

Mercury Systems

Darkest before dawn – reiterate Underperform and lower PO to \$20

Reiterate Rating: UNDERPERFORM | PO: 20.00 USD | Price: 29.13 USD

Lack of outlook and continued cost creep weigh

Mercury Systems (NASDAQ: MRCY), a defense electronics company that has sought to benefit from prime outsourcing, has historically grown through rapid fire M&A. However, integration proved to be an issue, leading to limited program oversight and eventual cost creep. This culminated with the pulling of its FY24 outlook earlier this month. Recent restructuring efforts indicate intentions are in the right place, but we remain cautious as the outlook suspension indicates cost rises may not be fully behind us. While we reiterate our Underperform, we lower PO to \$20 on our reduced earnings estimates as MRCY has yet to turn a corner on cost control.

Progress is being made, but still assessing the full extent

For MRCY, it may be darkest before dawn, as pushing forward on reducing costs may reveal other issues. MRCY continues to provide transparency into cost growth and its progress on correcting challenge programs, those that have been cited as pressure points for MRCY, through restructuring and cost structure alignment ([see prior report](#)). Additionally, we look favorably on faster than expected progress in closing out challenge programs. Nevertheless, cost growth continues to grow Q/Q. While non-recurring, these programmatic challenges continue to hamper revenue and margins.

Making progress on FCF w/ advances, unbilled, inventory

MRCY continues to place considerable attention towards managing WK, in line with its previously outlined focus areas ([see last quarter report](#)). The WK improvement was largely driven by stronger customer advances (+\$22.3mn) and reduced accounts and unbilled receivables (+\$42.7mn) and inventory (+\$12.1mn). However, we think the path back to historical levels of FCF conversion (+90%) will be a gradual process.

Still waiting on the sun

We reiterate our Underperform rating until we see MRCY turn a corner on cost control in order to reassess our rating and valuation. We lower our PO to \$20 (vs. prior \$30) based on a 1.1x multiple relative to defense peers (vs. prior 0.9x), below the historical average of 1.4x but slightly above prior levels to reflect recent efforts to streamline operations. This results in a 14x EV/EBITDA multiple on blended CY24/CY25 estimates (vs. prior 13x).

Estimates (Jun) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	2.19	1.00	0.20	1.05	1.45
GAAP EPS	0.20	(0.50)	(1.21)	(0.12)	0.37
EPS Change (YoY)	-9.5%	-54.3%	-80.0%	425.0%	38.1%
Consensus EPS (Bloomberg)			(0.45)	0.59	0.86
DPS	0	0	0	0	0
Valuation (Jun)					
P/E	13.3x	29.1x	145.7x	27.7x	20.1x
GAAP P/E	145.7x	NM	NM	NM	78.7x
EV / EBITDA*	10.6x	16.0x	26.8x	14.1x	12.0x
Free Cash Flow Yield*	-2.9%	-3.7%	1.8%	4.7%	6.4%

* For full definitions of *IQmethod*SM measures, see page 6.

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Timestamp: 20 February 2024 03:00AM EST

20 February 2024

Equity

Key Changes

(US\$)	Previous	Current
Price Obj.	30.00	20.00

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Stock Data

Price	29.13 USD
Price Objective	20.00 USD
Date Established	20-Feb-2024
Investment Opinion	B-3-9
52-Week Range	25.31 USD - 54.12 USD
Mrkt Val (mn) / Shares Out (mn)	1,620 USD / 55.6
Free Float	85.1%
Average Daily Value (mn)	20.80 USD
BofA Ticker / Exchange	MRCY / NAS
Bloomberg / Reuters	MRCY US / MRCY.OQ
ROE (2024E)	0.8%
Net Dbt to Eqty (Jun-2023A)	28.1%
ESGMeter TM	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

iQprofileSM Mercury Systems

iQmethodSM – Bus Performance*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	1.0%	-0.6%	-2.0%	1.0%	2.1%
Return on Equity	8.1%	3.7%	0.8%	3.9%	5.4%
Operating Margin	3.2%	-2.2%	-7.6%	3.0%	6.4%
Free Cash Flow	(47)	(60)	29	76	103

iQmethodSM – Quality of Earnings*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	-0.2x	-0.4x	5.4x	1.8x	1.6x
Asset Replacement Ratio	0.8x	0.9x	0.8x	0.9x	1.0x
Tax Rate	38.7%	41.6%	30.1%	21.0%	21.0%
Net Debt-to-Equity Ratio	25.1%	28.1%	26.6%	21.2%	20.2%
Interest Cover	5.4x	-0.9x	-1.9x	0.8x	1.9x

