# Cerner Corporation
## Fourth Quarter 2017
## Earnings Conference Call
## February 6, 2018

### Moderator

Welcome to Cerner Corporation's fourth quarter 2017 conference call. Today's date is February 6, 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, our Chief Operating Officer, Mike Nill, will provide operational highlights and then our new Chairman and CEO, Brent Shafer, will provide closing comments.

Turning to our results, for the most part, Q4 was a solid finish to 2017 with record bookings, revenue in our guidance range, strong cash flow, and earnings slightly below our expectations.

## Bookings, Backlog and Revenue

Our bookings in Q4 were $2.329 billion, an all-time high and up 62% from $1.437 billion in Q416. Bookings came in more than $300 million above the high end of our guidance range due to several large deals that Zane will discuss. Full-year bookings were $6.325 billion, which is up 16% over $5.446 billion in 2016. We indicated at the beginning of the year that the large and complex nature of the opportunities in our pipeline set us up for the potential of large quarterly swings in bookings. This did play out and, except for Q3, the volatility was reflected in upside relative to our guidance with the end result being a very strong year of bookings.

Our revenue backlog ended the year at $17.545 billion, which is up 10% from $15.927 billion a year ago.

Revenue in the quarter was $1.314 billion, which is up 4% over Q416. The revenue composition for Q4 was $363 million in System Sales, $262 million in Support and Maintenance, $661 million in Services, and $28 million in Reimbursed Travel.

For the full year, total revenue grew 7% over 2016 to $5.142 billion, which is in the range we provided at the beginning of the year.

System sales revenue for the quarter was up 3% compared to Q416, driven primarily by growth in licensed software. Our system sales margin percent of 65.5% was down year-over-year and sequentially due mostly to lower margins on technology resale related to a higher mix of device resale and lower subscription margins related to the mix of subscriptions having higher third-party costs. For the full year, system sales revenue grew 7% and margin increased 6% from 2016.

Moving to Services, total Services revenue, including professional and managed services, was up 6% from a tough comparable in Q416, when Services grew 18%. Full-year Services revenue was up 9% over 2016, reflecting good execution by our services organizations.

Support and Maintenance revenue increased 3% for both the quarter and the full year, which is in line with expectations.

Looking at revenue by geographic segment, domestic revenue increased 4% over the year-ago quarter to $1.154 billion and non-U.S. revenue of $160 million increased 10%. For the full year, domestic revenue grew 8% and non-U.S. revenue grew 3%.

As a preview to the annual update of our detailed business model that we'll provide at our investment community meeting on March 7th at HIMSS, I'd like to provide you with the total revenue and growth by business model for the full-year 2017.

- Licensed Software increased 11% to $612 million;
- Technology Resale was flat at $274 million;
- Subscriptions increased 6% to $469 million;
- Professional Services revenue grew 10% to $1.592 billion;
- Managed Services increased 7% to $1.047 billion;
- Support & Maintenance was up 3% to $1.047 billion, and
- Reimbursed Travel was $101 million, which is up 15%

Note that a portion of the strength in licensed software and the lower growth in subscriptions is related to a shift in how we sold some of our content during 2017. This shift in approach meant more content was sold as a license. The higher license revenue in 2017 creates a tough comparable for licensed software in 2018 and lowers the run rate of subscriptions.

Moving to gross margin. Our gross margin for Q4 was 82.6% which is down from 84.1% in Q3 and basically flat compared to a year ago. The sequential decline is largely due to a lower mix of services as a percent of total revenue compared to Q3 and the lower technology resale margins I previously mentioned. Full-year gross margin of 83.4% is down slightly from 83.8% in 2016.

## 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 2017 and/or 2016 Adjusted results exclude share-based compensation expense, share-based compensation permanent tax items, acquisition-related adjustments, tax reform impact, and voluntary separation plan expense, all as detailed and reconciled to GAAP in our earnings release.

## Operating Expense

Looking at operating spending, our fourth quarter GAAP operating expenses of $866 million were up 4% compared to $831 million in the year-ago period. Full-year GAAP operating expenses were $3.328 billion, up 7% from $3.106 billion in 2016.

Adjusted operating expenses were $815 million, which is up 9% compared to Q416. 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 9%. Software development increased 11%, driven by non-cash items as we had $1 million less capitalized software and $9 million more amortization than Q416. G&A expense was up 2%. Amortization of Acquisition-related Intangibles decreased 5% year over year.

For the full year, Adjusted operating expenses were up 9% to $3.138 billion.

