

Mercury Systems (MRCY)

\$79.70 (As of 08/12/20)

Price Target (6-12 Months): **\$68.00**

Long Term: 6-12 Months | **Zacks Recommendation:** **Underperform**
(Since: 08/12/20)
Prior Recommendation: Neutral

Short Term: 1-3 Months | **Zacks Rank:** (1-5) **5-Strong Sell**
Zacks Style Scores: VGM:C
Value: F | Growth: A | Momentum: B

Summary

Mercury's shares have underperformed the industry year to date. The company's prospects face significant risk from increasing chances of lower discretionary spending on defense due to the growing prospect of another round of fiscal stimulus to rejuvenate the coronavirus-ravaged economy. Moreover, higher coronavirus-related expenses related to continued supplies and services, including COVID-19 testing at Mercury's major manufacturing facilities, are expected to hurt bottom line. Further, capital expenditure is expected to increase due to continued investment on Mercury's custom microelectronics business as well as increased spending on COVID-19-related testing and facility modernization. This is expected to hurt free cash flow in fiscal 2021. Additionally, low-margin contract mix is expected to remain a drag on profitability.

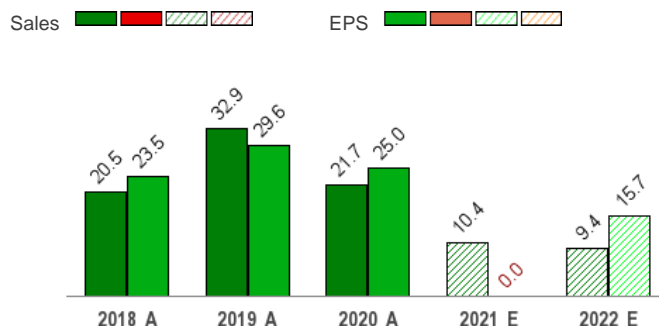
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$96.29 - \$52.24
20 Day Average Volume (sh)	286,809
Market Cap	\$4.4 B
YTD Price Change	15.3%
Beta	0.97
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Computer - Peripheral Equipment
Zacks Industry Rank	Bottom 26% (187 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	24.1%
Last Sales Surprise	1.6%
EPS F1 Est- 4 week change	-11.9%
Expected Report Date	11/03/2020
Earnings ESP	0.0%
P/E TTM	34.7
P/E F1	34.7
PEG F1	3.0
P/S TTM	5.6

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2022					963 E
2021	201 E	214 E	226 E	240 E	880 E
2020	177 A	194 A	208 A	217 A	797 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2022					\$2.66 E
2021	\$0.47 E	\$0.55 E	\$0.60 E	\$0.67 E	\$2.30 E
2020	\$0.44 A	\$0.54 A	\$0.60 A	\$0.72 A	\$2.30 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 08/12/2020. The reports text is as of 08/13/2020.

Overview

Headquartered in Andover, MA, Mercury Systems, Inc. was founded in 1981. The company is one of the world's leading providers of sensor and safety critical mission processing subsystems. Earlier, the company was known as Mercury Computer Systems. However, in November 2012, it changed the name to Mercury Systems, Inc.

The company operates across the United States, Europe, and the Asia Pacific and its products and solutions are used for various critical aerospace, defence, commercial aviation, and intelligence programs. Additionally, Mercury Systems' products and solutions are supplied to about 300 defense and intelligence programs with over 25 different defense prime contractors.

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

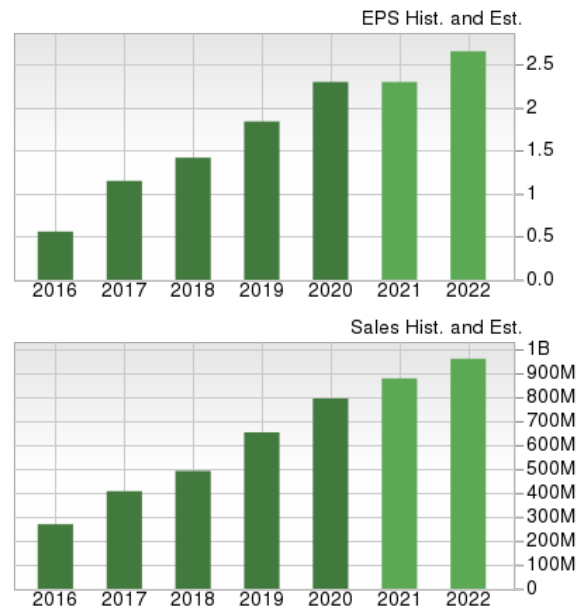
Other products offered by Mercury Systems include embedded processing modules and boards, switch fabric boards, input/output boards, digital receiver boards and transceivers, etc. Graphics and video processing, Ethernet and integrated subsystems are also part of the company's portfolio.