Income Statement Data (Jun)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	988	974	828	861	913
% Change	6.9%	-1.4%	-15.0%	4.0%	6.0%
Gross Profit	395	317	248	301	338
% Change	2.5%	-19.8%	-21.6%	21.3%	12.1%
EBITDA	201	132	79	150	177
% Change	-0.7%	-34.0%	-40.3%	89.9%	18.2%
Net Interest & Other Income	(13)	(27)	(36)	(35)	(31)
Net Income (Adjusted)	122	57	12	61	86
% Change	-8.8%	-53.5%	-79.4%	421.2%	40.7%

Free Cash Flow Data (Jun)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	11	(28)	(70)	(7)	22
Depreciation & Amortization	93	97	89	82	78
Change in Working Capital	(159)	(79)	16	(8)	(1)
Deferred Taxation Charge	(2)	(60)	(28)	0	0
Other Adjustments, Net	38	49	56	43	41
Capital Expenditure	(28)	(39)	(34)	(34)	(36)
Free Cash Flow	-47	-60	29	76	103
% Change	NM	-29.1%	NM	162.6%	35.4%
Share / Issue Repurchase	0	0	0	0	0
Cost of Dividends Paid	0	0	0	0	0
Change in Debt	0	0	55	(100)	0

Balance Sheet Data (Jun)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	66	72	157	133	136
Trade Receivables	144	125	102	104	108
Other Current Assets	605	741	715	676	685
Property, Plant & Equipment	127	120	111	106	109
Other Non-Current Assets	1,362	1,335	1,315	1,273	1,321
Total Assets	2,304	2,391	2,400	2,291	2,358
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	194	233	205	159	164
Long-Term Debt	452	512	567	467	467
Other Non-Current Liabilities	122	80	90	90	90
Total Liabilities	767	825	861	715	720
Total Equity	1,537	1,567	1,539	1,575	1,638
Total Equity & Liabilities	2,304	2,391	2,400	2,291	2,358

* For full definitions of iQmethodSM measures, see page 6.

Company Sector

Defense Electronics

Company Description

Mercury Systems is a defense electronics supplier providing affordable, technology-innovative, and secure subsystems development and deployment capabilities. MRCY's sensor and mission processing and platform management subsystems (including radio frequency, microwave, digitalization, and storage capabilities) are used to power US defense and intelligence applications.

Investment Rationale

Mercury Systems is a leader in secure and affordable defense electronic solutions for the US Department of Defense (DoD). The company is a beneficiary of the DoD's initiatives to reduce cost by using commercial off the shelf (COTS) solutions for defense electronics. Increased use of COTS solutions and a continued rise in US defense spending could provide long-term growth. We rate MRCY at Underperform as we see operational hurdles and semiconductor lead times as persistent headwinds.

Stock Data

Average Daily Volume 713,937

Quarterly Earnings Estimates

	2023	2024
Q1	0.24A	-0.24A
Q2	0.26A	-0.42A
Q3	0.40A	0.35E
Q4	0.11A	0.51E

Making sense of cost growths and other adjustments

Darkest before dawn – more costs might arise as work through challenge pgms

2QFY24 saw \$30mn Q/Q increase in cost growth (vs. \$18mn in 1QFY24). In our view, it is not clear that MRCY is out of the woods as further cost growth could creep up. We aim to offer clarity around the \$48mn in costs incurred in 2QFY24 by breaking them down into three categories:

1. **Program cost growth (\$31mn)** – Of this balance, roughly \$14mn was attributed to one of the previously noted “challenge programs”. The single affected program was hit by unexpected redesign and prototyping costs. Other development programs (\$8mn) and production programs (\$9mn) were responsible for the remaining cost growth, driven by revised baseline costs.
2. **Manufacturing adjustments (\$12mn)** – These adjustments were related to inventory reserves and higher scrap due to unfavorable yields.
3. **Contract settlements (\$5mn)** – MRCY worked to settle with customers and transition away from programs with unfavorable returns.

