MERCURY SYSTEMS INC
Form 10-Q
February 05, 2015
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2014
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO
COMMISSION FILE NUMBER: 0-23599

MERCURY SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

MASSACHUSETTS (State or other jurisdiction of incorporation or organization)	04-2741391 (I.R.S. Employer Identification No.)
201 RIVERNECK ROAD CHELMSFORD, MA	01824
(Address of principal executive offices)	(Zip Code)

978-256-1300
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes ¨ No x
Shares of Common Stock outstanding as of January 31, 2015: 34,149,555 shares

MERCURY SYSTEMS, INC.
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
MERCURY SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)
(Unaudited)

	December 31, 2014	June 30, 2014
Assets		
Current assets:		
Cash and cash equivalents	$56,987	$47,287
Accounts receivable, net of allowance for doubtful accounts of $77 and $34 at December 31, 2014 and June 30, 2014, respectively	47,432	37,625
Unbilled receivables and costs in excess of billings	19,774	22,036
Inventory	30,011	31,655
Deferred income taxes	15,172	15,216
Prepaid income taxes	4,729	1,481
Prepaid expenses and other current assets	3,835	3,631
Current assets of discontinued operations	1,095	1,374
Total current assets	179,035	160,305
Restricted cash	264	265
Property and equipment, net	12,968	14,144
Goodwill	168,146	168,146
Intangible assets, net	21,481	25,006
Other non-current assets	1,238	987
Non-current assets of discontinued operations	2,235	4,859
Total assets	$385,367	$373,712
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$11,300	$7,054
Accrued expenses	8,817	8,377
Accrued compensation	8,979	9,983
Deferred revenues and customer advances	8,778	5,898
Current liabilities of discontinued operations	1,583	1,618
Total current liabilities	39,457	32,930
Deferred gain on sale-leaseback	1,507	2,086
Deferred income taxes	5,021	5,911
Income taxes payable	3,277	3,154
Other non-current liabilities	1,165	1,666
Non-current liabilities of discontinued operations	724	818
Total liabilities	51,151	46,565
Commitments and contingencies (Note I)		
Shareholders' equity:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, $0.01 par value; 85,000,000 shares authorized; 32,222,498 and 31,284,273 shares issued and outstanding at December 31, 2014 and June 30, 2014, respectively	322	312

Additional paid-in capital	248,228	241,725
Retained earnings	84,863	84,099
Accumulated other comprehensive income	803	1,011
Total shareholders’ equity	334,216	327,147
Total liabilities and shareholders’ equity	$385,367	$373,712

The accompanying notes are an integral part of the consolidated financial statements.

MERCURY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(In thousands, except per share data)
(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2014	2013	2014	2013
Net revenues	$57,089	$50,932	$111,150	$101,658
Cost of revenues	30,054	26,607	60,116	55,771
Gross margin	27,035	24,325	51,034	45,887
Operating expenses:				
Selling, general and administrative	12,677	13,944	24,967	28,265
Research and development	7,895	10,142	15,846	19,454
Amortization of intangible assets	1,762	1,803	3,524	3,788
Restructuring and other charges	1,162	97	2,430	82
Total operating expenses	23,496	25,986	46,767	51,589
Income (loss) from operations	3,539	(1,661)	4,267	(5,702)
Interest income	4	3	7	4
Interest expense	(8)	(11)	(16)	(26)
Other income, net	398	440	392	872
Income (loss) from continuing operations before income taxes	3,933	(1,229)	4,650	(4,852)
Tax provision (benefit)	1,047	(442)	1,047	(1,761)
Income (loss) from continuing operations	2,886	(787)	3,603	(3,091)
Loss from discontinued operations, net of income taxes	(2,621)	(258)	(2,839)	(210)
Net income (loss)	$265	$(1,045)	$764	$(3,301)
Basic net earnings (loss) per share:				
Income (loss) from continuing operations	$0.09	$(0.02)	$0.11	$(0.10)
Loss from discontinued operations, net of income taxes	(0.08)	(0.01)	(0.09)	(0.01)
Net income (loss)	$0.01	$(0.03)	$0.02	$(0.11)
Diluted net earnings (loss) per share:				
Income (loss) from continuing operations	$0.09	$(0.02)	$0.11	$(0.10)
Loss from discontinued operations, net of income taxes	(0.08)	(0.01)	(0.09)	(0.01)
Net income (loss)	$0.01	$(0.03)	$0.02	$(0.11)
Weighted-average shares outstanding:				
Basic	32,052	30,988	31,880	30,820
Diluted	32,686	30,988	32,720	30,820
Comprehensive income (loss):				
Net income (loss)	$265	$(1,045)	$764	$(3,301)
Foreign currency translation adjustments	(111)	(74)	(208)	(15)
Total comprehensive income (loss)	$154	$(1,119)	$556	$(3,316)

The accompanying notes are an integral part of the consolidated financial statements.