## Operating Margins

Moving to operating margins. Our Q4 GAAP operating margin was 16.7% compared to 16.9% in the year-ago period. Full-year GAAP operating margin was 18.7% compared to 19.0% in the year-ago period. Our Adjusted Operating Margin was 20.5% in Q4, which is down from 23.3% in the year-ago period due to the previously discussed technology resale margins, revenue mix and non-cash expense. In addition, as I mentioned last quarter, we did have higher operating expense in Q4 tied to upfront investments on some large projects that won't contribute to revenue until this year.

The lower Q4 margins contributed to a lower full-year Adjusted Operating Margin of 22.4%, which is down from 23.6% last year. Another factor impacting our margins all year was our net software capitalization, which ended the year about $20 million lower than we had originally anticipated, as we capitalized less software than expected while increasing amortization as planned, so it had a larger than expected negative impact on our margins and earnings this year. The lack of margin expansion in 2017 is consistent with our original guidance, although the decline is slightly more than expected due to the reasons I discussed.

Going forward, we still see an opportunity to resume expanding margins, but we do face headwinds in the near term that I discussed throughout 2017. These include the following:

- A large expected increase in non-cash software amortization and depreciation related to large investments in software development and facilities to support our growth. Currently we expect these expenses to grow approximately $80 million in 2018. The growth of these items should begin to slow by 2019.
- Another factor is that we expect traditional software revenue to be relatively flat, due to the maturing EHR market, a shift to more SaaS models, and the tough comparable created by our strong software growth in 2017.
- The impact of this lower software mix is exacerbated by the recent success of our Works businesses, which contribute to good revenue visibility, but carry a lower margin than our overall margins. We are also making investments in our Works businesses this year by creating a bigger workforce in Kansas City. Longer-term, this creates the opportunity to centralize more functions and improve the profitability of our Works businesses, but it is dilutive near term.
- Finally, some of the investments in projects ahead of revenue being recognized is expected to continue into 2018.

Because of these factors, our 2018 guidance reflects a decline in operating margins instead of the roughly flat margins implied in our initial 2018 view. I do think 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 addition, as a leadership team, we have begun a process of looking across our entire business for ways to leverage our resources and support our growth in an efficient manner. The significant long-term growth opportunities we see in front of us create an environment where we believe we can attain economies of scale and improve our margins.

## Net Earnings / EPS

Moving to net earnings and EPS, our GAAP net earnings in Q4 were $337 million, or $1.00 per diluted share. Note that our GAAP net earnings includes a $115 million net income tax benefit, primarily driven by the revaluation of our net deferred tax liability because of the tax reform bill that was passed in December. For the full year, GAAP net earnings were $867 million, or $2.57 per diluted share.

Adjusted Net Earnings in Q4 were $196 million and Adjusted Diluted EPS was 58 cents, compared to $0.61 in Q416. For the full year, Adjusted Net Earnings were $805 million and Adjusted Diluted EPS was $2.38, up 4% from 2016.

Our GAAP tax rate for the quarter was negative 52%, primarily driven by the revaluation of our deferred tax liability. When excluding the tax benefit adjustment and share-based compensation permanent tax items, the Q4 tax rate was 28%, which is slightly below our full-year 2017 rate due to some smaller tax benefit items in Q4.

For 2018, we expect our tax rate to be approximately 24%. This reflects the decrease in our federal rate from 35% to 21%, slightly offset by the Section 199 deduction going away, the fact the lower rate only applies to domestic income, and an increase in the effective state rate since the benefit of deducting state taxes goes down due to the lower federal rate.

We are investing the majority of the benefit from this lower tax rate, so it does not fully pass through to our 2018 guidance, which I'll discuss in a minute. Primary areas of investment include increased R&D, hiring a local workforce of more than 600 people to support our Works businesses, and expanding our facilities, including the next phase of our Innovations Campus.

Before moving on to discuss our balance sheet, I wanted to mention part of the reason for our earnings being below our guidance. Recall that on our last call we indicated we expected the VA to sign in Q4. This was based on indications pointing to it signing by the end of November. Our plan assumed we'd begin working on initial task orders in Q4 and then ramp our workforce quickly throughout 2018. As you likely know, the signing did not occur in Q4. While we didn't factor in a significant amount for Q4, this timing, along with lower upfront revenue than expected on some of our larger fourth quarter contracts, did impact our results. Clearly, this is not significant in the scheme of the overall opportunity, but I did want to note it given its impact.

