Cerner Corporation (CERN)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

<table>
<thead>
<tr>
<th>Price ($) (5/12/20):</th>
<th>66.22</th>
</tr>
</thead>
<tbody>
<tr>
<td>52WK H-L ($) :</td>
<td>81 - 53</td>
</tr>
<tr>
<td>Market Cap (mil):</td>
<td>20,674</td>
</tr>
<tr>
<td>Shares Out (mil):</td>
<td>312.2</td>
</tr>
<tr>
<td>Float (mil):</td>
<td>303.2</td>
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<tr>
<td>Avg. Daily Vol (mil):</td>
<td>2.83</td>
</tr>
<tr>
<td>Dividend ($) :</td>
<td>0.72</td>
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<tr>
<td>Yield (%):</td>
<td>1.1</td>
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<tr>
<td>Rating:</td>
<td>Outperform</td>
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<tr>
<td>Suitability:</td>
<td>Average Risk</td>
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<tr>
<td>Price Target ($) :</td>
<td>82</td>
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<tr>
<td>L-Term Rev. Gr Rate Est:</td>
<td>8%</td>
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<tr>
<td>L-Term EPS Gr Rate Est:</td>
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<tr>
<td>Debt/Cap:</td>
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<td>ROE:</td>
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<tr>
<td>FY Dec</td>
<td>2019A</td>
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<tr>
<td>Revenue (Mil)</td>
<td>5,692.6</td>
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<tr>
<td>% Growth</td>
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<tr>
<td>Operating Margin</td>
<td>18.5%</td>
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<tr>
<td>Adj EBITDA Margin</td>
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Company Description

Cerner (CERN) sells, implements, and supports solutions that give healthcare providers access to clinical, administrative and financial data, allowing improved quality, safety and efficiency in healthcare delivery. Cerner is among the largest, broadest, and most deeply penetrated of healthcare information technology (HCIT) vendors with a comprehensive array of information software, professional services, medical device integration, remote hosting and employer health and wellness services across a client base (including acquired Siemens Health Services) that comprises more than 18,000 healthcare facilities (hospitals, physician practices, extended care, employer sites, and retail pharmacies).

Revenue Profile

- **Services (51% of revs)**. Revenue is typically recurring in nature and includes professional services and managed services (remote hosting, managed services, consulting).
- **Support & Maintenance (21% of revs)**. Includes implementation and maintenance of existing hardware and software.
- **System Sales (26% of revs)**. System sales revenues include revenue from the sale of licensed software, software as a service, technology resale (hardware, devices, and sub-licensed software), deployment period licensed software upgrade rights, installation fees, transaction processing, and subscriptions.
- **Reimbursed Travel (2% of revs)**. Reimbursed travel includes travel and other out-of-pocket expenses incurred during client servicing activities.

Figure 1: CERN Financial Profile

Source: Baird, company reports
Cerner Corporation
May 13, 2020

Competition

Overview of Competitive Landscape. Similar to most HCIT subsectors, the competitive landscape for provider HCIT solutions is relatively dynamic and highly competitive. As the industry bellwether, CERN competes against a wide variety of HCIT vendors, IT companies, and consulting firms. For clinical/EMR and financial IT solutions, key competitors include Epic Systems, MDRX, ATHN, MEDITECH, MEDHOST, CPSI, NXGN, and eClinicalWorks. For outsourced IT services and revenue cycle management, key competitors include Dell, Xerox, RCM, Optum360, and Conifer.

Quick Summary

1Q Recap: Relatively solid. Reported revenues of $1.41B (+2% YoY) came in 1-2% below Street estimates near $1.43B, and EBIT of $274M was fractionally above consensus at $273M. EPS of $0.71 was a penny above Street, supported by the slight EBIT upside and buybacks. Street models had not been adjusted for COVID, suggesting the underlying results were stronger. Relative to our model, revenue was mostly in-line, with higher Subscription and Professional Services, offsetting modestly lower Support (attrition).

