

MERCURY SYSTEMS INC
Form 10-Q
November 07, 2013
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2013

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 (I.R.S. Employer
incorporation or organization) Identification No.)

201 RIVERNECK ROAD 01824
CHELMSFORD, MA (Zip Code)
(Address of principal executive offices)
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 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 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
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

Shares of Common Stock outstanding as of October 31, 2013: 33,289,445 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)

| | September 30, 2013 | June 30, 2013 |
|---|-----------------------|------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$40,106 | \$39,126 |
| Accounts receivable, net of allowance for doubtful accounts of \$17 and \$33 at September 30, 2013 and June 30, 2013, respectively | 35,143 | 30,498 |
| Unbilled receivables and costs in excess of billings | 13,913 | 17,743 |
| Inventory | 35,179 | 37,432 |
| Deferred income taxes | 10,724 | 11,672 |
| Prepaid income taxes | 3,541 | 2,369 |
| Prepaid expenses and other current assets | 6,737 | 7,461 |
| Total current assets | 145,343 | 146,301 |
| Restricted cash | 546 | 546 |
| Property and equipment, net | 14,565 | 15,019 |
| Goodwill | 176,612 | 176,521 |
| Intangible assets, net | 32,758 | 34,866 |
| Other non-current assets | 1,061 | 1,178 |
| Total assets | \$370,885 | \$374,431 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$7,522 | \$4,813 |
| Accrued expenses | 6,743 | 7,999 |
| Accrued compensation | 8,403 | 12,218 |
| Deferred revenues and customer advances | 4,749 | 5,788 |
| Total current liabilities | 27,417 | 30,818 |
| Deferred gain on sale-leaseback | 2,953 | 3,242 |
| Deferred income taxes | 7,238 | 7,721 |
| Income taxes payable | 2,880 | 2,880 |
| Other non-current liabilities | 1,179 | 1,269 |
| Total liabilities | 41,667 | 45,930 |
| Commitments and contingencies (Note H) | | |
| 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; 30,927,319 and 30,381,254 shares issued and outstanding at September 30, 2013 and June 30, 2013, respectively | 309 | 304 |
| Additional paid-in capital | 234,620 | 231,711 |
| Retained earnings | 93,268 | 95,524 |
| Accumulated other comprehensive income | 1,021 | 962 |
| Total shareholders' equity | 329,218 | 328,501 |

| | | |
|--|-----------|-----------|
| Total liabilities and shareholders' equity | \$370,885 | \$374,431 |
|--|-----------|-----------|

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

MERCURY SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In thousands, except per share data)

(Unaudited)

| | Three Months Ended | | |
|--|--------------------|------------|---|
| | September 30, | | |
| | 2013 | 2012 | |
| Net revenues | \$53,940 | \$49,428 | |
| Cost of revenues | 31,355 | 29,038 | |
| Gross margin | 22,585 | 20,390 | |
| Operating expenses: | | | |
| Selling, general and administrative | 15,101 | 14,533 | |
| Research and development | 9,344 | 10,039 | |
| Amortization of intangible assets | 2,108 | 1,788 | |
| Restructuring and other charges | (15 |) 4,984 | |
| Acquisition costs and other related expenses | — | 230 | |
| Total operating expenses | 26,538 | 31,574 | |
| Loss from operations | (3,953 |) (11,184 |) |
| Interest income | 1 | 2 | |
| Interest expense | (15 |) (8 |) |
| Other income, net | 432 | 339 | |
| Loss before income taxes | (3,535 |) (10,851 |) |
| Tax benefit | (1,279 |) (3,651 |) |
| Net loss | \$(2,256 |) \$(7,200 |) |
| Basic net loss per share: | \$(0.07 |) \$(0.24 |) |
| Diluted net loss per share: | \$(0.07 |) \$(0.24 |) |
| Weighted-average shares outstanding: | | | |
| Basic | 30,653 | 29,883 | |
| Diluted | 30,653 | 29,883 | |
| Comprehensive loss: | | | |
| Net loss | \$(2,256 |) \$(7,200 |) |
| Foreign currency translation adjustments | 59 | 12 | |
| Net unrealized gain on investments | — | 21 | |
| Total comprehensive loss | \$(2,197 |) \$(7,167 |) |

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, | |
|---|-------------------------------------|------------|
| | 2013 | 2012 |
| Cash flows from operating activities: | | |
| Net loss | \$(2,256 |) \$(7,200 |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization expense | 4,120 | 3,999 |
| Stock-based compensation expense | 3,035 | 2,345 |
| Provision (benefit) for deferred income taxes | 464 | (3,507 |
| Excess tax benefit from stock-based compensation | — | (9 |
| Other non-cash items | (243 |) (18 |
| Changes in operating assets and liabilities, net of effects of businesses acquired: | | |
| Accounts receivable, unbilled receivable, and cost in excess of billings | (731 |) 1,758 |
| Inventory | 2,274 | (2,488 |
| Prepaid income taxes | (1,172 |) 972 |
| Prepaid expenses and other current assets | 736 | 75 |
| Other non-current assets | 27 | (31 |
| Accounts payable and accrued expenses | (2,750 |) (5,820 |
| Deferred revenues and customer advances | (1,238 |) (606 |
| Income taxes payable | — | 10 |
| Other non-current liabilities | (93 |) 571 |
| Net cash provided by (used in) operating activities | 2,173 | (9,949 |
| Cash flows from investing activities: | | |
| Acquisition of businesses, net of cash acquired | — | (67,721 |
| Purchases of property and equipment | (1,108 |) (980 |
| Increase in other investing activities | — | (265 |
| Net cash used in investing activities | (1,108 |) (68,966 |
| Cash flows from financing activities: | | |
| Proceeds from employee stock plans | 60 | 133 |
| Excess tax benefits from stock-based compensation | — | 9 |
| Payments of acquired debt | — | (6,575 |
| Payments of capital lease obligations | (121 |) (46 |
| Net cash used in financing activities | (61 |) (6,479 |
| Effect of exchange rate changes on cash and cash equivalents | (24 |) (2 |
| Net increase (decrease) in cash and cash equivalents | 980 | (85,396 |
| Cash and cash equivalents at beginning of period | 39,126 | 115,964 |
| Cash and cash equivalents at end of period | \$40,106 | \$30,568 |
| Cash paid (received) during the period for: | | |
| Interest | \$15 | \$8 |
| Income taxes | \$334 | \$(1,193 |
| Supplemental disclosures—non-cash activities: | | |
| Issuance of restricted stock awards to employees | \$7,728 | \$11,584 |
| Capital lease | \$494 | \$— |
| Share-based business combination consideration | \$— | \$513 |

