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CERN - Q1 2018 Cerner Corp Earnings Call

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OVERVIEW:

Co. reported 1Q18 GAAP net earnings of $160m or $0.48 per diluted share. Expects full-year 2018 revenue to be $5.325-5.450b and adjusted diluted EPS to be $2.45-2.55. Expects 2Q18 revenue to be $1.31-1.36b and adjusted diluted EPS to be $0.59-0.61.

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

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

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

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

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

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

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

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

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

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

Sean Wilfred Dodge *Jefferies LLC, Research Division - Equity Analyst*

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

Steven Paul Halper *Cantor Fitzgerald & Co., Research Division - Analyst*

PRESENTATION

Operator

Welcome to Cerner Corporation's First Quarter 2018 Conference Call. Today's date is May 2, 2018, and this call is being recorded.

The company has asked me to remind you that the 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, taxes, solution 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 measure discussed in this earning's 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 would 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, Ella. Good afternoon, everyone, and welcome to the call. I will 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 comments.

Turning to our results. Our first quarter included strong bookings and record cash flow, but revenue was below our expectations due to software, technology resale and subscriptions and the delay of the VA contract. The lower revenue was largely offset by expense control and a lower tax rate, resulting in our earnings being in line with expectations for Q1, but the slow start to the year and ongoing uncertainty as to the timing of the execution of VA contract has led us to revise our full year revenue and EPS outlook.

Now I'll go through the numbers. Our bookings in Q1 were $1.398 billion, which reflects a 12% increase over $1.25 billion in Q1 of '17. Our revenue backlog ended the quarter at $14.6 billion. Note that this reflects the adoption of new revenue recognition guidance under Topic 606. Certain provisions within the guidance impact how we calculate backlog, but the primary change being that we have removed a portion of backlog tied to long-term contracts that include an option to terminate before the end of the contract. In our experience, almost no contracts -- no clients exercise this option, so this doesn't change our total long-term revenue opportunity as this shortens the duration of what is included in the backlog.

Revenue in the quarter was [$1.293 billion] (corrected by company after the call), which is up 3% over Q1 of '17. You'll note that we have gone to a single revenue line on our income statement. This is also related to the adoption of Topic 606. While there's less detail on the face of the income statement, we're now including the business model detail that we previously provided annually as an additional disclosure each quarter. We'll use those to discuss our results instead of our old categories of system sales, support and maintenance and services.

Now I'll go through the business model detail and year-over-year growth compared to Q1 of '17. Licensed software revenue was $135 million, down 5%, primarily due to lower-than-anticipated levels of licensed software bookings in the quarter as well as tough year-over-year comparable due to the shift in how we sold some content in 2017. As I discussed on our last call, a higher amount of content that is typically sold as a subscription was sold as licensed software last year. Technology resale decreased 1% to $63 million.

The next item, subscriptions revenue, was impacted by 606, which reduced the backlog of subscription revenue. The shift in sales approach in 2017 that I mentioned previously also lowered the run rate of subscription revenue. In addition, a portion of subscription revenue is now treated as support under 606. This amount is classified as support and maintenance in the business model view for Q1 of '18. The impact of these items results in subscriptions revenue of $77 million as compared to $113 million in the prior year period.

Professional services revenue grew 11% to $441 million, driven largely by growth in our Works businesses. Managed services increased 3% to $268 million with lower growth rate mainly reflecting a tough comparable as Q1 of last year was the strongest growth quarter in 2017 for managed services. Support and maintenance was up 9% to $285 million, reflecting our expected low single-digit growth plus the adjustment for the support element formerly reflected in subscriptions. And finally, reimbursed travel was $24 million, which is up 7%.

Looking at revenue by geographic segment. Domestic revenue was flat from the year-ago quarter at $1.135 billion, and non-U.S. revenue of $158 million increased 23%.

Moving to gross margin. Our gross margin for Q1 was 82.1%, which is down from 82.6% in Q4 of '17 and 84.2% a year ago, primarily due to the lower levels of licensed software and higher third-party services cost.

Now I'll discuss spending, operating margin and net earnings. For these items, we provide both GAAP and adjusted or non-GAAP results. The adjusted results exclude share-based compensation expense, share-based compensation permanent tax items and acquisition-related adjustments. All is detailed and reconciled to GAAP in our earnings release.

Looking at operating spending. Our first quarter GAAP operating expenses of $866 million were up 6% compared to $817 million in the year-ago period. Adjusted operating expenses were $819 million, which is up 6% compared to $773 million in Q1 of '17. This growth was primarily driven by an increase in personnel expense related to revenue-generating associates and noncash items.

Looking at the line items. Sales and client service expense increased 6%. Software development expense increased 10%, driven by 5% increase in gross R&D and 23% increase in amortization. G&A expense was up 1%. Amortization of acquisition-related intangibles decreased 30% year-over-year.

Moving to operating margins. Recall that in our last earnings call, I highlighted a number of near-term headwinds that we anticipate will drive operating margins down in 2018, including increases in noncash software amortization and depreciation, traditional software revenue growth challenges due to the maturing EHR market, a shift to more SaaS models and the tough comparable created by our strong software growth in 2017, growth in our lower-margin Works businesses and investments in projects ahead of revenue being recognized. Each of these factors did impact our margin in Q1 as GAAP operating margin was 15.1% compared to 19.4% in the year-ago period, and adjusted operating margin was 18.8%, down from 22.9%. Our adjusted operating margin was below our expectations due primarily to software being even lower than we expected.