## Balance Sheet / Cash Flow

Now I'll move to our balance sheet. We ended Q4 with $1.003 billion of total cash and investments, which is up from $964 million in Q3 primarily due to strong free cash flow, partially offset by use of cash for our stock repurchase program. During the quarter, we finished the remaining $77 million of stock repurchases authorized in November of 2016, and executed $73 million of the $500 million stock repurchase authorized in May 2017. For the quarter, we repurchased a total of 2.3 million shares at an average price of $65.48. For the year, we repurchased 2.7 million shares for $173 million, at an average price of $65.33.

Moving to debt, our total debt, including capital lease obligations, was $527 million, which is down slightly compared to Q3.

Total receivables ended the quarter at $1.043 billion, which is up from $1.021 billion in Q3. Our Q4 DSO was 72 days, which is up from 69 days in the year-ago period and down from 73 days in Q3.

Operating cash flow for the quarter was strong at $349 million. Q4 capital expenditures were $100 million, and capitalized software was $64 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development costs, was $185 million for the quarter.

For the full year, operating cash flow was $1.308 billion, capital expenditures were $362 million, and capitalized software was $274 million. Full-year free cash flow was $671 million, which is $179 million higher than 2016. For 2018, we expect an increase in capital expenditures of more than $100 million primarily to support our facilities requirements, including the start of another phase of our Innovations Campus. However, we expect this increase to be more than offset by growth in operating cash flow, which should lead to another strong year of free cash flow.

## Guidance

Now I'll go through guidance.

- We expect revenue in Q1 to be between $1.315 and $1.365 billion, with the $1.340 billion midpoint reflecting growth of 6% over Q117, which was the quarter with the highest growth in 2017.

- For the full year, we expect revenue between $5.450 and $5.650 billion, with the $5.550 billion midpoint reflecting 8% growth over 2017.

- We expect Q1 Adjusted Diluted EPS to be 57 to 59 cents per share, with the 58 cent midpoint reflecting a penny less than Q117, which was also our toughest comparable quarter from an EPS standpoint. The lack of growth in Q1 is related to the higher level of expenses and lower expected software mix I previously mentioned.

- For the full year, we expect Adjusted Diluted EPS to be $2.57 to $2.73, with the $2.65 midpoint reflecting 11% growth over 2017.

- Moving to bookings guidance, we expect bookings revenue in Q1 of $1.250 billion to $1.450 billion. The $1.350 billion midpoint reflects 8% growth compared to Q117.

Now I'd like to discuss the differences between our preliminary 2018 outlook and the guidance we are providing today. Our revenue guidance midpoint is $50 million less than our initial outlook. This small difference primarily reflects refinement of our outlook after we finalized backlog and locked down our plan. It does reflect a decrease in expected revenue from the VA contract compared to our initial outlook, which contemplated a Q417 signing, but this is mostly offset by revenue associated with our strong Q4 Works bookings.

Our Adjusted EPS guidance is 5 cents higher than our initial outlook, but this is with approximately 24 cents of benefit created by our expected tax rate going to approximately 24% from 30%. The reasons for the approximately 19-cent decrease on a comparable basis include the following:

- First, as I discussed, we anticipated revenue from our work on the VA contract in Q1. We are also absorbing expenses for the workforce we have in place to begin project work, as we intend to be ready to deliver as soon as the contract signs. We believe being focused on project readiness offsets any negative from carrying the additional costs.
- The other primary factors impacting our guidance I mentioned when discussing operating margins, including the expected lower software and higher Works mix in our revenue, investments in local workforce for our Works businesses, and other large projects where we are incurring expenses ahead of revenue. We also expect some growth in our R&D investment, including work related to global opportunities and population health, which along with the non-cash growth, will impact our overall spending growth. In addition, our other personnel expenses are expected to be higher than our original plan, driven by higher health care costs and variable compensation.
- Most of the remaining difference in our EPS guidance compared to our initial outlook was the result of our normal process of finalizing a more detailed, bottoms-up version of our plan, which results in more precise estimates we use to give our best view for the year.

The final factor I'd like to discuss is the expected impact of the new revenue accounting standard, or Topic 606. We currently estimate the amount of adjustments to retained earnings under the new revenue accounting standard will be less than one percent of annual revenue. This estimate is preliminary and subject to change as we finalize our implementation of the standard. Relative to the income statement, our initial view is that for 2018 we expect the difference created by more favorable treatment in some circumstances will be roughly offset by items less favorably treated under the new standard.

In summary, while we realize you may have expected to see more of the tax benefit pass through as incremental earnings, we view most of what is not being passed through as investments back into our business in areas that are important to our future growth. And I expect these investments to position us for good earnings growth next year.

