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CERN - Q4 2017 Cerner Corp Earnings Call

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OVERVIEW:

Co. reported 4Q17 revenue of $1.314b and GAAP net earnings of $337m or $1.00 per diluted share. Expects 2018 revenues to be $5.45-5.65b and adjusted diluted EPS to be $2.57-2.73. Co. also expects 1Q18 revenues to be $1.315- 1.365b and adjusted diluted EPS to be $0.57-0.59.

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PRESENTATION

Operator

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, booking, taxes, solution development and future business outlook, including new markets or prospects for the company's solutions to services. Actual results may differ materially from those indicated by forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements that 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 the earning -- 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 Investors section of cerner.com. Cerner assumes no obligation to update any forward-looking statements or information, except as required by law.

At this time, I'd like to turn the call over to Marc Naughton, Chief Financial Officer of Cerner Corporation.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Thank you, Kevin. Good afternoon, everyone, and welcome to the call. I'll start with a review of our numbers. Zane Burke, our President, will follow me with the 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.

Our bookings in Q4 were $2.329 billion, an all-time high and up 62% from the $1.437 billion in Q4 of '16. 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 for 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 Q4 of '16. 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 Q4 of '16, 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 Q4 of '16, when services grew 18%. Full year services revenue was up 9% over 2016, reflecting good execution by our service 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 7 at HIMSS, I'd like to provide you with 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 and 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.

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.

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 Q4 of '16. This growth was primarily driven by an increase in personnel expense related to revenue-generating associates and noncash items.

Looking at the line items. Sales and client service expenses increased 9%. Software development increased 11%, driven by noncash items as we have $1 million less capitalized software and $9 million more amortization than Q4 of '16. 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.

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 noncash expenses. 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 noncash 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 in 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 a 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's 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 we do have opportunities to improve margins as our noncash expense growth slows, we get return on investments we are making on our Works businesses and our SaaS revenue related to population health ramps and balances the increase in the 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.

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 $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 $0.58 compared to $0.61 in Q4 '16. 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 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 of 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 the signing by the end of November. Our plan assumed we'd begin working on initial task orders in Q4 and then ramp up workforce quickly through 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 the 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 this impact.

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 our 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 of 2017. For the quarter, we purchased 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 $64 million. Free cash flow, defined as operating cash flow less capital purchases and capitalized software development cost, 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 Innovation 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.

Now I'll go through guidance. We expect revenue in Q1 to be between $1.315 billion and $1.365 billion, with the $1.340 billion midpoint reflecting growth of 6% over Q1 of '17, which is the quarter with the highest growth in 2017. For the full year, we expect revenue between $5.45 billion and $5.65 billion, with the $5.55 billion midpoint reflecting 8% growth over 2017. We expect Q1 adjusted diluted EPS to be $0.57 to $0.59 per share, with the $0.58 midpoint reflecting $0.01 less than Q1 of '17, which is 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 $1.35 billion midpoint reflects 8% growth compared to Q1 of '17.

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 Q4 of '17 signing, but this is mostly offset by revenue associated with our strong Q4 Works bookings.

Our adjusted EPS guidance is $0.05 higher than our initial outlook, but this is approximately with $0.24 of benefit created by our expected tax rate going to approximately 24% from 30%. The reasons for the approximately $0.19 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're 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're 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 noncash 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 cost and variable compensation. Most of the remaining difference in our EPS guidance compared to our initial outlook was a 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 1% 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 and August 2, respectively. For Q3 and Q4, we will target being back on our normal schedule, which is expected to be October 25 and February 5, 2019, respectively.

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

Zane M. Burke - *Cerner Corporation - President*

Thanks, Mark. Good afternoon, everyone. Today, I'll provide color on our results and make some marketplace observations. 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. This included the expanded relationship with the Adventist Health, which was announced earlier this month; another large 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; and 2 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 business, 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 of long-term was 35% compared to 30% last year.

From a competitiveness standpoint, we had a good quarter and year. This quarter, 22% of our bookings were from outside our core Millennium installed base. While this is lower than most quarters, it is still strong when you consider the volume of Works business, which was all back into the base and drove most of our over-attainment. Overall, we've 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 continued 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.

Moving to our business outside 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.