We do continue to believe that many of these factors are temporary in nature and that we do have opportunities to improve margins as our noncash expense growth slows, we get return on investments we are making in our Works businesses and our SaaS revenue related to population health ramps and balances the increase in mix of Works revenue. In fact, we believe the framework for margin expansion we laid out at our Investor Day is still valid. The principal change is that 2018, which we've already indicated as an investment year, is now forecasted to have lower margins, which creates a lower baseline from which we expect to begin expanding margins next year.

Moving to net earnings and EPS. Our GAAP net earnings in Q1 were $160 million or $0.48 per diluted share. Adjusted net earnings in Q1 were $194 million, and adjusted diluted EPS was $0.58 compared to $0.59 in Q1 of '17. Our GAAP tax rate for the quarter was 20%. And excluding share-based compensation permanent tax items, the Q1 tax rate was 22%, which is slightly below the high-level estimate we provided on our call last time. For the remainder of 2018, we expect our tax rate to be closer to 23% to 24%.

Now I'll move to our balance sheet. We ended Q1 with $1.093 billion of total cash and investments, which is up from $1.003 billion in Q4 of '17 due to strong cash flow, partially offset by use of cash for a stock repurchase program and making a debt payment. During the quarter, we repurchased 1.4 million shares of stock at an average price of $62.99 per share for a total of $88 million. We now have $330 million remaining at the $500 million stock repurchase program approved by the board in May of 2017. Given our strong cash performance, we have the ability to be active on the repurchase program.

Moving to debt. Our total debt, including capital lease obligations, was $446 million, which is down from $527 million in Q4 of '17. Total receivables ended the quarter at $1.041 billion, which is essentially flat to Q4 of '17. Our Q1 DSO was 73 days, which is up from 71 days in the year-ago period and 72 days in Q4 of '17.

Operating cash flow for the quarter was a record-high of $409 million. Q1 capital expenditures were $80 million, and capitalized software was $74 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development cost, was a record at $256 million for the quarter. Note that our operating cash flow benefited from a tax refund in Q1, so we do expect it to go down sequentially. However, we still expect strong operating cash flow for the year to more than offset the expected increase in capital expenditures and lead to another year of strong free cash flow.

Now I'll go through the guidance. We expect revenue in Q2 to be between $1.31 billion and $1.36 billion, with the $1.335 billion midpoint reflecting growth of 3% over Q2 of '17. For the full year, we expect revenue between $5.325 billion and $5.45 billion, with the $5.388 billion midpoint reflecting 5% growth over 2017. This guidance range is down from our previous range of $5.45 billion and $5.65 billion, reflecting the lower revenue in Q1, a more cautious view on the market environment and the delay of the VA contract. We are still confident we will sign an agreement with the VA, but we are now anticipating it will be in the second half of the year and will have less impact on our results.

We expect Q2 adjusted diluted EPS to be $0.59 to $0.61 per share, the $0.60 midpoint reflecting $0.01 less than Q2 of '17. For the full year, we expect adjusted diluted EPS to be $2.45 to $2.55, with the $2.50 midpoint reflecting 5% growth over 2017. This range is down from a prior guidance of $2.57 to $2.73 due to the follow-through impact of the lower Q1 software, a more cautious view on software for the rest of the year and the VA contract delay.

Moving to bookings guidance. We expect bookings revenue in Q2 of $1.35 billion to $1.55 billion. The $1.45 billion midpoint reflects an 11% decrease compared to a tough comparable in Q2 of '17. We do expect to return to bookings growth in Q3 when we'll have a much easier comparable period.

In summary, while some aspects of our results were solid, such as bookings and cash flow, we are disappointed in our revenue performance and that we needed to lower our outlook. However, it was necessary to factor in the VA contract delay and make sure we set attainable targets in what is a challenging near-term environment, even though we remain confident in our longer-term growth opportunities.

And 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 were strong overall as they grew 12% over Q1 '17 and were at the upper end of our guidance range.

In Q1, the percent of bookings coming from long-term contracts was higher than normal at 40%, reflecting good Works contributions and lower software and technology resale. As Marc discussed, the lower level of software and technology resale bookings and the delay of the VA contract did impact our revenue in the quarter. We did, however, have a good quarter from a competitive standpoint with 27% of bookings coming from outside our core Millennium installed base.

Our ambulatory business had a strong quarter, driven by ongoing penetration in ambulatory settings of our large health system clients. We're also seeing increased activity in the large independent provider market. In the smaller hospital market, we had strong Q1 success with our CommunityWorks offering. We continue to see record levels of activity in this space and are positioned for a strong year.

Moving to revenue cycle. Activity remains very high as it included almost all new deals and our existing clients continue to migrate from legacy systems to Cerner Millennium. Since the beginning of last year, we brought over 300 hospitals and more than 1,200 ambulatory facilities live on revenue cycle solutions.

In population health, we had a strong quarter. In addition to strong sales of HealtheIntent to provider clients, we had good contributions from other markets, further validating the broad applicability and addressable market for our population health solutions and services. One example of this in Q1 was the state of Montana Department of Health & Human Services choosing HealtheIntent for their Medicaid enterprise system to help manage 300,000 enrolled Medicaid lives.

