



Houston,
we have a
problem!

Mercury Systems Inc. | NASDAQ: MRCY

INVESTMENT RESEARCH REPORT

"Systems Failure"

RECOMMENDATION: *Strong Sell Opinion*

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Absent sufficient explanations from Mercury's CEO about its connection to the SEWIP cost overrun allegations, and its inability to generate free cash flow growth in the past three years while claiming 112% Adj. EBITDA growth, we believe the CEO of Mercury should resign, just like its CFO, Chief Accounting Officer and Treasurer did in Sept 2017 and Feb 2018.

Spruce Point Capital Is An Industry Recognized Research Activist Investment Firm Founded In 2009

- Founded by Ben Axler, a former investment banker with 17 years experience on Wall Street
- Ranked the #1 Short-Seller in the world by [Sumzero](#) after a comprehensive study of 12,000 analyst recommendations dating back to 2008 (March 2015)
- Ranked the #13 Most Influential FinTweeter on Twitter according to [Sentieo analysis](#) (Dec 2016)

CEO Departures Post Recent Spruce Point Research Activism

Report Date	Company / Ticker	Enterprise Value At Report Date (\$ billions)	CEO Departure / Date
7/13/17	Gentex / GNTX	\$4.7	Fred Bauer / Jan 2018
4/13/16	Sabre Corp / SABR	\$11.2	Tom Klein / June 2016
12/17/15	Intertain / IT.TO	\$1.5	John FitzGerald / Feb 2016
8/19/15	Caesarstone / CSTE	\$1.7	Yos Shiran / May 2016
2/10/15	Greif / GEF	\$3.2	David Fischer / Oct 2015
11/13/14	AMETEK / AME	\$14.0	Frank Hermance / May 2016
1/15/14	LKQ Corp / LKQ	\$11.8	Robert Wagman / March 2017
3/5/13	Boulder Brands / BDBD	\$1.0	Stephen Hughes / June 2015
6/14/12	Bazaarvoice / BV	\$1.2	Bret Hurt / Nov 2012



Executive Summary

Spruce Point Believes Mercury Systems (Nasdaq: MRCY) Is A “Strong Sell”

Mercury appears to be caught in the perfect storm of slowing growth, rising costs and debt. There are multiple material adverse changes currently facing Mercury which suggest 50% to 85% downside risk (\$7 to \$23 per share).

Numerous High Level Signs That Mercury Is Under Extreme Financial Pressures:

- Mercury’s Adj. EBITDA margins of 23.4% are extremely high for a government subcontractor, and have grown 450bps in the last three fiscal years, allowing Adj. EBITDA to balloon 112% while its free cash flow grew zero over the same period. Free cash flow is now trending down over the last 12 months. Days inventory and its cash collection cycle are near all-time highs; accounts receivables recently started to exceed sales
- Management’s annual cash bonuses are based solely on Adj. EBITDA, providing material incentive to inflate this financial metric
- Historically, radar systems is Mercury’s largest business, but now appears to be declining, while “Other Revenues” is the fastest growing segment. Mercury changed its financial presentation to bolster gross margins, while guidance for gross margins has quietly been talked down. For the first time in Q2’18, Mercury missed its gross margin (and EPS) target
- Mercury uses three different accounting methods for sales, but appears to be moving towards greater use of complex, subjective methods tied to percentage of completion accounting, an area notorious for accounting issues in the Aerospace & Defense industry
- Mercury sells itself as growing revenues organically 9.5% (double its end markets), yet we find evidence these results are not sustainable and growth may slow to 6.5% in CY 2018. Mercury announced the purchase of Themis Computer on Dec 21, 2017 (four days ahead of Christmas). It paid a rich 13.7x EBITDA multiple, and borrowed \$189m on its line of credit. In our opinion, the deal appears motivated to avoid missing Wall Street’s expectations. Consistent with prior practice, we expect Mercury to issue stock to pay down its line of credit, which at the current share price, amounts to 4m new shares
- Mercury added one sentence to its latest 10-K to disclose it expects to lose its Small Business status in FY 2018, a factor that will cause a Material Adverse Effect by disqualifying it from certain business opportunities and increasing costs of compliance

