Cerner Corporation
First Quarter 2018
Earnings Conference Call
May 2, 2018

Moderator

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 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 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. 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 lower 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 the VA contract has led us to revise our full-year revenue and EPS outlook.

Now I'll go through the numbers.

Bookings, Backlog and Revenue

Our bookings in Q1 were $1.398 billion, which reflects a 12% increase over $1.250 billion in Q117.

Our revenue backlog ended the quarter at $14.6 billion. Note that this reflects the adoption of the new revenue recognition guidance under Topic 606. Certain provisions within the guidance impact how we calculate backlog, with 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 clients exercise this option, so this doesn't change our total long-term revenue opportunity—it just shortens the duration of what is included in backlog.

Revenue in the quarter was $1.293 billion, which is up 3% over Q117. You'll note that we have gone to a single revenue line on our income statement. This is also related to our adoption of Topic 606. While there is less detail on the face of the income statement, we are 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 and Support, Maintenance and Services.

I'll now go through the business model detail and year-over-year growth compared to Q117.

- 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 a 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 Q118. 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 the lower growth rate mainly reflecting a tough comparable as Q1 of last year was the strongest growth quarter in 2017 for Managed Services.
- Support & 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 Q417 and 84.2% a year ago primarily due to the lower levels of Licensed Software and higher third-party services costs.

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

Operating Expense

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 Q117. This growth was primarily driven by an increase in personnel expense related to revenue generating associates and non-cash items. Looking at the line items, Sales & Client Service expense increased 6%. Software development expense increased 10%, driven by a 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.

Operating Margins

Moving to operating margins. Recall that, on 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 non-cash 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 non-cash 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 principle change is that 2018, which we had already indicated is 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.

Net Earnings / EPS

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 58 cents, compared to $0.59 in Q117.

Our GAAP tax rate for the quarter was 20%. When 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 last call. For the remainder of 2018, we expect our tax rate to be closer to 23%-24%.

Balance Sheet / Cash Flow

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 Q417, due to strong cash flow, partially offset by use of cash for our 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 for a total of $88 million. We now have $339 million remaining out of the $500 million stock repurchase program approved by the board in May 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 Q417.

Total receivables ended the quarter at $1.041 billion, which is essentially flat to Q417. Our Q1 DSO was 73 days, which is up from 71 days in the year-ago period and 72 days in Q417.

Operating cash flow for the quarter was a record high $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 costs, 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 an expected increase in capital expenditures and lead to another year of strong free cash flow.

Guidance

Now I'll go through guidance.

- We expect revenue in Q2 to be between $1.310 and $1.360 billion, with the $1.335 billion midpoint reflecting growth of 3% over Q217.

- For the full year, we expect revenue between $5.325 billion and $5.450 billion with the $5.388 billion midpoint reflecting 5% growth over 2017. This guidance range is down from our previous range of $5.450 and $5.650 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 59 to 61 cents per share, with the 60 cent midpoint reflecting a penny less than Q217.

- 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 our 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 $1.350 billion to $1.550 billion. The $1.450 billion midpoint reflects an 11% decrease compared to a tough comparable in Q217. 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.

With that, I will turn the call over to Zane.

Zane Burke
Thanks Marc. Good afternoon everyone. Today I'll provide color on our results and make some marketplace observations.

Results/Marketplace

I'll start with bookings, which were strong overall as they grew 12% over Q117 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 the 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 competitiveness standpoint with 27% of bookings coming from outside our core *Cerner Millennium*® installed base.

Our ambulatory business had a strong quarter driven by ongoing penetration in the ambulatory settings of our large health system clients. We are 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 is included in almost all new deals and our existing clients continue to migrate from legacy systems to *Cerner Millennium*. Since the beginning of last year, we have 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's Department of Health and Human Services choosing *HealtheIntent* for their Medicaid Enterprise System to help manage 300,000 enrolled Medicaid lives.

Non-U.S.

Moving to our business outside of 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 Region Skäne 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, and it also represents our first Nordic population health client, serving 1.3 million citizens. In addition to this strength in Sweden, we had strong contributions from the UK, Germany and Canada.

Looking ahead, we expect to have a good year, with Australia, Canada, Middle East, UK, Ireland, and Germany all forecasted to provide good contributions to our growth.

Federal Business

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 sites 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 are 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 Veterans Affairs. As you are likely aware, the signing of our 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 is just difficult to predict exactly when.

As I've indicated before, a delay does not change in any manner the magnitude or importance of the overall opportunity. We are honored to have the opportunity to serve our nation's veterans and will be ready to deliver when it signs.

Marketplace

Now 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 a 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 aggregate, and we are doing well with our *CommunityWorks* offering that aligns with the needs of smaller hospitals. In addition, because we have a footprint in 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 costs involved with managing multiple platforms.

Our large footprint also represents meaningful whitespace for us to cross-sell our solutions and services. We believe that lower penetration of revenue cycle, *Cerner RevWorks*℠, *Cerner ITWorks*℠, and population health represent 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 value to our clients, with a focus on demonstrating hard ROI, whether it be increased charge capture and more efficient collections through our revenue cycle solutions and *RevWorks* services, lower cost 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, local and federal business also represents significant opportunity, and we expect these 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 for these to drive meaningful contributions. As this plays out, we believe the timing of the growth will not only create a bridge to when we 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 the other solutions and services I've discussed.

To conclude, while much of our end market is currently facing financial pressure and uncertainty, our solutions 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 will turn the call over to Brent.

Brent Shafer

Thanks, Zane. Good afternoon everyone.

Marc and Zane did a good job covering the results and the current marketplace. We understand we didn't deliver against expectations we set, and we are disappointed. We have revised our outlook to factor in the near-term realities 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 would 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 and making excellent progress on a 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 three-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 process in the fall. Broadly, the refined strategies fall into three categories:

- Focusing on the client experience,
- Investing in platform, solution and service innovation, and
- 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 the tools to be successful and 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 non-hospital 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, 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 excited about our future together.

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