MERCURY SYSTEMS INC
Form 10-Q
November 03, 2016
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 SEPTEMBER 30, 2016
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	04-2741391
(State or other jurisdiction of incorporation or organization)	(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 October 31, 2016: 41,014,934 shares

MERCURY SYSTEMS, INC.
INDEX

		PAGE NUMBER
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements (unaudited)	3
	Consolidated Balance Sheets as of September 30, 2016 and June 30, 2016	3
	Consolidated Statements of Operations and Comprehensive Income for the three months ended September 30, 2016 and 2015	4
	Consolidated Statements of Cash Flows for the three months ended September 30, 2016 and 2015	5
	Notes to Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	16
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	24
Item 4.	Controls and Procedures	24
PART II. OTHER INFORMATION		
Item 1.	Legal Proceedings	25
Item 1A.	Risk Factors	25
Item 6.	Exhibits	25
	Signatures	26

PART I. FINANCIAL INFORMATION

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

	September 30, 2016	June 30, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 77,314	$81,691
Accounts receivable, net of allowance for doubtful accounts of $140 and $92 at September 30, 2016 and June 30, 2016, respectively	62,158	73,427
Unbilled receivables and costs in excess of billings	23,574	22,467
Inventory	58,443	58,284
Prepaid income taxes	2,804	3,401
Prepaid expenses and other current assets	7,665	6,122
Total current assets	231,958	245,392
Restricted cash	—	264
Property and equipment, net	31,376	28,337
Goodwill	344,525	344,027
Intangible assets, net	112,071	116,673
Other non-current assets	2,231	1,803
Total assets	$ 722,161	$736,496
Liabilities and Shareholders’ Equity		
Current liabilities:		
Accounts payable	$ 19,283	$26,723
Accrued expenses	8,970	10,273
Accrued compensation	14,355	13,283
Deferred revenues and customer advances	3,566	7,365
Current portion of long-term debt	10,000	10,000
Total current liabilities	56,174	67,644
Deferred income taxes	9,575	11,842
Income taxes payable	700	700
Long-term debt	180,246	182,275
Other non-current liabilities	927	991
Total liabilities	247,622	263,452
Commitments and contingencies (Note L)		
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; 39,053,991 and 38,675,340 shares issued and outstanding at September 30, 2016 and June 30, 2016, respectively	391	387
Additional paid-in capital	355,164	357,500
Retained earnings	118,029	114,210
Accumulated other comprehensive income	955	947
Total shareholders’ equity	474,539	473,044
Total liabilities and shareholders’ equity	$ 722,161	$736,496

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

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

	Three Months Ended September 30,	
	2016	2015
Net revenues	$87,649	$58,409
Cost of revenues	48,205	30,107
Gross margin	39,444	28,302
Operating expenses:		
Selling, general and administrative	17,544	12,126
Research and development	12,838	8,866
Amortization of intangible assets	4,602	1,713
Restructuring and other charges	297	338
Acquisition costs and other related expenses	421	2,128
Total operating expenses	35,702	25,171
Income from operations	3,742	3,131
Interest income	40	24
Interest expense	(1,822)	(2)
Other income, net	600	71
Income before income taxes	2,560	3,224
Tax (benefit) provision	(1,259)	368
Net income	$3,819	$2,856
Basic net earnings per share	$0.10	$0.09
Diluted net earnings per share	$0.10	$0.08
Weighted-average shares outstanding:		
Basic	38,865	32,778
Diluted	39,865	33,616
Comprehensive income:		
Net income	$3,819	$2,856
Foreign currency translation adjustments	8	17
Total comprehensive income	$3,827	$2,873