Newly Declassified DoD Inspector General Report Validates Problems At SEWIP Block 3, Mercury’s Material Business Program:

- Three of seven allegations against SEWIP 3 prime Northrop Grumman related to cost overruns have been validated by investigators, and two other allegations have been partially validated. Material cost overruns may suggest sales overstatement at Mercury
- Mercury talked about SEWIP Block 3 adding >\$140m of revenues and that it is a material driver of its results. Mercury has warned that the loss of SEWIP would have a Material Adverse Effect on its business. We find material inconsistencies between management statements and SEC disclosures on recent SEWIP revenue contributions
- Management enacted a 10b5-1 stock sale program in August 2017 (not disclosed until Oct 2017), ahead of the Inspector General audit report in Nov 2017

Spruce Point Believes Sees 50% To 85% Downside Risk To Mercury's Shares

Mercury's Fmr. CFO Was EVP Strategic Affairs, Chief Legal Officer, and Secretary At Cabletron/Enterasys Networks A Business Fraud

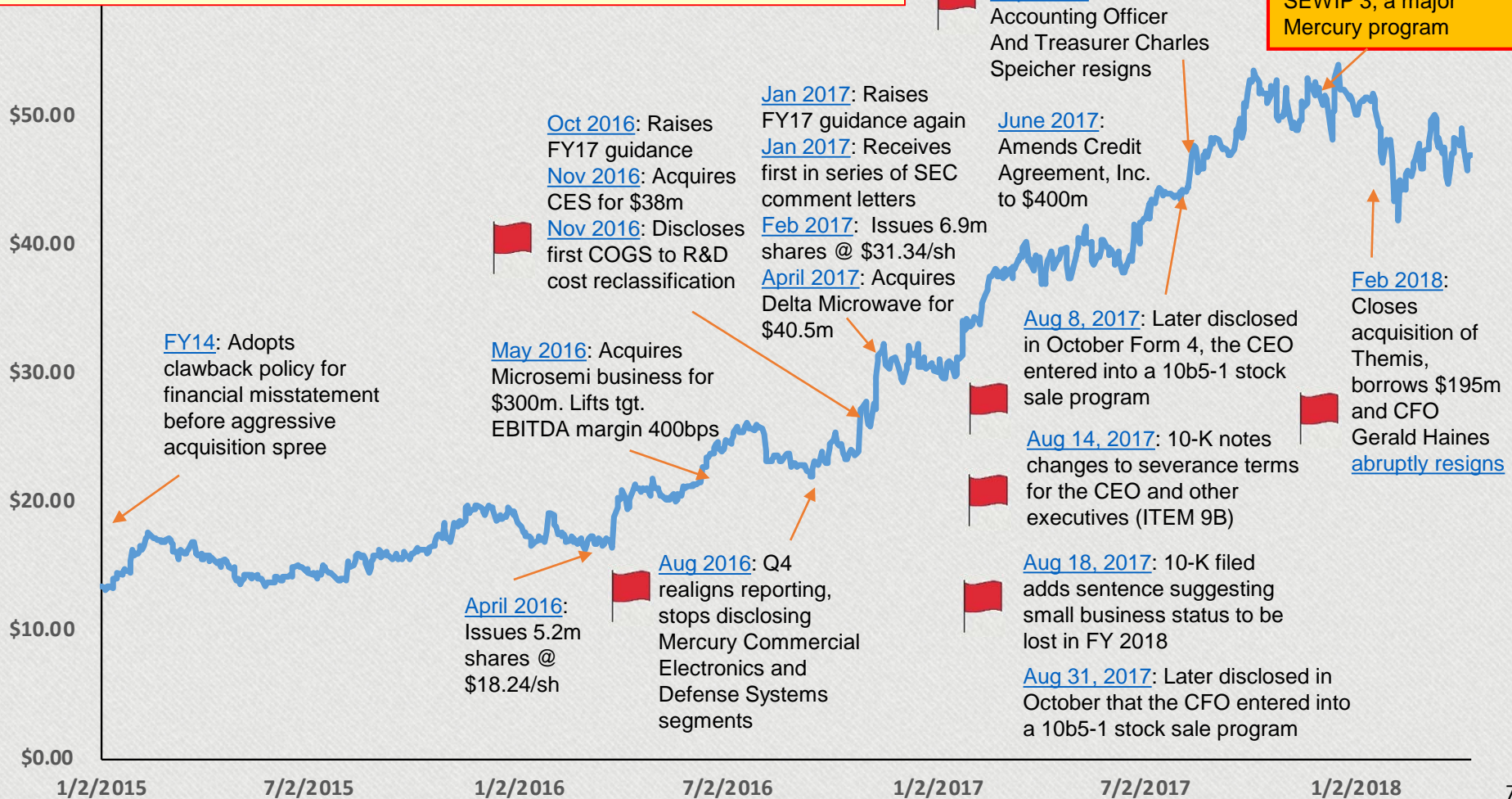
- Mercury recently moved its headquarters into the exact same office where the Cabletron/Enterasys fraud unfolded
- Mercury's long-time CFO Gerald Haines omits from his biography that he was the Chief Legal Officer and Secretary at Cabletron, making him a named executive and Board member. He abruptly resigned from Mercury in Feb 2018 after the closing of the Themis deal. Four of his colleagues at Cabletron were sentenced to prison, but Haines was not implicated
- In Sept 2017, Mercury's Chief Accounting Officer and Treasurer also abruptly resigned. Shortly before, and for the first time, Mercury's proxy statement revealed a new anonymous hotline, email and website for reporting accounting concerns
- In Aug 2017, subtle changes to executive severance agreements were made to define conditions for termination for "Cause" and called out "Fraud" and "Dishonesty"
- Mercury's audit fees per \$ of sales and employee are the highest in the Aerospace & Defense industry, adding to our concerns of potential issues. The Audit Committee is chaired by William O'Brien, a colleague of the CEO dating back to 2003