Moving to our business outside the U.S., following a strong second half of 2017, we continued the momentum into Q1 and had a very good quarter with 23% revenue growth. We also had strong non-U.S. bookings in Q1 with some of the strength driven by the signing of our contract for the Region Skåne in Sweden. This is a major win for our non-U.S. business as we will provide our core solutions to 10 hospitals and 190 primary care facilities. It also represents our first Nordic population health client serving 1.3 million citizens. In addition to the strength in Sweden, we had strong contributions from the U.K., Germany and Canada. Looking ahead, we expect to have a good year with Australia, Canada, Middle East, U.K., Ireland and Germany all forecasted to provide good contributions to our growth.

Next, I'd like to provide an update on our federal business, starting with the Department of Defense MHS GENESIS project. The optimization phase of the project at the initial site has been completed. This phase of the project resulted in several improvements, and we expect to begin the next wave of deployments this fall. We're also very pleased with the announcement last month that the United States Coast Guard now plans to adopt the same commercial EHR as DoD as part of the MHS GENESIS project.

Now I'll discuss our opportunity with the Department of Veteran Affairs. As you are all likely aware, the signing of the contract was delayed again in Q1. While this is disappointing, we continue to believe we have broad support from key stakeholders, and initial funding for the project was approved as a separate line item in the budget. Therefore, we still expect to sign the contract. It's just difficult to predict exactly when. As I've indicated before, the delay does not change in any manner the magnitude and importance of the overall opportunity. We are honored to have the opportunity to serve our nation's veterans, and we'll be ready deliver when it signs.

Next, I'll provide some marketplace observations and discuss how we are positioned for growth. While we remain optimistic about our overall market opportunity, particularly over the long term, our results and outlook are reflective of an environment in which providers are financially challenged and have a lower sense of urgency to make purchase decisions due to a lack of hard regulatory deadlines.

I'd like to discuss how we are adapting to the current environment and where we see growth opportunities. In the EHR market, there are still about 2,000 hospitals on legacy EHR platform. We believe most of these hospitals will need to move to a more modern platform at some point. While most of these are smaller, they represent a significant opportunity in the aggregate, and we're doing well with our CommunityWorks offering that aligns with the needs of smaller hospitals. In addition, because we have a footprint of 70 of the 100 largest health systems, many of these opportunities are accessible directly through our existing clients as they look to standardize on Cerner at sites that are still on legacy EHRs, which can save them money by reducing the cost involved with managing multiple platforms.

Our large footprint also represents meaningful whitespace for us to cross-sell our solutions and services. We believe that our lower penetration of revenue cycle, Cerner RevWorks, Cerner ITWorks and population health represents significant growth opportunity. A key to selling these solutions and services back into our base is demonstrating ROI, which has become increasingly important in the current environment.

We have had a significant focus on delivering new value to our clients with a focus on demonstrating hard ROI, whether it'd be increased card capture and more efficient collections through our revenue cycle solutions and RevWorks services, lower cost of operations with ITWorks or using our population health solutions to increase fee-for-service revenue or improve performance on value-based contracts. We have also demonstrated that the addressable market for our population health platform goes beyond our traditional provider end market, and we expect to continue expanding the reach of our population health solutions and services.

Our state and local and federal business also represents significant opportunity, and we expect this to contribute to growth as long as we continue to execute on our initial contracts. Clearly, getting to the next wave of DoD rollouts and getting started on the VA are important milestones that are needed to drive these meaningful contributions. As this plays out, we believe the timing of the growth will not only create a bridge to when we will have more contribution from our population health offerings but will also become an important long-term contributor to our market presence and growth.

There are also several niche markets and smaller venues that collectively represent a large opportunity, including ambulatory, behavioral health, post-acute, advisory consulting, employer services, workforce efficiency and provider communications to name a few.

Finally, our non-U.S. business is picking up, and it represents an earlier-stage EHR market opportunity than the U.S. as well as an opportunity for nearly all our other solutions and services I discussed.

To conclude, while much of our end market is currently facing financial pressure and uncertainty, our solution and tech-enabled services are aligned with these pressures and can be sold based on value. We believe our ability to do this is an important differentiator that will allow us to grow as we help our clients address the challenges of today while preparing for a post fee-for-service economy.

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

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

Thanks, Zane. Good afternoon, everyone. Marc and Zane did a good job of covering the results and the current marketplace. We understand we didn't deliver against the expectations we set, and we are disappointed. We have revised our outlook to factor in the near-term reality Zane discussed, and we will work very hard to deliver against these expectations.

Now I'd like to give you an update on my areas of focus. On our Q4 call in February, I mentioned that I'd be spending my first 100 days doing a deep dive into Cerner, talking with our clients and working with our leadership team to review our opportunities and investment priorities. It's now about 90 days in, and we're on track in making excellent progress on our review of markets, clients, workforce, solutions, services and opportunities.

Together with the leadership team, I've spent significant time with our clients. I've gained a clear understanding of our strategic value to them as well as some real opportunities for us to make improvements.

After a period of focused review and assessment, we recently got together as a leadership team for a 3-day strategic planning retreat. We discussed our findings and spent the majority of the time getting aligned on the elements of a refined strategic plan. We emerged from the retreat with a set of strategies that we intend to test and improve as we draw closer to our formal planning processes this fall. Broadly, the refined strategies fall into 3 categories: first, focusing on the client experience; second, investing in the platform, solution and service innovation; and third, profitable growth.

