

Cerner Corporation (CERN)

March 29, 2009

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Cerner Corporation		
Recommendation: BUY		
Ticker	CERN	
Current Price (USD)	\$43.37	
Target Price	\$56.00	
Total enterprise value (M)	\$3,322.58	
Market Cap (M)	\$3,483.81	
Relative Ratios		
	CERN	Comps
2009 Forward P/E	17.08	16.93
2009 TEV/EBITDA	6.60	10.03
Gross Margin (%)	78.28	51.27
Profit Margin (%)	15.35	7.82
EBITDA Margin (%)	25.42	26.82
ROIC (%)	8.40	7.31
YTD Revenue Growth (%)	18.06	16.33

Note: All figures calculated using price as of market close on March 27, 2009. Information for forward mean estimates for comparables accessed from Thomson One Analytics for fiscal year 2009. All margins, return, and growth are based on quarter ending December 2008 results. Companies included in comparable averages are: McKesson Corp., Quality Systems Inc., Streamline Health Solutions, and Mediware Information Systems.

We recommend a **BUY** for Cerner Corporation.

Investment Thesis:

- Cerner has a competitive advantage in its aggressive pursuit to corner international markets. International sales make-up 22% of total revenues.
- The company stands to profit from the current economic stimulus proposal due to the company's 20% domestic market share.
- Cerner has higher gross and profit margin, 78% and 15% respectively, compared to comparable companies with average gross and profit margins of 51% and 7%.
- Using a relative valuation Cerner is currently undervalued by 29%, resulting in a price target of \$56.

Company Overview:

Cerner Corporation creates Healthcare IT designed to provide operational efficiencies and facilitate increased utilization of electronic medical records (EMRs). The company also sells automated healthcare products to hospitals to communicate directly with EMRs.

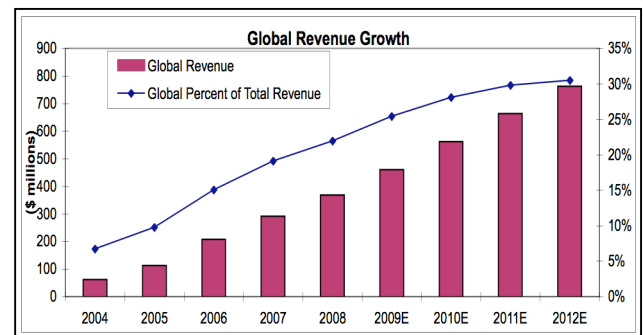
Forward Outlook:

Global Expansion

In 2008, the company recorded \$340 million of non-U.S. revenue versus \$29 million in 2002 resulting in a compound annual growth rate of 148%. In the last 5 years international sales have increased from 7% in 2004 of revenues to 22% in 2008.

Cerner is a key participant in a nationwide initiative in the United Kingdom to automate processes and utilize EMRs. This accounted for one-third of international revenue growth.¹ Cerner also claims between 60 and 70% of market share in Australia and look to completely capitalize on this market domination through the installation of its product in the majority of hospitals throughout the continent.² Figure 1 illustrates our growth forecast and international sales as a portion of total revenue.

Figure 1:



Economic Stimulus Package

Beginning in 2011, the average hospital will receive \$4 million dollars in government aid over 3 years time if an electronic health records (EHR) system is in place.³ After 2015, hospitals will be penalized for not having an EHR system.⁴ This places pressure on hospitals to begin investing in software systems such as Cerner's Millennium product. Revenue obtained as a result of the stimulus remains uncertain and we have not incorporated this variable into our growth projections. However, Cerner's current market position with 20% of domestic market share implies the company stands only to benefit from this government policy.⁵ If hospitals across the country do start making large investments in IT, we project Cerner's revenue growth to be closer to 18% by 2012 rather than our current projection of 12.3%.