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.

Mercury Systems claims that its investments in R&D is more than double that of its customers, which allows it better assisting customers in areas including cost minimization, reduce technical risks, time and budget management, and ensure trust and security in the supply chain. Its strategy has helped it in winning contracts across several programs, including Aegis, Predator, F-35, Reaper, F-16 SABR, and Surface Electronic Warfare Improvement Program.

In fiscal 2020, Mercury Systems generated \$796 million in revenues.

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 Sell:

- ▼ 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. The growing prospect of another huge fiscal stimulus to help the U.S. economy recover is expected to negatively impact discretionary budget spending that doesn't bode well for Mercury. 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. These factors make the stock risky for investors.
 - ▼ Unfavorable contract mix is likely to hurt the Mercury'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.
 - ▼ 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.
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Unfavorable contract mix, defense budget related risk and large number of low-margin contracts are hurting Mercury's profitability.

Risks

- 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. The company works with a number of key defense prime contractors on a regular basis, which should ensure healthy flow of orders. Moreover, 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.
 - Mercury'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.
 - 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. In the fourth quarter of fiscal 2020, Mercury reported acquired revenues (5.5% of total revenues) of \$11.9 million, primarily attributable to the buyouts of The Athena Group, Syntonic Microwave and American Panel Corporation. We believe that continued acquisitions will aid the company's growth.
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Last Earnings Report

Mercury Q4 Earnings Beat, Organic Revenues Aid Growth

Mercury Systems reported fourth-quarter fiscal 2020 non-GAAP earnings of 72 cents per share that beat the Zacks Consensus Estimate by 24.1%. The figure jumped 50% year over year.

Revenues of \$217.4 million also surpassed the consensus mark by 1.6% and grew 22.8% year over year driven by robust organic growth.

The company generated most its revenues from SEWIP, Filthy Buzzard, F-35, F-16 SABR, and a classified radar program.

Quarter Ending **06/2020**

Report Date	Aug 04, 2020
Sales Surprise	1.61%
EPS Surprise	24.14%
Quarterly EPS	0.61
Annual EPS (TTM)	2.30

Quarterly Details

Organic revenues (94.5% of total revenues) grew 17.5% to \$205.5 million in the reported quarter.

Moreover, acquired revenues (5.5% of total revenues) of \$11.9 million soared from \$2.1 million reported in the year-ago quarter, primarily attributable to the buyouts of The Athena Group, Syntonic Microwave and American Panel Corporation.

Mercury's total bookings increased 15% year over year to \$278.6 million, resulting in a 1.28 book-to-bill ratio. The company's largest bookings in the reported quarter were F-35, SEWIP, LTAMDS, a classified radar program, and Filthy Buzzard.

The company ended the quarter with a backlog of \$831.1 million, up \$205.7 million year over year. Within the next 12 months, \$567.7 million worth of products from this backlog of orders are expected to be shipped.

Operating Details

Gross margin in the fiscal fourth quarter contracted 70 basis points (bps) year over year to 44.4%.

Adjusted EBITDA grew 30.8% year over year to \$49.6 million. Also, adjusted EBITDA margin expanded 140 bps year over year to 22.8%.

Selling, general & administrative expenses as a percentage of revenues decreased 100 bps year over year to 15.4%.

However, research & development expenses as a percentage of revenues increased 90 bps to 12.4%.

Operating margin expanded 40 bps year over year to 12.2%.

Balance Sheet and Cash Flow

Mercury had cash and cash equivalents of \$226.8 million as of Jul 3, 2020, up from \$407.1 million at the end of the previous quarter.

The company generated \$28.7 million of cash flow from operating activities compared with \$30.1 million in the previous quarter and \$26 million in the year-ago quarter.

Free cash flow was \$17.2 million, down from \$19.2 million sequentially but slightly up on a year-over year basis.

