

Mercury Systems (MRCY)

\$75.38 (As of 01/20/20)

Price Target (6-12 Months): **\$79.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 10/16/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:C

Value: F

Growth: A

Momentum: D

Summary

Robust organic growth, including the expansion of microelectronics business is aiding Mercury's growth. Continuous design wins and a ramp-up in the current programs were tailwinds. 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. Estimates have been stable ahead of the company's Q2 earnings release. However, though Mercury has been steadily winning development contracts from the federal government, these low-margin deals are likely to affect its profitability in the long run. Further, intense competition from CACI and SAIC is a concern.

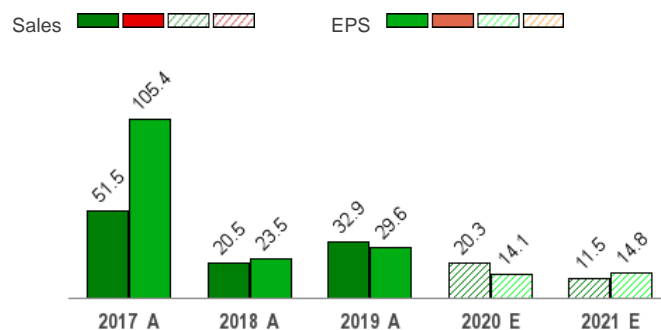
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$89.44 - \$47.12
20 Day Average Volume (sh)	336,475
Market Cap	\$4.2 B
YTD Price Change	9.1%
Beta	1.00
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Computer - Peripheral Equipment
Zacks Industry Rank	Top 37% (94 out of 254)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	7.3%
Last Sales Surprise	5.8%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	01/28/2020
Earnings ESP	0.0%
P/E TTM	40.1
P/E F1	35.9
PEG F1	3.1
P/S TTM	6.1

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	185 E	211 E	224 E	239 E	879 E
2020	177 A	193 E	205 E	213 E	788 E
2019	144 A	159 A	175 A	177 A	655 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.54 E	\$0.60 E	\$0.66 E	\$0.71 E	\$2.41 E
2020	\$0.44 A	\$0.48 E	\$0.55 E	\$0.62 E	\$2.10 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 01/20/2020. The reports text is as of 01/21/2020.

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.

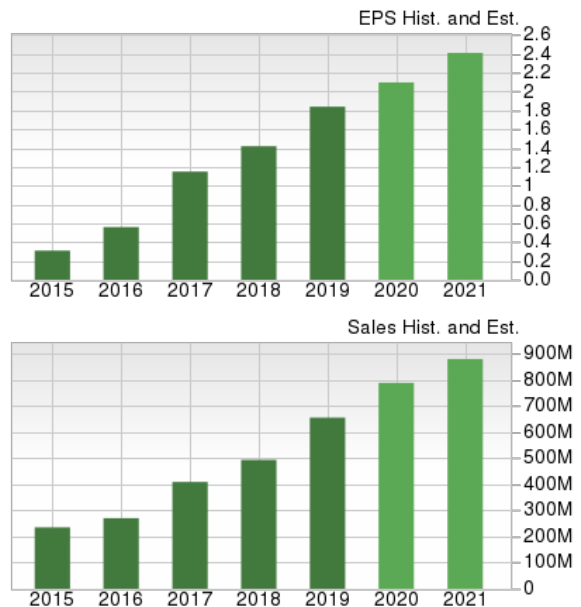
This apart, the company produces hardware products, including components, such as power amplifiers and limiters, switches, oscillators, filters, equalizers, converters, chips, integrated circuits, and memory and storage devices.

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 2019, Mercury reported acquired revenues (20% of total revenues) of nearly \$34.8 million, attributable to the acquisitions of Themis Computer, Germane Systems and GECO Avionics. We believe that continued acquisitions will aid the company's growth.

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 Q1 Earnings & Revenues Top Estimates

Mercury reported first-quarter fiscal 2020 (ended Sep 27, 2019) results, wherein both the bottom line and the top line outpaced the Zacks Consensus Estimate.

Non-GAAP earnings per share of 44 cents grew 12.8% year over year and beat the Zacks Consensus Estimate of 41 cents.

Revenues came in at \$177.3 million, marking a year-over-year jump of 23%. The metric also surpassed the Zacks Consensus Estimate of \$168 million.

Robust organic growth, including the expansion of microelectronics business, drove the company's performance.

A favorable defense funding and industry growth environment is a tailwind for the company. Recent design wins boosted its organic growth.

Quarterly Details

Organic revenues (89.2% of total revenues) grew 17% to \$158.1 million in the quarter.

