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EDITED TRANSCRIPT

Q3 2018 Cerner Corp Earnings Call

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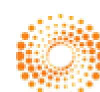

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PRESENTATION

Operator

Welcome to Cerner Corporation's Third Quarter 2018 Conference Call. Today's date is October 25, 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 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 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, Carmen. Good afternoon, everyone, and welcome to the call. I'll start with a review of our numbers. John Peterzalek, our Chief Client Officer, will follow me with result highlights and marketplace observations. And then Brent Shafer, our Chairman and CEO, will provide closing comments.

Turning to our results. We had a solid Q3, with all key metrics within our guidance ranges. Revenue was at the low end of our guidance range, primarily due to lower-than-expected software and technology resale, which was largely offset by reduced expenses. The Q3 lower level of software is expected to also impact Q4, leaving our earnings outlook for Q4 below consensus estimates. I would note that our full year outlook remains within our previously provided full year guidance range.

Our bookings in Q3 were $1.588 billion, which reflects a 43% increase over $1.111 billion in Q3 of '17. Q3 of last year was our lowest bookings quarter, so it's an easy comparable, but our year-to-date bookings growth of 19% is also strong. We ended the quarter with a revenue backlog of $14.7 billion, which is down from $14.79 billion in Q2. Recall that beginning in 2018, our backlog calculation under the new revenue standard excludes revenue potentially impacted by contract termination clauses. Most government contracts have standard termination clauses, and as I've mentioned before, some of our long-term contracts also have them. In our experience, clients rarely exercise this option, so this doesn't change our total long-term revenue opportunity. It just reduces the calculation of backlog.

Moving to revenue, which was $1.34 billion in Q3. This is up 5% over Q3 of '17, and as I mentioned, at the lower end of our guidance range

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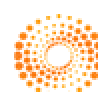

due to a lower-than-anticipated level of licensed software and technology resale.

I'll now go through the business model detail and year-over-year growth compared to Q3 of '17. Licensed software revenue was $140 million, down 3%, primarily due to lower-than-forecasted licensed software bookings in the quarter. This is in part due to the lower level of predictability related to fewer regulatory deadlines, as we have discussed in the past.

Technology resale increased 6% to $60 million but was below our forecast. Subscriptions revenue was $79 million in Q3 of '18, down from $123 million in Q3 of '17. As we have discussed, subscriptions were impacted by our adoption of the new revenue standard, which reduced subscription backlog and led to us classifying a portion of subscription revenue as support.

Professional services revenue grew 14% to $257 million, driven largely by growth in our Works businesses. Managed services increased 15% to $302 million, driven by strong year-to-date bookings. Support and maintenance was up 5% to $278 million, reflecting on our expected low single-digit growth plus the previously discussed impact of the new revenue standard. And finally, reimbursed travel was $24 million, which is flat year-over-year.

Looking at revenue by geographic segment. Domestic revenue was up 5% from the year ago quarter at $1.188 billion, and non-U.S. revenue of $152 million increased 7% from the year ago quarter.

Moving to gross margin. Our gross margin for Q3 was 82.8%, which is up from 82.5% in Q2 of '18 and down from 84.1% 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, acquisition-related adjustments and other adjustments, all was detailed and reconciled to GAAP in our earnings release.

Looking at operating spending. Our third quarter GAAP operating expenses of $903 million were up 9% compared to $825 million in the year ago period. Adjusted operating expenses were up 9% compared to Q3 of '17.

Looking at the line items. Sales in client service expense increased 9% over Q3 of '17. This increase was primarily driven by an increase in personnel expense related to our services business. Sales in client service was down 4% compared to Q2 of '18. This was driven largely by lower variable compensation related to the lower software in Q3 and our slightly lowered outlook for the year.

Software development expense increased 12%, driven by 5% increase in gross R&D, a 20% increase in amortization and slightly lower capitalized software. G&A expense was up 10%, and amortization of acquisition-related intangibles decreased 53% year-over-year.

Moving to operating margins. Our GAAP operating margin was 15.5% compared to 19.4% in the year ago period. And our adjusted operating margin was 19.2%, down from 23.1%. 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 our increased mix of Works revenue.

We continue to believe that many of these factors are temporary in nature. We are also continuing to work related to our profitable growth imperative that includes looking for ways to operate more efficiently. As we finish this work and finalize our 2019 and long-term plan, we expect to provide an updated view of our margin expansion opportunities.

Moving to net earnings and EPS. Our debt net earnings in Q3 were $169 million or $0.51 per diluted share compared to $0.52 in Q3 of '17. Adjusted net earnings in Q3 were $209 million, and adjusted diluted EPS was $0.63 compared to $0.61 in Q3 of '17. Our GAAP tax rate for the quarter was 21%. Our non-GAAP tax rate was also 21%, similar to our year-to-date tax rate. Note that for Q4 '18 and next year, we expect our tax rate to be closer to 22%.

Now move to our balance sheet. We ended Q3 with $814 million of cash and short-term investments, which is down from $886 million in Q2 of '18, with our free cash flow being offset by our $266 million investment in Lumeris' parent company and $58 million of share

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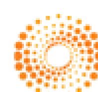

repurchases. We currently have $582 million of remaining authorization under our repurchase program.

Moving to debt. Our total debt, including capital-leased obligations, was unchanged from last quarter at $441 million. Total receivables ended the quarter at $1.211 billion, up from $1.152 billion in Q2 of '18. Our Q3 DSO was 82 days, which is up from 77 days in Q2 of '18, 73 days in the year ago period. The increase in DSO was mostly related to the timing of collecting a small number of large receivable balances. We expect DSO to return to the 70s in Q4.

