

Mercury Systems (MRCY)

\$88.17 (As of 05/07/20)

Price Target (6-12 Months): **\$93.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 10/16/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

2-Buy

Zacks Style Scores:

VGM:C

Value: D

Growth: B

Momentum: F

Summary

Robust organic growth aided Mercury's fiscal third-quarter 2020 results. Strong demand for products resulted in significant deal wins, which drove the top line. A raised view for fiscal 2020 is encouraging. Moreover, modernization in radar, electronic warfare and C4I is high, providing the company with new opportunities in weapon systems, space, avionics processing, and mission computing and embedded rugged service. Domain expertise in analog and digital integration has helped it build a solid long-term relationship with defense prime contractors. However, continued expansion in capex is expected in the near term owing to continued investments in business expansion. Further, intense competition from CACI and SAIC is concerning.

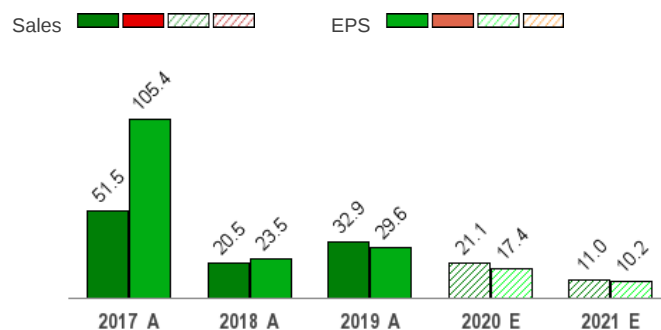
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$96.29 - \$52.24
20 Day Average Volume (sh)	312,009
Market Cap	\$4.9 B
YTD Price Change	27.6%
Beta	1.03
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Computer - Peripheral Equipment
Zacks Industry Rank	Top 32% (82 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	15.4%
Last Sales Surprise	4.3%
EPS F1 Est- 4 week change	1.8%
Expected Report Date	08/04/2020
Earnings ESP	0.6%
P/E TTM	43.0
P/E F1	41.0
PEG F1	3.5
P/S TTM	6.5

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	198 E	212 E	219 E	235 E	880 E
2020	177 A	194 A	208 A	214 E	793 E
2019	144 A	159 A	175 A	177 A	655 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.49 E	\$0.59 E	\$0.63 E	\$0.68 E	\$2.38 E
2020	\$0.44 A	\$0.54 A	\$0.60 A	\$0.58 E	\$2.16 E
2019	\$0.39 A	\$0.47 A	\$0.50 A	\$0.47 A	\$1.84 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 05/07/2020. The reports text is as of 05/08/2020.

Overview

Founded in 1981 and headquartered in Andover, MA, Mercury Systems, Inc. is a provider of sensor and safety critical mission processing subsystems. The company was earlier known as Mercury Computer Systems and changed its name to Mercury Systems in November 2012.

The company's products and solutions are supplied to about 300 defence and intelligence programs with 25 U.S. defense prime contractors.

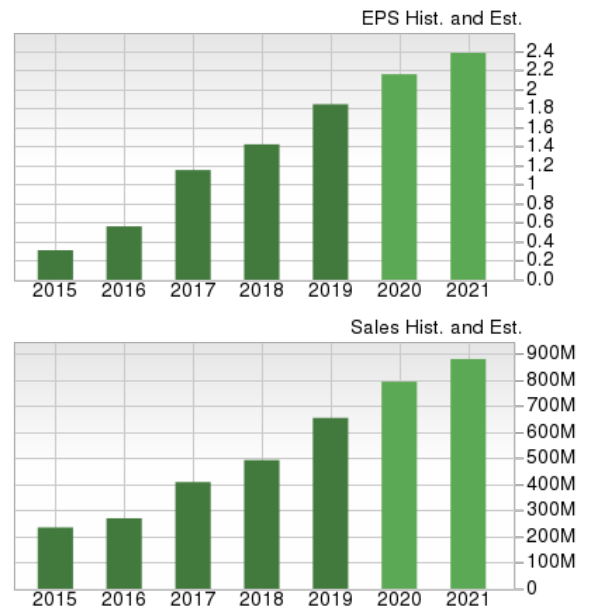
This apart, the company produces hardware products, including components, such as power amplifiers and limiters, switches, oscillators, filters, equalizers, converters, chips, integrated circuits, and memory and storage devices.