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

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

	Three Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	$3,819	$2,856
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	7,320	3,301
Stock-based compensation expense	3,632	2,702
Benefit for deferred income taxes	(2,606)	(412)
Non-cash interest expense	471	—
Other non-cash items	(51)	(121)
Changes in operating assets and liabilities, net of effects of businesses acquired:		
Accounts receivable, unbilled receivables, and costs in excess of billings	10,111	(12,781)
Inventory	(104)	(2,739)
Prepaid income taxes	597	706
Prepaid expenses and other current assets	(1,553)	3,378
Other non-current assets	(86)	37
Accounts payable and accrued expenses	(7,377)	9,017
Deferred revenues and customer advances	(3,816)	659
Income taxes payable	(35)	—
Other non-current liabilities	(39)	(21)
Net cash provided by operating activities	10,283	6,582
Cash flows from investing activities:		
Purchases of property and equipment	(6,050)	(1,867)
Increase in other investing activities	(111)	(185)
Net cash used in investing activities	(6,161)	(2,052)
Cash flows from financing activities:		
Proceeds from employee stock plans	80	629
Payments for retirement of common stock	(6,128)	(3,708)
Payments of term debt	(2,500)	—
Net cash used in financing activities	(8,548)	(3,079)
Effect of exchange rate changes on cash and cash equivalents	49	36
Net (decrease) increase in cash and cash equivalents	(4,377)	1,487
Cash and cash equivalents at beginning of period	81,691	77,586
Cash and cash equivalents at end of period	$77,314	$79,073
Cash paid during the period for:		
Interest	$1,351	$2
Income taxes	$717	$65
Supplemental disclosures—non-cash activities:		
Issuance of restricted stock awards to employees	$15,002	$7,114

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

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

A. Description of Business

Mercury Systems, Inc. (the “Company” or “Mercury”) is a leading commercial provider of secure processing subsystems designed and made in the U.S.A. Optimized for customer and mission success, its solutions power a wide variety of critical defense and intelligence programs. Headquartered in Chelmsford, Massachusetts, it is pioneering a next-generation defense electronics business model specifically designed to meet the industry's current and emerging technology and business needs. The Company delivers affordable 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, Reaper and Digital Electronic Warfare System ("DEWS"). The Company's organizational structure allows it to deliver capabilities that combine technology building blocks and deep domain expertise in the defense sector.

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 (“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, 2016 which are contained in the Company’s Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”) on August 16, 2016. The results for the three months ended September 30, 2016 are not necessarily indicative of the results to be expected for the full fiscal year.

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 GAAP 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.

RECLASSIFICATION

The Company has restated the income tax provision amount for the three months ended September 30, 2015 for the adoption of FASB Accounting Standards Update ("ASU") 2016-09, Improvements to Employee Share-Based Payment Accounting. The Company’s Consolidated Statements of Operations and Comprehensive Income and Consolidated Statements of Cash Flows have been updated to reflect this change.

The Company included costs related to the sustainment of its product portfolio as research and development expense, which was previously included as costs of revenue on the Consolidated Statements of Operations and Comprehensive Income. For comparative purposes, for the three months ended September 30, 2015, the Company has reclassified $773 from costs of revenues to research and development expense.

BUSINESS COMBINATIONS

The Company utilizes the acquisition method of accounting under FASB ASC 805, Business Combinations, (“FASB ASC 805”), for all transactions and events which it obtains control over one or more other businesses, to recognize the fair value of all assets and liabilities acquired, even if less than one hundred percent ownership is acquired, and in establishing the acquisition date fair value as the measurement date for all assets and liabilities assumed. The Company also utilizes FASB ASC 805 for the initial recognition and measurement, subsequent measurement and

accounting, and disclosure of assets and liabilities arising from contingencies in business combinations.

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 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 is 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 35% and 48% of total revenues in the three months ended September 30, 2016, and 2015, 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.