The company reported Acquired revenues (10.8%) of \$19.3 million, attributable to the buyouts of Germane Systems, GECO Avionics, The Athena Group and Syntonic Microwave.

The company completed the acquisition of American Panel Corporation ("APC") at the end of the fiscal first quarter.

Sensor and Effector Mission Systems revenues rose 29% year over year to account for 57% of the total revenues.

Revenues from Command, Control, Communications, Computers and Intelligence (C4I) represented 28% of the total revenues and jumped 11% 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 21% year over year to \$215.7 million, driving a 1.22 book-to-bill ratio. Key bookings included a classified radar program, Filthy Buzzard, F-35, Triton and E-2D Hawkeye.

The company ended the quarter with a backlog of \$711.8 million, up 40% year over year. Within the next 12 months, \$499.2 million of this total backlog of orders is expected to be shipped.

The company's largest revenue programs were Surface Electronic Warfare Improvement Program, Filthy Buzzard, next-generation missile system, E-2D Hawkeye and CPS.

Margins

Gross margin for the fiscal first quarter expanded 140 basis points (bps) to 44.2%.

Adjusted EBITDA grew 16% year over year to \$36.7 million. However, adjusted EBITDA margin contracted 120 bps to 20.7%.

Balance Sheet and Cash Flow

Mercury exited the quarter with cash and cash equivalents of \$161.3 million, down from \$257.9 million at the end of the earlier reported quarter.

The company generated \$24.3 million of cash flow from operational activities compared with \$26 million in the prior quarter.

Free cash flow was \$14.7 million, down from \$17.1 million sequentially.

Guidance

For the second quarter of fiscal 2020, revenues are predicted in the range of \$185-\$195 million, indicating a rise of 16.4-22.6% from the year-ago reported figure. The acquisition of APC is included in the guidance.

Adjusted EBITDA for the quarter is anticipated in the band of \$38.5-\$40.5 million. Adjusted earnings are projected within 46-48 cents per share.

Mercury raised guidance for fiscal 2020. The company now expects revenues of \$775-\$790 million, up from the earlier guided range of \$740-\$776 million, implying 18-21% growth from the prior-year reported number. The company expects organic revenue growth between 11% and 12%, up from previously expected 10% for the current fiscal year.

Adjusted EBITDA for the full fiscal is expected to be \$160.5-\$168.5 million.

Adjusted earnings for the full fiscal are now estimated to be \$2.03-\$2.11, up from \$1.97-\$2.08 guided earlier, suggesting an improvement of 10-15% from the year-earlier reported figure.

The raised guidance includes operating expenses of about \$2 million associated with the expansion of business in Phoenix. Capital expenditures of 6-7% of revenues are expected, reflecting Mercury's integration activities, ongoing investments and the expansion of the microelectronics

Quarter Ending **09/2019**

Report Date	Oct 29, 2019
Sales Surprise	5.82%
EPS Surprise	7.32%
Quarterly EPS	0.44
Annual EPS (TTM)	1.88

Recent News

On Jan 21, 2020, 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, 2020, 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.

On Oct 24, 2019, Mercury announced DCM6112 digitization transceiver aimed to provide low-latency and wide bandwidth for critical electronic warfare applications.

On Oct 15, 2019, Mercury announced that it is investing \$15 million to expand its custom microelectronics business. The company will provide commercial silicon technology to the Department of Defense to accelerate future modernization efforts.

On Oct 2, 2019, Mercury announced that it will be added to the S&P MidCap 400 and S&P SmallCap 600 indices this month.

On Sep 23, 2019, Mercury completed the acquisition of APC for \$100 million to expand its position in the growing avionics market.

On Sep 16, 2019, Mercury introduced the EnterpriseSeries RES Aero rugged rackmount server product suite that provides enterprise-class data center-caliber processing to compute-intensive airborne applications.

Valuation

Mercury shares are up 5.8% in the past six months and 59.8% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Computer & Technology sector have gained 2.8% and 16.4%, respectively in the past six months. Over the past year, while the Zacks sub-industry has increased 15.4%, the sector gained 35.3%.

The S&P 500 Index has risen 12.12% in the past six months and 25.7% in the past year.