Other products offered by Mercury Systems include embedded processing modules and boards, switch fabric boards, input/output boards, digital receiver boards and transceivers, etc. Graphics and video processing, Ethernet and integrated subsystems are also part of the company's portfolio.

Additionally, Mercury Systems is involved in the designing, marketing and licensing of software and middleware technology under the name MultiCore Plus to expedite the development of signal and image processing applications on various heterogeneous and multi-computing platforms.

In fiscal 2019, Mercury Systems generated \$654 million in revenues, hitting the highest mark to date.

Mercury Systems faces significant competition from Harris Corporation, CACI International and Science Applications as the provider of technology services to the U.S. government.



Reasons To Buy:

- ▲ Mercury is expected to benefit from high demand for electronic warfare, ISR and other related market segments in the coming years, as it continues to hone its expertise in design and development of electronic subsystems for these markets. Per the Renaissance Strategic Advisors, the global aerospace and defense electronics market, which was estimated to be \$103 billion in 2018, is poised to reach \$117 billion by 2022. Moreover, the U.S. defense electronics market is expected to grow from \$51 billion in 2018 to \$57 billion in 2022. Further, the company works with a number of key defense prime contractors on a regular basis, which should ensure healthy flow of orders.
- ▲ The long-term DoD budget pressure due to the two-year Budget Control Act, additional expenditures creeping into Overseas Contingency Operations account, flat budget growth and like, is making more and more contractors opt for upgrades of the electronic subsystems on existing platforms. This is expected to increase the demand for the company's cost-effective and open-architecture products.
- ▲ The company's continued efforts and investments, which have resulted in successful completion of deals, have created about \$800 million worth of potential C4I opportunity based on the estimated lifetime value of its top 30 programs. Management noted that the C4I market, which encompasses avionics, command and control, electronic warfare (EW), and dedicated communications, is growing faster than the overall defense space, which is encouraging it to increase its stronghold in it. Per Zion Market Research, the C4ISR market (Communication, Command & Control, Computers, Intelligence, Surveillance & Reconnaissance, and EW) is expected to witness a CAGR of 3.6% between 2018 and 2024 to hit \$127.2 billion globally. Moreover, per Transparency Market Research, the C4ISR market is expected to reach \$132.3 billion by 2026, at a CAGR of 3.8% over 2018-2026. These projections make us optimistic about Mercury's growth prospects.
- ▲ The company's significant investments in embedded computing technology reflect in its recently released board-to-board data transmission rates of 100 Gbps. Through this, Mercury aims to enable faster next-generation PCIe Gen-4 Ethernet and InfiniBand high-speed switch fabrics. These fabric switches run within OpenVPX embedded computing subsystems. Per Mordor Intelligence, the global embedded computing systems market is expected to witness a CAGR of 6.6% over the period of 2018 to 2023. This is promising for companies like Mercury with long-standing stronghold in the industry.
- ▲ Moreover, Mercury's domain expertise in analog and digital integration has helped it build a solid business relationship with defense prime contractors for a long time. Its embedded computing servers including the suite of EnsembleSeries blades have delivered processing solutions with long lifecycles, high performance, environmental resiliency, interoperability and SWaP optimization for 35 years.
- ▲ Mercury has a history of expanding through acquisitions. These buyouts have added significant value to the company and expanded its total addressable market. Management noted at the end of fiscal 2018 that it invested a total of \$620 million on acquiring seven firms, and it plans to continue growing inorganically through acquisitions. In the third quarter of fiscal 2020, Mercury reported acquired revenues (8% of total revenues) of nearly \$16.5 million, attributable to the acquisitions of GECO Avionics, The Athena Group, Syntonic Microwave and American Panel Corporation. We believe that continued acquisitions will aid the company's growth.
- ▲ Mercury has a strong balance sheet with ample liquidity position and less debt obligations. As of Mar 27, 2020, the company had net cash balance of \$207 million, compared with \$127 million at the end of December, 2019. Also, its total debt-to-capital ratio of 0.04 is much lower than the industry average of 1.03. Since it has net cash available on its balance sheet, the existing cash can be used for pursuing strategic acquisitions, investment in growth initiatives and distribution to shareholders.