Bookings light, but no surprise. 1Q bookings of $1.09B (-12% YoY) were below consensus at $1.2B and guidance of $1.1B-$1.3B. We were expecting softer bookings, given that COVID began impacting the volume of contracts during mid-March and software companies tend to close deals towards quarter-end. CERN expects these opportunities will close at some point in the future (i.e., not lost). Key bookings during the quarter included a large expansion with an investor-owned hospital, contributions from Federal (DoD/VA), and a large CareAwareConnect contract.

Guidance lowered for COVID, expecting a recovery in 2H. CERN lowered 2020 revenue guidance to $5.55B-$5.7B (from $5.725B-$5.975B) and EPS to $2.78-$2.90 (from $3.09-$3.19). The updated outlook includes a $185M revenue impact from COVID with $30M realized in 1Q, $95M expected in 2Q, and $60M spread over 3Q/4Q. More of the revenue impact is weighted to Professional Services, as clients have delayed projects. CERN has adjusted Professional Services resources (shifted to remote work, or other projects in backlog), but has not reduced staffing as management expects sales and project activity to improve during 2H.

Other highlights. (1) CERN expects 4Q20 EBIT margins will be 50-100bps below the prior 22.5% target, with full-year margins around/below 20%. (2) Bigger picture, CERN believes COVID will accelerate existing macro trends, especially care at home (i.e., telehealth), provider consolidation, and the government's role in healthcare. (3) CERN plans to continue dividend payments but will pause buyback activity for the time being. (4) CERN is optimistic CARES Act funding will help support clients more forward with IT projects.

Model update, final thoughts. CERN sounded very confident/confident Professional Services projects and sales would recover in 2H. Skeptics may argue this view is overly optimistic, given commentary from hospitals (some targeting >20-30% capex cuts). Regardless, the COVID impact seems manageable and the long-term bull thesis remains intact.

Investment Thesis

Our Call: We are Outperform-rated. We view CERN as a core long-term holding within the HCIT sector and think the company's broad range of solutions will support hospitals need for efficiency gains and adapt to value-based payment models. In our view, the company's strong positioning, large/stable client base, as well as continued market share opportunities, will support a decent growth outlook over the medium term (mid-single-digits in revenues, near 10% on EPS). While core growth has decelerated modestly in recent years due to diminishing regulatory drivers, we expect the DoD and VA contracts will support above-peer growth over the next several yeas.

Valuation and price target. Our $82 price target is based on a 25x P/E multiple applied to our 2021 estimate, toward the low end of CERN's long-term trading range of 25-33x (25th/75th quartiles) given CERN's strong industry positioning, the VA/DoD contracts, and growing services businesses squared against slower replacement cycles and less predictable bookings.

Risks & Caveats

Our suitability rating for CERN is Average Risk. Our suitability rating is based on CERN's growth profile, market positioning, and modest balance sheet leverage, squared against risks associated with declining Meaningful Use incentive payments and premium valuation.

Highly regulated industry and declining Meaningful Use incentive payments. Regulatory change, particularly around patient information/privacy and reimbursement policies, may continue to pressure CERN's client base or create unexpected work-around solutions. Additionally, hospital Meaningful Use incentive payments, which helped to finance EMR investments, are expected to decline over the next several years.

Information security. CERN's services involve the analysis, storage, and transmission of sensitive client and patient information. The inadvertent loss or theft of sensitive information could have an adverse impact on CERN and the company's ability to compete in the marketplace. CERN is also subject to various state and federal regulations primarily governed by HIPAA and HITECH legislation.

Management turnover. Turnover of key personnel is a constant risk, especially for a management story like CERN. We believe CERN has a deep bench and note that the market has generally shrugged off key departures. Following the passing of CERN's founder Neal Patterson in 2017, the company hired a new CEO (Brent Shafer) and the former President resigned.

Government contracts. CERN is currently supporting the DoD and the VA modernize clinical information systems. We estimate the company could generate in excess of $10B in revenues from these two contracts. A disruption in these relationships, or unexpected changes, could have a negative impact on CERN's growth.
Appendix - Important Disclosures and Analyst Certification

Approved on 13 May 2020 10:02EDT/ Published on 13 May 2020 10:07EDT.

Rating and Price Target History for: Cerner Corporation (CERN) as of 05-12-2020

1 Robert W. Baird & Co. Incorporated makes a market in the securities of CERN.

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