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MERCURY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended December 31, 2014	2013
Cash flows from operating activities:		
Net income (loss)	$764	$(3,301)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization expense	7,150	8,028
Stock-based compensation expense	4,933	5,752
(Benefit) provision for deferred income taxes	(1,314)	796
Impairment of goodwill from discontinued operations	2,283	—
Excess tax benefit from stock-based compensation	(536)	(3)
Other non-cash items	(568)	(527)
Changes in operating assets and liabilities:		
Accounts receivable, unbilled receivables, and costs in excess of billings	(7,103)	7,332
Inventory	1,584	4,319
Prepaid income taxes	(3,587)	(6,312)
Prepaid expenses and other current assets	(182)	560
Other non-current assets	291	336
Accounts payable and accrued expenses	4,126	(6,495)
Deferred revenues and customer advances	2,458	(762)
Income taxes payable	123	—
Other non-current liabilities	(16)	(192)
Net cash provided by operating activities	10,406	9,531
Cash flows from investing activities:		
Purchases of property and equipment	(2,123)	(3,934)
Decrease (increase) in other investing activities	1	(300)
Net cash used in investing activities	(2,122)	(4,234)
Cash flows from financing activities:		
Proceeds from employee stock plans	1,313	580
Excess tax benefit from stock-based compensation	536	3
Payments of capital lease obligations	(320)	(343)
Net cash provided by financing activities	1,529	240
Effect of exchange rate changes on cash and cash equivalents	(113)	(128)
Net increase in cash and cash equivalents	9,700	5,409
Cash and cash equivalents at beginning of period	47,287	39,126
Cash and cash equivalents at end of period	$56,987	$44,535
Cash paid during the period for:		
Interest	$16	$26
Income taxes	$5,512	$5,068
Supplemental disclosures—non-cash activities:		
Issuance of restricted stock awards to employees	$8,832	$8,313
Capital lease financings	$—	$494

The accompanying notes are an integral part of the consolidated financial statements.

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MERCURY SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands except per share data)
(Unaudited)

A. Description of Business

Mercury Systems, Inc. is a leading high-tech commercial provider of more affordable secure and sensor processing subsystems designed and made in the U.S.A. for critical defense and intelligence applications. The Company delivers innovative solutions, rapid time-to-value and service and support to its defense prime contractor customers. The Company's products and solutions have been deployed in more than 300 programs with over 25 different defense prime contractors. Key programs include Aegis, Patriot, Surface Electronic Warfare Improvement Program ("SEWIP"), Gorgon Stare, Predator, F-35 and Reaper. The Company's organizational structure allows it to deliver capabilities that combine technology building blocks and deep domain expertise in the defense sector. The Company believes its total portfolio of services and solutions is unique in the industry for a commercial company.

The Company's goal is to grow and build on its position as a critical component of the defense industrial base and become the leading provider of open and affordable secure and sensor processing subsystems. The Mercury Commercial Electronics ("MCE") operating segment designs, develops and builds open sensor processing products and subsystems that include embedded processing modules and subsystems, radio frequency ("RF") and microwave multi-function assemblies as well as subsystems, and RF and microwave components. The Mercury Defense Systems ("MDS") operating segment provides significant capabilities relating to pre-integrated, open, affordable electronic warfare ("EW"), electronic attack ("EA") and electronic counter measure ("ECM") subsystems and significant capabilities in signals intelligence ("SIGINT"), electro-optical/infrared ("EO/IR") processing technologies and radar environment test and simulation systems.

In June 2014, the Company initiated a plan to divest the Mercury Intelligence Systems ("MIS") operating segment, based on the Company's strategic direction and investment priorities focusing on its core business. As a result, the Company's MIS operating segment met the "held for sale" criteria in accordance with Financial Accounting Standard Boards ("FASB") Accounting Standards Codification ("ASC") 205, Presentation of Financial Statements, ("FASB ASC 205") as of June 30, 2014 and all reporting periods thereafter (see Note C to the Consolidated Financial Statements). The consolidated financial statements, excluding the statements of cash flows, and the notes to the consolidated financial statements were restated for all periods presented to reflect the discontinuation of the MIS operating segment, in accordance with FASB ASC 205. On January 23, 2015, the Company completed the sale of the MIS operating segment.

B. Summary of Significant Accounting Policies

BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to the Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures, normally included in annual consolidated financial statements have been condensed or omitted pursuant to those rules and regulations; however, in the opinion of management the financial information reflects all adjustments, consisting of adjustments of a normal recurring nature, necessary for fair presentation. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the fiscal year ended June 30, 2014 which are contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on August 14, 2014. The results for the three and six months ended December 31, 2014 are not necessarily indicative of the results to be expected for the full fiscal year.