Operating cash flow for the quarter was $338 million. Q3 capital expenditures were $117 million, and capitalized software was $66 million.

Free cash flow defined as operating cash flow less capital purchases and capitalized software development costs was $155 million for the quarter. This brings year-to-date free cash flow to $532 million, which is up 9% compared to last year. We continue to expect growth in 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 Q4 to be between $1.37 billion and $1.42 billion. The midpoint of this range reflects growth of 6% over Q4 of '17 and will bring full year of 2018 revenue to $5.396 billion, which reflects 5% growth over 2017 and is above the midpoint of our previously provided full year guidance range.

We expect Q4 adjusted diluted EPS to be $0.62 to $0.64 per share. The midpoint of this range is 9% higher than Q4 of '17 and will bring full year 2018 EPS to $2.46, which reflects 3% growth over 2017. We understand while this puts us in our guidance range for the year, it is below consensus expectations for the quarter, which were aligned with the midpoint of our previously provided full year guidance. The main reason our Q4 guidance is slightly lower is that the lower software bookings in Q3 also impact future quarters, and the expense benefits that we have in Q3 that offset the lower software are not expected in Q4.

Moving to bookings guidance. We expect bookings revenue in Q4 of $1.85 billion to $2.05 billion. The midpoint of this range reflects a 16% decrease compared to our record-high bookings of $2.329 billion in the fourth quarter of 2017 with -- but it would bring full year 2018 bookings to $6.711 billion, which reflects growth of 6% over 2017.

Moving to 2019. Historically, we have provided a preliminary outlook for the next year on our third quarter call. This outlook has always been based on a high-level plan since our detailed plan is never finalized until after we have ended the year and completed a bottoms-up plan that includes backlog from our Q4 results and our most current sales forecast.

For the past 2 years when we finalized our plan and provided guidance on our fourth quarter call, we've had to adjust our outlook. This is not something we like doing, given our focus on delivering against expectations we set. In addition, the process we are undergoing to create our plan is more involved this year. As you know, Brent has kicked off a series of work streams focused on client experience, innovation and profitable growth, all of which are informing our planning process. Brent is also very focused on us delivering against expectations. I believe the result will be a solid, strategically focused plan, but we are not at a point to provide a useful preliminary outlook for 2019. We will, as usual, provide 2019 guidance on our Q4 earnings call.

Please don't take this change of providing a preliminary view of our -- on our Q3 call as a sign that we expect our outlook to be poor. While there are some challenges in the near-term environment that we've discussed, we still believe we can deliver solid revenue and earnings growth next year. We just want our guidance to be based on more -- on a more complete plan.

As we've mentioned, we're also working on a 3-year strategic plan. We expect to use this, combined with our 2019 plan, as a basis for a more detailed discussion on our investor meeting during HIMSS, which we plan to have on the morning of February 13. At that time, we will share more detail on our views and expectations for long-term growth, margin expansion, cash flow and capital allocation.

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

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John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

Thanks, Marc. Good afternoon, everyone. Today, I'll provide comments on my new role, and then I'll cover Q3 results and the current marketplace environment.

As you know, Zane Burke will be stepping down effective November 2. I'd like to thank Zane for his 22 years of contributions to our clients, the industry and Cerner. With this transition, I am privileged to assume his responsibilities as Chief Client Officer, which is a new role and a title that reflects our increased emphasis on the success of our clients. As a 15-year Cerner associate with 30-plus years in the industry, I had spent most of my career working with clients in sales, delivery and the ongoing relationships in healthcare around the world.

As a leadership team, we will continue to reinforce our client-first philosophy at Cerner. This means we will double down on our efforts to put our clients' success at the center of everything we do and ensure that we consistently deliver value. This is a critical component of maintaining Cerner's growth and success, and I believe this focus will allow us to continue playing a key role into transformation of healthcare.

With that, I'll turn to discussing Q3 results. Our results for the quarter were solid, with the exception of the lower technology resale and software and its impact on revenue in the quarter and our Q4 earnings outlook. As Marc indicated, we grew our bookings 43% in Q3, and our year-to-date bookings growth is 19%. In Q3, the percent of bookings coming from long-term contracts was in a normal range at 34%, including the addition of an ITWorks client.

We also had a good quarter from a new business standpoint, with 30% of bookings coming from outside our core Millennium installed base. Bookings included broad contributions from large hospitals, community hospitals and ambulatory venues. In addition, we continue to have good contributions from our key growth areas, with population health, revenue cycle and ITWorks, all having solid quarters.

Regarding population health, I wanted to provide an update on the relationship with Lumeris, which we announced last quarter. As you recall, 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 and provide us sponsored health plans. Additionally, Lumeris is adopting HealtheIntent as the platform for its clinical methodology and advanced analytics.

Since we announced our collaboration in July, we have been focused on mobilizing our joint Cerner and Lumeris teams, launching our joint development efforts and kicking off our roadshow activity across the targeted list of prospective clients. We have visited with over a dozen prospective clients that are either evaluating the launch of our Medicare Advantage contract or beginning with an intermediate step of optimizing multi-payer arrangements. We also touched many of our clients during our Cerner Health Conference. The feedback we received has been very positive. I'd like to share a few observations from these initial interactions.

Our clients are all at different stages of experience with value-based payments. Many have had modest success with subside-only agreements such as an accountable care organization or Medicare shared savings programs. They are now considering expansions in the contracts, where they can capture a more significant portion of their premium dollar through value they provide through care delivery.

Next, Medicare Advantage has emerged as an attractive opportunity for leading health systems to expand their value-based care programs. A rapidly growing senior population, lower churn and the higher premiums are all contributing forces to make MA a desirable option.