Next, I'd like provide an update on our federal business. Last quarter, I indicated we are live in our 4 sites that comprise the Initial Operating Capability or IOC program for the Department of Defense MHS GENESIS project. We also mentioned 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 a 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 the commercial off-the-shelf comprehensive EHR solution in the federal space. Additionally, the project has led to a HIMSS Level 6 designation, with all 4 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 Department of Veteran 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 welcome this review as we're confident in our interoperability capabilities and believe it's good to have the requirements clearly defined. We also like that the VA's focused on pushing for interoperability across the industry, something we have long supported as you know.

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

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

Michael R. Nill - *Cerner Corporation - COO and EVP*

Thanks, Zane. Good afternoon, everyone. Since we have more contact -- content than normal on our call today, I'm just going to make a few brief comments about our Works businesses and then turn the call over to Brent.

I'll start by discussing the expanded relationship with Adventist Health that Zane mentioned. This included a significant expansion of our RevWorks relationship with Cerner and an initial ITWorks relationship. We will soon be taking over day-to-day management of the 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 our 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're in a position to excel in the future.

Looking more broadly at our ITWorks and revenue cycle businesses. The strength in our 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 of their existing spend in the current challenging operating environment for providers.

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

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

Thanks a lot, Mike. The team has done a great job of covering the results. I'd just like to make a few comments before we go to Q&A.

First of all, I'm very excited to join Cerner at a the time when there's so much impact we can have together. I spent my career in health care and I've always been aware of Cerner's successes and Neal Patterson's role. In my view, he was without peer in terms of his passion in 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's worked in health care and has seen so much of the 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. And as you know, 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 huge opportunity to impact cost, quality and satisfaction in health care. In the short time I've been on board, I've been extremely impressed with the talent of Cerner's leadership team. I did have the opportunity to spend a significant amount of time with the team leading up to my official start date last week, including a number of one-on-ones with key senior leaders and the opportunity to meet most of the top 100 executives in Cerner. I've had leaders -- the opportunity to meet with leaders of our client organization and the chance to sit in on the first quarter's progress reviews. I plan to spend the first 100 days diving deeper and talking with as many clients as possible. As a leadership team, we'll be focusing -- working together to review 3-year priorities for investments, refining our strategies and identifying 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'm optimistic about our future. I look forward to meeting many of you next month at HIMSS.

And with that, let me turn the call back over to the moderator so we can begin Q&A. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Charles Rhyee with Cowen.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Brent, maybe -- I think I'll start with you. Just as you come on board, and obviously, you've only had a limited time kind of surveying things, but maybe you can share for us sort of your thoughts of where you think the market's going overall, where health care technology is going and just sort of the role, obviously, Cerner has a leading position there, but sort of where you think things can go from here?

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

Well, thanks. I appreciate the question, and it has been very short, so I'll make my observation brief as well. But I think given what's happening with consolidation and chronic conditions and the need to deliver value, Cerner's positioning is really fantastic. I think we're in a great place. And I see the -- much of what Zane covered in his discussion, there's a lot of opportunity for us in the marketplace to expand and to -- globally, domestically and to go deeper in our key client relationships. So -- and I think it's a critical time for us as well in health care in -- with the position we have, with the work that's been done here in the fourth quarter and the year, I'm very optimistic about the opportunity it holds.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Great. And then maybe a follow-up. It sounds like RevWorks, a lot of good growth here. But one announcement, obviously, came out a little while back, Intermountain going with a competitor -- I'm sorry, the [10-year] deal. Can you talk about that since you do have a strong relationship with the organization in (inaudible)?

Zane M. Burke - *Cerner Corporation - President*

Sure. As you know, Intermountain's a great partner of Cerner's, and we are aligned with them on a multitude of elements. This was an arrangement. They've had a long-standing relationship with that particular organization and, in fact, our investors in that organization. And so that was an anticipated element of what -- of how that -- from that relationship moving forward. I think there's plenty of other opportunities for us to think about how to continue to move the cost curve and bring our scale along with Intermountain as we move forward. So I think you could look forward to more items in that space, but that's an area that we were very well apprised of.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Were you able to gain things out of that? Because if I remember, you were -- when you guys announced that several years back, you're talking about developing things for the RevWorks platform. Even if they made that decision, were you able to still gain knowledge and capabilities from that? And I'll stop there.

Zane M. Burke - *Cerner Corporation - President*

Absolutely. So from a solution perspective, they're utilizing our full solution set, all our rev cycle solutions. And we are continuing to develop the software side of this. This really reflects the outsourcing services component, which they already had a relationship existing previously, and then they expanded that relationship. And now it's part of what we anticipated. We will continue to drive software innovation on the revenue cycle side as we move forward.

