Cerner Corporation
Second Quarter 2018
Earnings Conference Call
August 2, 2018

Moderator

Welcome to Cerner Corporation's second quarter 2018 conference call. Today's date is August 2, 2018, and this call is being recorded.

The Company has asked me to remind you that various remarks made here today constitute forward-looking statements, including without limitation, those regarding projections of future revenues or earnings, operating margins, operating and capital expenses, bookings, solution, services and new offering development and future business outlook, including new markets or prospects for the Company's 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, overall, we had a solid Q2, with all key metrics coming in at or above our expectations.

Bookings, Backlog and Revenue

Our bookings in Q2 were $1.775 billion, which reflects a 9% increase over $1.636 billion in Q217. This is well above the guidance range we provided, largely due to the initial task orders for the Veterans Affairs contract that was announced in May. Note that while the total contract opportunity is $10 billion over 10 years, the impact to our bookings, revenue and earnings will be phased in over time as individual task orders are executed during the various phases of the project. With the initial task orders signed in Q2, we are positioned to achieve the expected contributions from the contract in the second half of the year that we discussed on our last call.

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

Revenue in the quarter was $1.368 billion, which is up 6% over Q217 and above the high end of our guidance range.

I'll now go through the business model detail and year-over-year growth compared to Q217.

- Licensed Software revenue was $172 million, up 11%, primarily due to strong licensed software bookings in the quarter.
- Technology Resale increased 3% to $75 million.

- Subscriptions revenue was $83 million in Q218, down from $119 million in Q217, but up 8% from $77M in Q118. Recall from our comments last quarter that subscriptions were impacted by our adoption of the new revenue standard, which reduced subscription backlog and also led to us classifying a portion of subscription revenue as support.
- Professional Services revenue grew 13% to $447 million, driven largely by growth in our Works businesses.
- Managed Services increased 9% to $286 million.
- Support & Maintenance was up 7% to $279 million, reflecting our expected low-single-digit growth plus the previously discussed impact of the new revenue standard.
- And finally, Reimbursed Travel was $25 million, which is down 5%.

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

Moving to gross margin. Our gross margin for Q2 was 82.5% which is up from 82.1% in Q118 and down slightly from 82.7% 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, and acquisition-related adjustments, all as detailed and reconciled to GAAP in our earnings release.

Operating Expense

Looking at operating spending, our second quarter GAAP operating expenses of $921 million were up 12% compared to $820 million in the year-ago period.

Adjusted operating expenses were $873 million, which is up 13% compared to $771 million in Q217. Looking at the line items, Sales & Client Service expense increased 14% over Q217. This increase was primarily driven by an increase in personnel expense related to our services businesses, including the hiring of Adventist Health revenue cycle staff and hiring additional revenue cycle staff in Kansas City. Software development expense increased 18%, driven by a 7% increase in gross R&D, a 26% increase in amortization, and 4% less capitalized software. G&A expense was up 4%, and Amortization of Acquisition-related Intangibles decreased 53% year over year.

Operating Margins

Moving to operating margins. Our GAAP operating margin was 15.2% compared to 19.3% in the year-ago period, and our Adjusted Operating Margin was 18.7%, down from 23.0%. 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 do continue to believe that many of these factors are temporary in nature and that we can begin expanding margins in 2019.

Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q2 were $169 million, or $0.51 per diluted share, compared to $0.53 in Q217. Adjusted Net Earnings in Q2 were $207 million and Adjusted Diluted EPS was 62 cents, compared to $0.61 in Q217.

Our GAAP tax rate for the quarter was 21%. Our non-GAAP tax rate was also 21%, which is slightly below our tax rate in Q1.

Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q2 with $1.004 billion of total cash and investments, which is down from $1.093 billion in Q118, primarily due to use of cash for our stock repurchase program. During the quarter, we repurchased 3.4 million shares of stock at an average price of $58.75 for a total of $200 million. We currently have $639 million of remaining authorization under our repurchase program after our board increased the authorized amount by $500 million in May.