Focusing on the client experience is a set of objectives for ensuring our clients have full access to Cerner's best capabilities and get what they need from Cerner to help them succeed. Our belief is that as we have grown in size and scope, our relationships with clients have grown more complex than they need to be. We want to simplify the experience of working together so that we can be a better transformational partner. This has become increasingly important in a consolidating marketplace, where we need to align with our large clients and provide them with tools to be successful to achieve their targeted benefits as they grow.

Investing in platform, solution and service innovation is a group of objectives focused on making targeted improvements to our technological platforms, solutions and services and speeding innovation of solutions and services that address new market opportunities.

Finally, we have a set of objectives around profitable growth that are focused on supporting markets that have the highest growth potential over the next few years: consolidators, community hospitals, governments, global markets, employers, payers and nonhospital providers.

In summary, regardless of the near-term challenges, the assessment process we've just gone through makes me optimistic about our market opportunities and prospects for growth. We have work to do. But if we execute, and we will, I believe the long-term growth targets we have shared with you remain attainable. Cerner's leadership team is exceptional, and we're working together extremely well. I'm very excited about our future together.

With that, I'll turn the call over to moderator so we can take some of your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Sean Dodge with Jefferies.

Sean Wilfred Dodge - *Jefferies LLC, Research Division - Equity Analyst*

Maybe starting with the VA contract. Zane, you're now expecting it will be signed in the second half of the year. You touched on it a bit. But I guess since there aren't any permanent senior leaders in place at the VA right now, what gives you confidence this is something you can still get done and get done as soon as the back half of this year?

Zane M. Burke - *Cerner Corporation - President*

Yes, great question, Sean. We continue to remain linked to kind of the Hill, the White House and the agency, all of those folks. And there is -- there are -- obviously, the secretary position is on an interim basis right now, but all of those factions are all seemingly moving ahead. And we feel strong about that. And the line item in the budget is a critical item as we move forward. That gives us the confidence in that. But obviously, it's been very challenging for us to predict the actual completion of that contract. And as such, we've moved that to the back half of the year.

Sean Wilfred Dodge - *Jefferies LLC, Research Division - Equity Analyst*

Okay. That's helpful. And then your comments in the prepared remarks about revising your outlook down because of the large contract delay and a less predictable end market. I get the delay portion, but can you give a little bit more color on what you mean about a less protectable end market? Is this the contracts are getting bigger and it's tougher to pin down timing? Or are you seeing clients get a little bit tighter with HCIT budgets and pushing off or delaying projects?

Zane M. Burke - *Cerner Corporation - President*

I think it's -- I think the -- it's multiple things. There are -- we had the one contract which -- obviously, the VA was a significant contract that moved out of the quarter that we had planned on. At the end market side of this, there's quite a bit of M&A activity. There's a competition for capital. The bottom lines are under pressure, and technology is still a lever by which people can make a difference in the space. And so what you're seeing is, as we've discussed over the last several quarters, is there's an unpredictability to the completion of some of that business. And I think that continues forward and can create some lumpiness in some of those elements and some predictability in part of these pieces.

Operator

Our next question is from Ricky Goldwasser with Morgan Stanley.

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

So when we talked about the profitable growth and the goal of supporting markets with largest growth areas, you've listed quite a large number of growth opportunities. I think you listed most of your clients. So can you give us maybe some perspective on within that group, where do you see the most realistic opportunities in the near term? And then also in the long term, as the health care landscape evolves and changes, we're seeing a lot of, obviously, M&A, vertical integration, which would suggest that the market might look very different 5 years out versus today. And within this context, you reiterated the long-term growth rate for the company. How long do you think it's going to take to return -- go back to these growth rates?

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

Yes, this is Marc. I think that the things that Brent laid out relative to those markets, if you will, that we're looking at from consolidators on, clearly we think all of those have potentials. That's why we're identifying them all as different markets. The consolidator market is completely -- is very different from what the non-consolidator market is from a provider perspective. The provider market on the non-consolidated end is very active. Lots of activity going on. Lots of opportunities. But as Zane said, there's a real ROI focus. There isn't a meaningful use. There isn't an external item that is forcing them to get to decisions. They have to go through the process to get to that ROI. In the consolidator market, we've got to be the people that are providing the tools that allow them to gain leverage and to gain scale as they go forward and work on their -- work on taking these accumulated assets and turning them into a single health system, which is the goal of most of those. But each of those areas, and obviously, governments, with VA, with foreign governments, as we realized with our Swedish deal with Skåne this quarter, those are big opportunities that we see. So each of those has a different timing and different uptake. As we talk about our 10-year view -- or the -- that we shared and our ability to continue that and strive to get to that, really, as you look at the elements that are out there that drive a lot of that growth, the Works businesses in both ITWorks and RevWorks, if you look at the population health element of that, all of those things still remain elements that all of health care is looking to add. And as we look globally, the population health certainly is an additional element that has helped us succeed in those global markets, where some of our primary competitors have been unsuccessful. So I think without quantifying, I think our 10-year model gives you an idea, if you look at each of those markets, when we think they're going to start providing more lift. And I think employer, on the population health side, those are likely in the out years, as we've indicated. Governments, we're starting to see uptick currently. We've seen more uptick in the governments in the global side. And then we continue to see activity in the -- certainly the non-consolidator market as well as the consolidator market. So some of that, the providers are probably more near term. The others are going to be meaningful longer term.

Operator

And our next question is from Sandy Draper with SunTrust.

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

Can you hear me okay?

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

Yes.