Analysts See 25% Upside In Mercury, But Miss Key Material Risks, And Take Results At Face Value. We See 50% - 85% Downside:

- Mercury lacks meaningful institutional support from fundamental owners. Many have been decreasing ownership over time, while passive index buyers accumulate Mercury for its exposure to the Aerospace & Defense industry
- Mercury's 2018E valuation of 4.7x, 19.3x and 31.5x sales, Adj. EBITDA and Adj. EPS is the highest in the Aerospace & Defense industry for peers over \$1.5bn in value, and its multiple is stretched near all-time highs. Analysts assume its financials are fairly stated, and that it can achieve 16% and 10% sales and EPS growth in CY 2018. However, with issues at SEWIP, loss of its Small Business status, and the recent acquisition of Themis, we estimate actual organic growth is set to decline significantly in CY 2018
- Mercury's leverage should come into focus for investors. Having borrowed nearly \$190m on its line of credit, and expanded its operations to materially increase its operating leases, we estimate Net Debt / Adj EBITDAR of 1.5x. However, investors are better served looking at its debt load relative to its thin free cash flow. We estimate Net Debt / Free cash flow of 7.7x
- Given our accounting concerns that Adj. EBITDA is not reflecting Mercury's underlying economics, we believe Mercury should be valued on its stagnant free cash flow, which at a 20x-25x multiple, justifies 75% - 85% downside. Alternatively, taking sales at face value and applying a normal multiple to reflect its reduced organic growth, we arrive at 50% - 75% downside

Mercury's Share Price Appreciation Merits Significant Scrutiny

Spruce Point has identified too many red flags as it relates to Mercury's meteoric 230%+ share price appreciation since 2015. Its significant EBITDA growth without corresponding cash flow growth should be evaluated relative to abrupt executive departures, insider selling, and a federal gov't investigation of SEWIP, a material program to Mercury's financial results



Capital Structure and Valuation

Mercury is currently borrowing on its credit facility to fund the acquisition of Themis Computer, which closed on February 1, 2018. Consistent with prior deal funding practices, we expect the Company to issue equity, which would dilute investors with 4 million new shares. Our report will illustrate that Mercury's valuation is the highest in the Aerospace & Defense industry on the belief that its industry leading Adjusted EBITDA margins are fairly stated, and its organic growth can continue at high single, low double digits per management's comments. Our critical forensic analysis will suggest otherwise. We think investors should focus on its free cash flow, which is trending down, while its leverage is rising meaningfully.