The Company's 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. Selling prices will be analyzed 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 generally do not include a general right of return relative to 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. The risk to the Company on a fixed-price contract is that if estimates to complete the contract change from one period to the next, profit levels will vary from period to period. 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 Company also considers whether contracts should be combined or segmented in accordance with the applicable criteria under GAAP. The Company combines closely related contracts when all the applicable criteria under GAAP are met. The combination of two or more contracts requires judgment in determining whether the intent of entering into the contracts was effectively to enter into a single project, which should be combined to reflect an overall profit rate. Similarly, the Company may separate a project, which may consist of a single contract or group of contracts, with varying rates of profitability, only if the applicable criteria under GAAP are met. Judgment also is involved in determining whether a single contract or group of contracts may be segmented based on how the arrangement was negotiated and the performance criteria. The decision to combine a group of contracts or segment a contract could change the amount of revenue and gross profit recorded in a given period.

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 retrospectively 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.

Contract costs also may include estimated contract recoveries for matters such as contract changes and claims for unanticipated contract costs. The Company records revenue associated with these matters only when the amount of recovery can be estimated reliably and realization is probable.

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. Examples of the Company's service revenues include: analyst services and systems engineering support, consulting, maintenance and other support, testing and installation. The Company combines its product and service revenues into a single class as service revenues are less than 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 September 30,	
	2016	2015
Basic weighted-average shares outstanding	38,865	32,778
Effect of dilutive equity instruments	1,000	838
Diluted weighted-average shares outstanding	39,865	33,616

Equity instruments to purchase 22 and 356 shares of common stock were not included in the calculation of diluted net earnings per share for the three months ended September 30, 2016, and 2015, respectively, because the equity instruments were anti-dilutive.

September 30, 2016 basic shares outstanding include the impact of 5,175 shares from the underwritten common stock public offering on April 4, 2016.

C.Acquisitions

CARVE-OUT BUSINESS AQUISITION

On March 23, 2016, the Company and Microsemi Corporation ("Microsemi") entered into a Stock Purchase Agreement, pursuant to which, Microsemi agreed to sell all the membership interests in its custom microelectronics, RF and microwave solutions and embedded security operations (the "Carve-Out Business") to the Company for $300,000 in cash on a cash-free, debt-free basis, subject to a working capital adjustment. On May 2, 2016, the transaction closed and the Company acquired the Carve-Out Business. Pursuant to the terms of the Stock Purchase Agreement, all outstanding Carve-Out Business employee stock awards

that were unvested at the closing were replaced by Mercury. The replacement stock awards granted were determined based on a conversion ratio provided in the Stock Purchase Agreement. Mercury funded the acquisition with a combination of a new $200,000 bank term loan facility (see Note I) and cash on hand, which included net proceeds of approximately $92,788 raised from an underwritten common stock public offering.

The following table presents the net purchase price and the preliminary fair values of the assets and liabilities of the Carve-Out Business:

	Amounts
Consideration transferred	
Cash paid at closing	$300,000
Value allocated to replacement awards	407
Net purchase price	$300,407
Estimated fair value of tangible assets acquired and liabilities assumed	
Accounts receivable and cost in excess of billings	$17,023
Inventory	25,477
Fixed assets	13,996
Other current and non-current assets	524
Current liabilities	(4,677)
Non-current deferred tax liabilities	(25,477)
Estimated fair value of net tangible assets acquired	26,866
Estimated fair value of identifiable intangible assets	102,800
Estimated goodwill	170,741
Estimated fair value of assets acquired	$300,407
Net purchase price	$300,407

The amounts above represent the preliminary fair value estimates as of September 30, 2016 and are subject to subsequent adjustment as the Company obtains additional information during the measurement period and finalizes its fair value estimates. The preliminary identifiable intangible asset estimates include customer relationships of $70,900, completed technology of $29,700 and backlog of $2,200. Any subsequent adjustments to these fair value estimates occurring during the measurement period will result in an adjustment to goodwill.