Finally, our clients have also acknowledged the importance of change in management and hiring experienced partners. We believe the combination of technology-enabled services and strong operational expertise that Maestro Advantage brings makes for a compelling solution.

While we're still early in our journey, we are pleased with how our clients have responded and look forward to continuing to update you on our progress.

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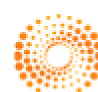

Next, I'd like to provide an update on our federal business. Starting with the Department of Defense, MHS GENESIS project, we recently kicked off our broader deployment by beginning implementations at 4 additional sites. We believe these sites will benefit from the optimization efforts that followed our initial go-lives. Also, it is worth noting that one of our initial sites has already achieved HIMSS Level 6, which is further evidence of the progress made since we went live last year.

Moving to the Department of Veterans Affairs. After signing the contract in Q2, activity continued as expected with 3 more task orders signing in Q3. These task orders, along with the work that began after the first set of task orders, kept us on track to steadily ramp our work on the project as we finish 2018 and move into 2019. The first major project milestone will be in 2020 when initial sites are scheduled to go-live.

Moving to our business outside the U.S. We had another solid quarter with 7% revenue growth. This was driven by good results in the U.K., Sweden, the Middle East and Canada.

Before turning the call over to Brent, I'd like to provide some comments about the marketplace and how we are looking at our growth potential. As we've discussed, we operate in an environment where providers are financially challenged and don't always have a high sense of urgency to make purchase decision due to fewer regulatory deadlines incentives. However, there is a counterforce in that, in that value-driven solutions do carry a sense of urgency and our solutions and services align with many of the challenges faced by providers to create value. As a result, we believe we have several sources of growth that position us to deliver solid results in this environment.

Our federal business is clearly an important foundation to this growth. With the DoD beginning to ramp and the VA now getting started, we have visibility to solid growth contributions for several years. Execution on these projects will be key, given the importance, not only to Cerner, but also to our active and retired service members.

In the HR marketplace, replacement opportunities remain, and we continue to do well competing for new business, although many of the opportunities are smaller with less software. Beyond new footprint opportunities, our large existing footprints represent meaningful light space for us to cross-sell our solutions and services. We continue to believe that revenue cycle, ITWorks and population health can contribute significantly to our growth.

While population health is still in an early stage and has ramped slower than we initially projected, we remain confident that it'll become a large contributor to growth in coming years. We believe that HealtheIntent is unmatched in depth and breadth, and that our path to adding meaningful services contributions to our population health revenue is now defined with our Lumeris collaboration.

Finally, our non-U.S. business continues to grow, and it represents an earlier-stage EHR market opportunity than the U.S. as well as an opportunity for nearly all the other solutions and services I've discussed.

In summary, I believe Cerner is well positioned to deliver solid results in the coming years, as we have solutions and tech-enabled services that align with the needs of our end markets. Healthcare is still in the initial stages of getting value out of the digitization that has occurred over the past decade, and we believe we are in a great position to play a significant role in helping healthcare stakeholders move towards a more efficient and higher-quality system of care.

With that, I'll turn it over to Brent.

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

Thanks a lot, John, and good afternoon, everyone. John, I think, did a very good job describing the significance of his new role and the marketplace dynamics that we're experiencing. John's perspective has been instrumental in our leadership's team's analysis of the complex healthcare environment we're in and the development of strategies for more closely aligning with our clients and increasing our responsiveness to their needs. As a result, operational and client-facing teams are becoming joined at the hip. This feels good internally, and we believe this is a difference our clients will notice as we move into 2019.

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I also want to take a moment and thank John and congratulate him on this well-deserved recognition for the new role he's been playing. I'd also like to echo John's thank you to Zane for his distinguished service to Cerner over the years.

Now I'd like to share more detail on our client-centric focus. As you know, we recently hosted thousands of clients at our annual Cerner Health Conference. During my presentation, I made several commitments to our clients that define our framework for delivering value in this era. These commitments are an expression of the strategic planning work I've referenced in prior calls, and I'd like to touch on them briefly today.

The first commitment is that we will relentlessly advance our clients' success. This commitment is the frame for every other decision we make. There's a real focus on disciplined execution. If we have obsessively focused on making our clients successful, we can't go wrong.

Our next commitment is to imagine, design and implement intelligent health networks.

Healthcare delivery organizations are facing tremendous challenges in their environment from primary care shortages to demographic-driven differences to shifts in policy and payment methods. The provision of care is increasingly moving out of high-acuity settings and into the community. Lower acuity prevention and intervention strategies are becoming critically important to payers and consumers. And for our clients, it's all about the network they can build within their ZIP codes to reach people where they are and deliver meaningful care and prevention strategies.

We see a big strategic opportunity in helping our clients build networks that can be activated to improve care across the full continuum. And we believe our HealtheIntent platform and our Lumeris collaboration will be key enablers of this strategy and commitment.

The third commitment is to make better healthcare experiences and outcomes our duty. We see an opportunity of focus on improving healthcare experiences and outcomes, both for the patients and consumers seeking a healthier life and for the providers who are overwhelmed by new world of evidence-based compliance.

The fourth and final commitment is that we will become the partner of choice for healthcare innovation. Our experience over multiple decades in building intelligent digital platforms makes Cerner a natural home for powerful innovation and partnerships. We love to build things, and we're not going to stop.

But the open area ahead is also full of opportunities to partner with clients and companies to create even more value by working together. Ultimately, as we execute on these commitments and deliver value for our clients, I expect it to fuel a transformation for Cerner. We are creating an operating model that's designed to support innovation at scale, which we believe will lead to ongoing value creation for our clients and will be central to us delivering profitable growth and creating shareholder value.