Rising costs hit both topline and bottom line – Radar the largest culprit

On program cost growth, MRCY conceded that much of the \$31mn in excess cost originated from Radar activities. While this involves an EAC adjustment that hit profit margins, it also involved an adjustment to previously recognized revenue that was reflected in the quarter. This manifested in Radar activities accounting for only 7% of revenue in the quarter (vs. historical average of 40%). These revenue reversals also contributed to the reduced revenue outlook for the year (see “2QFY24 results recap” section).

Notable programs supported in the Radar domain – which are applications in which radio frequency (RF) signals are used to detect, track, and identify objects – include F-35, F-16, Triton, Patriot, and Aegis. Management is confident that the issues on challenge programs have been isolated given that they all share a common processing architecture.

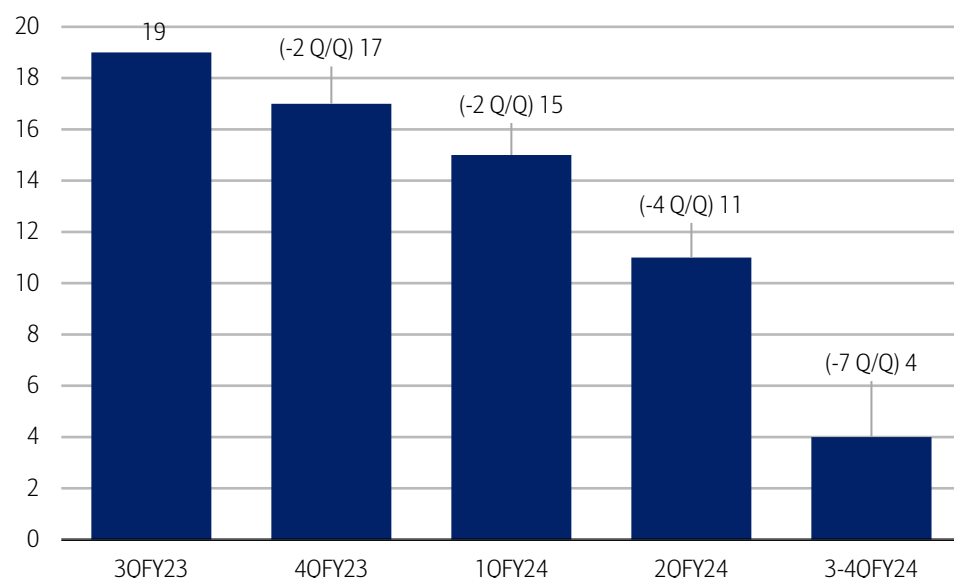
Succeeded in closing out more challenge programs than expected in 1HFY24

We commend MRCY for its efforts to manage its noted challenge programs. The company succeeding in closing out four additional programs (six in first half), coming ahead of prior expectations for five in 1HFY24. Additionally, MRCY now expects to close out FY24 with just four challenge programs.



Exhibit 1: Mercury Systems progress on challenge programs

MRCY succeeding in closing out four additional challenge programs in 2QFY24 (six in first half), coming ahead of prior expectations for five in 1H FY24



Source: Company presentation

BofA GLOBAL RESEARCH

Strong backlog to drive organic growth

MRCY reported a 1.65x book-to-bill in the quarter with near-record bookings of \$325.4mn. While this ratio was partially padded by depressed sales, we highlight that the company has made significant strides to improve its programmatic mix. One of the hallmark awards for 2QFY24 was the first Lower Tier Air and Missile Defense Sensor (LTAMDS) production contract earlier than expected. growth from that program is expected to drive organic growth in FY25, when it will be the largest single program on a revenue basis. However, in the near term, MRCY anticipates that the transition of development programs to production will drive the most organic growth.

Lower EPS estimates on slower revenue ramp

We are lowering our EPS estimates through the outyears to account of challenge programs impacting both topline and bottom line. We now expect EPS of \$0.20 (vs. prior \$1.25) in FY24, \$1.05 (vs. prior \$1.46) in FY25, and \$1.45 (vs. prior \$1.60) in FY26.

