Cerner should benefit from the need for greater efficiency of healthcare infrastructure.

**Analyst Note 08/03/2018**

Cerner reported results that fell in line with our expectations, and we are reiterating our $66 fair value estimate and wide moat rating for the firm. The firm experienced strong growth in both revenue and bookings for the quarter, reversing the disappointing growth numbers it has reported over the past several quarters. We find this development a welcome change from what has been a recent period of significant choppiness for the firm. We believe Cerner may now have a better handle on the flow of its operations, given a rapidly changing healthcare IT, or HCIT, market. However, we approach this quarter’s positive developments with caution, given the volatility of recent results. Adding to this uncertainty was a material decrease in profitability as operating margin compressed to 15.2% from 19.3% a year ago. Management stated that it is confident this trend will reverse by the end of the year, and that it expects margins to expand in 2019. From our perspective, the firm’s investment in realigning its operations has depressed margins this year, but will eventually yield increased operational efficiency. Given the highly scalable nature of HCIT services, we expect profits to move above the 20% mark by 2020 and have modeled this into our forecast.

**Investment Thesis 12/14/2017**

The outlook for the healthcare IT sector is solid, with the combination of increasing regulation and changing reimbursement structures motivating providers (hospitals, physician offices, diagnostic centers, and integrated provider networks) to either revamp or build new IT infrastructure. With a highly recognizable/trusted brand, leading software products, and significant customer switching costs, we believe Cerner has a wide economic moat. The integrated and essential nature of the firm’s offerings makes it a key player within the healthcare IT market and will allow it to produce economic profits over a significant period.

Strong customer switching costs is the bedrock of Cerner’s competitive advantages. Long product implementation periods (18-24 months), highly integrated/customized software packages, and service contracts that last years lock major provider clients into the firm’s grasp. Boosting the long-term demand for Cerner’s services are several factors, including the increasing complexity of Medicare reporting, strong growth of value-based payer reimbursement schemes, and electronic medical records regulatory compliance. The combination of these factors solidifies the firm’s long-term economic profitability.

However, Cerner has recently experienced bookings and revenue issues, as it has reported these metrics below management’s own guidance over the last several quarters. We believe Cerner is experiencing pressure within a maturing HCIT space that has also seen competition increase dramatically over the last handful of years.
The combination of these latest developments will likely pressure future top-line growth for the firm. From our perspective, competition from current and new HCIT players has accelerated given the growing need of providers to build in new reimbursement infrastructure and the prime opportunity this presents to the entire HCIT market. Nevertheless, we expect Cerner to have a better understanding of this operating environment and management’s missteps have built an increased level of uncertainty for the firm.

**Economic Moat** 12/14/2017

We believe Cerner has a wide economic moat. The firm is a major player within the healthcare IT market, where its provider clients utilize integrated and customized software/service packages. This dynamic locks the firm's clients into long-term relationships that can last several years given the significant costs and extreme difficulty of revamping back-office IT infrastructure. Accordingly, Cerner's client base is very sticky and allows the firm the ability to scale each contract into value-creating economic profits. Uniquely, Cerner also develops and creates its own software and services internally. This dynamic gives it a material advantage of offering nearly seamless, integrated product offerings. Augmenting the demand for Cerner's services are several long-term factors including the increasing complexity of Medicare reporting, strong growth of value-based payer reimbursement schemes, and EMR regulatory compliance. The combination of all these factors solidifies the firm's long-term economic profitability.

**Valuation** 12/14/2017

Our fair value estimate for Cerner is $66. We believe the firm is experiencing increasing pressure within its operating environment, which has slowed the rate of growth for both top- and bottom-line metrics. From our perspective, these developments point to a shift among its customer base as hospitals and medical service providers are now demanding greater value from their healthcare IT vendors. Additionally, we believe new entrants such as UnitedHealth and traditional rivals such as Epic Systems have increased their sales efforts and are now willing to accept less-advantageous payment terms. The confluence of these factors has caused Cerner to experience a delay in revenue growth and margin expansion. These factors do provide headwinds for Cerner, but we would highlight them as short term. We believe the outlook remains robust for Cerner as the new fundamental dynamics of the U.S. healthcare market will motivate most providers to become more efficient, with up-to-date healthcare IT playing a key role in that process. The confluence of an aging U.S. population, influx of previously uninsured into the healthcare market, and greater need for EMR/analytical tools will provide a platform for solid long-term top- and bottom-line growth. Accordingly, we have factored in a 7.4% five-year revenue CAGR and 21.6% average operating margins over our explicit forecast period.

**Risk** 12/14/2017

The major risk facing Cerner is a disastrous malfunction of its software that could literally cause several life-and-death scenarios for its clients. The critical nature of the firm's products in intense medical environments means that the performance of its IT products has to be close to flawless. Any little disruption to a client's IT infrastructure as a result of a development misstep would be a major issue for Cerner. We also believe competition is likely to increase from well-capitalized rivals. We see a plausible scenario where competition increases materially for the healthcare IT industry, causing pricing and market share headwinds for Cerner.

**Management** 12/14/2017

We believe stewardship at Cerner has been largely solid with the firm being led by one of its founding partners since its creation in 1979. The team has built the
healthcare player into a major industry powerhouse. Cerner's management team has developed one of the most respected and effective software product lineups among all IT-based businesses.

We are impressed that the firm has been able to produce consistent double-digit revenue growth over the last five years while at the same time being able to expand ROIC. From our perspective, Cerner's capital allocation has been prudently managed as major value destroying acquisitions and product developments have been virtually nonexistent. The firm has also stayed focused on developing healthcare IT products and not branching out into markets outside of its core competency. This variable has been a major contributor to Cerner's stalwart position.

However, the firm's management team has been lackluster in meeting its own revenue guidance as of late. The team missed its own revenue targets during most of the past two years and we believe the firm is experiencing increasing pressure within its operating environment. We believe management's missteps have built in an increased level of uncertainty for the firm. We will watch closely how this trend develops over the coming quarters.

Overview

Profile:

Cerner is a top-tier healthcare information technology supplier that helps its provider clients to improve efficiency within their complex healthcare operations. The company provides a wide range of software, hardware, and services to more than 9,000 facilities globally and has a footprint in roughly 30% of all U.S. hospitals.