Now I'd like to turn it over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Stephen Valiquette with Barclays.

Steven J. James Valiquette ***Barclays Bank PLC, Research Division - Research Analyst***

Just quickly. So you're not providing guidance today for 2019 we all know that now, obviously. But you did previously talk about a focus on margin expansion for 2019, and that is still part of the -- a meaningful part of the investment thesis for some investors for next year. So I guess, I'm just curious to see if you're able to at least confirm that your margin expansion is still part of your focus for the company in 2019.

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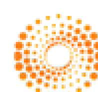

Marc G. Naughton ***Cerner Corporation - Executive VP & CFO***

Yes, this is Marc. I mean, clearly, we've talked about margin expansion as part of our focus for beyond 2019 as well. I think as we look at kind of the numbers that are out there, particularly the consensus number that's out there, I think if you apply an operating margin to the -- to get to that model, you're probably looking at well over 100 basis points of margin expansion, which is way beyond the 30 to 60 points that we thought is kind of what is in our purview for an annual growth level. Once you don't want to be careful about talking about '19 until we get much a better view, but we clearly expect to continue expanding margins. I talked about us being able to grow revenue and grow earnings next year and that we see solid growth for the company. But I think it certainly is part of our plan. We've got a lot of strategic growth in front of us. We want to be able to fund that growth. We'd like to take existing spend and go fund that new opportunities. And I think that's going to be a part of our focus as we land 2019. Certainly, 2019 continues to have the headwind of significant increase in noncash expenses. And so those are -- whether or not increasing as much as they did in '18, they still are going to grow up in '19. So I think that's something that we're going to factor into our plan as well. But once again, the 30, 60 basis points we've talked about is certainly our overall goal. And where we can fit into that range as we look into 2019, we'll be able to share with you once we land our plan.

Operator

Our next question comes from Ricky Goldwasser with Morgan Stanley.

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

Just going back to your prepared remarks where you talked about the replacement opportunity where you see some smaller opportunities. Can you talk a little bit about what has changed this year that impact your views on the replacement market? And also, if you can just give us some more color on the bookings this quarter. What came from kind of, like, new cuts and new opportunities versus expansion of long-term contracts?

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

Ricky, thanks for the question. This is John. I can talk about the replacement market in general, and Marc can share if he wants to share on the bookings side. But I'm not sure anything has changed on the replacement market. And we're seeing that replacement market is an active market. My comment about smaller deals, I would view more to new business opportunities that we have and haven't necessarily made a selection or are making a selection or transition to a new platform. So the replacement market is still active and strong. And as I had mentioned in my comments, the new business market remains strong as well. The only difference is the new business, they tend to be smaller entities, which come with smaller bookings and smaller software, which we discussed. But I feel very, very good about both the replacement market and the new business market in the U.S.

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

Ricky, this is Marc. I think our percent from new is similar to what we've seen. It was around 30%, which is kind of consistent with what we see. And I would echo John's comments that, really, the market continues to be the market we've seen coming into the year. It's an active market. Some of the opportunities are smaller, but it's a market that our pipeline would indicate is going to continue into 2019.

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

And some of your competitors are struggling this year. Are you seeing more RFP activities as a result of that?

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

I would say back to -- I see a very consistent level of RFPs. And in the spaces where the RFPs come out, which we'd crossed a little over in that conversation into outside of the U.S., where the procurement is largely RFP based, that all procurements generally have some component of RFP. But I don't see a change in the volume, and we are working every day very diligently to respond to RFPs. We don't have a lack of volume there.

Operator

And our next question comes from Ross Muken with Evercore ISI.

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Ross Jordan Muken ***Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology***

So maybe what in your mind would it take for there to be a return to sort of growth in the licensed software line sort of above the corporate average, which would obviously help in terms of your margin expansion goals? Because it seems like a lot of the revenue growth this year is coming from some of your lower-margin segments. And so that's obviously hard to offset on the expense line. So just give us the picture of that transition of what gets that growth rate back if we're not seeing a big change in sort of the replacement market.

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

Yes, and I think -- this is Marc. We continue to see opportunities on that replacement market side. But from a licensed perspective, clearly, we've kind of indicated that the government opportunities we have as those task orders get signed, some of those task orders will include chunks of software. So that certainly is probably -- maybe something that not everybody is fully considering as far as an opportunity in a market that is beyond the replacement market. It's kind of a brand-new market, if you will. So the software opportunities on the federal side and the government side are pretty significant. When you combine that with the replacement market side we see and selling back into our base of new innovations we create, we think that gives us a pretty good runway to get us to where our HealtheIntent platform is starting to kick off more of the SaaS business and more of our licenses recurring business that hits the top line with the higher margin. So I think that probably, when you asked the question, I think the government business may be the one that is not giving the full view as far as the impact they can have relative to software.

Ross Jordan Muken ***Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology***

And maybe just 2 other quick things. So one, Marc, could you just give us what the [605] revenue growth is for the year or what we've seen so far just so we know apples-to-apples? And then secondarily, on the balance sheet, the free cash flow, obviously, is coming in a bit. You don't have a lot of leverage, I guess. How are you thinking after Lumeris just about capital allocation into kind of next year and prioritizing repurchases versus tuck-in M&A?

