Cerner Corporation CERN [XNAS] | Pending

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
77.99 USD	—	—	—	Medium	Wide	Exemplary		Health Information Services

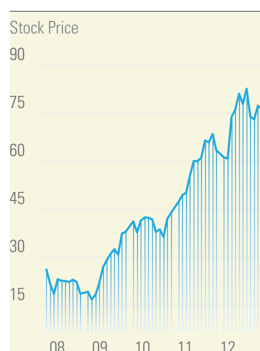
Cerner Under Review

by Morningstar Equity Analysts

Analyst covering this company do not own its stock.

Pricing as of Nov 20, 2012.
Rating as of Nov 20, 2012.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.



Analyst Note Sep. 14, 2012

We are placing Cerner CERN under review as we transfer coverage to a new analyst.

Thesis May. 09, 2012

Cerner is developing as the main beneficiary of an epochal shift in electronic health record, or EHR, software. This will allow it to take share, lock in a whole new generation of customers, and expand margins over a 5-10 year time horizon. The company provides EHR software to the health-care industry and is the leader in large acute care (inpatient facilities with 200-plus beds) hospitals, with 25%-30% market share. This software tracks thousands of data points relevant to individual patients, such as their vital signs, blood chemistry, treatment schedules, clinical progress, and financial attributes. In the 20th century and before, doctors and nurses would record this information by hand, subjecting these data to loss, the inability to electronically search and recombine data, and the inability to pull in data from medical devices and processes that touch the patient. The medical industry is leaving this model behind and applying software to manage routine tasks and improve clinical outcomes.

This is being pushed not by doctors, who are culturally reluctant to change, but by payors, including the biggest payor of them all, the U.S. federal government. With health-care spending in the United States now at $2.3 trillion, according to our reading of BEA NIPA data, there is a massive opportunity for improvement. Health-care spending in the United States has grown at nearly 4 times the rate of GDP growth over the last 10 years. We believe EHR software will be used as a key component in lowering cost trends and improving patient care.

This secular opportunity is supported by federal regulation contained in the Health Information Technology for Economic and Clinical Health, or HITECH, Act within the 2009 American Recovery and Reinvestment Act of 2009. This act mandates adoption of Electronic Health Record software for acute care facilities and provides financial incentives for adoption over a decade and then penalties for non-compliance. This has been a boon for EHR providers and has created a defection point for hospitals to leave old EHR software platforms that are not ready for these new regulations. Cerner and privately-owned Epic have benefited greatly from this adoption cycle while Allscripts MDRX and privately owned Meditech appear to be losing ground because their software is not keeping up with the pace of change in the industry. This leaves their customers ripe for switching, no matter the cost, which opens the door to Cerner taking market share.

We see this in Allscripts' most recent bookings, which declined by 8% year over year in its first quarter versus 24% growth for Cerner. Such a divide in bookings has more than an immediate effect in application software with average customer lives of 20-30 years. It indicates the loss of those relationships that will probably not be eligible for re-capture until the year 2030 or later. EHR software is extremely sticky because it is so costly to replace, in terms of enterprise risk in switching, in re-training doctors and nurses on new systems, in the 18-24 month implementation timeline, and in terms of necessary capital and operating expenditures. However, when a customer has to upgrade from an old platform to a new platform, it's just as costly to stay with the incumbent as it is to change vendors. Platform changes mandated by regulations or created by technology evolution create natural defection points, which benefits Cerner as the leader in features and functionality for this new generation of EHR systems.

Part of this is due to the fact that Cerner has grown almost exclusively through organic means, rather than trying to bolt competing vendors' software onto its own platforms. Over the last eight years, Cerner has devoted to R&D an average of 62% of its free cash flow before R&D. Its R&D budget is nearly 3 times that of its largest publicly traded competitor, Allscripts, while its R&D spending is probably twice as large

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Oper Income	Net Income
General Electric Co	USD	216,228	146,016	16,498	13,360
McKesson, Inc.	USD	22,067	123,186	2,389	1,602
AthenaHealth, Inc.	USD	2,309	398	32	18
Allscripts-Misys Healthcare Solutions, Inc.	USD	2,121	1,484	86	49

as the number-two industry player, Epic, which is half Cerner's size. Allscripts has spent much more on M&A in the last two years than Cerner has spent cumulatively in the last nine years. We believe Allscripts' operating problems directly reflect these differing growth philosophies.