\$ in mm, except per share figures

		Street Valuation (CY)	2017A	2018E	2019E
Stock Price	\$46.00	EV / Sales	5.3x	4.7x	4.1x
Shares Outstanding	48.2	EV / Adj. EBITDA	22.6x	19.4x	16.8x
Market Capitalization	\$2,219.2	Price / Adj. EPS	36.4x	31.5x	28.6x
\$400m Credit Facility due 2022 (1)	\$188.9	Price / Book	3.0x	--	
Total Debt Outstanding	\$188.9	Growth and Margins	2017A	2018E	2019E
Less: Cash and Equivalents (1)	\$40.9	Sales Growth	31.7%	12.1%	16.2%
Enterprise Value	\$2,367.1	SP Est. Organic Growth (2)	N/A	6.5%	--
		Adj. EBITDA Margin	23.4%	24.4%	24.2%
Operating Leases (3)		Free Cash Flow Margin	5.5%	5.5%	--
Add: PV of Operating Leases	\$61.2	Adj. EPS Growth	19.9%	15.4%	10.3%
Adjusted Debt	\$250.1	Credit Metrics	2017A	2018E	2019E
		Net Debt / Adj. EBITDA	--	1.2x	1.1x
		Adj Net Debt / Adj. EBITDAR		1.5x	1.5x
		Net Debt / SP Est. Free Cash Flow	--	5.4x	5.4x
		Adj. Net Debt / SP Est. Free Cash Flow	--	7.7x	7.7x

Source: Company financials and Wall St. Research Estimates

Note: Figures Calendarized for Dec 31st year end. Mercury FY ends June 30th

- 1) Pro forma for Themis Computer acquisition ([source](#))
- 2) Estimated below long-term trend of 9.5%
- 3) Mercury significantly increased its reported operating leases from \$43.3m to \$70.2m between June 30th and Dec 31, 2017, which we discount at 3%. We estimate incremental rent expense \$1.8m (including \$0.8m for Themis)

Mercury's Now \$190m In Debt And Beholden To Its Creditors

Mercury amended its credit facility in June 2017 to increase its revolver to \$400m, and made certain reps and warranties that its financial statements were accurate, and post closing, there were no material adverse effects. Our research questions the accuracy of Mercury's financials, and provides evidence that indicates Mercury is experiencing material adverse changes related to SEWIP, its largest revenue program, and the upcoming loss of its Small Business status.

Since signing this agreement both Mercury's CFO, Chief Accounting Officer and Treasurer resigned.

Section 6.05. Financial Statements.

(a) The Annual Financial Statements fairly present in all material respects the financial condition of the Borrower and its Subsidiaries, as of the date thereof and their results of operations for the period covered thereby in accordance with GAAP consistently applied throughout the period covered thereby, except as otherwise expressly noted therein.

(b) The Quarterly Financial Statements fairly present in all material respects the financial condition of the Borrower and its Subsidiaries, as of the date thereof and their results of operations for the period covered thereby, in accordance with GAAP consistently applied throughout the period covered thereby, except as otherwise expressly noted therein and subject to the absence of footnotes and to normal year-end audit adjustments.

Section 6.06. No Material Adverse Effect. Since the Closing Date, there has been no event or circumstance, either individually or in the aggregate, that has had or could reasonably be expected to have a Material Adverse Effect.