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

I guess it's a little bit of a follow-up to Ricky's question but more on the expense side. When you think about still being optimistic about the long-term impact of the higher growth, when you think about the near-term challenges, how do you balance? At what point do you pull back on expenses and recognize, okay, for this period, we're not going to hit the higher end, so we need to curb expenses because you guys, over the long term, have done a great job of growing [to the extent you] spend and grow and spend and grow. The market analogy, as you said, is challenging. There's no obvious end. How do you sort of balance the long-term focus versus near term, hey, we don't know when this is going to get better. We're going to pull back on expenses until we have clear signs. Just thoughts about that. I don't know, Brent, if that was something you brought up and discussed in your deployment strategy.

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

Yes, this is Marc. Certainly, we talked about our cost structure as part of the retreat. I think the key for us is we divide our resources and our associates into revenue-producing and those that aren't. We are making -- and then we said on the last call, we're making an investment in 2018 related to the market. We believe the VA's going to happen. We're going to be absolutely prepared to deliver on that when it does, and we're going to continue to have a level of investment in that business. We talked about adding a Kansas City Works business. We hired 200 of those people in Q1 versus our 600 target. So we are continuing to invest in those businesses because we think that it's the right thing to do. Those businesses are there, and they're going to happen. We're going to continue to invest in our IP organization because innovation is our differentiator in the marketplace. Certainly, as we look at anything that isn't revenue-producing or isn't creating innovation, we look at those expenses very carefully. We're managing -- those of you know me can expect a travel level, open cards or open headcount positions as far as, do we fill those immediately? Or do we hold them for a month or 2? So if you look at the total spend we incurred in Q4 compare it to total spend in Q1, I think we went up about $3 million in total spend. And that was an increase in amortization. So I think -- your points are great, Sandy. We are certainly focused in making sure that we're not spending crazily and spending in a way that doesn't match the opportunity we see. But as an investment year and given our history that we've been able to invest in and drive future growth, we see '18 as one of those years. And we are going to control spending that isn't directly related to accomplishing those goals, but we are going to spend where we think that can -- we can drive those goals forward.

Operator

Our next question is from Eric Percher with Nephron Research.

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

(inaudible) to your comments about (inaudible). As we consider those costs and the ramp over time, how much have you had to bring on in order to be prepared? I know part of this is Cerner expense. There would also be third parties involved. And how should we think about what's been fixed versus variable and your ability to ramp that down or up as you're waiting?

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

Yes. We've missed the first part of the question, but I assume it's about -- based on the VA and the ramp expense related to that.

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

Yes.

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

Yes. For the most part, the third-party expense, we're not incurring third-party expense at this point. They're doing the same thing. They're ramping up. They're being prepared. But we are not incurring any third-party expense. It is all on the -- our side of the expenses being incurred, and that includes the services teams. It includes the hosting of the VA data center. It includes provisioning and getting in the data center. So there's elements -- those are the elements that we're ramping up. So from a timing and ability to repurpose those, certainly the people on the services side, we're filling some of their time with short-term projects to get some revenue out of them. But they're not going to be as productive as they will be if there were fully on the fact. And keep in mind, from -- that's just -- relative to what our cost structure is, this is -- the VA is working through a process. It's a federal procurement process. So we've got to be careful how much we talk about that. But from what we're doing to be prepared, I can tell you that certainly, we're doing -- we're incurring the cost that we think we need to. But those -- the ability to change in direction on those, we'll speak something -- at this point, we don't see the need to do that. If that was necessary, the services people have skills that can be applied to other places in the organization, and the capabilities -- other capabilities are ones that we can extend -- expand in our existing clients.

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

And just following up to Brent's commentary, from the time line he laid out, it sounds like the process is really one that looks at the forward year. When will we begin to hear about what's coming out of that process? Is there a period -- I know you'll have your health care conferences. Is that when you start to speak to clients? And when do we, as investors, start to hear about some of the outcomes?

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

It's, I think, definitely in that same time period. We'll try to align there and make sure we're keeping you informed appropriately.

Operator

Our next question is from Jeff Garro with William Blair.

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

Wanted to ask about the comments around lower software sales, and maybe if you could just follow up with any particular areas where you're seeing weakness more so than others, maybe acute versus ambulatory or the core segment versus population health or revenue cycle.

Zane M. Burke - *Cerner Corporation - President*

This is Zane. I think what you'd see is it's really the mix of the clients themselves. So it's really -- we saw, actually, quite a lot of activity from a number of deals. It was just some of the larger opportunities weren't there that we'd anticipated being there in the first quarter. And so we saw great activity really in this -- in the community hospital side, but it was probably in the larger opportunity side that some of those were not where we thought they would be. And those just come with more software.

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

Got it. And then one more, if I could. Zane, you mentioned it was a good quarter from a Works contribution aspect. And maybe you could provide a little bit more deal -- detail on ITWorks versus RevWorks. Any fully outsourced ITWorks clients that you're adding to the cohort there?

Zane M. Burke - *Cerner Corporation - President*

Sure. This is -- we saw strong activity in our business office services from a RevWorks perspective. And so that was a big contributor. We saw some additional ITWorks extensions into some other areas that we hadn't previously worked in. But not really a new footprint per se.

Operator

Our next question is from David Larsen with Leerink Partners.

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

Of the 200 individuals that were hired for like, I guess, the Works area in Kansas City, what is their utilization right now? Are they all billing 40 hours a week? Or is it more like 20 hours a week each? Any sense for, I guess, how utilized they are.