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. (the “Company” or “Mercury”) provides commercially developed, open sensor and Big Data processing systems, software and services for critical commercial, defense and intelligence applications. The Company delivers innovative solutions, rapid time-to-value and world-class service and support to our 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”), Predator and Reaper. The Company also delivers services and solutions in support of the intelligence community. Mercury Systems operates across a broad spectrum of defense and intelligence programs and the Company delivers its solutions and services via three business units: (i) Mercury Commercial Electronics (“MCE”); (ii) Mercury Defense Systems (“MDS”) and; (iii) Mercury Intelligence Systems (“MIS”). MCE delivers innovative, commercially developed, open sensor and Big Data processing systems, software and services that include embedded multi-computing and embedded sensor processing. Mercury's products include, but are not limited to, embedded processing boards, digital receiver boards, and chassis-based systems using air, conduction, and proprietary cooling technologies. MCE has added capabilities around radio frequency (“RF”) and microwave technologies, including tuners, converters, transceivers, switch filters, and power amplifiers and limiters, as well as emerging new manufacturing capabilities on a more scalable basis. MDS leverages commercially available technologies and solutions (or “building blocks”) from the Company's MCE business. MDS leverages this technology to develop integrated sensor processing subsystems and capabilities, for the C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance), electronic warfare (“EW”), electronic counter measures (“ECM”), signal intelligence (“SIGINT”) and radar test and simulation markets. MIS delivers Big Data processing capabilities, software data processing solutions and predictive analytics capabilities to address intelligence community and Department of Defense (“DoD”) mission needs. These three business units allow the Company to deliver capabilities that combine technology building blocks, deep domain expertise in the defense sector and critical solution areas, and specialized skills in serving the DoD and the intelligence community.

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, 2013 which are contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”) on August 16, 2013. The results for the three months ended September 30, 2013 are not necessarily indicative of the results to be expected for the full fiscal year. The Company is comprised of the following three operating segments: MCE, MDS and MIS. The Company reports MCE as a standalone reportable segment and has aggregated MDS and MIS to form the reportable segment Mercury Defense and Intelligence Systems (“MDIS”). The Company has presented prior period amounts to conform with the new reportable segments. None of these changes impact the Company's previously reported consolidated financial results. See Note K 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.

USE OF ESTIMATES

The preparation of financial statements in conformity with U.S. 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.

REVENUE RECOGNITION

The Company relies upon FASB ASC 605, Revenue Recognition to account for its revenue transactions. Revenue from sales are 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 reimbursed 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 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 27% and 30% of total revenues in the three months ended September 30, 2013 and 2012, 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 Company uses BESP in its allocation of arrangement consideration. 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. Revenues recognized in excess of the amounts invoiced to clients are classified as unbilled receivables. 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 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. 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. Assumed recoveries for claims included in contracts in process were not material for the three months ended September 30, 2013 and 2012.

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, | |
|---|-------------------------------------|--------|
| | 2013 | 2012 |
| Basic weighted-average shares outstanding | 30,653 | 29,883 |
| Effect of dilutive equity instruments | — | — |
| Diluted weighted-average shares outstanding | 30,653 | 29,883 |

Equity instruments to purchase 4,178 and 4,402 shares of common stock were not included in the calculation of diluted net earnings per share for the three months ended September 30, 2013 and 2012, respectively, because the equity instruments were anti-dilutive.

C. Fair Value of Financial Instruments

The Company measures at fair value certain financial assets and liabilities, including cash equivalents and restricted cash. FASB ASC 820, Fair Value Measurement and Disclosures, specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs have created the following fair-value hierarchy:

Level 1—Quoted prices for identical instruments in active markets;

Level 2—Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

Level 3—Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

The following table summarizes the Company's financial assets measured at fair value on a recurring basis at September 30, 2013:

| | Fair Value Measurements | | | |
|--|-------------------------|----------|---------|---------|
| | September 30, 2013 | Level 1 | Level 2 | Level 3 |
| Assets: | | | | |
| U.S. Treasury bills and money market funds | \$27,024 | \$27,024 | \$— | \$— |
| Operating cash | 13,082 | 13,082 | — | — |
| Restricted cash | 546 | 546 | — | — |
| Total | \$40,652 | \$40,652 | \$— | \$— |

The carrying values of cash and cash equivalents, including all U.S. Treasury bills and money market funds, accounts receivable and payable, and accrued liabilities approximate fair value due to the short-term maturities of these assets and liabilities.

D. 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. The Company reduces the value of inventory for excess and obsolete inventory, consisting of on-hand and non-cancelable on-order 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, 2013 | June 30, 2013 |
|-----------------|-----------------------|------------------|
| Raw materials | \$16,368 | \$17,512 |
| Work in process | 11,956 | 13,432 |
| Finished goods | 6,855 | 6,488 |
| Total | \$35,179 | \$37,432 |

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

E. Goodwill

The following table sets forth the changes in the carrying amount of goodwill for the three months ended September 30, 2013:

| | MCE | MDS | MIS | Total |
|---|-----------|----------|---------|-----------|
| Balance at June 30, 2013 | \$133,783 | \$33,768 | \$8,970 | \$176,521 |
| Goodwill adjustment for the Micronetics acquisition | 91 | — | — | 91 |
| Balance at September 30, 2013 | \$133,874 | \$33,768 | \$8,970 | \$176,612 |

In the three months ended September 30, 2013, there were no triggering events, as defined by FASB ASC 350, which required an interim goodwill impairment test. The Company performs its annual goodwill impairment test in the fourth quarter of each fiscal year. The goodwill adjustment for the Micronetics acquisition is the result of changes in fair value estimates derived from additional information gained during the measurement period which ended August 7, 2013.

The Company determines its reporting units in accordance with FASB ASC 350, by assessing whether discrete financial information is available and if management regularly reviews the operating results of that component. Following this assessment, the Company determined that its reporting units are the same as its operating segments, MCE, MDS and MIS.

F. Restructuring Plan

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

| | Severance & Related | Facilities & Other | Total |
|---|------------------------|-----------------------|--------|
| Restructuring liability at June 30, 2013 | \$434 | \$286 | \$720 |
| Cash paid | (305 |) (218 |) (523 |
| Reversals(*) | (15 |) — | (15 |
| Restructuring liability at September 30, 2013 | \$114 | \$68 | \$182 |

(*) Reversals result from the finalization of severance agreements and unused outplacement services.

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

G. Income Taxes

The Company recorded a tax benefit of \$1,279 and \$3,651 on a loss before taxes of \$3,535 and \$10,851 for the three months ended September 30, 2013 and 2012, respectively. Income tax benefit for the three months ended September 30, 2013 differed from the federal statutory rate primarily due to the impact of federal research and development tax credits, Section 199 manufacturing deduction and stock compensation. Income tax benefit for the three months ended September 30, 2012 differed from the federal statutory rate primarily due to the impact of a Section 199 manufacturing deduction, state taxes and stock compensation.