The goodwill of $170,741 largely reflects the potential synergies and expansion of the Company's offerings across product lines and markets complementary to the Company's existing products and markets. The Carve-Out Business provides the Company with additional capability and expertise related to embedded security custom microelectronics, and microwave and radio frequency technology. The acquisition is directly aligned with the Company's strategy of expanding its capabilities, services and offerings along the sensor processing chain. The goodwill from this acquisition is reported under the Carve-Out Business reporting unit. As of September 30, 2016, the Company had $29,266 of goodwill deductible for tax purposes.

The revenues and net loss from the Carve-Out Business included in the Company's consolidated results for the three months ended September 30, 2016 were $24,311 and $(2,419), respectively.

Pro Forma Financial Information

The following tables summarize the supplemental statements of operations information on an unaudited pro forma basis as if the Carve-Out Business acquisition had occurred on July 1, 2015:

	Three Months ended September 30, 2015
Pro forma net revenues	$ 83,103
Pro forma net income	$ 2,039

Basic pro forma net earnings per share	$ 0.05
Diluted pro forma net earnings per share	$ 0.05

9

The unaudited pro forma results presented above are for illustrative purposes only for the applicable periods and do not purport to be indicative of the actual results which would have occurred had the transaction been completed as of the beginning of the period, nor are they indicative of results of operations which may occur in the future.

LEWIS INNOVATIVE TECHNOLOGIES ACQUISITION

On December 16, 2015, the Company entered into a share purchase agreement (the "Share Purchase Agreement") with Lewis Innovative Technologies, Inc. ("LIT") and the holders of the equity interests of LIT. Pursuant to the Share Purchase Agreement, the Company completed its purchase of all of the equity interests in LIT, and LIT became a wholly-owned subsidiary of the Company. Based in Decatur, Alabama, LIT provides advanced security technology and development services necessary for protecting systems critical to national security while meeting strict Department of Defense ("DoD") program protection requirements.

The Company acquired LIT for a cash purchase price of $9,756. The Company funded the purchase with cash on hand. The purchase price was subject to a post-closing adjustment based on a determination of LIT's closing net working capital. In accordance with the Share Purchase Agreement, $1,000 of the purchase price was placed into escrow to support the post-closing working capital adjustment and the sellers' indemnification obligations. The escrow is available for indemnification claims through June 16, 2017. The Company acquired LIT free of debt.

The preliminary fair value estimates of LIT's assets and liabilities have not changed since June 30, 2016. The fair value estimates are subject to subsequent adjustment as the Company obtains additional information until the measurement period ends on December 15, 2016.

D. Fair Value of Financial Instruments

The following table summarizes the Company's financial assets measured at fair value on a recurring basis at September 30, 2016:

	Fair Value Measurements			
	September 30, 2016	Level 1	Level 2	Level 3
Assets:				
Certificates of deposit	$ 30,104	$ —	$ 30,104	$ —
Total	$ 30,104	$ —	$ 30,104	$ —

The carrying values of cash and cash equivalents, including money market funds, restricted cash, accounts receivable and payable, and accrued liabilities approximate fair value due to the short-term maturities of these assets and liabilities. The fair value of the Company's certificates of deposit are determined through quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable. The Company determined the face value of its long-term debt approximates fair value at September 30, 2016 due to the recent issuance and stability of interest rates during this period. The cost-method investment, which is presented within other non-current assets in the accompanying consolidated balance sheets, does not have a readily determinable fair value, as such the Company recorded the investment at cost and will continue to evaluate the asset for impairment on a quarterly basis.

E. Inventory

Inventory is stated at the lower of cost (first-in, first-out) or market value, and consists of materials, labor and overhead. On a quarterly basis, the Company uses consistent methodologies to evaluate inventory for net realizable value. Once an item is written down, the value becomes the new inventory cost basis. The Company reduces the value of inventory for excess and obsolete inventory, consisting of on-hand inventory in excess of estimated usage. The excess and obsolete inventory evaluation is based upon assumptions about future demand, history, product mix and possible alternative uses. Inventory was comprised of the following:

	September 30, 2016	June 30, 2016
Raw materials	$ 33,603	$ 31,205
Work in process	15,401	15,967
Finished goods	9,439	11,112
Total	$ 58,443	$ 58,284

There are no amounts in inventory relating to contracts having production cycles longer than one year.