We believe Cerner will further leave behind its competitors and will form a duopoly of "haves" versus the pack of "have-nots" in EHR software.

Valuation, Growth and Profitability

Our fair value estimate for Cerner is $98 per share, which implies a 2012 price/earnings multiple of 42 times, an enterprise value to EBITDA multiple of 20 times, and a free cash flow yield of 2.3%. This reflects our base-case assumption of 17% revenue growth over five years, driven by regulatory mandates, expansion into adjacencies, international growth, and market share gains. On the margin line, we believe a gross margin of 80%, contribution margin of 49%, and incremental margins of 29%-38% over the last two years indicate the potential for pronounced margin expansion over the coming five years. We see EBIT margin expanding from 21% in 2011 to 29% in 2016 and 36% in 2021. This translates midteens revenue growth over our five- and 10-year time horizons to EPS growth of 24% and 19%, respectively.

Over the coming 1-3 years, we see average revenue growth of 18% and 150 bps of average annual EBIT margin expansion as new licenses are signed and software support and maintenance streams flow from these. Potential headwinds include the hospital industry successfully lobbying federal agencies to push out or permanently relax Meaningful Use regulations. We see this as a lower probability with operational, financial, and regulatory momentum squarely behind these mandates.

We believe margin expansion will push ROICs up from an already respectable level into rates enjoyed by other wide-moat technology producers. Cerner ROIC over the last five years has averaged 18%. We see this expanding to an average of 25% over the coming five years. We believe all these levels are supportive of value creation versus our WACC assumption of 10%. We believe Cerner will convert an average of 88% of its net income to free cash flow over this time horizon, which will eventually support dividends or sizable share repurchases.

Risk

Cerner is living on, at least at the margin, the gift of new government regulation. The repeal or alteration of such regulation could hurt the firm. The impact would take the form of lower revenue growth, lower margins through less operating leverage, or lower margins through higher operating expenses to remediate client software to comply with new regulations. We believe the enterprise is safe from anything but extreme shifts in government policy, but this could severely harm equity investors.

Cerner has successfully navigated major platform evolutions in the EHR industry and has benefited from these. If it does not reinvest successfully or backs the wrong technologies, it could find itself ten years from now in the same place as today's share losers find themselves. This is a growth company and its stock is priced like a growth stock, taking into account a high rate of revenue growth, margin expansion, and a long duration to its competitive advantage.

Since the company's reputation is built on making health-care institutions more effective, poor clinical outcomes traced to logical or architectural errors in the software could lead to numerous patient deaths. Besides the legal risk this introduces for Cerner, the reputational damage from such an outcome could severely impair the company's profitability.

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Bulls Say

- Cerner and its primary competitor, Epic, have pulled further ahead of the pack in EHR software, enhancing their competitive positions and marginalizing those of their competitors.
- Outcomes-based health care, which ties clinical results to reimbursement levels for care providers, is a long-wave secular trend that will benefit Cerner as the clearinghouse for all the data necessary to make this a reality.
- As a leader in its market, Cerner is enjoying pricing power and operating leverage as it scales, leading to margin expansion potential of 100-200-plus basis points per year over the next 5-10 years.
- Cerner has withstood more than a decade of competitive threats from the likes of GE and IBM, which have gained little headway while Cerner has grown at a 15% organic rate over this period with 10 percentage points of margin expansion.

Bears Say

- Oracle or SAP could enter the market and pose a threat to Cerner, bundling database and application software to create a compelling alternative value for hospitals.
- Margins have expanded by nearly 1,000 basis points over five years and the market is pricing in much more. Cerner is vulnerable to a pause in margin expansion.
- Very large companies such as General Electric, IBM, Microsoft, and Siemens have targeted the health-care IT space for growth, which could pose a threat to Cerner.