Moving to debt, our total debt, including capital lease obligations, was $441 million, which is down from $446 million in Q118.

Total receivables ended the quarter at $1.152 billion, up from $1.041 billion in Q118. Our Q2 DSO was 77 days, which is up from 73 days in both the year-ago period and Q118.

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

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

Guidance

Now I'll go through guidance.

- We expect revenue in Q3 to be between $1.335 and $1.385 billion, with the $1.360 billion midpoint reflecting growth of 7% over Q317.
- For the full year, we continue to expect revenue between $5.325 billion and $5.450 billion with the $5.388 billion midpoint reflecting 5% growth over 2017.
- We expect Q3 Adjusted Diluted EPS to be 62 to 64 cents per share. The 63 cent midpoint is two pennies higher than Q317. Note that while consensus EPS for the year is in-line with our annual guidance midpoint, the consensus estimates reflect a different quarterly ramp, so our Q3 guidance range is below the current Q3 consensus.

- For the full year, we continue to expect Adjusted Diluted EPS to be $2.45 to $2.55, with the $2.50 midpoint reflecting 5% growth over 2017.
- Moving to bookings guidance, we expect bookings revenue in Q3 of $1.450 billion to $1.650 billion. The $1.550 billion midpoint reflects a 40% increase compared to Q317, which was our lowest bookings quarter of 2017.

In summary, we are pleased with our solid performance in Q2 and our outlook for the rest of the year.

With that, I 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 grew 9% over a strong Q217 and was well above our guidance range. In Q2, the percent of bookings coming from long-term contracts was in a normal range at 35%. Multiple large transactions contributed to our bookings this quarter, with a record 7 contracts over $75 million. We were also pleased with the quarter from a new business standpoint, with 31% of bookings coming from outside our core *Cerner Millennium*® installed base, including a noteworthy win at a large academic medical center.

This quarter included broad contributions across several areas that reflect the diversity of our offerings and end markets. We had good results from almost all of our solution and service categories, large and small clients, and U.S. and non-U.S. geographies.

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

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

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

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 efforts we have discussed have led to many improvements in access and efficiency at our initial sites, and we remain on track to begin the next wave of implementations later this year. In addition, DoD announced last week that they are increasing the contract ceiling for MHS Genesis by $1.2 billion to include the Coast Guard and expand the scope of solutions and services.

Moving to the Department of Veterans Affairs. As Marc mentioned, we signed a contract in May with the VA as the prime contractor to replace their VistA system with one built off the EHR we are deploying across the military health system.

With VA managing one of the largest health care systems in the country, we believe there is great potential for broad industry impact. At the core of this project, Cerner will enable seamless care through a single system that links both veteran and military populations, totaling more than 18 million people, while also delivering national interoperability to the commercial market. This will allow patient data to be shared between VA, DoD, and community providers through a secure system. We also expect to accelerate our efforts in population health, open platforms and telehealth—all of which have relevance to our commercial client base.

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

Non-U.S.

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

Population Health / *Maestro Advantage™*

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

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

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

We believe this offering, which will combine solutions and services from Cerner and Lumeris, will be differentiated in the marketplace in several ways.

- We believe it will be the most comprehensive technology and service offering that leverages the experience of a proven 4.5 Star Medicare Advantage Plan;
- It will provide connectivity across the provider, health plan, and consumer and will be designed to improve outcomes and lower costs by embedding actionable insights inside the provider workflow;
- It will include a unique accountable care clinical model that supports a health system's development of a high-performing integrated delivery network and share savings with providers through value-based incentive alignment; and

- Finally, this offering is differentiated by Lumeris' long-term strategic partnership with Mutual of Omaha to deploy Medicare Advantage plans nationally utilizing Lumeris' collaborative payer model and Mutual of Omaha's marketing, distribution and funding.

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

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

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

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

With that I will turn the call over to Brent.

Brent Shafer

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

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

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

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

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

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

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

With that, I congratulate our team on a solid second quarter and will turn the call over to the moderator for questions.