No material changes in the Company's unrecognized tax positions occurred during the three months ended September 30, 2013. The Company estimates that the unrecognized tax benefits could decrease by up to \$684 within the next 12 months as a result of resolutions of tax positions and the expiration of applicable statutes of limitations.

H. Commitments and Contingencies

LEGAL CLAIMS

The Company is subject to litigation, claims, investigations and audits arising from time to time in the ordinary course of our business. Although legal proceedings are inherently unpredictable, the Company believes that it has valid defenses with respect to any matters currently pending against the Company and intends to defend itself vigorously. The outcome of these matters, individually and in the aggregate, is not expected to have a material impact on the Company's cash flows, results of operations, or financial position.

INDEMNIFICATION OBLIGATIONS

The Company's standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company's products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments the Company could be required to make under these indemnification provisions is, in some instances, unlimited.

PURCHASE COMMITMENTS

As of September 30, 2013, the Company has entered into non-cancelable purchase commitments for certain inventory components and services used in its normal operations. The purchase commitments covered by these agreements are for less than one year and aggregate to \$17,373.

I. Debt

Senior Unsecured Credit Facility

On October 12, 2012, the Company entered into a credit agreement (the "Credit Agreement") with a syndicate of commercial banks, with KeyBank National Association acting as the administrative agent. The Credit Agreement provides for a \$200,000 senior unsecured revolving line of credit (the "Revolver"). The Company can borrow up to \$200,000 based on consolidated EBITDA for the four quarters ended September 30, 2013 and subject to compliance with the financial covenants discussed below. The Revolver is available for working capital, acquisitions, and general corporate purposes of the Company and its subsidiaries. The Revolver is available for borrowing during a five year period, with interest payable periodically during such period as provided in the Credit Agreement and principal due at

the maturity of the Revolver.

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The Credit Agreement has an accordion feature permitting the Company to request from the lenders an increase in the aggregate amount of the credit facility in the form of an incremental revolver or term loan in an amount not to exceed \$50,000. Any such increase would require only the consent of the lenders increasing their respective commitments under the credit facility.

The interest rates applicable to borrowings under the Credit Agreement involve various rate options that are available to the Company. The rates are calculated using a combination of conventional base rate measures plus a margin over those rates. The base rates consist of LIBOR rates or prime rates. The actual rates will depend on the level of these underlying rates plus a margin based on the Company's leverage at the time of borrowing.

Borrowings under the Credit Agreement are senior unsecured loans. Each of the Company's domestic subsidiaries is a guarantor under the Credit Agreement.

The Credit Agreement provides for conventional affirmative and negative covenants, including a maximum leverage ratio of 3.50x and a minimum interest coverage ratio of 3.0x. Each of the two ratios referred to above is calculated based on consolidated EBITDA, as defined in the Credit Agreement, for each consecutive four fiscal quarter period, after giving pro forma effect for any acquisitions or dispositions. Acquisitions are permitted under the Credit Agreement without any dollar limitation so long as, among other requirements, no default or event of default exists or would result therefore; as of September 30, 2013, the Company is in compliance with a maximum leverage ratio of 3.25x and a minimum interest coverage ratio of 3.0x, in each case, after giving pro forma effect to the applicable acquisition. In addition, the Credit Agreement contains certain customary representations and warranties, and events of default.

As of September 30, 2013, there was \$43,110 of borrowing capacity available. There were no borrowings outstanding on the Credit Agreement; however, there were outstanding letters of credit of \$4,299. The Company was in compliance with all covenants and conditions under the Credit Agreement.

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 7,764 shares at September 30, 2013. The 2005 Plan will be increased by any future cancellations, forfeitures or terminations (other than by exercise) under the Company's 1997 Stock Option Plan (the "1997 Plan"). 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 966 shares available for future grant under the 2005 Plan at September 30, 2013.

The number of shares authorized for issuance under the 1997 Plan was 8,650 shares, of which 100 shares could be issued pursuant to restricted stock grants. The 1997 Plan provided for the grant of non-qualified and incentive stock options and restricted stock to employees and non-employees. All stock options were 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. The options typically vested over periods up to four years and have a maximum term of 10 years. Following shareholder approval of the 2005 Plan on November 14, 2005, the Company's Board of Directors determined that no further grants of stock options or other awards would be made under the 1997 Plan, and the 1997 Plan subsequently expired in June 2007. The foregoing does not affect any outstanding awards under the 1997 Plan, which remains in full force and effect in accordance with their terms.

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 1,400 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, 2013 and 2012. Shares available for future purchase under the ESPP totaled 256 at September 30, 2013.

STOCK OPTION AND AWARD ACTIVITY

The following table summarizes activity of the Company's stock option plans since June 30, 2013:

| | Options Outstanding | | Weighted Average Remaining Contractual Term (Years) |
|-----------------------------------|---------------------|---------------------------------|---|
| | Number of Shares | Weighted Average Exercise Price | |
| Outstanding at June 30, 2013 | 2,070 | \$ 13.44 | 2.60 |
| Granted | — | — | |
| Exercised | (10 |) 5.82 | |
| Cancelled | (191 |) 20.77 | |
| Outstanding at September 30, 2013 | 1,869 | \$ 12.73 | 2.58 |

The following table summarizes the status of the Company's non-vested restricted stock awards since June 30, 2013:

| | Non-vested Restricted Stock Awards | |
|-----------------------------------|------------------------------------|--|
| | Number of Shares | Weighted Average Grant Date Fair Value |
| Outstanding at June 30, 2013 | 2,007 | \$ 10.82 |
| Granted | 838 | 9.22 |
| Vested | (536 |) 10.54 |
| Forfeited | — | — |
| Outstanding at September 30, 2013 | 2,309 | \$ 10.31 |

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, 2013 and 2012 in accordance with FASB ASC 718 and 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. The following table presents share-based compensation expenses included in the Company's consolidated statements of operations:

| | Three Months Ended September 30, | |
|---|----------------------------------|---------|
| | 2013 | 2012 |
| Cost of revenues | \$236 | \$131 |
| Selling, general and administrative | 2,332 | 1,903 |
| Research and development | 467 | 311 |
| Share-based compensation expense before tax | 3,035 | 2,345 |
| Income taxes | (1,090 |) (853 |
| Net compensation expense | \$1,945 | \$1,492 |

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 presently organized in three operating segments. The following operating segments were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company's management structure:

Mercury Commercial Electronics ("MCE"): this operating segment delivers innovative, commercially developed, open sensor and Big Data processing systems, software and services for critical commercial, defense and intelligence applications. MCE delivers solutions that are secure and based upon open architectures and widely adopted industry standards. MCE's products include, but are not limited to, embedded processing

boards, digital receiver boards, chassis-based systems using air, conduction, and proprietary cooling technologies and RF and microwave technologies, including tuners, converters, transceivers, switch filters, and power amplifiers and limiters. MCE delivers rapid time-to-value and world-class service and support to our commercial and defense prime contractor customers.