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

Yes, I mean, relative to [605], I don't know that I have that number right off the top of my head to tell you what that impact is for the year. I think it'll be -- we've disclosed that on a quarterly basis in the Q. I would also kind of indicate that when you look at the disclosures that are in the Q relative to 605 versus [606], this is the new revenue standard. You have to take into account that, that basically takes whatever new contracts get signed looks at the specific language in those contracts and then applies the old rules and the new rules. In the 606 era, our contracts are different. There's flexibility in that era that we're taken advantage of that our clients appreciate that doesn't change the revenue recognition that is appropriate. And so we apply those contract terms. 605, one of the issues with 605 was you could have one sentence in a contract that could result in making the revenue deferred for an indefinite amount of time. So when you see a comparison between 605 and 606, we could have continued contracting under our old methodology and our old terms, and there wouldn't be any difference in new contracts between 605 and 606 or there'd be a very small difference. So I think trying to focus on 605 to 606, at least as far as the disclosures that are required, isn't a very valuable exercise. It's a little bit like trying to look at the current backlog that we have under 606 versus 605. There's a lot of contracts, as we mentioned in my prepared comments that have -- have cancellation clauses in them, don't ever get -- that don't get triggered. But they're in there, and since they're in there, they don't get included in the backlog. And that's hundreds of millions of dollars of revenue in the next 12 months that's not sitting in our backlog today. So once again, trying to look at the backlog number and get a good sense of what's going to happen in the company is difficult. Overall, we're still going to drive out in the 12-month period over 80% of our revenue out of the backlog. Trying to figure that out from looking at the 606 backlog number will be a little bit challenging. I think from a capital allocation standpoint, we'll visit this more deeply when we do our HIMSS presentation. But I think it's pretty consistent with what you've seen us recently talk about is we continually want to do share buybacks, certainly to offset dilution and potentially at a slightly higher level than that. I think our Lumeris is a great example of us leveraging the balance sheet for an opportunity to make an investment that we think gets us to a future growth opportunity more quickly than we'd be able to do it on our own. And I think that's going to be something you'll see us incorporate as part of our going-forward capital allocation strategy. But more to come on that when we talk to you guys in February.

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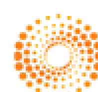

Operator

Our next question comes from George Hill with RBC.

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

I guess, Marc, kind of on the Q3 bleeding into Q4 software weakness, I guess, how long should we expect that to drag on? And given -- under the new accounting standard, like, how long does the short -- I guess, just the weakness in the short-term software bookings and software revenue recognition, how long -- what is the duration of that weakness that we should expect to see in the income statement?

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

Well, I think you've got -- to the extent that some of that license gets deferred, it obviously doesn't hit the current quarter, but it will hit future quarters. So it actually will, at some point, benefit future periods more than it would if the revenue were coming sooner. For Q3, some of the issue was just lower software sales. So that doesn't necessarily -- that doesn't get made up from an accounting standpoint or from a rollout standpoint. That gets made up by going and taking those transactions that are still in the pipeline and giving them to get across the line and driving that software sale, and therefore, the software revenue from it. So the key point we were making relative to Q4 and lower Q3 bookings is under [606], there is a bigger percentage of the revenue that is not recognized currently in the quarter. More of that gets pushed out to later quarters. And to some -- so if that number is lower in Q3, the amount that gets pushed out to Q4 is also lower and impacts us. And then, obviously, on the spend side, there was benefits in Q3 that we got because of our -- from the incentive comp side and adjusting for the lower full year outlook that won't be repeated in Q4.

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

Okay, that's helpful. And maybe a quick kind of follow-up for John. I guess, how do we think about -- there's a couple of pending rules with the government right now in interoperability and data blocking. I guess, if they go through, it's particularly the data blocking, how do we think about which kind of subsegments get advantaged or disadvantaged by these regulatory changes? And I think about things like the interface business that I know has historically been like a lucrative small submarket for Cerner. I guess, maybe just talk about maybe the interface segment of the business. Is that something that you see is at risk, given proposed regulatory changes and just whatever is happening there?

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

My first reaction should be not really at risk because interoperability and interfacing are kind of 2 different things. And we've been on record many times to saying that we view the interoperability as a right that data blocking or not being interoperable is -- cannot be interoperable in sharing data between entities. And we'll continue to do that. So, to answer the first part of your question, I think we're really strong if those regulations complete, and they will. There'll be more interoperability regulations coming, whether it's now or later. I think we're really well positioned, and frankly, have been leaders are running interoperability. But I think what we do on interfaces is different, and there will always be a need for interfaces between systems and technical systems and those type of things. So, I don't see that as a huge threat.

Operator

And our next question comes from Matthew Gillmor with Robert Baird.

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

I want to come back to the software bookings for the quarter, and you'd mentioned that as one of the main drivers for the lower margins for the back half. But can you tell us what solution categories were software? Or were there specific deals that slipped -- that'll come back? Or do you think it was just more of the lack of regulatory pressure that's making it less predictable?

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

This is Marc. Clearly, from a regulatory guide -- time line perspective, yes, there isn't anything that's forcing clients to go get deals done. And I said that Q3 traditionally has been a lower software quarter. And I think we saw that more this quarter than we might have had in prior years. So, I think that's the impact. There's still -- as John said, the market is still active. There's still software out there to go get. We just didn't get much of it in Q3. Certainly, we'd expect to get some more software in Q4, which is usually our indication -- what our history to do that. But it's not going to offset some of the Q3 shortfall.

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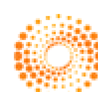

Matthew Dale Gillmor ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Okay. And then maybe asking about the VA contribution to revenue and how that hits. Based on the task orders, it seems like there's maybe even $500 million in bookings so far from the first task orders. Can you give us any sense for how that flows into revenue? Is that a multi-year thing? Or will we see the bulk of it in 2018 and 2019?