Zane M. Burke - *Cerner Corporation - President*

So this is Zane. These folks are in training at this point because these are going to be our shared services groups for our enhanced revenue cycle solutions. And that will yield significant results, both top and bottom line, over time. But there's a ramp-up to that. And there's a much more significant investment, frankly, in these resources than in some of our implementation resources just given the nature of the activities of what these folks do. So I would tell you at this point, they're all in training, and it takes a time period for them to get productive and into full use.

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

So are there projects that you have lined up for them to work on in the back half of the year where they will all be able to bill?

Zane M. Burke - *Cerner Corporation - President*

So this is Zane again. We absolutely have a backlog of revenue cycle opportunities, and we've had a good contribution -- a good contribution again, bookings on business office services. So the work is there. We're feeling good about where that work is. But this is a little bit different in terms of billability and how that works. It's not a straight-up professional services rate per hour kind of situation. These are folks that are filling needs and -- for a revenue cycle position. This -- over time, it will give us much more leverage in our cost model as we move forward in that space. But at this point in time, you're a bit doubled up on cost from either the resources still of the client sites and you're paying for the training on this side of the house as well.

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

Yes, David, this is Marc. The goal is to obviously create the centralized billing center in Kansas City and use that to not only take on new business but to take on some of the business we're already funding from some diverse resources that are located in different places around the country. So I think that's a key there. If you will, it's almost like a fixed fee engagement. We charge the clients a certain amount of money, and then we do the work that's necessary to deliver the service. If not, we don't get paid by the hour. We get paid by the month, if you will, and time frame based on the size of the client and what they're doing. But as Zane said, right now, those people are not driving any revenue as they train.

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

Great. It sounds like your international team is doing a great job.

Operator

Our next question is from Sean Wieland with Piper Jaffray.

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

A couple of quantification questions. So first, content sold as license that would normally be sold as subscription. Could you quantify that from last quarter? And is that an ongoing trend that you are -- you saw again in the first quarter? I misunderstood that.

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

Sorry. The -- we can't necessarily quantify. But the point is that in 2017, as we sold subscriptions and we would sell content, and historically, we might have sold that as getting paid for it over time. The new 606 revenue standard basically would have said on the date those were signed, that's when the revenue will be taken into the new standard. And when the standards took effect January 1, all of that future revenue would have gone out of our backlog. So as we looked at it, we were able to convert some of that content into perpetual licenses, which allowed us normal licensing treatment to taking the revenue and it goes -- roll into the licensed software number. So that's the main point. Under 606, which is the rules beginning in Q1, there isn't a distinction between subscriptions of a certain type and licensed software. It's all -- to the extent, it's both our point in time revenue that are recognized on the appropriate either signing date or first productive use or whatever the milestone is. But those -- so the -- what we did in '17 and what we talked -- or referenced is the licensed software number was a little bit stronger because of our -- ability to convert some of those deals to licensed. What it did going forward is it reduces the subscription number going forward because we didn't book as much subscriptions in '17 as that revenue was going away anyway. We're now basically operating under the same way we did in '17 relative to that. As you look at Q1, the amount of subscription bookings was a little -- was below plan. So that's part of the shortfall we had in license software. So it -- while the accounting treatment would be the same to how we sold it as perpetual software last year, it didn't have an impact in Q1 because of the level of bookings we had in that space.

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

Right. So if I get this straight, it's not an end market like a customer wanted to buy it differently? It was the accounting treatment of it that caused you to account for it differently? Am I hearing that correctly?

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

It caused us to sell it differently as a licensed rather than a subscription. And therefore, the accounting treatment followed the way it was sold. But we did alter it in advance of 606 being adopted to minimize the impact of 606. If you look at the overall impact of 606 on our company, I mean,

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the net retained earnings adjustment, which is kind of the net revenue -- or the net impact on earnings for all the adjustments that were made, is probably $7 million. So I think we did a pretty good job of managing and trying to be prepared for the reduction of backlog that you would see for subscriptions coming from that. You also see an increase of backlog coming from some other items. And you also see commission expense, which we have previously taken 100% of commission expense in the past, we now get to take it again as it rolls out over a period of time. But the net of the backlog adjustment plus the expense impact kind of nets down to that $7 million over a period of time as all of those things were allowed. So that was part of that activity.

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

Okay. And the other quantification question I had. Could you quantify the direct costs associated with the VA in the quarter? And when you eventually sign this contract, are you going to get -- made whole in those expenses?

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

No. I can't quantify it.

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

Will you be made whole?

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

I can't quantify them. It's a federal procurement, and I can't discuss anymore, sorry.

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

Got it. Don't want to get you in trouble.

Operator

Our next question is from George Hill with RBC.

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

Maybe I'll ask part of Sean's question in a different way, which is, I guess, can you quantify the risk to the guidance in the balance of the year should the VA not sign, if this kind of process continues to drag on?

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

Yes, I mean, as Zane indicated, we still have in our guidance signing of VA in the back half of the year. So there is -- that is part of the forecasting we've done. That's part of the assumptions we have. So if, in fact, VA did not sign at all during the year, that would have an impact. But currently, it's obviously lower -- we reduced our guidance based on the fact that the number we have in there is less than we initially had in -- as we went into the year, moving it from the first half of the year to the second half of the year. But I think at this point, I can't really quantify it any more than that just based on things we've talked about before. But that is -- the numbers still does have VA in it with the second half impact.