2QFY24 results recap**Sales and adj. EPS miss to Consensus and BofAe**

MRCY reported 2QFY24 adj. EPS of \$(0.42), below consensus of \$0.09 and BofAe of \$0.24. The miss was primarily driven by softer volumes on cost growth, manufacturing adjustments, and contract settlements.

FY24 outlook: revenue lower & net income/EPS suspended

MRCY reduced its sales outlook for FY24 to \$800-850mn (vs. prior \$950mn-\$1bn) based on softer volumes slated for 2H FY24. Lower volumes are expected to persist into the second half as MRCY focuses on driving operational capacity and reduce working capital (unbilled receivables). Demand is expected to remain robust, with the company maintaining its bookings outlook of \$1bn for FY24. GAAP net income, GAAP EPS, adj. EBITDA, and adj. EPS outlooks were all withdrawn given timing uncertainties, further possible contract settlements, and cost structure adjustments. OCF and FCF are both expected to be positive for 2H FY24 and the full fiscal year. MRCY does not expect to breach net leverage thresholds of credit agreement through FY24.

Price objective basis & risk

Mercury Systems (MRCY)

Our \$20 PO is based on a 1.1x relative EV/EBITDA multiple on CY24/CH25 blended estimates, below the historical average of 1.4x. We believe this fairly accounts for the operational challenges across a higher mix of development programs and long semiconductor lead times.

Risks to the upside: Faster than expected improvement to the high-end processing supply chain could positively impact our estimates. Accretive acquisitions could provide upside to our estimates.

Risks to the downside: If there were a reversal in the defense primes' secular shift towards subsystems outsourcing, Mercury Systems' revenue would be negatively affected. Despite the complex and costly defense business process and high-capital requirements, the large commercial enterprises (such as blade server providers) or Silicon Valley technology companies could enter the military secure processing and storage subsystems business. Should MRCY run into any further problems with integrating M&A, containing its costs, or transitioning development programs to production, there could be downside risk to our estimates.

Analyst Certification

I, Ronald J. Epstein, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	AerCap Holdings N.V.	AER	AER US	Ronald J. Epstein
	Air Lease Corporation	AL	AL US	Ronald J. Epstein
	Booz Allen Hamilton	BAH	BAH US	Mariana Perez Mora
	BWX Technologies, Inc.	BWXT	BWXT US	Ronald J. Epstein
	CACI International	CACI	CACI US	Mariana Perez Mora
	Cadre Holdings Inc	CDRE	CDRE US	Ronald J. Epstein
	Crane Co.	CR	CR US	Ronald J. Epstein
	Embraer	ERJ	ERJ US	Ronald J. Epstein
	General Dynamics	GD	GD US	Ronald J. Epstein
	HEICO Corporation	HEI	HEI US	Ronald J. Epstein
	Howmet Aerospace Inc.	HWM	HWM US	Ronald J. Epstein
	KBR	KBR	KBR US	Mariana Perez Mora
	Leidos Holdings	LDOS	LDOS US	Mariana Perez Mora
	Leonardo DRS, Inc.	DRS	DRS US	Ronald J. Epstein
	Northrop Grumman	NOC	NOC US	Ronald J. Epstein
	Palantir Technologies	PLTR	PLTR US	Mariana Perez Mora
	Parsons Corporation	PSN	PSN US	Mariana Perez Mora
	RBC Bearings Inc	RBC	RBC US	Ronald J. Epstein
	Rocket Lab	RKLB	RKLB US	Ronald J. Epstein
	Teledyne Technologies Inc	TDY	TDY US	Ronald J. Epstein
	TransDigm Group Inc.	TDG	TDG US	Ronald J. Epstein
	Triumph Group	TGI	TGI US	Ronald J. Epstein
NEUTRAL				
	Albany International	AIN	AIN US	Ronald J. Epstein
	Boeing	BA	BA US	Ronald J. Epstein



US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Garmin	GRMN	GRMN US	Ronald J. Epstein
	Hexcel Corporation	HXL	HXL US	Ronald J. Epstein
	L3Harris	LHX	LHX US	Ronald J. Epstein
	Lockheed Martin	LMT	LMT US	Ronald J. Epstein
	RTX Corp	RTX	RTX US	Ronald J. Epstein
	Textron	TXT	TXT US	Ronald J. Epstein