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

Yes. The way the revenue flows in from those contracts varies. A lot of -- primarily, it's a percent of completion. For the most part, a lot of it is services-oriented. So that flows in basically as the work gets done. So, some of those task orders can be longer term. Some of them are relatively shorter term. So, it'll vary with the task order. I mean, our practice is we're not going to refer to a specific client and provide revenue numbers that come from that specific client. So, to the extent that you've got a sense of what the bookings are and kind of what the total opportunity is, that'll probably flow out. It could be anywhere from 12 to 24 months, depending on what the specific task order is looking at. The government yearly contracts and -- well, the overall opportunity is $10 billion. The task order is usually contracted for in shorter period chunks that can be somewhere in that time period. But it will vary by task order. So, by trying to broadly apply a certain time frame to a certain bookings number is going to be a little problematic to pick a quarter of what the revenue contribution is. We've kind of talked about over time that we expect somewhere in the 2022 timeframe that continue being successful in that area that we could have task orders that would drive $1 billion of annual revenue. But the path up there is not going to necessarily be linear. So, there'll be -- especially at the start, when you do a lot of preliminary work at some of your initial sites that there's good work, but it's limited to a few sites, and therefore, not spread across many sites, which would drive a higher level of revenue. So that's -- hopefully, that gives you a little bit of color, but we're not going to give you precise numbers to any of our client's contribution to our revenue.

Operator

And our next question comes from David Larsen with Leerink.

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

Can you talk a little bit more about population health management and your deal with Lumeris? When can you increase your PMPM rate? And when can you start providing deeper sources? Because it seems to me like that's really the future of where healthcare IT is moving.

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

Sure, David. This is Marc. I'll just take a shot at the Lumeris. Certainly, we absolutely believe it is an area of population health that kind of combines value-based care and all the elements that are hitting healthcare today that we think is a huge opportunity for us. As we said the last quarter, the actual financial impact on us is going to be fairly limited early on because most of the work that's going to be done is initial work with clients, maybe doing some surveys and doing some initial consulting work as they look to see if they are ready to set up plans. And by the time a client or a provider decides that they're going to set up plan, you're probably -- you don't have 2 years down the road. They're going to set up the plan. They're going to have an initial group of members. That membership will then grow. So, it's -- as we said, it's probably a 3, 4-year time frame before you're going to see anything meaningful being contributed financially by that business. But during that time, we're spending a lot of time talking to our clients, prospecting and making sure they understand what we're going have available and then working with Lumeris on leveraging the HealtheIntent platform to be the platform that basically empowers their MA efforts. So, all -- it's part of our plan, but it's not a quick impact on the financial statements. This is an investment in the future that we think will pay off handsomely once it gets to fruition.

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

Okay. And then in 3 or 4 years, what could your PMPM collectively be? $15? $20? Any sense for that?

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

Yes. I mean, David, we talked a little bit about the fact that just selling [2 0s] is probably a $3 to $4 type PMPM. But if we can add in a set of services from a technology, care management, other areas that we think are things that we could provide from a service that leverages the technology, once again, we don't like to get into a service business that doesn't leverage technology that the potential to get to somewhere around $15-plus PMPM is certainly very reasonable. And that's -- given your other $3 to $4 PMPM being able to deliver something that's 4 to 5x of that from that same membership base is very attractive.

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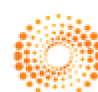

Operator

And our next question comes from Jamie Stockton with Wells Fargo.

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

I guess, maybe just on the software revenue during the quarter and bookings. Can you give us any more color on the type of software that maybe you saw a little softness in? I mean, was it clinical? You've made a couple of comments about how there aren't necessarily regulatory drivers right now. Or was it on the revenue cycle side? Maybe were there not mega deals in the quarter, this quarter, maybe like you saw last quarter? Just any color there would be great.

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

Yes, this is John. And I think if you look at our software mix itself, there's -- there isn't one thing. I think it was purely a volume thing that we still sell across all of our software components, whether they're clinical or outside of the clinical or those types of things, anything that carries software, there wasn't a particular weakness in any area. It was just an issue of not as many larger things coming through.

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

Yes, James, once again, this is pretty -- it's an era where things are going to be lumpy. And Q3 is traditionally where the lumpiness usually hits, and getting deals done is more challenging. And there isn't usually the incentive from a fiscal year's perspective on the client that gets something to accomplish. So, I think as much as anything, as I look at the tealeaves at the end, that's kind of what hit us. There wasn't any lack of desire on any of the solutions we offer. And I think our pipeline definitely shows the activity in it that would indicate there's a lot of interest in people coming to market and looking to go buy software.

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

And if you look at our software pipeline, the software pipeline is broad. There's -- and so frankly, I'm optimistic about whether to keep working on the software side. If we have a lot of innovations available, we create new innovations literally every day, and our pipeline shows there's a demand for it.

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

Okay, that's great. Maybe one other question on the bookings outlook for Q4. I know it's down year-over-year, where you had a very difficult comp, but still a very high number on an absolute basis. I think last quarter, you guys said that you had a number of ITWorks deals that were in the pipeline. Is that maybe a decent building block for the confidence in the bookings number that you guided for in Q4?

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

I think the confidence number in Q4 comes from there. We have a series of relatively large items that we've been working on for quite a while that are coming to land in Q4. So, it's a little bit of the services side. It's a little bit of some larger things that have worked their way through the process that double land in the quarter. So, I think it's just a good strong quarter. As we have a lot of times in Q4 as things build up through the year, but nothing in particularly other than some larger items that are coming to rest.

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

Yes, Jamie, I think, as you indicated, while it's down year-over-year, it will be -- if we deliver the second-highest quarter in the history of the company, as you intimated. And I think the mix will probably be very similar to what you normally see in a strong quarter. So, I don't think there's going to be anything that's driving that number higher or changing the mix and ratio of kind of long term and not long term.