Mercury Defense Systems (“MDS”): this operating segment delivers innovative, open sensor processing solutions to key defense prime contractors leveraging commercially available technologies and solutions from our MCE business. MDS leverages this technology to develop integrated sensor processing subsystems, often including classified application-specific software and intellectual property (“IP”) for the C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance), EW, and ECM markets. MDS's products include, but are not limited to, Digital Radio Frequency Memory (“DRFM”) jammers and radar environment simulators.

Mercury Intelligence Systems (“MIS”): this operating segment delivers technologically advanced hardware and software data processing solutions and predictive analytics capabilities to address the intelligence community and Department of Defense mission needs.

The Company’s operating segments were evaluated in accordance with FASB ASC 280- “Segment Reporting” in order to determine which operating segments qualified as reportable segments. The Company considered qualitative factors, including the economic characteristics of each operating segment to determine if any of its three operating segments qualified for aggregation into fewer reportable segments.

The Company’s evaluation of the economic characteristics of its operating segments included comparisons of revenues and applicable growth rates, gross margins, operating margins, future projections, and additional non-GAAP financial measurements which indicate that MDS and MIS have similar economic characteristics. The Company also evaluated the following qualitative factors in accordance with FASB ASC 280 paragraph 10-50-11: the nature of products and services, the corresponding production processes, the types of customers, distribution methods for products and services and the nature of the corresponding regulatory environment associated with its operating segments. The Company determined each of these factors are similar for both the MDS and MIS operating segments and supports the aggregation of MDS and MIS into one reportable segment, Mercury Defense and Intelligence Systems (“MDIS”). The Company analyzed quantitative thresholds of each reportable segment including but not limited to reported revenues, including sales to external customers and intersegment sales or transfers, reported profits or losses, and total assets of each operating segment. The Company determined that both MCE and MDIS met the quantitative thresholds for reporting.

During fiscal 2013, the Company redefined its operating and reportable segments. The Company reclassified the segment data for the prior periods presented below to conform to the current year’s presentation.

The accounting policies of the reportable segments are the same as those described in “Note B: Summary of Significant Accounting Policies.” The profitability measure employed by the Company and its CODM as the basis for allocating resources to segments and assessing segment performance is adjusted EBITDA. The Company believes the adjusted EBITDA financial measure assists in providing an enhanced understanding of its underlying operational measures to manage its business, to evaluate its performance compared to prior periods and the marketplace, and to establish operational goals.

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Adjusted EBITDA is defined as net income (loss) before interest income and expense, income taxes, depreciation, amortization of acquired intangible assets, restructuring, impairment of long-lived assets, acquisition costs and other related expenses, fair value adjustments from purchase accounting and stock-based compensation costs. Prior year's amounts have been presented to reflect the current profitability measures for comparative purposes. Additionally, asset information by reportable segment is not reported because the Company and its CODM utilize consolidated asset information when making business decisions. The following is a summary of the performance of the Company's operations by reportable segment:

| | MCE | MDIS | Eliminations | Total |
|--|------------|----------|--------------|----------|
| THREE MONTHS ENDED | | | | |
| SEPTEMBER 30, 2013 | | | | |
| Net revenues to unaffiliated customers | \$43,488 | \$11,130 | \$(678) | \$53,940 |
| Intersegment revenues | 1,114 | — | (1,114) | — |
| Net revenues | \$44,602 | \$11,130 | \$(1,792) | \$53,940 |
| Adjusted EBITDA | \$2,343 | \$1,358 | \$(82) | \$3,619 |
| THREE MONTHS ENDED | | | | |
| SEPTEMBER 30, 2012 | | | | |
| Net revenues to unaffiliated customers | \$31,897 | \$15,827 | \$1,704 | \$49,428 |
| Intersegment revenues | 4,908 | 8 | (4,916) | — |
| Net revenues | \$36,805 | \$15,835 | \$(3,212) | \$49,428 |
| Adjusted EBITDA | \$(2,209) | \$3,223 | \$624 | \$1,638 |

The following table reconciles the Company's net loss, the most directly comparable GAAP financial measure, to its adjusted EBITDA:

| | Three Months Ended September 30, | |
|---|-------------------------------------|------------|
| | 2013 | 2012 |
| Net loss | \$(2,256) | \$(7,200) |
| Interest expense, net | 14 | 6 |
| Tax benefit | (1,279) | (3,651) |
| Depreciation | 2,012 | 2,211 |
| Amortization of intangible assets | 2,108 | 1,788 |
| Restructuring and other charges | (15) | 4,984 |
| Acquisition costs and other related expenses | — | 230 |
| Fair value adjustments from purchase accounting | — | 925 |
| Stock-based compensation expense | 3,035 | 2,345 |
| Adjusted EBITDA | \$3,619 | \$1,638 |

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

| | US | Europe | Asia Pacific | Eliminations | Total |
|--|----------|--------|--------------|--------------|----------|
| THREE MONTHS ENDED | | | | | |
| SEPTEMBER 30, 2013 | | | | | |
| Net revenues to unaffiliated customers | \$52,670 | \$508 | \$762 | \$— | \$53,940 |
| Inter-geographic revenues | 819 | 157 | 140 | (1,116) | — |
| Net revenues | \$53,489 | \$665 | \$902 | \$(1,116) | \$53,940 |
| THREE MONTHS ENDED | | | | | |
| SEPTEMBER 30, 2012 | | | | | |
| Net revenues to unaffiliated customers | \$47,635 | \$345 | \$1,448 | \$— | \$49,428 |
| Inter-geographic revenues | 1,177 | 49 | 26 | (1,252) | — |
| Net revenues | \$48,812 | \$394 | \$1,474 | \$(1,252) | \$49,428 |

Foreign revenue is based on the country in which the Company's legal subsidiary is domiciled.

The geographic distribution of the Company's long-lived assets is summarized as follows:

| | U.S. | Europe | Asia Pacific | Eliminations | Total |
|--------------------|-----------|--------|--------------|--------------|-----------|
| September 30, 2013 | \$ 14,528 | \$ 37 | \$— | \$— | \$ 14,565 |
| June 30, 2013 | \$ 14,986 | \$ 33 | \$— | \$— | \$ 15,019 |

Identifiable long-lived assets exclude goodwill and intangible assets.

Customers comprising 10% or more of the Company's revenues for the periods shown below are as follows:

| | Three Months Ended | | | |
|------------------------------|--------------------|--------------------|--|---|
| | September 30, 2013 | September 30, 2012 | | |
| Northrop Grumman Corporation | 15 | % 12 | | % |
| Raytheon Company | 13 | % 12 | | % |
| Lockheed Martin Corporation | 11 | % * | | |
| BAE Systems PLC | 10 | % * | | |
| Sierra Nevada Corporation | * | 14 | | % |
| | 49 | % 38 | | % |

*Indicates that the amount is less than 10% of the Company's revenues for the respective period.