The Company is comprised of the following operating segments: MCE and MDS. See Note L of the Notes to Consolidated Financial Statements for further discussion.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

REVENUE RECOGNITION

The Company relies upon FASB ASC 605, Revenue Recognition to account for its revenue transactions. Revenue is recognized upon shipment provided that title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, and customer acceptance criteria, if any, have been successfully demonstrated. Out-of-pocket expenses that are reimbursable by the customer are included in revenue and cost of revenue.

Certain contracts with customers require the Company to perform tests of its products prior to shipment to ensure their performance complies with the Company’s published product specifications and, on occasion, with additional customer-requested specifications. In these cases, the Company conducts such tests and, if they are completed successfully, includes a written confirmation with each order shipped. As a result, at the time of each product shipment, the Company believes that no further customer testing requirements exist and that there is no uncertainty of acceptance by its customer.

The Company uses FASB Accounting Standards Update (“ASU”) No. 2009-13 (“FASB ASU 2009-13”), Multiple-Deliverable Revenue Arrangements. FASB ASU 2009-13 establishes a selling price hierarchy for determining the selling price of a deliverable, which includes: (1) vendor-specific objective evidence (“VSOE”) if available; (2) third-party evidence (“TPE”) if VSOE is not available; and (3) best estimated selling price (“BESP”), if neither VSOE nor TPE are available. Additionally, FASB ASU 2009-13 expands the disclosure requirements related to a vendor’s multiple-deliverable revenue arrangements.

The Company enters into multiple-deliverable arrangements that may include a combination of hardware components, related integration or other services. These arrangements generally do not include any performance-, cancellation-, termination- or refund-type provisions. Total revenue recognized under multiple-deliverable revenue arrangements was 26% and 28% of total revenues in the three and six months ended December 31, 2014, respectively. Total revenue recognized under multiple-deliverable revenue arrangements was 56% and 42% of total revenues in the three and six months ended December 31, 2013, respectively.

In accordance with the provisions of FASB ASU 2009-13, the Company allocates arrangement consideration to each deliverable in an arrangement based on its relative selling price. The Company generally expects that it will not be able to establish VSOE or TPE due to limited single element transactions and the nature of the markets in which the Company competes, and, as such, the Company typically determines its relative selling price using BESP.

The objective of BESP is to determine the price at which the Company would transact if the product or service were sold by the Company on a standalone basis. Determination of BESP involves the consideration of several factors based on the specific facts and circumstances of each arrangement. Specifically, the Company considers the cost to produce the deliverable, the anticipated margin on that deliverable, the selling price and profit margin for similar parts, the Company’s ongoing pricing strategy and policies as evident from the price list established and updated by management on a regular basis, the value of any enhancements that have been built into the deliverable and the characteristics of the varying markets in which the deliverable is sold.

The Company analyzes the selling prices used in its allocation of arrangement consideration at a minimum on an annual basis and on a more frequent basis if a significant change in the Company’s business necessitates a more timely analysis or if the Company experiences significant variances in its selling prices.

Each deliverable within the Company’s multiple-deliverable revenue arrangements is accounted for as a separate unit of accounting under the guidance of FASB ASU 2009-13 if both of the following criteria are met: the delivered item or items have value to the customer on a standalone basis; and for an arrangement that includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. The Company's revenue arrangements do not include a general right of return for delivered products. The Company considers a deliverable to have standalone value if the item is sold separately by the Company or another vendor or if the item could be resold by the customer.

Deliverables not meeting the criteria for being a separate unit of accounting are combined with a deliverable that does meet that criterion. The appropriate allocation of arrangement consideration and recognition of revenue is then determined for the combined unit of accounting.

The Company also engages in long-term contracts for development, production and services activities which it accounts for consistent with FASB ASC 605-35, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, and other relevant revenue recognition accounting literature. The Company considers the nature of these contracts and the types of products and services provided when determining the proper accounting for a particular contract. Generally for fixed-price contracts, other than service-type contracts, revenue is recognized primarily under the percentage of completion method or, for certain short-term contracts, by the completed contract method. Revenue from service-type fixed-price contracts is recognized ratably over the contract period or by other appropriate input or output methods to measure service provided, and contract costs are expensed as incurred. The Company establishes billing terms at the time project deliverables and milestones are agreed. Revenues recognized in excess of the amounts invoiced to clients are classified as unbilled receivables. For time and materials contracts, revenue reflects the number of direct labor hours expended in the performance of a contract multiplied by the contract billing rate, as well as reimbursement of other billable direct costs. For all types of contracts, the Company recognizes anticipated contract losses as soon as they become known and estimable.