Financial Overview

Financial Health:Cerner is in excellent financial condition, with $1.3 billion in cash and investments on hand versus $153 million in debt. The company is generating loads of free cash flow without skimping on investment. It has generated $632 million in cumulative free cash flow over the last two years while we believe competitors who invest less in R&D as a percentage of sales and certainly in dollar terms are building their coffins. Finally, Cerner's ROIC is well above its cost of capital while Allscripts is barely there or below. We believe Meditech beats its cost of capital, but wonder if it has a "burning platform" problem in that the duration of those excess profits is low. Finally, we believe Epic is a very worthy competitor that beats its cost of capital by the same margin as Cerner or more.

Company Overview

Profile: Cerner is a leader in providing application software to the health-care industry. Its software and service offerings power clinical record-keeping and decision-making, financial management, and operations in hospitals, outpatient settings, physician practices, and other venues. It's a leader in acute care hospitals, a position from which it's extended outward rapidly. The company generates an ROIC of 18% today, driven by a strategy of organic reinvestment and differentiation, and is growing revenue and EBIT at a 15%-25% rate in the near term.

Management: Management and the board have been exemplary stewards of the firm and the interests of its owners. Over the last 10 years, the company's 15% revenue CAGR and 22% EBIT CAGR have largely been created organically. Cumulative acquisition outlays of $243 million pale in comparison with cumulative free cash flow of $1.7 billion over this time period and are far more modest than the more frenetic pace of acquisitions executed by smaller competitors. We believe Cerner's track record of organic execution on its growth opportunities and avoidance of large deals has created a much strong company today and has shielded owners from operating, technology, and financial risks.

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Management and the board currently hold a 14% beneficial interest in Cerner, 85% of which takes the form of "hard capital," or outright ownership of stock versus options. "Hard" ownership aligns for more completely the interests of shareholders and management than derivative "soft" ownership stakes. Fourteen percent of the company is owned by two co-founders, chairman and CEO Neal Patterson and vice-chairman Cliff Illig.

We believe the board has also acted very responsibly with respect to equity grants. Many companies with Cerner's track record of growth hand out equity like candy, but not Cerner. Gross equity dilution has averaged 1% per year over the last three years. We don't think it's coincidental to see this low level of equity dilution in a company managed by substantial "hard capital" owners.

Our only complaint with Cerner's corporate governance is in bonus metrics, which is EPS growth for almost the entire executive team. More than 100% of the company's net income has converted to free cash flow in the last three years, which makes us comfortable with the quality of earnings, but EPS growth can incentivize short-term behavior at the expense of long-term value creation. We believe a wider array of metrics could augment the potency of Cerner's performance incentive plans.

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Cerner Corporation CERN

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
2,571	13,291	Health Information Services	Technology

Cerner is a leader in providing application software to the health-care industry. Its software and service offerings power clinical record-keeping and decision-making, financial management, and operations in hospitals, outpatient settings, physician practices, and other venues. It's a leader in acute care hospitals, a position from which it's extended outward rapidly. The company generates an ROIC of 18% today, driven by a strategy of organic reinvestment and differentiation, and is growing revenue and EBIT at a 15%-25% rate in the near term.

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—	77.47	—	—	—	—

per share prices in USD

Growth Rates Compound Annual

Grade: C	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	19.1	9.5	9.8	15.0
Operating Income %	28.0	18.1	22.6	22.3
Earnings/Share %	26.6	15.9	21.3	—
Dividends %	—	—	—	—
Book Value/Share %	19.1	19.0	18.3	17.1
Stock Total Return %	33.7	26.9	23.4	23.9
+/- Industry	23.4	12.8	7.7	8.5
+/- Market	15.2	17.6	24.3	19.7