While the Company typically has customers from which it derives 10% or more of its revenue, the sales to each of these customers are spread across multiple programs and platforms. For the three months ended September 30, 2013, no single program comprised 10% or more of the Company's revenue. For the three months ended September 30, 2012, the Gorgon Stare program individually comprised 14% of the Company's revenues.

L. Subsequent Events

The Company has evaluated subsequent events from the date of the consolidated balance sheet through the date the consolidated financial statements were issued.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
 ITEM 2. OPERATIONS
 FORWARD-LOOKING STATEMENTS

From time to time, information provided, statements made by our employees or information included in our filings with the Securities and Exchange Commission may contain statements that are not historical facts but that are "forward-looking statements," which involve risks and uncertainties. The words "may," "will," "would," "should," "could," "p," "expect," "believe," "anticipate," "continue," "estimate," "project," "intend," "likely," "forecast," "probable," and similar expressions are intended to identify forward-looking statements regarding events, conditions and financial trends that may affect our future plans of operations, business strategy, results of operations and financial position. These forward-looking statements, which include those related to our strategic plans, business outlook, and future business and financial performance, involve risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Such risks and uncertainties include, but are not limited to, continued funding of defense programs and the timing and amounts of such funding, including the potential for a continuing resolution for the defense budget and the potential for continued defense budget sequestration, general economic and business conditions, including unforeseen economic weakness in our markets, effects of continued geo-political unrest and regional conflicts, competition, changes in technology and methods of marketing, delays in completing various engineering and manufacturing programs, changes in customer order patterns, changes in product mix, continued success in technological advances and delivering technological innovations, changes in the U.S. Government's interpretation of federal procurement rules and regulations, market acceptance of our products, shortages in components, production delays due to performance quality issues with outsourced components, inability to fully realize the expected benefits from acquisitions and restructurings or delays in realizing such benefits, challenges in integrating acquired businesses and achieving anticipated synergies, changes to export regulations, increases in tax rates, changes to generally accepted accounting principles, difficulties in retaining key employees and customers, unanticipated costs under fixed-price service and system integration engagements, and various other factors beyond our control. These risks and uncertainties also include such additional risk factors as set forth under Part I-Item 1A (Risk Factors) in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2013. We caution readers not to place undue reliance upon any such forward-looking statements, which speak only as of the date made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

OVERVIEW

Mercury Systems, Inc. (the "Company" or "Mercury") provides commercially developed, open sensor and Big Data processing systems, software and services for critical commercial, defense and intelligence applications. We deliver innovative solutions, rapid time-to-value and world-class service and support to our defense prime contractor customers. Our 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"), Predator and Reaper. We also deliver services and solutions in support of the intelligence community. Mercury operates across a broad spectrum of defense and intelligence programs and we deliver our solutions and services via three business units: (i) Mercury Commercial Electronics ("MCE"); (ii) Mercury Defense Systems ("MDS") and; (iii) Mercury Intelligence Systems ("MIS").

As of September 30, 2013, we had 752 employees. Our revenue, net loss and adjusted EBITDA for the three month period ended September 30, 2013 were \$53.9 million, \$(2.3) million, and \$3.6 million, respectively. See the Non-GAAP Financial Measures section for a reconciliation of our net loss to adjusted EBITDA.

Our operations are organized in the following two reportable segments: (i) Mercury Commercial Electronics ("MCE") and (ii) Mercury Defense and Intelligence Systems ("MDIS"). We combined the MDS and MIS businesses as they both entail similar products and services and have a similar customer base. See below for a description of our two reportable segments:

Mercury Commercial Electronics, or MCE, delivers innovative, commercially developed, open sensor and Big Data processing systems for critical commercial, defense and intelligence applications. We deliver solutions that are secure and based upon open architectures and widely adopted industry standards. MCE's products include, but are not limited

to, embedded processing boards, digital receiver boards, chassis-based systems using air, conduction, and proprietary cooling technologies and RF and microwave technologies, including tuners, converters, transceivers, switch filters, and power amplifiers and limiters. We deliver rapid time-to-value and world-class service and support to prime defense contractors and commercial customers. MCE provides solutions to prime contractor customers on a variety of programs. MCE also provides technology building blocks to Mercury Defense Systems on key classified and unclassified programs. MCE has a legacy of embedded multi-computing and embedded sensor processing expertise. More recently, MCE has added substantial capabilities around radio frequency ("RF") and microwave technologies as well as emerging new manufacturing capabilities to bring design, production and test capabilities of our RF and microwave solutions to market on a more scalable basis.

For the three months ended September 30, 2013, MCE accounted for 79% of our total net revenues.

Mercury Defense and Intelligence Systems, or MDIS, leverages the technology building blocks developed within MCE for key solutions required by our prime contractor customers. This segment represents an aggregation of Mercury Defense Systems ("MDS") and Mercury Intelligence Systems ("MIS"). Technology building blocks from MCE are deployed as part of solutions that fall into the areas of electronic warfare ("EW"), electronic counter measures ("ECM"), signals intelligence ("SIGINT"), electro optical/infrared, and radar test and simulation. Most of this work is done with Defense Contract Audit Agency ("DCAA") oversight on behalf of one or more of our prime contractor customers and U.S. Department of Defense agencies. MDIS's products include, but are not limited to, Digital Radio Frequency Memory ("DRFM") jammers and radar environment simulators. MDIS also provides analyst and systems engineering support, also under DCAA oversight, to the intelligence community. This professional services work falls into the critical areas of Big Data processing, predictive analytics and multi-intelligence analysis. For the three months ended September 30, 2013, MDIS accounted for 21% of our total net revenues.

Since we are an OEM supplier to our commercial markets and conduct much of our business with our defense customers via commercial items, requests by customers are a primary driver of revenue fluctuations from quarter to quarter. Customers specify delivery date requirements that coincide with their need for our products. Because these customers may use our products in connection with a variety of defense programs or other projects of different sizes and durations, a customer's orders for one quarter generally do not indicate a trend for future orders by that customer. Additionally, order patterns do not necessarily correlate amongst customers and, therefore, we generally cannot identify sequential quarterly trends, even within our business units.

