Cerner Corporation
Third Quarter 2018
Earnings Conference Call
October 25, 2018

Moderator

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; new solution, services and 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 investor 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 Naughton

Thank you. Good afternoon everyone and welcome to the call.

I will start with a review of our numbers. John Peterzalek, our Chief Client Officer, 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, we had a solid Q3, with all key metrics within our guidance ranges. Revenue was at the lower-end of our guidance 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.

Bookings, Backlog and Revenue

Our bookings in Q3 were $1.588 billion, which reflects a 43% increase over $1.111 billion in Q317. Q3 of last year was our lowest bookings quarter, so it was an easy comparable, but our year-to-date bookings growth of 19% is also strong.

We ended the quarter with a revenue backlog of $14.70 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 $1.340 billion in Q3. This is up 5% over Q317 and, as I mentioned, at the lower end of our guidance range 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 Q317.

- 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 Q318, down from $123 million in Q317. 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 $457 million, driven largely by growth in our Works businesses.
- Managed Services increased 15% to $302 million, driven by strong year-to-date bookings.
- Support & Maintenance was up 5% to $278 million, reflecting 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 Q218 and down from 84.1% a year ago.

Earnings

Now I will discuss spending, operating margin and net earnings. For these items, we provide both GAAP and "Adjusted," or Non-GAAP, results. The Adjusted results exclude share-based compensation expense, share-based compensation permanent tax items, acquisition-related adjustments and other adjustments, all as detailed and reconciled to GAAP in our earnings release.

Operating Expense

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 Q317. Looking at the line items, Sales & Client Service expense increased 9% over Q317. This increase was primarily driven by an increase in personnel expense related to our services businesses. Sales & Client service was down 4% compared to Q218. 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 a 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.

Operating Margins

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 non-cash expenses, investments in our Works businesses and an increased mix of Works revenue.

We continue to believe that many of these factors are temporary in nature. We are also continuing 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.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q3 were $169 million, or $0.51 per diluted share, compared to $0.52 in Q317. Adjusted Net Earnings in Q3 were $209 million and Adjusted Diluted EPS was 63 cents, compared to $0.61 in Q317.

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 Q418 and next year, we expect our tax rate to be closer to 22%.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q3 with $814 million of cash and short-term investments, which is down from $886 million in Q218, with our free cash flow being offset by our $266 million investment in Lumeris' parent company and $58 million of share repurchases. We currently have $582 million of remaining authorization under our repurchase program.

Moving to debt, our total debt, including capital lease obligations, was unchanged from last quarter at $441 million.

Total receivables ended the quarter at $1.211 billion, up from $1.152 billion in Q218. Our Q3 DSO was 82 days, which is up from 77 days in Q218 and 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 70's 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.

Guidance

Now I'll go through guidance.

- We expect revenue in Q4 to be between $1.370 and $1.420 billion. The midpoint of this range reflects growth of 6% over Q417 and would bring full-year 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 62 to 64 cents per share. The midpoint of this range is 9% higher than Q417 and would bring full-year 2018 EPS to $2.46, which reflects 3% growth over 2017. We understand that 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 impacts future quarters, and the expense benefits we had in Q3 that offset the lower software are not expected in Q4.
- Moving to bookings guidance, we expect bookings revenue in Q4 of $1.850 billion to $2.050 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, but it would bring full-year 2018 bookings to $6.711 billion, which reflects growth of 6% over 2017.

2019 Commentary

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 two years, when we finalized our plan and provided guidance on our fourth quarter call, we have 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 workstreams 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 from providing a preliminary view 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 have discussed, we still believe we can deliver solid revenue and earnings growth next year. We just want our guidance to be based on a more complete plan.

As we've mentioned, we are 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 at our investor meeting during HIMSS, which we plan to have 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 will turn the call over to John.

John Peterzalek

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 Nov 2. I would 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 title that reflects our increased emphasis on the success of our clients. As a 15-year Cerner associate with 30 years total in IT, I have spent most of my career working with clients in sales and delivery and have ongoing relationships in health care organizations around the world.

As a leadership team, we will continue to reinforce a 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 in the transformation of healthcare.

With that, I'll turn to discussing Q3 results.

Results and Marketplace

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 *Cerner 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 categories, with population health, revenue cycle and *ITWorks* all having solid quarters.

Population Health / *Maestro Advantage*^{TM}

Regarding population health, I wanted to provide an update on the relationship with Lumeris we announced last quarter. As you'll recall, we are launching an EHR-agnostic offering with Lumeris called *Maestro Advantage*^{TM} that will be designed to help health systems set up and manage Medicare Advantage Plans and provider-sponsored health plans. Additionally, Lumeris is adopting *HealtheIntent*^{SM} 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 a targeted list of prospective clients. We have visited with over a dozen prospective clients that are either evaluating the launch of new Medicare Advantage contracts or beginning with an intermediate step of optimizing multi-payer arrangements. We also touched many clients during our Cerner Health Conference. The feedback we have 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 upside-only agreements such as an Accountable Care Organization or Medicare Shared Savings Program. They are now considering expansion into contracts where they can capture a more significant portion of the premium dollar for 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 higher premiums are all contributing forces that make MA a desirable option.
- Finally, our clients have also acknowledged the importance of change management and hiring experienced partners. We believe the combination of technology enabled services and strong operational expertise that *Maestro Advantage*^{TM} 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.

Federal Business

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 four 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 they went live last year.

Moving to the Department of Veterans Affairs. After signing the contract in Q2, activity continued as expected with three more task orders signing in Q3. These task orders, along with the work that began after the first set of task orders, keep 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.

Non-U.S.

Moving to our business outside of 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.

Close / Long-term Growth

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 decisions due to fewer regulatory deadlines and incentives. However, there is a counterforce to 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 EHR market, 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 footprint represents meaningful whitespace for us to cross-sell our solutions and services. We continue to believe that revenue cycle, *Cerner ITWorks*^{SM}, and population health can contribute significantly to our growth.

While population health is still at an earlier stage and has ramped slower than we initially projected, we remain confident it will 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 more defined with our Lumeris collaboration.

Finally, our non-U.S. business is 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 coming years, as we have solutions and tech-enabled services that align with the needs of our end markets. Health care 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 health care stakeholders move towards a more efficient and higher quality system of care.

With that I will turn the call over to Brent.

Brent Shafer

Thanks, John. Good afternoon everyone.

John did a good job describing the significance of his new role and the marketplace dynamics. John's perspective has been instrumental in our leadership team's analysis of the complex health care environment and 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. I also want to take a moment to thank John and congratulate him on the well-deserved recognition for the role he has been playing. I'd also like to echo John's thank you to Zane for his distinguished service to Cerner.

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 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 is a real focus on disciplined execution. If we obsessively focus on making our clients successful, we can't go wrong.

Our next commitment is to imagine, design and implement intelligent health networks. Health care 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. 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. We believe our *HealtheIntent* platform and Lumeris collaboration will be key enablers of this strategy and commitment.

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

The fourth and final commitment is that we will become the partner of choice for health care innovation. Our expertise 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 era ahead will also be 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 in Cerner. We are creating an operating model designed to support innovation at scale, which we believe will lead to ongoing value creation for our clients and be central to us delivering profitable growth and creating shareholder value.

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