UNDERPERFORM

	Bombardier	BDRBF	BDRBF US	Ronald J. Epstein
	Bombardier Inc.	YBBD B	BBD/B CN	Ronald J. Epstein
	CAE Inc.	YCAE	CAE CN	Ronald J. Epstein
	CAE Inc.	CAE	CAE US	Ronald J. Epstein
	Huntington Ingalls Industries	HII	HII US	Ronald J. Epstein
	Mercury Systems	MRCY	MRCY US	Ronald J. Epstein
	Spirit AeroSys-A	SPR	SPR US	Ronald J. Epstein

iQmethodSM Measures Definitions**Business Performance**

Return On Capital Employed

Return On Equity
Operating Margin
Earnings Growth
Free Cash Flow

Numerator

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income
Operating Profit
Expected 5 Year CAGR From Latest Actual
Cash Flow From Operations – Total Capex

Denominator

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Amortization
Shareholders' Equity
Sales
N/A
N/A

Quality of Earnings

Cash Realization Ratio
Asset Replacement Ratio
Tax Rate
Net Debt-To-Equity Ratio
Interest Cover

Numerator

Cash Flow From Operations
Capex
Tax Charge
Net Debt = Total Debt – Cash & Equivalents
EBIT

Denominator

Net Income
Depreciation
Pre-Tax Income
Total Equity
Interest Expense

Valuation Toolkit

Price / Earnings Ratio
Price / Book Value
Dividend Yield
Free Cash Flow Yield
Enterprise Value / Sales

Numerator

Current Share Price
Current Share Price
Annualised Declared Cash Dividend
Cash Flow From Operations – Total Capex
EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities
Enterprise Value

Denominator

Diluted Earnings Per Share (Basis As Specified)
Shareholders' Equity / Current Basic Shares
Current Share Price
Market Cap = Current Share Price × Current Basic Shares
Sales

EV / EBITDA

Basic EBIT + Depreciation + Amortization

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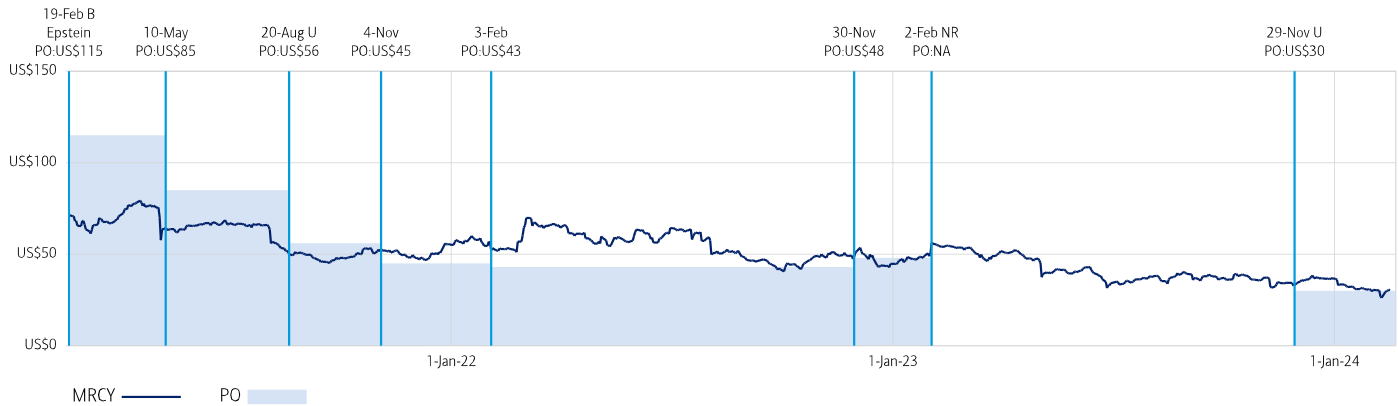
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Disclosures

Important Disclosures

Mercury Systems (MRCY) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Aerospace/Defense Electronics Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	31	62.00%	Buy	23	74.19%
Hold	11	22.00%	Hold	9	81.82%
Sell	8	16.00%	Sell	6	75.00%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

^{R1} Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster ^{R2}
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

^{R2} Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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