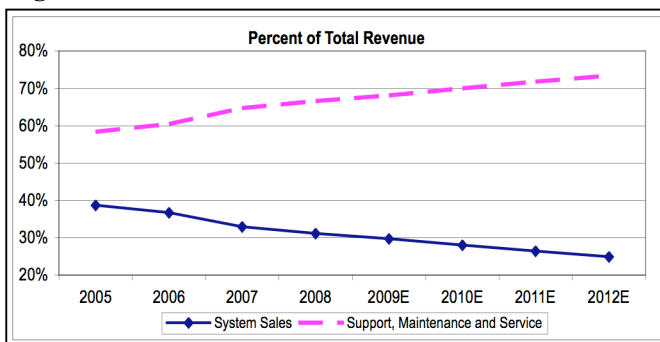
New Innovation

The company values continual innovation. This is incorporated in our projections for capital expenditures to increase to between \$140 and \$150 million annually. Management emphasizes “playing offense” while competition is “playing defense.” In an economic climate where others are cutting R&D costs, Cerner plans to continue investing in its competitive advantage. The company has over 300 devices to offer to clients, a number that has doubled since 2007.⁶ We believe this is a positive and have accordingly projected revenue growth of 7.9%, 10.4%, 11.2%, and 12.4% for the next four years.

Improving Operational Efficiency

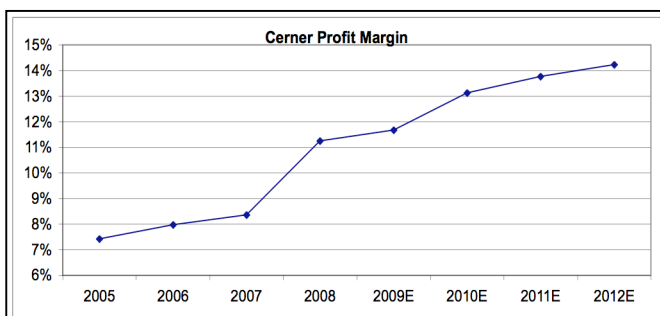
The company increased recurring revenue generated by support services as a portion of total revenue over time.

Figure 2:



This translates to higher margins due to the extremely low cost of support revenues, which has a gross margin of 94.5%. Decreasing revenue growth’s dependency on one-time revenue from system sales results in a trend toward more profitable revenue stream. We project operating margins to continue to strengthen hitting 20% in 2010, resulting in improving profit margin over time.

Figure 3:



Valuation:

Key Assumptions:

Using a relative valuation with both 2009 Price/Sales and TEV/EBITDA, Cerner is undervalued. Our forecast uses a weighted average cost of capital of 12.2%. For other key assumptions see Figure 4.

	2008	E2009	E2010	E2011	E2012
Revenues	\$ 1,676	\$ 1,810	\$ 1,999	\$ 2,223	\$ 2,499
Growth	10.27%	7.98%	10.43%	11.24%	12.39%
Gross Profit	1,380	1,500	1,669	1,872	2,121
Margin	82.34%	82.88%	83.53%	84.20%	84.90%
Operating Profit	279	313	388	454	527
Margin	16.64%	17.28%	19.43%	20.40%	21.10%
Net Income	\$ 189	\$ 211	\$ 262	\$ 306	\$ 356
EPS	\$ 2.26	\$ 2.54	\$ 3.15	\$ 3.68	\$ 4.27
Growth	48.02%	12.30%	24.10%	16.73%	16.19%
FCF per Share	\$ 3.30	\$ 3.18	\$ 3.00	\$ 3.88	\$ 4.15

Note: All figures are in millions of USD with the exception of per share data.

Relative Valuation:

Cerner has stronger operating margins than comparable firms. Average gross margin for comparables is 51%, but Cerner achieves 78% gross margin. The company also has higher ROIC of 8.4% versus comparable’s average of 7.3%. Despite more efficient operations and higher revenue growth, Cerner has a lower 2009 TEV/EBITDA multiple than comparable firms meaning the company is trading at a discount.

Using an average 2009 TEV/EBITDA multiple of 10.03 the target price of Cerner is \$56.02. This implies a 29.1% undervaluation.

Summary:

We believe growth potential lies within Cerner’s global segment, current domestic government stimulus aid, and its healthcare device offerings. These combined result in a BUY on Cerner Corporation.

¹ Cerner 10-K filed 3/2/09 p.29

^{2, 4, 5} Kells, Allan. "Q&A Session with Cerner Corporation." Personal interview. 27 Mar. 2009.

³ Hickens, Michael. "Uncertain Health IT Specs could Hamper Hospital Stimulus Spending." Business Net 15 Feb 2009 1-2. 29 Mar 2009 <<http://industry.bnet.com/technology/1000844/>>.

⁶ Valentine, Michael. "2008 Earnings Call with Cerner." Interview. Cerner Investor Relations. 10 Feb. 2009. 25 Mar. 2009.