Operator

Our next question comes from Ross Muken with Evercore.

Ross Jordan Muken - *Evercore ISI, Research Division - Senior MD, Head of Healthcare Services and Technology Research & Fundamental Research Analyst*

So just on the cost side and the investments. Obviously, we've seen sort of some chunkiness in the bookings and obviously, had some great success on the ITWorks side, and we're still sort of waiting, I guess, on VA. How hard is it, given the Mosaic and maybe some of the lumpiness on the bookings front, to kind of plan for or forecast the cost needs? Because I'm guessing some of this is people in ramp ahead of the sort of revenue come through. So just help us think through that. And then in that transition into '19, what is the real element that sort of ramps down in terms of cost? Is it really just these software comp line -- software cap lines? Or is it some of the people side as well?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes. This is Marc. The investment component, you are correct, there are elements of these large projects that we are starting that we have ramped up ahead of time to be prepared. We are spending time on both from a projects readiness, from the services side, to an IP side, preparing for some of these large contracts. And we've made the decision that we were going to ramp up ahead so that we were prepared and we can deliver. So there is an expense impact to that, but we made that decision, and we expect that near-term impact to be relatively brief as we go -- those contracts get signed, begin to drive revenue and begin offsetting the costs, which we've invested in, in ahead of time. So I think as we look -- so you're exactly right. We made that decision. Lumpy bookings, very big transactions obviously can make a difference and -- but we'll err on the side, in this case, when we have these large opportunities of ensuring we deliver, even if it's a near-term impact on the income statement. I think, as you look to 2019, I think certainly the things that are hitting us is part of the increases this year from relative to the noncash expenses, relative to some of the investments in these projects that we've made, relative to some of the R&D. I think all of those growth -- all of that growth moderates when we get to '19, and that's why we see '18 really as an investment year. I mean, we're very fortunate that the federal government gave us a fairly significant amount of capital to invest in the business, and we're actually doing that in '18 with the expectation that as we get to '19, we should be set up for growth again.

Ross Jordan Muken - *Evercore ISI, Research Division - Senior MD, Head of Healthcare Services and Technology Research & Fundamental Research Analyst*

That's helpful. And maybe on the market, just in terms of rev cycle. It feels like we're kind of hitting inflection. I think you kind of called that out. I mean, it seems like a business that should have maybe come sooner and the benefits are obvious. So what's actually transpiring at the provider level that's making them sort of more open to some of those more substantial transactions and what sort of the impetus? And is it sort of unusual to see so many occur maybe at one time?

Zane M. Burke - *Cerner Corporation - President*

Ross, this is Zane. I think there's multiple things going on, but the biggest of which is, when you look at this space, there's a significant amount of cost in the administration of the claim. And it is incredibly labor-intensive. And that labor tends to be a maturing labor workforce, a less educated workforce that is the right spot for the -- a tech-enabled services organization to help solve problems for our clients. And so I think what you're seeing here is really a timing of clients that are trying to get their cost structure in order and get to a high-performance on collections and on those pieces and we can offer a scale to that. So -- and I think that we -- the focus going from the Meaningful Use environment kind of exclusively to, "Here's some other things that we can work on," also plays into that revenue cycle focus as well because it allows some of the attention to go on to some solutions that have been there for 30-plus years, and now they need to get on to the current applications. And then as you're thinking about getting on the current applications, how do I think about what my workflows ought to look like on a go-forward basis versus how we've done it for the past 30 years. So there's kind of a multiple effect there, and I do think we're on the front side of a very strong buying wave in that space. And I really like our position.

Operator

Our next question comes from Lisa Gill with JPMorgan.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

Marc, can I just start first with a question around tax? So it looks like you're raising numbers by about $0.05 for tax, but talking about really spending the incremental. Can we talk about what the actual tax benefit is? Is it something that's closer to what we projected, maybe $0.15 to $0.20? How do I think about what the actual tax is? And how that potentially impacts '19 as you talk about some of these investments rolling off in '19?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, Lisa. The -- we would look at the number to be kind of between $0.20 and $0.24. So delivering $0.05 of that to the bottom line means that we're basically taking $0.19 of that and putting it towards investments. I -- so -- and especially in this year, when those investments are things like large projects, pre-work, the 600 people that I'm putting into a, basically, Works business center in Kansas City to help drive that business as the last question talked about, the opportunities we see in that space. So that is the impact relative to what -- if we haven't invested in any of that, you would have seen between $0.20 and $0.24. And if we -- based on what we are investing, we're taking about $0.19 or $0.17 or so of that and putting it back into the business.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