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	15.4	13.9	9.8	22.8
Return on Assets %	11.9	10.0	5.5	9.3
Fixed Asset Turns	4.9	3.8	14.4	7.7
Inventory Turns	32.1	25.7	102.0	17.0
Revenue/Employee USD K	259.7	222.7*	—	1055.7
Gross Margin %	77.2	82.0	35.6	39.7
Operating Margin %	21.4	17.6	9.3	16.6
Net Margin %	14.7	11.6	5.0	11.1
Free Cash Flow/Rev %	16.5	8.9	7.7	0.1
R&D/Rev %	11.5	0.2	—	9.5

Financial Position

Grade: A	12-11 USD Mil	09-12 USD Mil
Cash	243	288
Inventories	23	24
Receivables	563	542
Current Assets	1502	1746
Fixed Assets	489	552
Intangibles	536	539
Total Assets	3000	3470
Payables	86	135
Short-Term Debt	40	55
Current Liabilities	439	496
Long-Term Debt	87	142
Total Liabilities	690	774
Total Equity	2311	2697

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	36.1	31.7	49.3	—
Forward P/E	27.9	—	—	13.2
Price/Cash Flow	19.5	17.1	20.3	—
Price/Free Cash Flow	32.0	—	33.1	—
Dividend Yield %	—	—	0.2	2.0
Price/Book	4.9	3.9	3.0	—
Price/Sales	5.3	3.7	2.1	—
PEG Ratio	1.5	—	—	0.3

Stock Performance

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	Stock Performance
-39.1	21.1	40.5	72.4	-0.7	24.0	-31.8	114.4	14.9	29.3	26.5	Total Return %
-15.7	-5.3	31.5	69.4	-14.3	20.5	6.7	91.0	2.1	29.3	12.5	+/- Market
-7.1	-18.5	8.5	3.7	30.3	16.8	-10.2	32.2	3.1	10.6	19.7	+/- Industry
—	—	—	—	—	—	—	—	—	—	0.0	Dividend Yield %
1110	1341	1932	3504	3555	4510	3114	6730	7849	10376	13291	Market Cap USD Mil

Financials

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Financials
752	840	926	1161	1378	1520	1676	1672	1850	2203	2571	Revenue USD Mil
36.0	76.9	78.8	78.1	78.9	81.6	82.3	83.2	82.7	80.0	77.2	Gross Margin %
91	78	111	140	166	204	279	292	359	460	549	Oper Income USD Mil
12.1	9.3	12.0	12.1	12.1	13.4	16.6	17.5	19.4	20.9	21.4	Operating Margin %
48	43	65	86	110	127	189	193	237	307	377	Net Income USD Mil
0.33	0.30	0.43	0.55	0.67	0.77	1.13	1.16	1.39	1.76	2.15	Earnings Per Share USD
—	—	—	—	—	—	—	—	—	—	—	Dividends USD
148	145	150	157	163	166	167	168	171	174	175	Shares Mil
3.11	3.49	4.11	4.97	5.88	7.08	8.09	9.68	11.50	13.64	15.72	Book Value Per Share USD
37	134	168	229	233	275	282	347	456	546	696	Oper Cash Flow USD Mil
-60	-84	-56	-101	-193	-250	-182	-222	-194	-208	-272	Cap Spending USD Mil
-23	51	112	128	40	24	99	126	262	338	424	Free Cash Flow USD Mil

Profitability

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Profitability
6.4	5.2	7.0	7.5	7.9	8.0	10.6	9.6	10.4	11.3	11.9	Return on Assets %
11.5	9.1	11.8	12.7	13.1	12.4	15.4	13.4	13.6	14.6	15.4	Return on Equity %
6.4	5.1	7.0	7.4	8.0	8.4	11.3	11.6	12.8	13.9	14.7	Net Margin %
1.01	1.02	1.01	1.02	0.99	0.96	0.94	0.83	0.81	0.81	0.81	Asset Turnover
1.8	1.7	1.6	1.7	1.6	1.5	1.4	1.4	1.3	1.3	1.3	Financial Leverage

Financial Health

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	09-12	Financial Health
282	252	310	392	445	530	518	788	840	1064	1250	Working Capital USD Mil
137	125	109	194	187	178	111	96	68	87	142	Long-Term Debt USD Mil
441	495	597	761	918	1132	1311	1581	1905	2311	2697	Total Equity USD Mil
0.31	0.25	0.18	0.26	0.20	0.16	0.08	0.06	0.04	0.04	0.05	Debt/Equity