The use of contract accounting requires significant judgment relative to estimating total contract revenues and costs, including assumptions relative to the length of time to complete the contract, the nature and complexity of the work to be performed, anticipated increases in wages and prices for subcontractor services and materials, and the availability of subcontractor services and materials. The Company's estimates are based upon the professional knowledge and experience of its engineers, program managers and other personnel, who review each long-term contract monthly to assess the contract's schedule, performance, technical matters and estimated cost at completion. Changes in estimates are applied prospectively and when adjustments in estimated contract costs are identified, such revisions may result in current period adjustments to earnings applicable to performance in prior periods.

The Company defines service revenues as revenue from activities that are not associated with the design, development, production, or delivery of tangible assets, software or specific capabilities sold by us. Examples of the Company's service revenues include: consulting, maintenance and other support, testing and installation. The Company combines its product and service revenues into a single class as services revenues do not exceed 10 percent of total revenues.

The Company does not provide its customers with rights of product return, other than those related to warranty provisions that permit repair or replacement of defective goods. The Company accrues for anticipated warranty costs upon product shipment. Revenues from product royalties are recognized upon invoice by the Company. Additionally, all revenues are reported net of government assessed taxes (e.g. sales taxes or value-added taxes).

WEIGHTED-AVERAGE SHARES

Weighted-average shares were calculated as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2014	2013	2014	2013
Basic weighted-average shares outstanding	32,052	30,988	31,880	30,820
Effect of dilutive equity instruments	634	—	840	—
Diluted weighted-average shares outstanding	32,686	30,988	32,720	30,820

Equity instruments to purchase 654 and 740 shares of common stock were not included in the calculation of diluted net earnings per share for the three and six months ended December 31, 2014, because the equity instruments were anti-dilutive. Equity instruments to purchase 3,871 shares of common stock were not included in the calculation of diluted net earnings per share for the three and six months ended December 31, 2013, because the equity instruments were anti-dilutive.

C.Discontinued Operations

During the fourth quarter of fiscal 2014, the Company conducted a strategic review of the Mercury Intelligence Systems ("MIS") business unit which encompassed an assessment of MIS' financial performance and contemporaneous future financial projections. The Company, with Board of Director's approval, concluded that a plan to divest the MIS business unit would be in the best interests of the Company and its shareholders.

As of June 30, 2014, the Company's MIS operating segment met the "held for sale" criteria in accordance with FASB ASC 205. As the Company will not have continuing involvement in the operations of MIS after its divestiture in January 2015, the MIS operating results have been reported as a discontinued operation for all periods presented. On January 23, 2015, the Company completed the sale of the MIS operating segment.

MIS is considered its own operating segment and was previously aggregated with MDS into one reportable segment based on similar economic and qualitative factors in accordance with FASB ASC 280. As MIS is a discontinued operation, the results of MIS have been excluded from the MDS reportable segment. Accordingly, the revenues, costs of revenue, operating expenses, assets and liabilities of MIS have been reported separately in the Consolidated Statements of Operations and Comprehensive Income (Loss) and Consolidated Balance Sheets for all periods presented. The discontinued operation's balances in the Consolidated Balance Sheets do not reflect intercompany receivable balances of MIS, and the results of discontinued operations do not reflect interest expense or the allocation of the Company's corporate general and administrative expenses.

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The amounts reported in loss from discontinued operations, net of income taxes were as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2014	2013	2014	2013
Net revenues of discontinued operations	$1,321	$2,158	$3,160	$5,372
Costs of discontinued operations:				
Cost of revenues	951	1,545	2,176	3,736
Selling, general and administrative	600	809	1,247	1,588
Research and development	105	89	276	121
Amortization of intangible assets	124	124	248	248
Acquisition costs and other related expenses	76	—	109	—
Impairment of goodwill	2,283	—	2,283	—
Loss from discontinued operations before income taxes	(2,818)	(409)	(3,179)	(321)
Tax benefit	(197)	(151)	(340)	(111)
Loss from discontinued operations, net of income taxes	$(2,621)	$(258)	$(2,839)	$(210)

The amounts reported as assets and liabilities of the discontinued operations were as follows:

	December 31, 2014	June 30, 2014
Accounts receivable, net	$452	$925
Unbilled receivables and costs in excess of billings	133	248
Deferred income taxes	88	77
Prepaid income taxes	340	—
Prepaid expenses and other current assets	82	124
Property and equipment, net	387	475
Goodwill	—	2,283
Intangible assets, net	1,815	2,062
Other non-current assets	33	39
Assets of discontinued operations	$3,330	$6,233
Accounts payable	$5	$127
Accrued expenses	1,041	802
Accrued compensation	537	689
Deferred income taxes	724	818
Liabilities of discontinued operations	$2,307	$2,436

The depreciation, amortization and significant operating and investing non-cash items of the discontinued operations were as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2014	2013	2014	2013
Depreciation	$45	$39	$89	$77
Amortization of intangible assets	$124	$124	$248	$248
Capital expenditures	$—	$18	$—	$18
Impairment of goodwill	$2,283	$—	$2,283	$—