RESULTS OF OPERATIONS:

Three months ended September 30, 2013 compared to the three months ended September 30, 2012

The following tables set forth, for the three months periods indicated, financial data from the consolidated statements of operations:

| (In thousands) | September 30, 2013 | As a % of Total Net Revenue | September 30, 2012 | As a % of Total Net Revenue | |
|--|-----------------------|-----------------------------------|-----------------------|-----------------------------------|----|
| Net revenues | \$53,940 | 100.0 | % \$49,428 | 100.0 | % |
| Cost of revenues | 31,355 | 58.1 | 29,038 | 58.7 | |
| Gross margin | 22,585 | 41.9 | 20,390 | 41.3 | |
| Operating expenses: | | | | | |
| Selling, general and administrative | 15,101 | 28.0 | 14,533 | 29.4 | |
| Research and development | 9,344 | 17.3 | 10,039 | 20.3 | |
| Amortization of intangible assets | 2,108 | 3.9 | 1,788 | 3.6 | |
| Restructuring and other charges | (15 |) — | 4,984 | 10.1 | |
| Acquisition costs and other related expenses | — | — | 230 | 0.5 | |
| Total operating expenses | 26,538 | 49.2 | 31,574 | 63.9 | |
| Loss from operations | (3,953 |) (7.3 |) (11,184 |) (22.6 |) |
| Other income, net | 418 | 0.8 | 333 | 0.6 | |
| Loss before income taxes | (3,535 |) (6.5 |) (10,851 |) (22.0 |) |
| Tax benefit | (1,279 |) (2.4 |) (3,651 |) (7.4 |) |
| Net loss | \$(2,256 |) (4.1 |)% \$(7,200 |) (14.6 |)% |

REVENUES

| (In thousands) | September 30, 2013 | September 30, 2012 | \$ Change | % Change | |
|----------------|-----------------------|--------------------------|-----------|----------|---|
| MCE | \$43,488 | \$31,897 | \$11,591 | 36 | % |
| MDIS | 11,130 | 15,827 | (4,697) | (30) | % |
| Eliminations | (678) | 1,704 | (2,382) | (140) | % |
| Total revenues | \$53,940 | \$49,428 | \$4,512 | 9 | % |

Total revenues increased \$4.5 million, or 9%, to \$53.9 million during the three months ended September 30, 2013 as compared to the comparable period in fiscal 2013. This increase was driven by higher commercial sales of \$2.6 million, coupled with a \$1.9 million increase in defense sales. The increase in total revenues is primarily attributed to increases in the SEWIP and B-1 Bomber programs, as well as increased revenues from international customers, including foreign military sales through our prime customers and direct sales to non-U.S. based customers.

International sales increased from \$10.2 million in the three months ended September 30, 2012 to \$15.4 million for the three months ended September 30, 2013. Key programs driving the increase in international revenues were Patriot, F-16, F-15 and higher shipments to a telecommunications customer for product that was designated as end of life.

Net MCE revenues increased \$11.6 million, or 36%, during the three months ended September 30, 2013 as compared to the same period in the prior fiscal year. This increase was primarily driven by higher defense sales of \$8.9 million related to increases from the Patriot, SEWIP, F-16, F-15 and B-1 Bomber programs, partially offset by lower Joint Strike Fighter revenues, and a \$2.6 million increase in commercial sales as the result of higher shipments to a telecommunications customer for product that was designated as end of life.

Net MDIS revenues decreased \$4.7 million, or 30%, during the three months ended September 30, 2013 as compared to the same period in the previous fiscal year. This decrease was primarily driven by lower revenues from the Gorgon Stare program, as well as lower DRFM jammer and MIS revenues due to customer funding delays.

Eliminations revenue is attributable to development programs where the revenue is recognized in each segment under contract accounting, and reflects the reconciliation to our consolidated results.

GROSS MARGIN

Gross margin was 41.9% for the three months ended September 30, 2013, an increase of 60 basis points from the 41.3% gross margin achieved during the same period in fiscal 2013. The higher gross margin between years was due to a more favorable product mix and lower inventory provision. In addition, for the three months ended September 30, 2012 there was a \$0.8 million non-recurring charge for a fair value adjustment from purchase accounting resulting from the Micronetics acquisition.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased \$0.6 million, or 4%, to \$15.1 million during the three months ended September 30, 2013, compared to \$14.5 million during the comparable period in fiscal 2013. The increase was primarily due to an increase in employee stock compensation expense. Selling, general and administrative expenses decreased as a percentage of revenues to 28.0% during the three months ended September 30, 2013 from 29.4% during the same period in fiscal 2013 due to higher revenues in the first quarter of fiscal 2014 as compared to the comparable period in fiscal 2013.

RESEARCH AND DEVELOPMENT

Research and development expenses decreased \$0.7 million, or 7%, to \$9.3 million during the three months ended September 30, 2013, compared to \$10.0 million during the comparable period in fiscal 2013. The decrease was primarily due to savings related to restructuring actions initiated in fiscal 2013 that were partially offset by lower resource allocations to customer funded projects.

AMORTIZATION OF INTANGIBLE ASSETS

Amortization of acquired intangible assets increased \$0.3 million, to \$2.1 million for the three months ended September 30, 2013 as compared to \$1.8 million during the comparable period in fiscal 2013, primarily due to amortization of intangible assets from the Micronetics acquisition which was completed midway through the first

quarter of fiscal 2013.

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RESTRUCTURING EXPENSE

We implemented restructuring plans in the first and fourth quarters of fiscal 2013. These plans consisted of involuntary separation costs related to a reduction in force and facility charges for our Hudson, NH, Huntsville, AL, and Ewing, NJ sites. The plans were implemented to cope with reduced defense revenues and the near term uncertainties in the defense industry driven by the potential for sequestration. The \$5.0 million of restructuring expense recorded during the three months ended September 30, 2012 related to the elimination of 142 positions largely from our engineering, administrative and manufacturing functions.

OTHER INCOME, NET

Other income, net increased to \$0.4 million during the three months ended September 30, 2013, as compared to \$0.3 million for the same period in fiscal 2013. Other income, net consists of \$0.3 million in amortization of the gain on the sale leaseback of our corporate headquarters located in Chelmsford, Massachusetts and foreign currency exchange gains and losses. Interest income and interest expense were de minimis.

INCOME TAXES

We recorded an income tax benefit of \$1.3 million during the three months ended September 30, 2013 as compared to a \$3.7 million income tax benefit for the comparable period in the prior fiscal year. Our income tax benefit for the three months ended September 30, 2013 differed from the federal statutory tax rate of 35% primarily due to the impact of federal research and development tax credits, Section 199 manufacturing deduction and stock compensation. Our effective tax rate during the comparable period in fiscal 2013 also differed from the federal statutory rate primarily due to the impact of the Section 199 manufacturing deduction, state taxes and stock compensation.

As of September 30, 2013, we had approximately \$3.5 million in net deferred tax assets. Each quarter, we determine the probability of the realization of deferred tax assets, using significant judgments and estimates with respect to, among other things, historical operating results, expectations of future earnings and tax planning strategies. If we determine in the future that there is not sufficient positive evidence to support the valuation of these assets we may be required to further adjust the valuation allowance to reduce our deferred tax assets.