Operator

And our next question comes from Jeff Garro with William Blair.

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

I wanted to ask about the long-term margin outlook and maybe more specifically, progress on ITWorks and RevWorks on the cost side, whether you have any insight into -- if the profitability of those businesses has grown through this year or been way down a little bit by investments and how we should think about the longer-term margin expansion potential of those businesses with growth and add scale?

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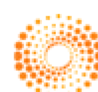

Marc G. Naughton ***Cerner Corporation - Executive VP & CFO***

Yes, this is Marc. We talked earlier in the year about certainly making investment in our revenue cycle, RevWorks outsourcing, that we are hiring people in Kansas City to basically kind of jump-start our local billing office there. I think we're up to almost 500 people in that effort at this point. So that's going along well. I think we're -- so that clearly was a drag on that business' earnings. That business' margin basically expands as we are able to get those clients to fully utilize, both from the clinician side as well as the billings side to Cerner software that allows them to clinically drive that billing. And I think that's a clear element that's going to, over the long term, allow us to grow the margin of that business. So, as I said, we don't like to be in the services business that isn't going to have a technology impact, but we can drive better margins. And I think you're going to -- you'll see that in that business. That business is pretty young. Clearly, we just rebadged all the people and our largest client who really made a big addition to that workforce in this year. So, it is early. It's an investment phase for that. From an ITWorks standpoint, the services component of that is still in the single-digit margins. But when you combine all of the elements of an ITWorks client, which is additional software that gets sold into support all of the other elements that occur, those clients are 40% margin clients. So, they're already contributing significantly. Our goal there is to continue to grow above the 30-plus we already have today and to be able to centralize those functions and gain that leverage by having a single source of support for a lot of these systems that those clients are running. But -- so it's early on. I mean, when we talk about margin expansion long term for the opportunity and how you continue, how do you keep growing margins, driving 30, 60 basis points on an annual basis, those things right now are more anchors against that then they are contributing towards it. Ideally, in the next couple of years, we'll see that start moving to where we'll start incorporating those margins and allowing them to be incrementing up to our total margins. But right now, those are investment phases, both of them to some extent. And they eventually will be drivers of our margin growth, but certainly in the out years.

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

Great. That's very helpful. Then one more question, if I could. I want to ask about HealtheIntent, and specifically, your progress selling HealtheIntent outside of the Millennium base and to non health system provider clients and just kind of where those efforts fit in your priorities?

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

This is John. Actually, it's a large priority to get outside of the Millennium base. As we had mentioned multiple times, one of the -- not only is HealtheIntent obviously strong within our current client base, but by design, it's HR-agnostic. It can work in many different environments. And I think we've had reasonable success in going outside of a core Millennium client. And it is a high priority to us. It's an expansion into an area that's new greenfield for us, and not only on the provider side, but maybe in what we've had as nontraditional clients on the payer side and those type of things. So, I think it's a very powerful platform to get outside of our current client base and have some opportunities out there.

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

And we see this key in, certainly, in states as well. I think that's probably one of the -- certainly, in the Medicaid area, where HealtheIntent can be a valuable tool for states as they look to manage those fairly diverse populations.

Operator

Our next question comes from Stephanie Demko with Citi.

Stephanie July Demko ***Citigroup Inc, Research Division - VP & Senior Analyst***

Just continuing on the thought of expanding outside your current client base and getting your large data stores, have you ever looked at some initiatives on data monetization and how that can maybe impact the margin model?

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

Yes, this is Marc. Certainty, data is like the magic elixir that everyone thinks is -- has huge independent value. And there's certainly some truth to that. But I think it's how you're going to use that data. And in medical world, you have to have the right to use that data. So, we spend a lot of time with our clients, preparing them and making them capable to use that data to better manage the health of that patient, to better manage them when they are in an episodic condition within the hospital. That's the key data you -- and we certainly have some business relative to de-identified data and using that in a broader context. But it's still early. We still think there is an

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opportunity to use that data and create more of the business. But there is a lot of regulatory limitations as to what you can do with medical data today. And so I think anybody that's talking about medical data and is not paying attention to what those limitations are, can be overstating what some of the -- at least near-term opportunities are. I think the opportunity to get past some of those limitations to get universal consents, that is something that eventually is going to make that data valuable. But today, near term, that's not a focus that I can see.

Stephanie July Demko ***Citigroup Inc, Research Division - VP & Senior Analyst***

Understood. I want a quick follow up on the DoD, blast from the past there. But one of your counterparts on that mentioned this morning that the GENESIS ramp was seeing some elongation this year. Could you talk if you're seeing a similar cadence or if this is kind of a one-off vendor-specific issue?

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

Was the question that you're seeing some delay on the GENESIS side? I didn't get the whole question.

Stephanie July Demko ***Citigroup Inc, Research Division - VP & Senior Analyst***

Leidos has been saying that they're seeing some elongation there. So, I'd just like to see if you're think they're similar or if that is just a one-off.

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

This is Marc. From our standpoint, we've implemented the first 4. We've actually been authorized to go to the next 4. So, in our view, that project is moving along well and is on track. So maybe another supplier-specific issue, but for us, the DoD is a great client, and they want to move forward quickly and we are moving along.

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

Our 4 life sites are going as planned. They're in the optimization mode as planned, and the authorization for 4 more were up and running and should see go-lives there in early 2020, I believe, the date is. We believe, and we did backing on that, that we're making -- we are on target what we've been asked to do and what we're committed to do.

Operator

And our next question comes from Charles Rhyee with Cowen.