High demand for electronic warfare, increased upgrades on electronic subsystems, and continued flow of deals are aiding Mercury's growth.

Reasons To Sell:

- ▼ Unfavorable contract mix is also likely to hurt the company's profitability. The company continues to witness increase in service-led contracts compared with legacy product based deals, which is expected to be a drag on margins.
- ▼ Though Mercury has been steadily winning development contracts from the federal government, these low-margin deals threaten to affect the company's profitability in the long term.
- ▼ Customer concentration is a major risk for Mercury. Its revenues were concentrated in two defense prime contractors, including Lockheed Martin and Raytheon for the last three consecutive years. These defense prime contractors comprised an aggregate of 37% of revenues in fiscal 2019, which is significant. This exposes the company to major revenue loss even if one of the customers ends its association with Mercury.
- ▼ Moreover, in fiscal 2019, about 95% of Mercury's revenues came from sales to the U.S. federal government either as a prime contractor or subcontractor. Due to this massive dependency, changes in the government's IT spending budget is a huge deciding factor for the company's top-line growth. Moreover, these contracts are subject to extensive legal and regulatory hurdles, which are stringent, and subject to change from time to time. The government also investigates operations periodically to ensure that the terms and conditions have been properly adhered to. Deviations from the terms laid out by the government might result in huge penalties or termination.
- ▼ Mercury competes primarily in the government IT services arena, which, like other government sectors, consists of many competitors of various sizes. Its main competitors include ManTech International Corporation, CACI, Unisys, Accenture, IBM — all of which are established players in the industry. Consequently, the company has to continuously invest in value drivers, which act as a hedge against competition. These increase its operating costs and reduce profitability.

Unfavorable contract mix and large number of low-margin contracts are hurting the company's profitability.

Last Earnings Report

Mercury Beats on Q3 Earnings & Revenues

Mercury Systems reported third-quarter fiscal 2020 (ended Mar 27, 2020) results, wherein both top and bottom lines outpaced the Zacks Consensus Estimate.

Non-GAAP earnings per share of 60 cents grew 22.4% year over year and beat the Zacks Consensus Estimate by 15.4%.

Revenues came in at \$208 million, marking a year-over-year increase of 19%. The metric also surpassed the Zacks Consensus Estimate of \$199 million.

Robust organic growth drove the company's performance.

Strong demand for weapon systems, space, avionics processing and mission computing, and secure rugged servers resulted in significant deal wins, which drove the top line.

Notably, the company was not materially impacted by the coronavirus-led economic disruptions.

Quarterly Details

Organic revenues (92% of total revenues) grew 11% to \$191.5 million in the quarter.

The company reported Acquired revenues (8%) of \$16.5 million, which increased massively from \$2.5 million reported in the prior-year quarter, attributable to the buyouts of GEICO Avionics, The Athena Group, Syntonic Microwave and American Panel Corporation.

Sensor and Effector Mission Systems revenues rose 24% year over year and accounted for 57% of total revenues.

Revenues from Command, Control, Communications, Computers and Intelligence (C4I) represented 30% of total revenues and grew 22% year over year.

Modernization in radar, Electronic Warfare and C4I was high, providing the company with new opportunities in weapon systems, space, avionics processing, and mission computing and embedded rugged service.

Mercury's total bookings increased 32% year over year to \$250 million, resulting in a 1.2 book-to-bill ratio.

The company ended the quarter with a backlog of \$769.8 million, up 38% year over year. Within the next 12 months, \$544.8 million worth of products from this backlog of orders are expected to be shipped.

Margins

Gross margin for the fiscal first quarter expanded 260 basis points (bps) to 44.9%.