Mercury Systems Connection To Enterasys Networks, A Former Fraud

Three key members of Mercury came from Enterasys Networks (formerly Cabletron), where they were credited with turning around the troubled company and selling it to Gores in 2006 ([source](#)). Many Enterasys executives went to jail and others settled with the SEC. Mercury's recently resigned CFO, Gerald Haines, worked at Enterasys prior to the scandal unfolding as its Chief Legal Officer and Secretary, which he omits from his biography.

It is unusual that Mercury management recently decided to move offices back into the site of Enterasys ([source](#))

ENTERASYS NETWORKS INC /DE/ CIK#: 0000846909 (see all company filings)

SIC: 3576 - COMPUTER COMMUNICATIONS EQUIPMENT
State location: MA | State of Inc.: DE | Fiscal Year End: 0101
formerly: CABLETRON SYSTEMS INC (filings through 2001-01-16)
(Assistant Director Office: 3)
Get **insider transactions** for this issuer.

Business Address
50 MINUTEMAN ROAD
ANDOVER MA 01810
978-684-1000

Mailing Address
50 MINUTEMAN ROAD
ANDOVER MA 01810

[Source](#)

MERCURY SYSTEMS INC CIK#: 0001049521 (see all company filings)

SIC: 3670 - ELECTRONIC COMPONENTS & ACCESSORIES
State location: MA | State of Inc.: MA | Fiscal Year End: 0630
formerly: MERCURY COMPUTER SYSTEMS INC (filings through 2012-11-13)
(Assistant Director Office: 10)
Get **insider transactions** for this issuer.

Business Address
50 MINUTEMAN ROAD
ANDOVER MA 01810
9782561300

Mailing Address
50 MINUTEMAN ROAD
ANDOVER MA 01810

[Source](#)

- Many executives from [Cabletron](#) and [Enterasys](#) went to prison for fraud and received [SEC complaints](#)
- None of Mercury's executives who came from Enterasys were implicated
- CEO Aslett and Director O'Brien joined after the scandal unfolded
- **However, Mercury's former CFO Haines was the Chief Legal Officer, working along side convicted felons [Fiallio](#) and [Gagalis](#)**

Current Mercury Executive	Tenure at Enterasys		Notes
	Appointed	Ending	
Gerald Haines Recent Former CFO	2000	2006	<ul style="list-style-type: none"> • Haines' bio discloses he worked at Cabletron and Enterasys Networks, while his Linkedin bio omits the Cabletron reference or that he was Chief Legal Officer (a named executive) and Secretary • He was EVP and General Counsel (Chief Legal Officer) of Enterasys/Cabletron from 2000-2001 during the early part of the Enterasys scandal unwinding • Haines resigned from Mercury abruptly after closing Themis (Feb 2018) • Note: Haines, a lawyer by background, had always served as General Counsel at prior jobs (Verenium, Enterasys, Applied Extrusion Tech), never as the appointed CFO
Mark Aslett CEO	April 2003	2006	<ul style="list-style-type: none"> • Joined Enterasys as President, and was COO and CEO from 2003-2006 • Was on the Board from 2004 – 2006 (source)
William K O'Brien Audit Committee Chair	April 2002	2004	<ul style="list-style-type: none"> • Spent over 30yrs as an accountant at PWC • Was appointed CEO of Enterasys in 2002 and later Executive Chairman from 2003-2006 (source)

Spruce Point Calls To The Board For A Fresh Review of Mercury's Financials

Mercury's Board needs fresh independent eyes. Mercury's auditor KPMG has been at the helm for 10yrs and **being paid abnormally high fees**. The Audit Committee chair Mr. O'Brien is a long-time colleague of CEO Aslett. We are asking Mercury's newest Board member, Under Secretary of the Air Force, Ms. Lisa Disbrow for her objective review.



April 18, 2018

Dear Ms. Disbrow:

As the newest member of Mercury Systems, Inc. ("Mercury" or "the Company") Board of Directors, and a member of the Audit Committee, Spruce Point Capital Management urges you to take a close look at the accuracy of the public statements made by Mercury's management, and the financial statements filed with the Securities and Exchange Commission (SEC).