One final thing I'd like to mention before turning the call over to Zane is that we expect to report our Q1 and Q2 results later than our normal schedule to allow us more time to do the work necessary to report under the new revenue standard. Tentatively, we are planning on Q1 and Q2 release dates of May 10$^{th}$ and August 2$^{nd}$, respectively. For Q3 and Q4, we will target being back on our normal schedule, which is expected to be October 25, 2018, and February 5$^{th}$, 2019, respectively.

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. As Marc discussed, we significantly over-attained our bookings target, which led to a record level of bookings for Q4 and for the year. This quarter included closing key deals that had pushed from Q3 as well as success at closing other large deals forecasted in Q4.

Multiple large transactions contributed to the strength of our bookings. In fact, we signed 6 contracts that were greater than $75 million in Q4. These included the expanded relationship with Adventist Health, which was announced early this month; another large *Cerner ITWorks*℠ contract at an academic health system on the east coast; an expansion of services and solutions, including population health, with a major Children's hospital; two different IDNs expanding solutions, services and sites; and an expanded global relationship.

Looking at bookings mix, as you'd expect with the strength of our Works bookings, the percent of bookings coming from long-term contracts was higher than normal in Q4 at 46%. Even with this mix, we still had strong growth in the non-long-term bookings of 28%. For the year, the percent from long-term was 35%, compared to 30% last year.

From a competitiveness standpoint, we had a good quarter and year. This quarter, 22% of bookings were from outside our core *Cerner Millennium*® installed base. While that is lower than most quarters, it is still strong when you consider the volume of Works business, which was all back into our base and drove most of the over attainment. Overall, we maintained our greater than 50% win rate this year, and continued to have success against our primary competitor in an environment where prospects are focused on return on investment.

In the ambulatory market, we had another very good quarter and year. For the year, ambulatory bookings grew 15%, and we had 27 displacements of our primary ambulatory competitors.

In the smaller hospital market, we continue to do well with our CommunityWorks offering. Our CommunityWorks bookings grew more than 30% for the year, driven by the addition of 29 new clients and higher average deal sizes compared to past years, as we've been able to move up market with this offering. We now have more than 180 CommunityWorks clients across 39 states.

We also had a good year in revenue cycle, with 15% revenue growth and over 50% bookings growth. This was driven by inclusion of revenue cycle in almost all new EHR deals as well as increasing penetration of revenue cycle in our base. For the year, we had 25 displacements of various competitors' revenue cycle systems. The year also included record services bookings, driven by the *Cerner RevWorks*℠ expansion at Adventist Health.

In population health, we continue to make good progress at adding clients to the *HealtheIntent*℠ platform and ended the year with 144 unique clients. For the year, population health bookings grew 42% and revenue grew 20%. We have been able to continue growing in an environment that includes uncertainty regarding when the broader shift from fee-for-service to value-based care will occur because of our platform's ability to help clients optimize fee-for-service models while also preparing them for the shift to value-based payments.

A noteworthy population health win in Q4 was signing with our first commercial health plan. This plan will use *HealtheIntent* to enhance their service to more than 300,000 Medicaid and Medicare Advantage lives. They are using *HealtheIntent* solutions to support their growing risk-based arrangements and give their providers a single source of truth for risk metrics and clinical information. A key differentiator in the selection process was *HealtheIntent's* ability to aggregate a wide range of clinical and claims data from multiple sources and turn it into actionable information.

## Non-U.S.

Moving to our business outside of the U.S., we had a good quarter, with 10% revenue growth. The 3% growth for the full year that Marc mentioned reflects a soft first half of the year being offset by a good second half. Looking at bookings, our non-U.S. bookings were an all-time high in 2017. The record bookings combined with a strong pipeline position us well for good revenue growth going forward.

## Department of Defense / Veterans Affairs

Next, I'd like to provide an update on our federal business. Last quarter, I indicated we are live at the four sites that comprise the Initial Operating Capability, or IOC, program for Department of Defense MHS GENESIS project. We also mentioned that the next step is a review process that identifies where the system can be optimized. Some media coverage suggested this exercise represents a setback in the project, but this is a planned exercise. The next milestone is the Full Deployment Decision, which is expected this summer, and we remain on track to begin full deployment later this year.