The stock is currently trading at 4.99X forward 12-month sales, which compares to 0.55X for the Zacks sub-industry, 3.74X for the Zacks sector and 3.57X 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 3.64X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$79 price target reflects 5.24X 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	4.99	0.55	3.74	3.57
	5-Year High	6.38	6.9	3.74	3.574
	5-Year Low	1.87	0.34	2.3	2.54
	5-Year Median	3.64	5.09	3.01	3
EV/S TTM	Current	5.81	0.86	4	3.08
	5-Year High	7.11	0.86	4.02	3.3
	5-Year Low	1.69	0.29	2.56	2.17
	5-Year Median	4.44	0.57	3.38	2.77
EV/EBITDA TTM	Current	26.45	6.84	11.58	11.4
	5-Year High	33.1	6.84	12.56	12.83
	5-Year Low	11.83	1.57	7.66	8.5
	5-Year Median	23.78	3.16	10.24	10.56

As of 01/20/2020

Industry Analysis Zacks Industry Rank: Top 37% (94 out of 254)



Top Peers

Heico Corporation (HEI)	Outperform
Teledyne Technologies Incorporated (TDY)	Outperform
CACI International, Inc. (CACI)	Neutral
Curtiss-Wright Corporation (CW)	Neutral
FLIR Systems, Inc. (FLIR)	Neutral
Northrop Grumman Corporation (NOC)	Neutral
Raytheon Company (RTN)	Neutral
Science Applications International Corporation (SAIC)	Neutral

Industry Comparison Industry: Computer - Peripheral Equipment				Industry Peers		
	MRCY Neutral	X Industry	S&P 500	CACI Neutral	NOC Neutral	SAIC Neutral
VGM Score	C	-	-	C	A	A
Market Cap	4.19 B	93.82 M	24.65 B	6.78 B	64.04 B	5.34 B
# of Analysts	6	1.5	13	7	7	6
Dividend Yield	0.00%	0.00%	1.73%	0.00%	1.39%	1.60%
Value Score	F	-	-	C	C	B
Cash/Price	0.04	0.24	0.04	0.01	0.02	0.03
EV/EBITDA	35.45	8.87	14.11	18.38	15.29	25.93
PEG Ratio	3.12	2.75	2.08	2.22	1.26	3.10
Price/Book (P/B)	3.23	2.88	3.39	2.79	6.58	3.85
Price/Cash Flow (P/CF)	34.80	9.15	13.81	19.02	14.26	20.49
P/E (F1)	36.36	34.15	19.19	22.16	16.53	17.08
Price/Sales (P/S)	6.08	1.75	2.69	1.31	1.92	0.89
Earnings Yield	2.79%	2.79%	5.21%	4.51%	6.05%	5.85%
Debt/Equity	0.04	0.06	0.72	0.77	1.55	1.35
Cash Flow (\$/share)	2.17	0.87	6.94	14.23	26.65	4.52
Growth Score	A	-	-	B	B	A
Hist. EPS Growth (3-5 yrs)	39.60%	14.62%	10.56%	16.70%	22.40%	15.97%
Proj. EPS Growth (F1/F0)	14.04%	31.51%	7.57%	16.77%	12.74%	7.57%
Curr. Cash Flow Growth	25.32%	-0.70%	14.73%	29.08%	61.17%	33.43%
Hist. Cash Flow Growth (3-5 yrs)	39.83%	12.96%	9.00%	11.71%	14.12%	16.56%
Current Ratio	5.35	2.06	1.24	1.35	1.29	1.20
Debt/Capital	3.94%	5.96%	42.99%	43.62%	60.86%	57.41%
Net Margin	8.51%	-0.23%	11.14%	4.91%	9.05%	2.62%
Return on Equity	7.59%	1.18%	17.16%	10.86%	39.12%	22.10%
Sales/Assets	0.52	1.00	0.55	1.04	0.84	1.30
Proj. Sales Growth (F1/F0)	20.31%	3.89%	4.16%	13.69%	5.34%	37.62%
Momentum Score	D	-	-	F	A	A
Daily Price Chg	-0.55%	0.00%	0.27%	0.42%	-0.99%	-0.51%
1 Week Price Chg	0.72%	0.72%	0.39%	2.80%	-0.17%	5.48%
4 Week Price Chg	4.20%	4.20%	2.95%	9.35%	11.03%	7.85%
12 Week Price Chg	2.70%	9.69%	7.76%	24.46%	6.46%	17.23%
52 Week Price Chg	55.94%	4.33%	22.29%	76.22%	43.88%	41.02%
20 Day Average Volume	336,475	29,949	1,536,375	144,758	865,074	375,178
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.00%	0.00%	0.00%	-0.12%	-0.33%	0.24%
(F1) EPS Est 12 week change	1.74%	-1.20%	-0.40%	1.07%	1.76%	-0.59%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.00%	-0.88%	0.00%	0.15%

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	D
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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