And so as we think about the future periods, my expectation would be that you would recognize some of that in earnings once these investments are done?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Clearly, the -- as we start getting return on those investments, the tax rate is going to stay the same, the benefit from that is going to be an annual recurring item, but it -- today, it's helping us play forward a little bit on those investments and then absolutely. That's why I look at '19 and say, "We should start getting returns on those investments starting '19, and I'm still driving the same tax benefit." So yes.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

That's perfect. And then my second question, this is around the VA. I understand you'll sign it soon, talk about it when it's done. But do you have anything currently in the guidance for 2018 as it pertains to VA?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes. I think, as we look at our 2018 plan, we certainly have -- as we did before, we had elements of the VA in there. We have revised those elements, and we certainly have some of that in the revised '18 plan, certainly with a lesser impact than we did originally. Obviously, I can't provide any more color than that on kind of what that amount is. We're still pending, obviously, signature of the contract. And once we get more information and have more facts, we'll be able to kind of share a little bit more detail. But at this point, it is included but certainly at a lesser amount than we originally -- after a Q4 signing was in our projections.

Operator

Our next question comes from Sean Wieland with Piper Jaffray.

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

So just a follow-up on Lisa's question because I'm a little confused, and I'm not trying to play got you here. But the transcript last -- from last quarter says, "Our guidance does not assume a significant booking for the VA contract." And this quarter, you're saying plan had assumed work would start in Q4. So just trying to reconcile those 2 statements.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, when we're talking about bookings in Q4, where we're thinking there was going to be a $300 million, $400 million number coming through from the VA, we absolutely didn't think that. We think there was going to be an initial task order or so the task orders would be in lesser amount to allow us to get working and would allow us to start driving revenue from that. Yes, that was our expectation. Certainly, our expectation was that by the time we kicked off this year, we had that workforce in place, they would all be working on the project, and we would kind of be up and running, kind of on a, certainly, the initial phase kind of running full speed. So that's -- we've certainly in Q4 didn't expect a big number, but we did expect to get something out of that.

Zane M. Burke - *Cerner Corporation - President*

And I want to just add, we would have anticipated additional task orders coming in 2018 follow -- because of the Q4 signing, which obviously all those pieces would have fallen out. So 2018 would add a significant impact. So the timing is significant here.

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

So if the fax machine started buzzing in your office right now with that order, would that drive an upward revision to estimate -- to guidance at this point?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Well, if it's only up to a fax machine, but I think the reality is -- the good news, Sean, is it's very public, right? You're going to know when it gets signed. You're going to know when the task orders get issued. So it will be very visible to you when those things happen, and you'll have actually a pretty good sense of the magnitude of what's happened. And once that happens, then we can kind of give you some guidance as to when that flows into revenue in our income statement. But until we get to that point, and we're being appropriately, in our minds, circumspect. And certainly, when we have -- when we get an updated view, we certainly will adjust our estimates relative to that updated view.

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

Okay. So there is an adjustment when the deal is signed?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

If it varies from what we already have in our plan, then that could be an adjustment. What we will do is certainly update our plan for what happens. And if that results in a change to our estimates, we'll certainly provide that. Keep in mind, I did say that there is an element of VA in the 2018 numbers, so it's not like it's -- that the number is 0. So -- but depending on what happens, depending on what task orders get signed, that can vary from our plan, and we will certainly adjust estimates as appropriate, if necessary, based on that change.

Operator

Our next question comes from George Hill with RBC.