We believe that shareholders and the investing public require a fresh and independent set of eyes to examine Mercury. To illustrate, KPMG has been Mercury's auditor for over a decade, having been appointed in 2006 when PwC notified the Company of its resignation. Mr. William O'Brien has chaired the Audit Committee since 2011, and was a former colleague of CEO Mark Aslett dating back to their work together at Enterasys Networks in 2003. Given the abnormally high fees being paid to KPMG, and close relationship between Mr. O'Brien and Mr. Aslett, we believe now is the time for an objective and independent review of Mercury's financial statements.

Spruce Point's concerns about Mercury Systems are a result of recently conducted external forensic financial investigation based on publicly available information. Our key concerns are outlined as follows:

1. Mercury has embarked on an aggressive acquisition spree starting in FY 2015. During this period, Mercury has promoted Adjusted EBITDA as a key metric of its financial performance to investors. Adjusted EBITDA has risen from \$44.4m at 6/30/15 to \$104.7m in the LTM 12/31/17 – representing remarkable growth of 136%. During the same period, free cash flow has declined from \$26.2m to \$24.7m or -5.7%. Why is Mercury's Adjusted EBITDA not translating into free cash flow? Does the fact that Mercury's Compensation Committee ties management's annual bonus solely to Adjusted EBITDA margin provide abnormal incentives for management to manipulate this metric to extract bonuses?
2. Mercury has engaged in various changes to its financial presentation and reporting. Notably, research and development costs were reclassified from cost of goods sold to improve reported gross margins. This was done ahead of repeated contractions to gross margins and reduction to gross margin forecasts
3. In June 2017, Mercury amended its Credit Agreement with various banking institutions to increase its line of credit to \$400m. During this process, Mercury attested its financial statements were prepared in accordance with GAAP, and that it was not aware of any event or circumstance that could have a Material Adverse Effect on the business
4. In September 2017, Charles Speicher, Mercury's long-time Chief Accounting Officer and Treasurer resigned. Shortly before, the proxy statement revealed new methods to anonymously report accounting concerns. Is this pure coincidence or is something nefarious occurring that the public should be aware of?
5. In October 2017, various Form 4 filings filed with the SEC revealed that management (including the CEO, CFO, and COO) entered into a 10b5-1 stock sale program. We are alarmed that this stock sale program was established in early August 2017, ahead of the Annual Report that disclosed Mercury risks losing its small business status in FY 2018 – a fact that could have a Material Adverse Effect on the business



Evidence of Financial Struggles

Recent Deal Activity Picking Up

Mercury has been growing through the acquisitions of small companies and does not often disclose EBITDA contributions. The most recent acquisition of Themis caught our attention because of the large valuation multiple, and sudden resignation of the CFO just after the deal closing. The Themis deal was also announced on Dec 21, 2017 right near Christmas, which may indicate the urgency with which Mercury needed an acquisition to cover its increasingly apparent financial shortfalls.

Mercury Key Acquisitions

\$ in millions

Deal Close	Quarter	Target	Business Segment	Deal Value	Form	Est. Sales	Est. EBITDA	EBITDA Margin	EV/Sales	EV/EBITDA	Synergies
2/1/18	Q3'18	Themis Computer	Designer, manufacturer and integrator of commercial, SWaP-optimized rugged servers, computers and storage systems for U.S. and international defense programs	\$180.0	Cash	\$57.0	\$13.1	23.0%	3.2x	13.7x	\$1m of cost synergies
7/3/17	Q1'18	Richland Tech	Safety-critical and high integrity systems, software, and hardware development as well as safety-certification services for mission-critical applications	NA	Cash	NA	NA	NA	NA	NA	NA
4/3/17	Q4'17	Delta Microwave	Designer and manufacturer of high-value radio frequency (RF), microwave and millimeter wave subassemblies and components for military and space markets	\$40.5	Cash	\$12.8	NA	NA	3.2x	NA	\$2.5 cost synergies
11/4/16	Q2'17	Creative Electronic Systems	Provider of embedded solutions for military and aerospace mission-critical computing applications	\$38.0	Cash	\$23.0	NA	NA	1.7x	NA	NA
5/2/16	Q3'16	Microsemi Carve-Out	Embedded security, RF and microwave, and custom microelectronics businesses from Microsemi	\$300.0	Debt/ New Equity	\$100.0	\$28.0	28%	3.0x	10.7x	\$10m cost synergies by 2020
12/16/15	Q2'16	Lewis Innovative Technologies	Technologies and services focused on secure embedded processing for defense and commercial applications	\$9.7	Cash	NA	NA	NA	NA	NA	NA
Total Acquisitions and Blended Average				\$568.2	--	\$192.8	\$41.1	21.3%	2.9x	13.8x	\$10m

