambulatory acute and revenue cycle, and then many of our clients who have been a long-term Millennium clients want to get on a single instance. But we have had some Soarian sales. There's still a marketplace for stand-alone patient accounting and we offer that. But from a solution perspective, Soarian's architecture to be very portable in terms of functionality and those pieces. And we've taken much of the best things out of Soarian and have been able to port those to Millennium. And that's been very helpful. And we would anticipate that we'll continue to utilize both those. But I would say, the vast majority of the revenue cycle opportunity is on a Millennium basis.

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

Okay. Great. And unrelated follow-up. How would you describe the appetite for two-sided risk models within your base? And do you see that as kind of key to the relationship with Lumeris and the overall population health?

Zane M. Burke - *Cerner Corporation - President*

I think in the population health space, there's an appetite for that dialogue. And we're tiptoeing our way appropriately into it so we're not putting ourselves at risk -- in significant risk as Marc indicated. But most of these are upside opportunities as we've done that. And so we'll kind of continue to work our way through that and mature on how comfortable we get with all the risk elements of that before we get too far.

Marc G. Naughton - *Cerner Corporation - Executive VP & CFO*

Sean, this is Marc. We think we can do very well and grow very -- to a significant number without having to take downside risk.

Operator

Our next question comes from Donald Hooker with KeyBanc.

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

Great. Just kind of a side question. A lot of questions have been asked. But was curious, you guys -- how you guys think about telemedicine. And you guys have a partnership I know with American Well. And you mentioned some work with the VA on -- around virtual health care as well. Well, just -- how does telemedicine ft in your outlook for health care and your business model over the next 2 years?

Zane M. Burke - *Cerner Corporation - President*

This is Zane. I mean, obviously, telemedicine is an important piece. And I think the recent changes in reimbursement are very helpful for telemedicine. I think there's going to be more as it relates to the consumer aspects of, really, wellcare and utilizing the physician and acute settings for really high-acuity situations as opposed to these many situations where people have to go to the doctor's office and use the valuable resources that are very costly. So I think you'll see telemedicine -- I think you're going to see the wearables. I think you're going to see a whole lot of different technologies on the go-forward, which puts the people that don't need to utilize these very expensive, very talented resources -- we are not using those for those people that don't have a high acuity, that we only use those resources when there's a real need for high acuity. And so we're going to continue to look for both -- telehealth is one of those pieces, but -- and the telemedicine side of that, we're going to look for other technologies, which continue that strategy of, "Let's make sure that high acuity meets the high cost pieces versus the low acuity using up all that bandwidth and network."

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

Got you. And maybe one last quick one. You guys have been press-releasing a lot of wins in the smaller rural hospital space. So I guess one, can you update us within -- where you are in terms of sort of the number of hospitals, the footprint you have with that CommunityWorks offering in the sort of the sub-75 bed hospital area? And you had mentioned kind of taking that multitenant offering up into larger hospitals. I thought that was an interesting development a few quarters ago. I was just wondering if that -- if there is an appetite for CommunityWorks-style offering as you move up in the larger settings.

Zane M. Burke - *Cerner Corporation - President*

Yes. So this is Zane. We're well over 100 hospitals in that, that have taken that live, actually, today. And we're well in the contracted and significant in excess of that. The moving up into larger settings is really one of those pieces around both M&A activity, around ease of use and predictable costs models. And so we see that more as a delivery model than we do as a market segment. So instead of thinking just pure Community Hospital, it's also surgical centers. It's behavioral health. It's all those things. It's really a delivery model when we talk about CommunityWorks. So it's much broader than that. We see there's quite a bit of applicability for that model. And we are competing and doing extremely well in that marketplace. And it is as -- there's as much activity as there's ever been in that space. So it is very, very high activity level, and we're competing and winning more than our share.

David Brent Shafer - *Cerner Corporation - Chairman & CEO*

Thanks, Marc. I want to thank everyone -- this is Brent. I want to thank everyone for joining us today. I'm very pleased with our solid results for this quarter, and we will continue to focus on delivering against the expectations we set. My conviction is that Cerner has great opportunity to grow over the long term, and those continue to increase. I think we're taking the steps necessary to realize this potential, and we appreciate you being with us. Have a great evening. Thank you. Bye-bye.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation. Have a wonderful day.