Key Q4 Developments

In April, Mercury received a \$4.7 million order from a leading defense prime contractor to provide artificial intelligence-processing technology for integration into an advanced airborne electro-optic system. The order was booked in the company's fiscal 2020 third quarter and is expected to be shipped over the next several quarters.

Moreover, it received a \$30 million multi-year award from a leading defense prime contractor to provide video-display technology for integration into mobile ground vehicles. The award has a 36-month planned performance and shipment period.

Further, Mercury announced the SpectrumSeries RFM3103s ultra-wideband dual upconverter, which is designed to align with the emerging sensor open systems architecture's technical standard for electronic-warfare environments.

In June, Mercury announced the new GSC6204 OpenVPX which is NVIDIA's Turing architecture-based GPU co-processing engine. The solution provides accelerated high-performance computing capabilities to commercial aerospace and defense applications.

Moreover, the company received a \$49 million order from a leading defense prime contractor for high-performance signal processing and radio-frequency solutions for a missile-defense program. The order was booked in Mercury's fiscal 2020 fourth quarter and is expected to be shipped over the next several quarters.

The company also received a \$3.9 million multi-phase contract award from a leading defense prime contractor for the development of a high-density system-in-package solution for radar systems utilizing its novel 2.5D chip-scale integration technology.

Further, it received a \$25 million follow-on order from a leading defense prime contractor for integrated radio frequency and digital subsystems for an advanced naval electronic-support application. The order was booked in Mercury's fiscal 2020 fourth quarter and is expected to be shipped over the next several quarters.

Mercury also announced volume production of its newest, high-density secure memory device, with the highest capacity in the smallest form factor available.

Guidance

For the first quarter of fiscal 2021, revenues are expected to be \$190-\$205 million.

Adjusted EBITDA is anticipated in a band of \$38-\$41 million. Adjusted earnings are projected to be 43-47 cents per share.

The company expects CapEx in the first quarter of fiscal 2021 to be roughly 7% of revenues.

Mercury expects fiscal 2021 revenues of \$860-\$885 million. Top-line growth is expected to be driven by high single-digit organic-revenue growth.

Adjusted EBITDA is expected to be \$188-\$196 million. Adjusted earnings are estimated to be \$2.15-\$2.26 per share.

Recent News

On Jun 30, Mercury Systems announced it received a \$25 million follow-on order from a leading defense prime contractor for integrated radio frequency and digital subsystems for an advanced naval electronic support application.

On Jun 25, Mercury System announced receiving a \$3.9 million multi-phase contract award from a leading defense prime contractor.

On Jun 23, Mercury Systems announced volume production of its newest, high-density (HD) secure memory device, with the most capacity in the smallest form factor available.

On Jun 15, Mercury Systems announced receiving a \$49 million order from a leading defense prime contractor for high-performance signal processing and RF solutions for a missile defense program.

On Jun 11, Mercury Systems unveiled the new GSC6204 OpenVPX 6U NVIDIA Turing architecture-based GPU co-processing engine. The newly launched product will provide accelerated high-performance computing capabilities to commercial aerospace and defense applications.

On Apr 21, 2020 Mercury Systems unveils SpectrumSeries RFM3103s ultra-wideband dual upconverter, which is designed to align with the emerging sensor open systems architecture technical standard.

On Apr 16, Mercury Systems announced receiving a \$30 million contract for providing video display technology for integration into mobile ground vehicles.

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 15.3% in the year to date (YTD) period but down 4.1% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Computer & Technology sector have increased 18.8% and 18%, respectively, year-to-date (YTD). Over the past year, while the Zacks sub-industry increased 32.1%, the sector soared 36.1%.

The S&P 500 Index has increased 3.3% YTD and 17.5% in the past year.

The stock is currently trading at 5.01X forward 12-month sales, which compares to 0.68X for the Zacks sub-industry, 3.99X for the Zacks sector and 3.65X for the S&P 500 index.