Valuation

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Valuation
23.7	32.0	31.0	41.7	33.9	36.9	17.0	35.7	34.1	34.8	36.1	Price/Earnings
—	—	—	—	—	—	—	—	—	2.0	—	P/E vs. Market
1.5	1.6	2.2	3.1	2.7	3.1	1.9	4.1	4.4	4.8	5.3	Price/Sales
2.5	2.7	3.2	4.6	3.9	4.0	2.4	4.3	4.1	4.5	4.9	Price/Book
31.4	10.2	11.9	15.5	15.9	17.1	11.4	19.9	17.7	19.4	19.5	Price/Cash Flow

Quarterly Results

Revenue USD Mil	Dec 11	Mar 12	Jun 12	Sep 12
Most Recent Period	615.6	641.2	637.4	676.5
Prior Year Period	500.2	491.7	524.2	571.6

Rev Growth %	Dec 11	Mar 12	Jun 12	Sep 12
Most Recent Period	23.1	30.4	21.6	18.3
Prior Year Period	7.3	14.0	15.0	23.6

Earnings Per Share USD	Dec 11	Mar 12	Jun 12	Sep 12
Most Recent Period	0.52	0.51	0.56	0.56
Prior Year Period	0.41	0.38	0.42	0.45

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Cerner Corporation	13291	2571	36.1	15.4
General Electric Co	216647	146016	15.4	10.8
McKesson, Inc.	21883	123186	14.2	21.6

Major Fund Holders

	% of shares
	—
	—
	—

*3Yr Avg data is displayed in place of 5Yr Avg

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

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Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

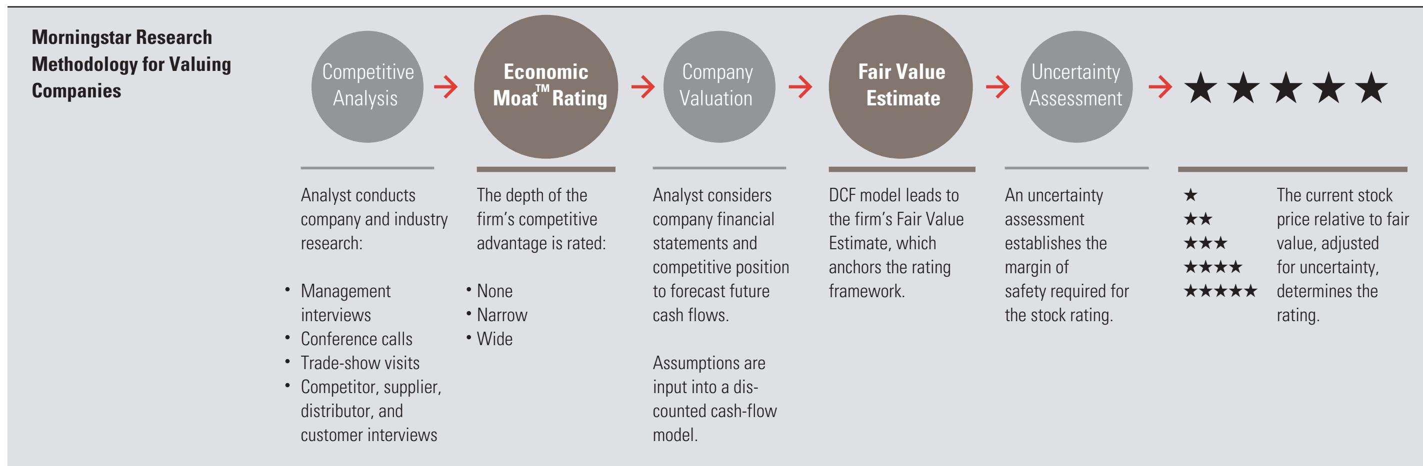
Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such



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economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow
This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate
We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value
This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty
To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety
This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling
The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades
Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

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