SEGMENT OPERATING RESULTS

We use adjusted EBITDA as the profitability measure for our segment reporting. Adjusted EBITDA for MCE increased \$4.5 million during the three months ended September 30, 2013 to \$2.3 million as compared to \$(2.2) million for the comparable period in fiscal 2013. The increase in adjusted EBITDA is primarily driven by higher revenues of \$11.6 million primarily from the Patriot, SEWIP, and B-1 Bomber programs, coupled with higher gross margins.

Adjusted EBITDA for MDIS decreased \$1.8 million during the three months ended September 30, 2013 to \$1.4 million as compared to \$3.2 million for the comparable period in fiscal 2013. The decrease in adjusted EBITDA was primarily due to lower revenues from the Gorgon Stare and DRFM jammer programs and corresponding gross margin due to customer funding delays.

See Note K to our consolidated financial statements included in this report for more information regarding our operating segments.

LIQUIDITY AND CAPITAL RESOURCES

Our primary source of liquidity comes from existing cash and cash generated from operations. Our near-term fixed commitments for cash expenditures consist primarily of payments under operating leases and inventory purchase commitments with our contract manufacturers. We do not currently have any material commitments for capital expenditures.

Based on our current plans and business conditions, we believe that existing cash, cash equivalents, available line of credit, cash generated from operations, and financing capabilities will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months.

Senior Unsecured Credit Facility

On October 12, 2012, we entered into a credit agreement (the "Credit Agreement") with a syndicate of commercial banks, with KeyBank National Association acting as the administrative agent. The Credit Agreement provides for a \$200.0 million senior unsecured revolving line of credit (the "Revolver"). We can borrow up to \$200.0 million based on consolidated EBITDA for the four quarters ended September 30, 2013 and subject to compliance with the financial

covenants discussed below. The Revolver is available for working capital, acquisitions, and general corporate purposes of the Company and its subsidiaries. The Revolver is available for borrowing during a five year period, with interest payable periodically during such period as provided in the Credit Agreement and principal due at the maturity of the Revolver.

The Credit Agreement has an accordion feature permitting us to request from the lenders an increase in the aggregate amount of the credit facility in the form of an incremental revolver or term loan in an amount not to exceed \$50.0 million. Any such increase would require only the consent of the lenders increasing their respective commitments under the credit facility.

The interest rates applicable to borrowings under the Credit Agreement involve various rate options that are available to us. The rates are calculated using a combination of conventional base rate measures plus a margin over those rates. The base rates consist of LIBOR rates or prime rates. The actual rates will depend on the level of these underlying rates plus a margin based on our leverage at the time of borrowing.

Borrowings under the Credit Agreement are senior unsecured loans. Each of our domestic subsidiaries is a guarantor under the Credit Agreement.

The Credit Agreement provides for conventional affirmative and negative covenants, including a maximum leverage ratio of 3.50x and a minimum interest coverage ratio of 3.0x. Each of the two ratios referred to above is calculated based on consolidated EBITDA, as defined in the Credit Agreement, on a consolidated basis for each consecutive four fiscal quarter period, after giving pro forma effect for any acquisitions or dispositions. Acquisitions are permitted under the Credit Agreement without any dollar limitation so long as, among other requirements, no default or event of default exists or would result therefore; at September 30, 2013, we are in compliance with a maximum leverage ratio of 3.25x and a minimum interest coverage ratio of 3.0x. In addition, the Credit Agreement contains certain customary representations and warranties, and events of default.

As of September 30, 2013, there was \$43.1 million of borrowing capacity available. There were no borrowings outstanding on the Credit Agreement; however, there were outstanding letters of credit of \$4.3 million. We were in compliance with all covenants and conditions under the Credit Agreement.

Shelf Registration Statement

On August 2, 2011, we filed a shelf registration statement on Form S-3 with the SEC. The shelf registration statement, which has been declared effective by the SEC, registered up to \$500 million of debt securities, preferred stock, common stock, warrants and units. We intend to use the proceeds from a financing using the shelf registration statement for general corporate purposes, which may include the following:

- the acquisition of other companies or businesses;
- the repayment and refinancing of debt;
- capital expenditures;
- working capital; and
- other purposes as described in the prospectus supplement.

CASH FLOWS

| (In thousands) | As of and for the period ended September 30, | |
|--|--|-------------|
| | 2013 | 2012 |
| Net cash provided by (used in) operating activities | \$2,173 | \$(9,949) |
| Net cash used in investing activities | \$(1,108) | \$(68,966) |
| Net cash used in financing activities | \$(61) | \$(6,479) |
| Net increase (decrease) in cash and cash equivalents | \$980 | \$(85,396) |
| Cash and cash equivalents at end of period | \$40,106 | \$30,568 |

Our cash and cash equivalents increased by \$1.0 million from June 30, 2013 to September 30, 2013, primarily as a result of \$2.2 million in cash generated from operating activities, partially offset by \$1.1 million in purchases of property and equipment.

Operating Activities

During the three months ended September 30, 2013, we generated \$2.2 million in cash from operating activities compared to \$9.9 million in cash used for operating activities during the same period in fiscal 2013. The \$12.1 million increase in cash generated by operating activities was primarily a result of a smaller comparable net loss of \$4.9 million, \$4.8 million in lower inventory purchases, and a \$3.1 million decrease in cash used for payables and accrued

expenses. These increases in cash generated from operations were partially offset by \$2.5 million in higher accounts receivable. Our ability to generate cash from

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operations in future periods will depend in large part on profitability, the rate and timing of collections of accounts receivable, our inventory turns and our ability to manage other areas of working capital.

Investing Activities

During the three months ended September 30, 2013, we used cash of \$1.1 million in investing activities compared to \$69.0 million used by investing activities during the same period in fiscal 2013. The \$67.9 million decrease in cash used in investing activities was driven by \$67.7 million of cash spent on the Micronetics acquisition during the three months ended September 30, 2012.

Financing Activities

During the three months ended September 30, 2013, we used \$0.1 million for financing activities compared to \$6.5 million used for financing activities during the same period in fiscal 2013. The \$6.4 million change in cash from financing activities was primarily due to a \$6.6 million payment to settle debt acquired as part of the Micronetics acquisition during the three months ended September 30, 2012.