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

Okay. And then I kind of wanted to ask Sean's question in a different way, which was typically, the accountants make you report the business from an operating perspective the way that you guys run the business. You guys have kind of moved from reporting to the -- what we'll call the business model perspective versus the prior perspective. Is it changing anything about the way that the company goes to market and approaches its customers? And is it changing the way in which Cerner tries to contract with customers at all? Like is the new reporting reflective of any actual go-to-market changes?

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

No. The line of business that we're doing to provide additional detail on the revenue line is the number that we've shared with you guys annually for as long as I can remember doing this. So I think it is -- that's one of the reasons we went to that -- 606 said your revenue is one line on the income statement, but you need to provide a disaggregation of that number in the financial statements. We decided that the business model was among that was most familiar to investors, and for the most part, other than the subscription differences I discussed earlier, is consistent with what you've seen that number be in the past. It absolutely is going to provide more transparency because as you look to analyze our results because you're going to see elements that would have been included in another category on the former income statement. So I think from an accounting perspective, it's -- the goal will be to provide some additional level of transparency. And certainly for our standpoint, it's merely taken a number that we provided annually and now providing it quarterly. But you will see some fluctuation in those numbers because those numbers can vary somewhat quarter by quarter to the extent that they are onetime items and not recurring in nature. But I think that's part of the transparency. That's the goal of the standard. So there is no change in how we do business, no change in how we're going to go to market other than, obviously, the retreat we had and the things that we'll certainly look at as we go look at markets and decide how we want to attack those. But it doesn't -- yes, the accounting is not driving how we're operating the business. In fact, this is one time when what they've asked to do on the transparency line actually makes sense.

Operator

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

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

I just have one question. A lot of them have been asked. You talked a lot about whether it's the VA contract being timing-oriented, some of the choppiness in the market but still confident in the long-term health of the business. You guys have very frequently had a very clean, almost pristine, balance sheet. So nice cash flow in the quarter. Why not be more aggressive in the capital deployment side, particularly given the opportunity and the potential to do something like -- whether it's something like share repurchase, a more sustainable return of capital to investors, even the long discussed and questioned dividend? Any thoughts around changing the capital deployment structure, particularly given that this seems to be, at least from your perspective, a very short-term or at least medium-term blip in your business versus something that's permanently impairing the organization?

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

Yes, Michael. This is Marc. We certainly had record free cash flow for Q1. So that was certainly a huge positive. We have $339 million of stock repurchase authorization still remaining to be exercised. And I would believe that our expectation is to be aggressively working on that as we work through this quarter. And we made -- my expectation is that certainly the board will consider a more -- may -- board and shareholder meeting expanding that to a broader repurchase because I think today, from a capital deployment, we look at the opportunities to repurchase shares. And we look at the opportunities to -- is there anything from an M&A perspective that might make sense for us from an investment perspective that might further these businesses that we expect to be long-term growth potentials for us. So we want to be able to do that. I think from a dividend perspective, that's probably not in the near-term opportunities just because I think we are a growth company. We think there are other opportunities for things for us to invest our capital in. I think that at this point, we'll probably focus, from a shareholder perspective, on stock repurchases as our capital deployment vehicle.

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

Yes, understood. Just more curious because I think you're probably the only company that I cover that has a net cash position on your balance sheet. So appreciate the color on that.

Operator

Our next question is from Steve Halper with Cantor Fitzgerald.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

Appreciate the comments around you're still a growth company. But I guess when you look at the current environment and how and what you go to market with, what gives you the confidence to say that we can reaccelerate the growth back to those established long-term targets? Given what you know today, obviously, things can change. But what do you know today that can help us sort of believe that, that is attainable?

Zane M. Burke - *Cerner Corporation - President*

This is Zane, Steve. The things that our clients need are the kind of tech-enabled services that we have around ITWorks, RevWorks and what we do in population health. So actually, solving the challenges, they need more technology, and they need those tech-enabled services and solutions. And the uptick of that, I think, is continuing to go well. And that gives us a lot of optimism in the future in our core marketplace. Then as you think about that government marketplace and the state, local, federal space, that really has an opportunity to become incredibly meaningful on a growth top line perspective for Cerner overall. And then some new marketplaces that our technology really works effectively. And really, we have all kind of the pieces. If you look at employer and payer and the beginnings of some of that coming together, those pieces are picking up steam in some pretty meaningful ways. And I think the pace of change causes some to freeze at some point in time. And I think that's a little of what we've seen in some of the marketplaces, but it will also cause enough pain that people will have to make decisions and make moves that they haven't historically considered, like outsourcing their revenue cycle, like outsourcing their IT shop. And I see that picking up in the long range quite significantly. And I think you can see -- this would be a different conversation had this VA secretary been in place at the end of the first quarter. And I think we'd be having a different conversation about how the outlook of the year is. And so I think it's important not to look too far past what that really means to the overall business and really how we're viewing this from an optimistic perspective and where we are.

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

Yes, Steve. I'd just add that from the Works businesses, one of the good things about them is the client is already spending those dollars. You're not looking for additional spend. You're just trying to take the dollars they're already spending. And so that's a pretty key element. And as the ROI and the focus becomes even more intense, as Zane said, those businesses will be just -- our conversations are more people thinking, I know I'm probably going to get there. It's just -- I got to decide what the timing is.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

And just one follow-up. Just a housekeeping question. I appreciate the comments. When you look at the cash flow statement, the capitalized software cost and CapEx, is that -- both of those items, are those good proxies for the rest of the year? Or is there any change?