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

Just wanted to maybe clarify something around the VA as well as DoD. If I recall correctly, with DoD, all the software-related bookings went to you, and then the rest was sort of divvied up with Leidos being sort of the prime contractor. I know the VA is a little bit more flipped here, but I know you mentioned earlier that when we can think about licensed software in the future coming from the government side, are any of those revenues shared with sort of your partners going forward on the VA side, or is that also coming back to Cerner?

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

Yes. No, that all comes back to Cerner from both -- from the VA, the DoD were a sub, Leidos is the prime. So, all the dollars go to Leidos. And then they contract with us, and we receive the value for the license and other components that we are -- have to provide there. For the VA, all the revenue flows through us. We then pay out our third-party partners. But that means all the software license stays with us as well.

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

Okay. And have you -- and I can't recall if you have given sort of the splits in terms of what you -- we should expect for you guys to keep in terms of the -- on the VA side. I think you've given some kind of basic parameters, but wondered if you can share anything more there.

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

Yes. At this point, it's still early to tell for the long term exactly how much of work we will perform and how much our partners will perform. I mean, we threw out a 50-50 split at some point, just to try to do math. But I think that's still to be determined. We're pretty early in that process. And with the task orders given, a lot of them are initial, a lot of that work is work we're doing, but some of our

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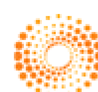

partners are doing part of it as well. But once it really cranks up, we're still a little early on deciding exactly what share of that work we'll perform and what share our partners will perform.

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

Okay. And just one follow-up. You talked about 2022, we could be looking at $1 billion a year in terms of work. If we were to try to model that out a little bit, should we think of it more as a linear ramp? Or would you say it's still kind of small next year and even maybe 2020 and then ramps kind of quickly into 2022?

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

Yes. I think it's the ramp-up of VA, as we said, is not necessary going to be linear. It could be a little lumpy, depending on what work is being done, kind of slower start. And then once it gets up to scale, there's a lot to go do. So, you'll have multiple projects going on. So that ramp can be probably more back-end loaded than it is front-end loaded.

John T. Peterzalek ***Cerner Corporation - Chief Client Officer***

Why don't we take one more call? Thanks, Charles.

Operator

And our last question comes from Robert Jones with Goldman Sachs.

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

Most of the stuff on the quarter has been asked and answered. I guess, just if I think back to CHC, Brent, I know you made some comments around reprioritizing some of the R&D initiatives longer term and talking about wanting to focus in on making bigger R&D bets. So just wanted to follow up there and see if maybe you'd be willing to share a little bit more on what areas in particular you are excited about funding. And then just more for clarity, should we think about the reprioritization of R&D over time as an overall lower spend? Or is this just kind of a reallocation of where dollars are actually spent in R&D?

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

Thanks for the question, Bob. We're kind of right in the thick of it, as we speak. In fact, I just had a 2-day session with kind of our top 50 leaders today, and we've got about 8 weeks, 8 to 9 weeks of grinding through the details in front of us. But there's kind of 2 pieces. One is the efficiency of the spend and making clear choices to get maximum return because, given the breadth of our portfolio and the variety of things we touch, one of the concerns is if you give -- if you put just a little bit on everything, do you really maximize your returns? And so, it's really looking at making good choices on the areas that have best return, and in many cases, best returns in the next couple of years, in line with the strategic direction we're starting to outline here. So, we'll certainly share more detail with you as we get through that, but we're in the thick of it right now. But hopefully, that gives you a little sense.

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

Yes, I would just indicate that relative to total R&D, it's not our expectation to reduce our R&D spend. We have a lot of opportunity. This is a sector, and we're in a position where we have -- the issue we have is trying to pick which opportunities we think are going to be the big bets. So, our expectation is continued spending on R&D. As Brent said, we want to be very thoughtful. And if things aren't going to become $100 million businesses, then let's refocus what we're spending in that space and put it in things where we think it can go to that size.

With that, I thank everybody for their questions, and I turn it over to Brent's for closing.

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

Yes. Maybe just a couple of comments. One, I think, is significant, given what we announced at CHC. But we saw bipartisan legislation passed today on opioids, which is amazing in and of itself to see bipartisan legislation. But it was signed today. And for those of you who followed CHC, we announced an opioid toolkit. And that is really about improved stake database access and predictive analytics for high-risk patients and advanced clinical decision support for opioid prescribing. So -- and we know how deep and broad this crisis is and how much it's impacting the country. So really think that's a great example of how technology can be leveraged to help providers with a real need in our country.

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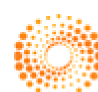

So -- and I appreciate your time today. And I want to just reinforce that we're very focused on setting attainable expectations and then delivering on them. And we remain absolutely focused on significant long-term opportunities that are in front of us. And I mentioned they've the opportunity spent 2 full days with our basically top 50 leaders in the business. And coming out of that really looking at some of our opportunities is just really encouraging about where we're positioned and the opportunities ahead. And we think we have a real significant opportunity to play a meaningful role in the transformation of healthcare. And I think for us at Cerner, recognizing that as we look at our portfolio and our investment plans, there's some transformation of our own that we need to do to make sure we're positioned well for the opportunities in front of us, and that's what we've been referring to. And I'd mentioned it briefly, but part of that work is creating an operating model that is really designed to support innovation at scale as we are at scale now and want to continue to scale. So, having a consistent approach to that as we continue to grow is really important. And that's all about delivering ongoing value creation to our clients and will be very central to us, delivering profitable growth and creating shareholder value.

So, thanks very much for joining us, and have a great evening.

Operator

And with that, ladies and gentlemen, we thank you for participating in today's conference. This concludes the program, and you may all disconnect. Have a wonderful night.

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