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

I guess, Marc, I want to kind of focus in again on this investment. And I guess, if I heard you're right, it sounded like part of the investment was for Works deals that are coming on, in part is for the VA. I guess, first, I just want to make sure I heard that right. Then the second part is kind of, how do we think about visibility and operating leverage as we go from '18 to '19? And I guess, what I'm trying to figure out is, what portion of the expenses related to future expected revenue are we already recognizing such that we understand the profitability of this revenue when it rolls on? Kind of how far out ahead of the -- how far out ahead of the revenue recognition, and if there's any way you can tell us order of magnitude are we with the incursion in the expenses versus the expected revenue?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes. I think the incursion of the expenses ahead of revenue, I think '18, the revenue streams will turn on relative to a significant portion of those -- of that investment certainly on the project side of the house so that by the time -- and that's why in '19, by the time we hit '19, we should be making money on all of those resources that are now basically a pre-existing investment. I think the 600-person investment that we're making in Kansas City for our Works offering, that will begin to -- that will help us drive business in '17 and should be contributing to delivering the '18 because, as in many of those Works businesses, centralization is the key to driving efficiencies. And by creating that centralized location in Kansas City, to begin doing that work right away rather than waiting for it to occur over a 5-year period of time, we're trying to accelerate that efficiency and our ability to centralize into 1 or 2 locations, something activities that might be occurring at 10 to 15 places today. So as we start to...

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

So if we just use the 600 number that you used then, I guess, I would ask, how many of those people have you already sold through on Works deals and how many of those people are capacity for deals that haven't been sold yet?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Most of those people are -- keep in mind, on the Works deal, we rebadged the existing workforce. So for the most part, those 600 people aren't rebadged. They are new Cerner associates. And therefore, they are cost today as we sign new business and are able to start putting them on projects and using them to facilitate existing projects, that's when we'll start getting the pull-through from them. I do expect most of that to kind of occur in 2018, setting us up for '19, but it will -- there is an impact as we kind of roll through this year -- through '18.

Operator

Our next question comes from Matthew Gillmor with Robert Baird.

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

Maybe following up on some the margin comments. I think you've talked in the past about 50 to 100 bps of expansion in a normal year. And I know you've got these investments for '18 in the noncash items. But as you think about getting leverage off of that, is that still a good number to think about in '19? Or does some of the revenue mix items you've also discussed impact that range in a normal year?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes -- no, I think, obviously, great question. The business, we've always talked about 50 to 100 bps being what we think should be able to -- to be able to be driven. I think -- certainly, one of the things, and part of the investments we're making is to help drive efficiencies and drive those -- the margins in those -- the businesses and get those projects started at a -- at a -- on a quick pace so that we can start driving the revenue from those projects quickly and the margins related to that. It is going to be dependent somewhat on the mix because if the Works business just takes off and goes absolute the crazy and software, basically, is flat or slightly up, then that mix is going to at least impact near-term margins. I think, our goal -- and that would be a great high-class problem if we were drilling the top line of the business really quickly, so that it actually impacting our margins in that way. Our goal and our target is those Works businesses, over time, we continue driving efficiencies and enhancing those margins. So if I can, basically, without growing margins, bringing a bunch of top line revenue and then start increasing those margins, these 50 to 100 basis point increase that we talk about should be attainable. But I think you make a very good point that it is going to be dependent on risk, and we'll continue to try to provide our view of the mix of the business. That's why we give you the business model view that we'll talk about in HIMSS at more detail to let you kind of see what the mix of the business is and how it's impacting the margins.

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

Okay. And then on the revenue performance. Marc, you've talked about -- and you've given some numbers around the portion of revenues from backlog and bookings on an annual basis. Can you just give us a sense for how that came in for '17? And did you see any better or worse conversion out of backlog versus bookings versus what you thought?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes. I mean, '17 was just almost exactly on what we were expecting from backlog. So it was actually -- felt really good. I think we delivered what we thought we would deliver from that revenue side. As we look at our 2018 plan, as we went into '17, we're looking about kind of somewhere around 82% of our revenue coming in from backlog for the year. As we go into 2018, we're at that same 82%. So I think we still -- on a bigger revenue number, we're still driving a significant amount of that coming from our backlog. And I think that's probably 26% of our total backlog that we'll look to trigger in 2018. So it's a very similar look. The one thing that -- as you look at that number, it's actually -- it's maybe even a little better than the 82% we had in '17 merely because the revenue standard does take some of your backlog away from you and basically takes it out of some of those future periods. The rev standard also, kind of the offset to the income statement is, it will give you a little bit more onetime revenue from certain transactions. So net-net, for '18, it's not going to be a material impact one way or the other. But from where the revenue comes from, it will be a little less from backlog, a little more that comes from our normal, current signings. So it's -- we feel pretty good as we look at '18 in how it's set up relative to how much of the revenue is coming at it from backlog.

Operator

Our next question comes from Stephanie Davis of Citi.