On The Surface, Reported Organic Revenue Growth Looks Good

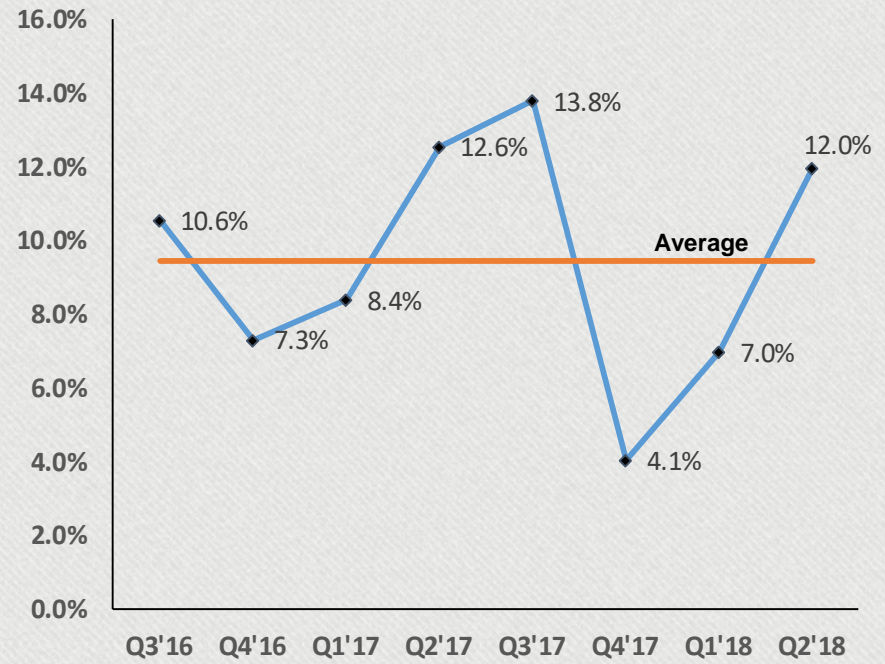
Mercury is selling investors on its organic growth that is growing at 2x the rate of its end markets. Mercury claims it is gaining market share and that it expects high single digit, low double digit organic growth to continue. (1)(2) However, we will lay out the case that organic growth is set to contract, and has not been translating into cash flow.

Long-Term Estimated Growth In Mercury's End Markets Approximately 4.8% (3)

Mercury's Reported Organic Revenue Growth Is Averaging 9.5%; Double Its End Market And Surged In Q2'18

Aerospace & Defense Platform and Systems Electronics Content

	C4I			Sensor & Effector Mission Systems				
	Platform & Mission Mgmt	C2I	Comms	EW	Radar	EO/IR	Acoustics	Weapons
2018 Market (\$B)	\$26.3B	\$29.3B	\$12.5B	\$8.1B	\$8.0B	\$9.3B	\$3.6B	\$5.6B
2018 Market (\$B)	\$6.8B	\$6.2B	\$4.7B	\$4.3B	\$4.2B	\$2.4B	\$1.1B	\$2.6B
2018 Market (\$B)	2.3%	3.3%	3.0%	5.0%	4.4%	2.2%	6.1%	4.2%
2018 Market (\$B)	3.5%	4.9%	4.5%	6.1%	5.5%	3.5%	7.3%	5.3%
2018 Market (\$B)	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR