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

Relative to the amount incurred in Q1 compared for the year?

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

Yes.

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

Yes. I mean, I think that as you look forward for capital -- CapEx, I mean, we probably -- we talked it's probably going to be in the range of $450 million to $500 million, would be my expectation. Capitalized software is probably going to be slightly above what it was last year. So I think that's -- that gives you a sense of where we're at. Our overall thought is that free cash flow for the year basically lands about what it was last year, maybe just slightly -- a little bit up from last year but in that range.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

So based on that commentary, you're expecting an increase in the -- in CapEx for the next 3 quarters, and that's based on projects at the new campus. Is that...

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

Yes, basically, projects -- the campus project is the one that's going to have the biggest impact. And as you said, it's probably $100 million more CapEx year-over-year based on those projects.

Steven Paul Halper - *Cantor Fitzgerald & Co., Research Division - Analyst*

Okay. And then it should moderate next year?

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

Yes, it will. We have a second year on one of the campus expansions that will impact, but some of those projects will reduce as well. So we'll give it another view, but it could be a 2-year version of that at that level and then declining after that.

Operator

Our next question is from Donald Hooker with KeyBanc.

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

So obviously, a lot of questions asked, but I'll throw in one sort of more detailed question. I was curious if you could elaborate on that Medicaid agreement in Montana. It was probably small in terms of its contribution, of course, but it seems a little bit different. And I wonder -- I would like to hear what kind of solutions you're offering there and what that might bode going forward for state opportunities.

Zane M. Burke - *Cerner Corporation - President*

Donald, thanks for the question. So this is the state's Medicaid population, and they're deploying our [payer] registries to start with. And then they'll move into a full Enterprise Data Warehouse and analytics of their Medicaid population. And this is direct competition against kind of a different, bigger competitor that we normally see and play against in a public procurement. And this is reflective of the marketplace that we think is pretty significant. And this is a multimillion-dollar booking arrangement for us. So it is significant. It's meaningful. And it's the precursor to additional work that you can do beyond the software and analytics. It's the additional services you can go do in those spaces. So we do view that state and local government is a great growth opportunity for us as we move forward. And we sell -- we have offerings well beyond the EHR in this space. It's probably -- it's one of those things that we'll spend some time highlighting as we move forward. So thanks for the question.

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

I mean, are there other states -- remind me if there are other states that you're working with in this manner as well.

Zane M. Burke - *Cerner Corporation - President*

This is a first of its kind. We do work with other states on a number of different -- a number of different solutions. So we work with states from an employer clinic perspective. We work with states from a behavioral health perspective or from an electronic health record. We work with states in multiple ways. So we're working with, I think, about 7 different states. The Department of Corrections in California is a very large client of ours. And so there are some pretty significant markets that are just not thought of in a traditional sense that give us quite a bit of optimism in the state and local space.

Operator

Our last question is from Matthew Gillmor with Robert W. Baird.

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

I just had 2 quick follow-ups. The first one, Marc, was Topic 606 a headwind to revenues for the quarter? Or was it about neutral?

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

Yes, I mean, for the -- it rolls out differently each quarter. Overall, it was probably a slight positive when you talk about the backlog, revenue side and you talk about the commission expense offset against that. For the quarter, from an earnings perspective, it was about a negative $2 million impact. I think for the overall revenue, those 2 items netted to a pretty small amount. There is also -- Topic 606 did impact the [Dennis West] contract that we have relative to RevWorks. We re-badged those associates on April 1. And normally, under the old rules, when you re-badge them, you start taking the software gross. But with Topic 606, you would take the gross all the time even if you haven't re-badged associates. We knew that, that was going to be the case. We were looking at re-badging those associates on the 1st of January. But because 606 wouldn't let us start taking that revenue anyway, we deferred the re-badge to April 1 at the client's request. So if you -- the number that shows up in 606 will have a -- probably 80% of it will be related to that Dennis West contract and the revenue from it in Q1. Going forward, there will be no difference between 606 and the old rules because we will have re-badged them. So net-net, what I see is 606, which is the backlog adjustments and the expenses was pretty nominal impact.

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

Okay. And then another topic that you touched on, on a previous question, but I was hoping to get some more details. Does the VA readiness crowd out other revenues and other projects you don't otherwise be working on that would generate revenue? And do you have an estimate for what that would be?

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

I don't have an estimate. There's certainly people that could be on other jobs working more efficiently than some of the things we have them filling in on today. So certainly, it is a loss of revenue relative to those. And that's why we characterize it as an investment. It's -- clearly, I wouldn't expect that my spend would exceed my revenue as it is on those resources. And that's what it is today. But I can't quantify that for you right now.

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

Okay. Thank you, Marc. This is Brent. I'd just like to thank you all for joining us today. I want to reiterate what a pleasure it is to be here at Cerner. And the first 90 days have passed in a heck of a hurry. It's already clear to me that Cerner is a company with great opportunities. We talked about some of those today, and we'll talk more with you as the year goes on. I know we have a lot of work to do. We have a very strong leadership team and a strong associate base. And I really believe we can deliver lasting growth by making focused investments in innovation and ensuring we do the things necessary to make our clients successful. And that's what we're all about. So thanks for being with us. Have a good evening.

Operator

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