Stephanie July Davis - *Citigroup Inc, Research Division - VP & Senior Analyst*

This is Stephanie Davis on. I just wanted to hear a little bit more about the commercial health plan win on pop health. Is this a bit of a one-off? Or how should we think about the expansion into this end market?

Zane M. Burke - *Cerner Corporation - President*

This is Zane. This is a part of the market that we have turned our attention to in pretty good order, and I would anticipate we'll see -- I mean, we're competing today on a number of those scenarios and we're competing very well. This particular win was a multistate environment, and we have a couple of those that look very similar to that in our pipeline and progressing well. So our view is really helping -- it's an incredibly powerful tool that we can utilize in many ways. And it's -- whether it's in our provider clients, payer clients and I think some nontraditional places, where access to health care data, creating longitudinal health records, making -- taking data from multiple systems, normalizing that data and creating actionable items back into the workflow, there's a lot of applicability and a lot of marketplace for that. And I feel very good about the market position that we put ourselves into. And I think there's only going to be growth in the addressable market for that tool set as we move forward.

Stephanie July Davis - *Citigroup Inc, Research Division - VP & Senior Analyst*

All right. That makes sense. And then one follow-up for that. Could you -- just given the recent traction you're seeing in pop health and RCM bookings, and it sounded to be longer term, but you could walk us through the puts and takes to kind of your longer-term margin expansion?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Well, clearly, we talked to you a little bit about the target that we've traditionally had of trying to grow margins 50%, 100% -- or 50, well, basis points, 100 basis points annually. And I think that -- you made a good point as was made before that the more that -- the more of those business -- that growth is predicted somewhat on the mix of business and the more we have of the Works-type businesses, there are -- those can be somewhat lower margins on the services component. The more we have from the pop health business, which tends to be higher margins because of the software in the tool and cloud nature of the tool, brings us up to where that -- those increases in margin can be greater. So as we look at our mix and we look to grow both the Works business and our pop health business, at kind of on our 2025 view, we end up with the Works businesses are a strong contributor, but almost about the same size, you see pop health. And on that scenario, you should see us being able to expand margins as we go forward.

Operator

Our next question comes from Robert Jones of Goldman Sachs.

Robert Patrick Jones - *Goldman Sachs Group Inc., Research Division - VP*

Just wanted to go back to overall market demand. Marc, I think you described the EHR market as mature, which isn't necessarily new news, but we have seen some SOP updates from some of your ambulatory peers recently. So I'm just curious, maybe if you could share what you're seeing out there from an RFP standpoint, has your win rate trended up or down? And if we maybe put this in the context of Cerner's system sales, are you expecting growth as we look across 2018?

Zane M. Burke - *Cerner Corporation - President*

Robert, I'll take the first crack, and if Marc wants to do any cleanup, he can. I'll look at it and say we're seeing very strong activity in community hospital marketplace, the small hospital marketplace. Those are for all-in EHR systems, clinical, revenue cycle, administrative, ambulatory in those phases. And actually, those remain at near record -- actually, at record highs in terms of numbers. The size of those deals are smaller, but we also have some very large items like the federal government and state and local opportunities. So we're actually seeing demand at kind of that record pace side of that. But much of that is -- we have the lumpiness on some of the bigger items, and then much of our activity is a little bit smaller deal size. So we still see good market opportunity in over 2,000 sites that are not on a currently marketed EHR solution, and that is really reflective of a little less than half of the marketplace in the U.S. total needs if you buy a current contemporary electronic health record. So while we obviously view it as a more maturing situation, there's still quite a bit of runway in that space. I think what -- I'll let Marc comment on the reflection in our guidance. I think given you will see some smaller deal sizes, with the exception of some of those big items, there are -- that is reflective in our -- in the guidance as we move forward.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, this is Marc. Relative to the systems sales, I think our 2018 plan would assume that we are growing system sales. So the components of that, even in a mature market, you have different impact on -- obviously, had a strong year this year in traditional license. But even the things we sell on the cloud basis or an ASP basis had significant growth. So I think as we see the -- our SaaS business continue to take off, that's always going to go in there. And my expectation for growth in system sales basically assumes that tech resale is, basically -- it is flat. It doesn't contribute to any of that growth. So that growth is coming primarily from the other realm of the system sales, which is primarily softly delivered in some form, either SaaS or through normal licenses.