Note that IOC sites represent the first successful deployment of a commercial, off-the-shelf comprehensive EHR solution in the federal space. Additionally, the project has led to a HIMSS Level 6 designation, with all four sites using functionality they didn't have prior to implementing Cerner, such as advanced clinical decision support, proactive care management, structured messaging, business and clinical intelligence and the capability to share data with the community-based EHR. MHS GENESIS is also driving patient engagement as patients can now access the portal from multiple devices.

I'd also like to provide an update on our opportunity with the Department of Veterans Affairs. As Marc mentioned, our contract did not sign in Q4 as we expected. The delay was primarily related to the VA's decision to conduct an external validation process to ensure their interoperability requirements can be met. We welcomed this review as we are confident in our interoperability capabilities and believe it good to have the requirements clearly defined. We also like that the VA is focused on pushing for interoperability across the industry, something we have long supported as you know.

This delay does not change the magnitude or importance of the overall opportunity, and we believe the contract will sign soon. We look forward to providing more details at that time.

## Marketplace

Now I'll provide some marketplace observations and discuss how we are positioned for growth.

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. Many of these are smaller hospitals, but there are still some large opportunities. 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.

Our large footprint also represents meaningful whitespace for us to cross-sell our solutions and services. Penetration of revenue cycle, *ITWorks*, and population health remains low, and we believe still represent significant growth opportunity just within our base. The bookings over-attainment this quarter was largely driven by these types of sales back into our base.

We believe our high share of the larger health systems also positions us well to benefit from the ongoing industry consolidation, as many of our clients have been the consolidators and could look to standardize acquired sites on our EHR. Consolidation could also benefit *HealtheIntent* sales as we are seeing some mergers where a logical approach could be to keep two different EHRs and use *HealtheIntent* across both systems for analytics and population health.

Our state, local and federal business also represents significant opportunity, and we expect these segments to contribute to growth over an extended period of time as long as we continue to execute on our initial contracts.

Overall, while most of our end market is 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 Mike.

**Mike Nill**

Thanks Zane. Good afternoon everyone. Since we have more content than normal on our call today, I am just going to make some brief comments about our Works businesses, then turn it over to Brent.

***Works / Adventist Health***

I'll start by discussing the expanded relationship with Adventist Health that Zane mentioned. This included a significant expansion of their *RevWorks* relationship with Cerner and an initial *ITWorks* relationship. We will soon be taking over day-to-day management of their revenue cycle and clinical applications IT staff and will ultimately manage all applications that involve a patient, including clinical EHR, revenue cycle, *CareAware* and *HealtheIntent*. We will also build on the foundational work of the Value Creation Office that was established to optimize clinical and operational performance levels across their enterprise.

I believe this will create a more aligned and embedded relationship where we can be more effective at addressing the challenges of today, while also innovating so we are positioned to excel in the future.

Looking more broadly at our *ITWorks* and Revenue Cycle businesses, the strength in the fourth quarter led to both achieving record levels of bookings for the year. I believe this could be the beginning of a ramp in our Works businesses, as both *ITWorks* and *RevWorks* align directly with our clients' need to get more out of their existing spending in the current challenging operating environment for providers.

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

**Brent Shafer**

Thanks, Mike. The team has done an excellent job of covering the results, but I want to make a few comments before I turn things over to the moderator for Q&A.

First of all, I'm excited to join Cerner at a time when there is so much impact we can have together. I've spent my entire career in health care, and I've always been aware of Cerner's success - and Neal Patterson's role in it. In my view, he was without peer in terms of his passion and the way he shaped the development of the health IT industry. Together with the other founders and the team they built, they created a remarkable company.

For someone like me who has worked in health care and has seen so much unaddressed need, it's impossible not to be excited about Cerner's position in the market. The investments in platforms and services have been well-timed. In the U.S. and globally, health care spending continues to rise, consumer expectations of technology are at an all-time high, and the payment models are shifting toward paying for value. Together with our clients, we have a huge opportunity to impact cost, quality and satisfaction in health care.

In the short amount of time I have been on board, I have been extremely impressed with the talent of Cerner's leadership team. I spent a significant amount of time with the team leading up to my official start date last week, including one-on-one time with all the senior leaders. I've met with more than 100 of Cerner's top executives; I met with leaders of our Client organization; and I had the chance to sit in on the first quarter Progress Review with the groups driving our operations.

I plan to spend the first 100 days diving deeper and talking with as many clients as possible. As a leadership team, we will be working together to review 3-year priorities for investments, refine our strategies, and identify opportunities to optimize our business so we can keep our strong forward momentum and achieve our goals for innovation and profitable growth.

Cerner is incredibly well positioned, and I am optimistic about our future. I look forward to meeting many of you next month at HIMSS.

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