COMMITMENTS AND CONTRACTUAL OBLIGATIONS

The following is a schedule of our commitments and contractual obligations outstanding at September 30, 2013:

| (In thousands) | Total | Less Than 1 Year | 2-3 Years | 4-5 Years | More Than 5 Years |
|-------------------------------------|----------|---------------------|--------------|--------------|----------------------|
| Purchase obligations | \$17,373 | \$17,373 | \$— | \$— | \$— |
| Operating leases | 24,652 | 4,892 | 8,745 | 4,641 | 6,374 |
| Capital lease obligations and other | 633 | 419 | 209 | 5 | — |
| | \$42,658 | \$22,684 | \$8,954 | \$4,646 | \$6,374 |

We have a liability at September 30, 2013 of \$2.9 million for uncertain tax positions, not included in the table above, that has been taken or is expected to be taken in various income tax returns. We expect to make a payment of \$0.7 million in the next twelve months as a result of resolutions of certain tax positions.

Purchase obligations represent open non-cancelable purchase commitments for certain inventory components and services used in normal operations. The purchase commitments covered by these agreements are for less than one year and aggregated approximately \$17.4 million at September 30, 2013.

Our standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with certain intellectual property infringement claims by any third party with respect to our products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments we could be required to make under these indemnification provisions is, in some instances, unlimited.

OFF -BALANCE SHEET ARRANGEMENTS

Other than our lease commitments incurred in the normal course of business and certain indemnification provisions, we do not have any off- balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not consolidated in the financial statements. Additionally, we do not have an interest in, or relationships with, any special purpose entities.

NON-GAAP FINANCIAL MEASURES

In our periodic communications, we discuss two important measures that are not calculated according to U.S. generally accepted accounting principles (“GAAP”), adjusted EBITDA and free cash flow.

Adjusted EBITDA, the profitability measure for our segment reporting, is defined as net income (loss) before interest income and expense, income taxes, depreciation, amortization of acquired intangible assets, restructuring, impairment of long-lived assets, acquisition costs and other related expenses, fair value adjustments from purchase accounting and stock-based compensation costs. We use adjusted EBITDA as an important indicator of the operating performance of our business. We use adjusted EBITDA in internal forecasts and models when establishing internal operating budgets, supplementing the financial results and forecasts reported to our board of directors, determining a component of bonus compensation for executive officers

and other key employees based on operating performance and evaluating short-term and long-term operating trends in our operations. We believe the adjusted EBITDA financial measure assists in providing a more complete understanding of our underlying operational measures to manage our business, to evaluate our performance compared to prior periods and the marketplace, and to establish operational goals. We believe that these non-GAAP financial adjustments are useful to investors because they allow investors to evaluate the effectiveness of the methodology and information used by management in our financial and operational decision-making.

Adjusted EBITDA is a non-GAAP financial measure and should not be considered in isolation or as a substitute for financial information provided in accordance with GAAP. This non-GAAP financial measure may not be computed in the same manner as similarly titled measures used by other companies. We expect to continue to incur expenses similar to the adjusted EBITDA financial adjustments described above, and investors should not infer from our presentation of this non-GAAP financial measure that these costs are unusual, infrequent or non-recurring.

The following table reconciles our net loss, the most directly comparable GAAP financial measure, to our adjusted EBITDA:

| (In thousands) | Three Months Ended September 30, | |
|---|-------------------------------------|-------------|
| | 2013 | 2012 |
| Net loss | \$ (2,256) | \$ (7,200) |
| Interest expense, net | 14 | 6 |
| Tax benefit | (1,279) | (3,651) |
| Depreciation | 2,012 | 2,211 |
| Amortization of intangible assets | 2,108 | 1,788 |
| Restructuring and other charges | (15) | 4,984 |
| Acquisition costs and other related expenses | — | 230 |
| Fair value adjustments from purchase accounting | — | 925 |
| Stock-based compensation cost | 3,035 | 2,345 |
| Adjusted EBITDA | \$3,619 | \$1,638 |

Free cash flow, a non-GAAP measure for reporting cash flow, is defined as cash provided by operating activities less capital expenditures for property and equipment. We believe free cash flow provides investors with an important perspective on cash available for investments and acquisitions after making capital investments required to support ongoing business operations and long-term value creation. We believe that trends in our free cash flow are valuable indicators of our operating performance and liquidity.

Free cash flow is a non-GAAP financial measure and should not be considered in isolation or as a substitute for financial information provided in accordance with GAAP. This non-GAAP financial measure may not be computed in the same manner as similarly titled measures used by other companies. We expect to continue to incur expenditures similar to the free cash flow adjustment described above, and investors should not infer from our presentation of this non-GAAP financial measure that these expenditures reflect all of our obligations which require cash.

The following table reconciles cash provided by operating activities, the most directly comparable GAAP financial measure, to free cash flow:

| (In thousands) | Three Months Ended September 30, | |
|---|-------------------------------------|--------------|
| | 2013 | 2012 |
| Cash provided by (used in) operating activities | \$2,173 | \$ (9,949) |
| Capital expenditures | (1,108) | (980) |
| Free cash flow | \$1,065 | \$ (10,929) |

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In July 2013, the FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, an amendment of the FASB Accounting Standards Codification. The ASU requires an unrecognized tax benefit to be presented as a decrease in a deferred tax asset when net operating loss carryforwards, similar tax losses, or tax credit carryforwards exist and

certain criteria are met. The

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ASU is effective prospectively for annual reporting periods beginning after December 15, 2013. This guidance is not expected to have a material impact to our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There were no material changes in our exposure to market risk from June 30, 2013 to September 30, 2013.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

We conducted an evaluation under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively), regarding the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2013. We continue to review our disclosure controls and procedures and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our Company's business. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

(b) Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rules 13c-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to litigation, claims, investigations and audits arising from time to time in the ordinary course of our business. Although legal proceedings are inherently unpredictable, we believe that we have valid defenses with respect to those matters currently pending against us and intend to defend our self vigorously. The outcome of these matters, individually and in the aggregate, is not expected to have a material impact on our cash flows, results of operations, or financial position.

ITEM 1A. RISK FACTORS

You should carefully review and consider the information regarding certain factors that could materially affect our business, financial condition or future results set forth under Item 1A (Risk Factors) in our Annual Report on Form 10-K for the fiscal year ended June 30, 2013. There have been no material changes from the factors disclosed in our 2013 Annual Report on Form 10-K filed on August 16, 2013, although we may disclose changes to such factors or disclose additional factors from time to time in our future filings with the Securities and Exchange Commission.

ITEM 6. EXHIBITS

The following Exhibits are filed or furnished, as applicable, herewith:

- | | |
|-------|---|
| 31.1 | Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1+ | Certification of the Company's Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | The following materials from the Company's Quarterly Report on the Form 10-Q for the quarter ended September 30, 2013 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Cash Flows; and (iv) notes to the Consolidated Financial Statements |

Furnished herewith. This certificate shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, nor shall it be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

MERCURY SYSTEMS, INC.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Chelmsford, Massachusetts, on November 7, 2013.

MERCURY SYSTEMS, INC.

By: /S/ KEVIN M. BISSON
 Kevin M. Bisson
 Senior Vice President,
 Chief Financial Officer, and Treasurer

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