10

F. Goodwill

The following table sets forth the changes in the carrying amount of goodwill by reporting unit for the three months ended September 30, 2016:

	MCE	MDS	Carve-out Business	Total
Balance at June 30, 2016	$134,378	$39,406	$170,243	$344,027
Goodwill adjustment for the Carve-Out Business acquisition	—	—	498	498
Balance at September 30, 2016	$134,378	$39,406	$170,741	$344,525

During the three months ended September 30, 2016, the Company recorded a $498 adjustment to goodwill related to the acquisition of the Carve-out Business. The adjustment was the result of changes in fair value estimates derived from additional information obtained during the measurement period.

In the three months ended September 30, 2016, there were no triggering events, as defined by FASB ASC 350, Intangibles - Goodwill and Other, which required an interim goodwill impairment test. The Company performs its annual goodwill impairment test in the fourth quarter of each fiscal year.

G. Restructuring

The following table presents the detail of activity for the Company's restructuring plans:

	Severance & Related	Facilities & Other	Total
Restructuring liability at June 30, 2016	$ 190	$ 736	$926
Restructuring and other charges	214	83	297
Cash paid	(63)	(272)	(335)
Restructuring liability at September 30, 2016	$ 341	$ 547	$888

During the three months ended September 30, 2016, the Company incurred net restructuring and other charges of $297. In the event that the Company is unable to sublease the unoccupied portion of its headquarters complex in Chelmsford, Massachusetts, it will incur nominal, periodic restructuring charges through fiscal 2017.

All of the restructuring and other charges are classified as operating expenses in the consolidated statements of operations and comprehensive income and any remaining severance obligations are expected to be paid within the next twelve months. The restructuring liability is classified as accrued expenses in the consolidated balance sheets.

H. Income Taxes

The Company recorded an income tax (benefit) provision of $(1,259) and of $368 on income from operations before income taxes of $2,560 and $3,224 for the three months ended September 30, 2016 and 2015, respectively. The effective tax rate for the three months ended September 30, 2016 differed from the federal statutory rate primarily due to federal research and development credits, domestic manufacturing deduction, excess tax benefits related to stock compensation, and state taxes. The effective tax rate for the three months ended September 30, 2015 differed from the federal statutory rate primarily due to domestic manufacturing deduction, excess tax benefits related to stock compensation, and state taxes.

No material changes in the Company's unrecognized tax positions occurred during the three months ended September 30, 2016. The Company is currently under audit by the Internal Revenue Service for fiscal year 2013. There have been no significant changes to the status of this examination during the three months ended September 30, 2016. It is reasonably possible that within the next 12 months the Company's unrecognized tax benefits, exclusive of interest, may decrease by up to $757 at the conclusion of the audit. The Company expects that the decrease, if recognized, would not affect the effective tax rate.

I. Debt

TERM LOAN AND REVOLVING CREDIT FACILITIES

On May 2, 2016, the Company and certain of its subsidiaries, as guarantors, entered into a Credit Agreement (the "Credit Agreement") with a syndicate of commercial banks and Bank of America, N.A acting as the administrative agent. The Credit Agreement provides for a $200,000 term loan facility ("Term Loan") and a $100,000 revolving credit facility ("Revolver"). As

11

of September 30, 2016, the Company's outstanding balance on the Term Loan was $197,500, net of $7,254 of unamortized debt issuance costs. The stated interest rate of the Term Loan was 2.8% as of September 30, 2016. The Company was in compliance with all covenants and conditions under the Credit Agreement. There were no borrowings against the Revolver; however, there were outstanding letters of credit of $1,938 under this Credit Agreement as of September 30, 2016.