Over the past five years, the stock has traded as high as 6.38X and as low as 1.99X with a 5-year median of 4.25X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$68 price target reflects 4.26X 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 F12M	Current	5.01	0.68	3.99	3.65
	5-Year High	6.38	6.9	4.01	3.65
	5-Year Low	1.99	0.34	2.32	2.53
	5-Year Median	4.25	5.09	3.14	3.05
EV/Sales TTM	Current	5.36	1.19	4.59	3.23
	5-Year High	7.11	1.19	4.59	3.46
	5-Year Low	1.77	0.29	2.58	2.14
	5-Year Median	4.92	0.57	3.65	2.86
EV/EBITDA TTM	Current	26.6	13.49	13.1	12.55
	5-Year High	33.1	13.62	13.51	12.84
	5-Year Low	12.19	1.57	7.59	8.24
	5-Year Median	25.77	3.48	10.91	10.9

As of 08/12/2020

Industry Analysis Zacks Industry Rank: Bottom 26% (187 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
Leidos Holdings, Inc. (LDOS)	Neutral	3
Northrop Grumman Corporation (NOC)	Neutral	3
Science Applications International Corporation (SAIC)	Neutral	3
Teledyne Technologies Incorporated (TDY)	Neutral	2
Heico Corporation (HEI)	Underperform	4

Industry Comparison Industry: Computer - Peripheral Equipment				Industry Peers		
	MRCY	X Industry	S&P 500	CACI	NOC	SAIC
Zacks Recommendation (Long Term)	Underperform	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	5	-	-	3	3	3
VGM Score	C	-	-	A	A	A
Market Cap	4.43 B	91.43 M	23.75 B	5.34 B	56.58 B	4.91 B
# of Analysts	3	1	14	9	7	7
Dividend Yield	0.00%	0.00%	1.68%	0.00%	1.71%	1.75%
Value Score	F	-	-	A	B	A
Cash/Price	0.05	0.21	0.07	0.01	0.08	0.06
EV/EBITDA	29.61	11.62	13.35	15.12	16.61	14.46
PEG Ratio	2.98	9.72	2.98	1.25	NA	NA
Price/Book (P/B)	3.20	1.60	3.20	2.08	5.83	3.49
Price/Cash Flow (P/CF)	28.63	12.64	12.97	14.97	12.31	10.33
P/E (F1)	34.65	40.77	22.17	15.32	15.14	13.99
Price/Sales (P/S)	5.56	1.11	2.54	0.93	1.63	0.75
Earnings Yield	2.89%	-0.42%	4.31%	6.53%	6.61%	7.15%
Debt/Equity	0.05	0.09	0.77	0.69	1.61	1.99
Cash Flow (\$/share)	2.78	0.54	6.94	14.23	27.58	8.18
Growth Score	A	-	-	A	A	A
Hist. EPS Growth (3-5 yrs)	37.43%	-8.74%	10.41%	18.19%	23.60%	17.71%
Proj. EPS Growth (F1/F0)	0.00%	1.91%	-6.32%	10.24%	5.69%	6.69%
Curr. Cash Flow Growth	29.10%	-22.98%	5.22%	29.08%	2.21%	74.09%
Hist. Cash Flow Growth (3-5 yrs)	44.93%	2.22%	8.55%	11.71%	14.43%	23.85%
Current Ratio	5.04	2.08	1.33	1.38	1.35	1.05
Debt/Capital	4.61%	8.64%	44.59%	40.99%	61.62%	66.55%
Net Margin	10.76%	-7.93%	10.13%	5.62%	6.91%	3.17%
Return on Equity	7.92%	-5.38%	14.59%	12.86%	40.24%	25.32%
Sales/Assets	0.50	0.85	0.51	1.04	0.82	1.30
Proj. Sales Growth (F1/F0)	9.68%	0.00%	-1.40%	5.77%	4.71%	13.40%
Momentum Score	B	-	-	D	C	D
Daily Price Chg	0.29%	1.41%	0.67%	0.22%	-0.72%	-1.00%
1 Week Price Chg	2.38%	-0.13%	2.30%	1.47%	1.31%	4.10%
4 Week Price Chg	6.65%	6.35%	4.87%	6.84%	12.85%	15.52%
12 Week Price Chg	-5.58%	31.14%	13.54%	-10.57%	5.93%	0.92%
52 Week Price Chg	-4.11%	-8.33%	6.06%	2.77%	-6.09%	3.68%
20 Day Average Volume	286,809	54,726	2,006,991	208,684	963,969	476,900
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	-11.86%	0.93%	1.95%	0.00%	1.36%	0.00%
(F1) EPS Est 12 week change	-11.86%	-5.79%	2.72%	0.00%	1.43%	-0.96%
(Q1) EPS Est Mthly Chg	36.00%	20.00%	0.84%	0.37%	-1.28%	0.00%

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	F
Growth Score	A
Momentum Score	B
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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