Robert Patrick Jones - *Goldman Sachs Group Inc., Research Division - VP*

Okay. Now that's really helpful. And then I guess some quick follow-up on Adventist. Congrats on the contract expansion there. I was hoping maybe you could just give us some sense of the scope of the expanded relationship and then maybe any context around how much this particular expansion contributed to the really nice bookings in the quarter.

Zane M. Burke - *Cerner Corporation - President*

This is Zane. I'll comment as it relates to what the scope of it is, and then I'll let Marc decline your second part of your comment. The scope of this is a full revenue cycle outsourcing. So it's a full rebadging of all the personnel for Adventist Health. And previously, we were doing some work with Adventist around the RevWorks side of this and outsourcing. This is actually a full rebadging. So on the rev cycle side, it's all-in with Cerner Corporation. This -- in addition to that, they also did a portion of their IT shop and outsource part of that and created ITWorks business as well. So kind of a full all-in on the revenue cycle and then a big step in around the ITWorks side, but there's more to be had there. And that's reflective probably more broadly of what we're doing from our value-creation office and really how we are partnered with Adventist around driving value overall. And so it's a true trading partnership and relationship in terms of the trust to what we're doing and the value they're receiving that they are so heavily invested now with us, both on the full outsourcing and revenue cycle side and the partial ITWorks outsourcing side.

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, as far as to quantify, and keep in mind, it was an expansion. So you're not going to see the full -- the, I don't know, whole amount come in. But it's certainly a good sized deal. One of the deals that's over $75 million that we had during the quarter. So it's good sized. But once again, it was an expansion from the RevWorks side.

Operator

Our next question comes from Mohan Naidu with Oppenheimer.

Mohan A. Naidu - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Marc, a quick clarification on the numbers, and I think on that system sales side, you'll note the shift in some sales. I think you said content from subscription to license. Can you elaborate on that a little bit?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Yes, I think it was just -- as we look at the performance that we had in 2017, we had a strong -- certainly, strong license. As we went into 2017, the sale of our content, we actually changed a little bit on how we sold some of that content. We can totally structure that as a license, which put more of that revenue into the license, less of it into subscriptions. Once we go into 2018, that change will -- won't be in place. So I think as we go forward and look at 2018, we're just kind of making the point that big growth on license software, less growth on subscriptions. This probably will reverse a little bit, so that there's -- there will be some growth on the license side and maybe a little bit more growth on subscriptions as we kind of move to next year. But overall, both ways are just ways of selling intangible properties. So as long as we're -- when we look at and we kind of combine those 2. But as you guys look at it, there might be -- you'll hear -- see 2 different numbers and we'll talk about license sales being a separate number. So just want to make sure you understood that, that number was up this year. It's not going to grow as much next year. Subscriptions wasn't up as much and that likely grows more next year.

Operator

Our next question comes from Jamie Stockton with Wells Fargo.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

I guess, just, Marc, with the margin headwind that we're certainly seeing in 2018, what are your thoughts about getting a lot more aggressive on the buyback front? Your balance sheet's clean. You guys are generating good free cash flow. Could we see maybe that use as a lever to improve the trajectory of earnings if we see these margin headwinds?

Marc G. Naughton - *Cerner Corporation - CFO, EVP and Treasurer*

Well, certainly, margin headwinds are something that we're focusing on addressing in and of themselves from a business standpoint because I think these investments have got to drive more increased margins in the future. And that's why we're making them or we wouldn't make them. As I said in my comments, the board had approved -- the latest approval is for $500 million of stock repurchase authorization. I think we spent about $70 million of that. So we still have that available. I think we've -- last year, the year before, we were very aggressive, bought back a lot. Last year, a little less. I think, right now, we still are focused on buyback enough to offset any dilution that we have from a -- relative to options and another stock-based compensation. But I think, given our free cash flow, we're certainly investing a lot. But even with that investment we're going to make from a capital standpoint, we still expect to grow free cash flow. We're going to continue to look at ways to invest our capital. We'll continue to look at opportunities from an acquisition standpoint, although as we've talked, there's just not that much out there that's that interesting of size that would be something we'd be looking at. So given that those options are less likely, the way we use our capital would be to do stock repurchases.

I appreciate everybody's time today. We thank you for being with us, and we hope you have a good day. Thank you. Bye-bye.

Operator

Ladies and gentlemen, this does conclude today's presentation. You may now disconnect, and have a wonderful day.