Adjusted EBITDA grew 21% year over year to \$47.1 million. Also, adjusted EBITDA margin expanded 40 bps year over year to 22.6%.

Balance Sheet and Cash Flow

Mercury exited the quarter with cash and cash equivalents of \$407.1 million, up from \$182 million at the end of the previous quarter.

The company generated \$30.1 million of cash flow from operating activities compared with \$32.1 million in the prior quarter.

Free cash flow was \$19.2 million, down from \$20.7 million sequentially.

Guidance

For the fourth quarter of fiscal 2020, revenues are expected to be \$205.8-\$215.8 million.

Adjusted EBITDA for the quarter is anticipated in a band of \$46.4-\$49.4 million. Adjusted earnings are projected to be 54-58 cents per share.

Continued expansion in capex is expected in the fiscal third quarter owing to continued investments in business expansion, including a \$15-million investment to expand its trusted microelectronics business in Phoenix.

Mercury raised guidance for fiscal 2020. The company now expects revenues of \$785-\$795 million, up from the earlier guidance of \$785-\$790 million.

Adjusted EBITDA for the fiscal is expected to be \$173-\$176 million, up from the earlier expectation of \$172.5-\$176 million.

Adjusted earnings for the fiscal are now estimated to be \$2.12-\$2.16 per share, increasing from \$2.09-\$2.13 guided earlier.

Quarter Ending	03/2020
Report Date	Apr 28, 2020
Sales Surprise	4.27%
EPS Surprise	15.38%
Quarterly EPS	0.60
Annual EPS (TTM)	2.05

Recent News

On Apr 9, Mercury Systems Received a \$4.7M Artificial Intelligence Processing Technology order for Airborne Electro-Optic Application from a leading defense prime contractor.]

On Jan 21, Mercury launched the EnsembleSeries CIOE-1390 module, a commercially-available compute module with Intel Atom multicore processors and embedded BuiltSAFE technology for flight safety certification.

On Jan 15, Mercury adopted cybersecurity company Tortuga Logic's products to support the development of hardware and software designs for DARPA's (Defense Advanced Research Projects Agency) Guaranteed Architecture for Physical Security (GAPS) program.

Valuation

Mercury shares have gained 27.6% in the year to date (YTD) period, while are up 17% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Computer & Technology sector have fallen 3.4% and 5.1%, respectively, year-to-date (YTD). Over the past year, while the Zacks sub-industry increased 1.1%, the sector increased 3.2%.

The S&P 500 Index has declined 10.9% YTD and 1.7% in the past year.

The stock is currently trading at 5.65X forward 12-month sales, which compares to 0.52X for the Zacks sub-industry, 3.50X for the Zacks sector and 3.21X for the S&P 500 index.

Over the past five years, the stock has traded as high as 6.38X and as low as 1.87X with a 5-year median of 4.09X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$93 price target reflects 5.93X forward 12-month sales.

The table below shows summary valuation data for MRCY

Valuation Multiples - MRCY					
		Stock	Sub-Industry	Sector	S&P 500
P/S F 12M	Current	5.65	0.52	3.50	3.21
	5-Year High	6.38	6.9	3.59	3.44
	5-Year Low	1.87	0.34	2.32	2.54
	5-Year Median	4.09	5.13	3.10	3.01
EV/Sales TTM	Current	6.01	0.87	3.90	2.82
	5-Year High	7.11	0.92	4.43	3.43
	5-Year Low	1.69	0.29	2.58	2.11
	5-Year Median	4.77	0.56	3.58	2.80
EV/EBITDA TTM	Current	32.99	21.79	11.33	10.66
	5-Year High	34.38	26.41	12.84	12.87
	5-Year Low	11.63	1.57	7.6	8.27
	5-Year Median	25.07	3.33	10.6	10.78

As of 05/07/2020

Industry Analysis Zacks Industry Rank: Top 32% (82 out of 253)