J. Stock-Based Compensation

STOCK OPTION PLANS

The number of shares authorized for issuance under the Company's 2005 Stock Incentive Plan, as amended and restated (the "2005 Plan"), is 15,252 shares at September 30, 2016. The 2005 Plan provides for the grant of non-qualified and incentive stock options, restricted stock, stock appreciation rights and deferred stock awards to employees and non-employees. All stock options are granted with an exercise price of not less than 100% of the fair value of the Company's common stock at the date of grant and the options generally have a term of seven years. There were 1,580 shares available for future grant under the 2005 Plan at September 30, 2016.

As part of the Company's ongoing annual equity grant program for employees, the Company grants performance-based restricted stock awards to certain executives pursuant to the 2005 Plan. Performance awards vest based on the requisite service period subject to the achievement of specific financial performance targets. Based on the performance targets, some of these awards require graded vesting which results in more rapid expense recognition compared to traditional time-based vesting over the same vesting period. The Company monitors the probability of achieving the performance targets on a quarterly basis and may adjust periodic stock compensation expense accordingly.

EMPLOYEE STOCK PURCHASE PLAN

The number of shares authorized for issuance under the Company's 1997 Employee Stock Purchase Plan, as amended and restated ("ESPP"), is 1,800 shares. Under the ESPP, rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at either the beginning or the end of each six-month offering period. The ESPP permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee's compensation as defined in the ESPP. There were no shares issued under the ESPP during the three months ended September 30, 2016 and 2015, respectively. Shares available for future purchase under the ESPP totaled 398 at September 30, 2016.

STOCK OPTION AND AWARD ACTIVITY

The following table summarizes activity of the Company's stock option plans since June 30, 2016:

	Options Outstanding		
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)
Outstanding at June 30, 2016	258	$ 13.34	1.06
Granted	—	—	
Exercised	(6)	13.07	
Cancelled	—	—	
Outstanding at September 30, 2016	252	$ 13.35	0.81

The following table summarizes the status of the Company's non-vested restricted stock awards since June 30, 2016:

	Non-vested Restricted Stock Awards	
	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at June 30, 2016	1,666	$ 13.09
Granted	633	23.69
Vested	(633)	10.89
Forfeited	(18)	16.66

Outstanding at September 30, 2016	1,648	$	17.97

STOCK-BASED COMPENSATION EXPENSE

The Company recognized the full expense of its share-based payment plans in the consolidated statements of operations for the three months ended September 30, 2016 and 2015 in accordance with FASB ASC 718, Compensation - Stock Compensation. The Company had $177 of capitalized stock-based compensation expense on the consolidated balance sheets as of September 30, 2016. In the prior year, the Company did not capitalize any such costs on the consolidated balance sheets, as such costs that qualified for capitalization were not material. Under the fair value recognition provisions of FASB ASC 718, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the service period, net of estimated forfeitures. The following table presents share-based compensation expenses from continuing operations included in the Company’s consolidated statements of operations:

	Three Months Ended September 30,	
	2016	2015
Cost of revenues	$75	$149
Selling, general and administrative	3,039	2,128
Research and development	518	425
Share-based compensation expense before tax	3,632	2,702
Income taxes	(1,389)	(1,041)
Share-based compensation expense, net of income taxes	$2,243	$1,661

K. Operating Segment, Geographic Information and Significant Customers

Operating segments are defined as components of an enterprise evaluated regularly by the Company's chief operating decision maker (“CODM”) in deciding how to allocate resources and assess performance. The Company is comprised of one operating and reportable segment. The Company utilized the management approach for determining its operating segment in accordance with FASB ASC 280.

The geographic distribution of the Company’s revenues is summarized as follows:

	US	Europe	Asia Pacific	Eliminations	Total
THREE MONTHS ENDED SEPTEMBER 30, 2016					
Net revenues to unaffiliated customers	$83,048	$ 854	$ 3,747	$ —	$87,649
Inter-geographic revenues	3,286	15	—	(3,301)	