Top Peers

Company (Ticker)	Rec	Rank
CACI International Inc (CACI)	Neutral	3
CurtissWright Corporation (CW)	Neutral	3
FLIR Systems Inc (FLIR)	Neutral	3
Heico Corporation (HEI)	Neutral	4
Leidos Holdings Inc (LDOS)	Neutral	2
Northrop Grumman Corporation (NOC)	Neutral	3
Science Applications International Corporation (SAIC)	Neutral	2
Teledyne Technologies Incorporated (TDY)	Neutral	3

Industry Comparison Industry: Computer - Peripheral Equipment				Industry Peers		
	MRCY	X Industry	S&P 500	CACI	NOC	SAIC
Zacks Recommendation (Long Term)	Neutral	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	2	-	-	3	3	2
VGM Score	C	-	-	A	F	A
Market Cap	4.90 B	51.79 M	19.51 B	6.27 B	54.04 B	4.77 B
# of Analysts	6	2.5	14	9	6	7
Dividend Yield	0.00%	0.00%	2.15%	0.00%	1.63%	1.80%
Value Score	D	-	-	B	D	B
Cash/Price	0.08	0.21	0.06	0.01	0.06	0.04
EV/EBITDA	41.40	8.70	11.77	17.11	16.20	12.52
PEG Ratio	3.60	5.22	2.54	1.67	NA	NA
Price/Book (P/B)	3.63	1.31	2.67	2.45	5.96	3.33
Price/Cash Flow (P/CF)	40.70	8.84	10.44	17.57	11.75	10.08
P/E (F1)	41.86	40.91	19.30	20.42	14.59	13.52
Price/Sales (P/S)	6.48	0.71	1.99	1.12	1.58	0.75
Earnings Yield	2.44%	1.13%	4.91%	4.90%	6.86%	7.40%
Debt/Equity	0.20	0.08	0.75	0.69	1.72	1.30
Cash Flow (\$/share)	2.17	0.54	7.01	14.23	27.58	8.18
Growth Score	B	-	-	A	F	B
Hist. EPS Growth (3-5 yrs)	36.52%	-4.48%	10.87%	18.19%	23.40%	17.06%
Proj. EPS Growth (F1/F0)	17.12%	37.94%	-9.87%	17.07%	4.75%	7.72%
Curr. Cash Flow Growth	25.32%	-26.07%	5.88%	29.08%	2.21%	74.09%
Hist. Cash Flow Growth (3-5 yrs)	39.83%	16.17%	8.55%	11.71%	14.43%	23.85%
Current Ratio	6.52	2.27	1.24	1.38	1.29	1.27
Debt/Capital	16.52%	7.51%	44.23%	40.99%	63.22%	56.47%
Net Margin	9.43%	-2.23%	10.68%	4.96%	6.57%	3.54%
Return on Equity	7.04%	-4.55%	16.36%	11.26%	39.22%	25.09%
Sales/Assets	0.49	0.92	0.55	1.04	0.83	1.37
Proj. Sales Growth (F1/F0)	21.14%	0.00%	-2.26%	13.83%	4.11%	13.58%
Momentum Score	F	-	-	D	F	D
Daily Price Chg	1.45%	0.00%	1.52%	1.15%	0.34%	0.33%
1 Week Price Chg	5.36%	0.00%	0.53%	3.30%	-3.32%	-7.14%
4 Week Price Chg	17.42%	3.37%	0.73%	8.68%	-3.72%	5.24%
12 Week Price Chg	2.89%	-30.23%	-21.09%	-10.08%	-11.92%	-12.62%
52 Week Price Chg	17.00%	-40.51%	-10.17%	23.19%	9.88%	8.72%
20 Day Average Volume	312,009	40,964	2,398,409	160,972	789,297	641,898
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	-0.45%	-0.23%	0.00%
(F1) EPS Est 4 week change	1.85%	0.00%	-6.95%	-1.52%	-4.05%	-2.02%
(F1) EPS Est 12 week change	0.84%	-73.47%	-15.68%	-1.47%	-4.21%	-1.34%
(Q1) EPS Est Mthly Chg	-10.05%	-22.21%	-13.12%	-3.37%	-6.06%	-3.50%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	D
Growth Score	B
Momentum Score	F
VGM Score	C

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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