Source: Mercury financial statements

Source: [Mercury Investor Day presentation](#), 11/7/17
 1) [Q1'18 earnings conference call](#), 10/24/17
 2) Statement made at the Baird conference 11/8/17
 3) Weighted average across categories

Evidence To Suggest Mercury's Reduced Market Visibility, Slowing Growth

Mercury recently omitted a key slide about long-term end market growth it expects in key verticals (bottom left). Instead, it prefers to show where it is acquiring businesses. We believe that by excluding the recent acquisition of Themis and Delta Microwave, Mercury's organic growth will decline in CY 18 below trend to approximately 6.5% (1)

Notice That Mercury Recently Gave Long-Term End Market Guidance To Investors As of Nov 2017

Notice Now How Mercury Excludes Slide To Left In March 2018, Favoring Acquisitions and Obscures Market Growth

Aerospace & Defense Platform and Systems Electronics Content								
C4I			Sensor & Effector Mission Systems					
Platform & Mission Mgmt	C2I	Comms	EW	Radar	EO/IR	Acoustics	Weapons	
Avionics / Vetronics	Command & Control / Battle Management	Dedicated Communications	Electronic Warfare	Radar	Electro-Optical/ Infrared	Acoustics	Missiles/ Munitions	
Control & operation of platform & mission systems	Processing & exploitation of information	Dissemination of information	Offensive / defensive exploitation of EM spectrum	Use of RF signal to detect, track, ID	Thermo-graphic camera with video output	Sound pulses to determine object location	Seekers, HEL, HPM Naval Launched Air Launched	
2018 Tier 2* Market (\$B)	\$26.3B	\$29.3B	\$12.5B	\$8.1B	\$8.0B	\$9.3B	\$3.6B	\$5.6B
2018 Tier 2* Market (\$B)	2.3%	3.3%	3.0%	5.0%	4.4%	2.2%	6.1%	4.2%
'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR
2018 Tier 2* Market (\$B)	\$6.8B	\$6.2B	\$4.7B	\$4.3B	\$4.2B	\$2.4B	\$1.1B	\$2.6B
2018 Tier 2* Market (\$B)	3.5%	4.9%	4.5%	6.1%	5.5%	3.5%	7.3%	5.3%
'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR

Notes:
*Tier 2 includes Embedded computing and subsystems with RF content. Includes US Government and Global Commercial Aerospace Markets
Sources: RSAdvisors research & analysis

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Aerospace & Defense Platform and Systems Electronics Content								
C4I			Sensor & Effector Mission Systems					
Platform & Mission Mgmt	C2I	Comms	EW	Radar	EO/IR	Acoustics	Weapons	
Avionics / Vetronics	Command & Control / Battle Management	Dedicated Communications	Electronic Warfare	Radar	Electro-Optical/ Infrared	Acoustics	Missiles/ Munitions	
Control & operation of platform & mission systems	Processing & exploitation of information	Dissemination of information	Offensive / defensive exploitation of EM spectrum	Use of RF signal to detect, track, ID	Thermo-graphic camera with video output	Sound pulses to determine object location	Seekers, HEL, HPM Naval Launched Air Launched	
2018 Tier 2* Market (\$B)	THEMIS	THEMIS	THEMIS	MICRONETICS	DELTA MICROWAVE	\$9.3B	\$3.6B	
2018 Tier 2* Market (\$B)	CES	CES	CES	KOR ELECTRONICS	LNK	2.2%	6.1%	
'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	
2018 Tier 2* Market (\$B)	RNL	DELTA MICROWAVE	ECHOTEX CORP.	MICROSEMI		\$2.4B	\$1.1B	MICROSEMI
2018 Tier 2* Market (\$B)						3.5%	7.3%	
'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	'18-22 CAGR	

Notes:
*Tier 2 includes Embedded computing and subsystems with RF content. Includes US Government and Global Commercial Aerospace Markets
Sources: RSAdvisors research & analysis
(1) Represents carve-out acquisition from Microsemi Corp.

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Source: Mercury Investor Day presentation, 11/7/17

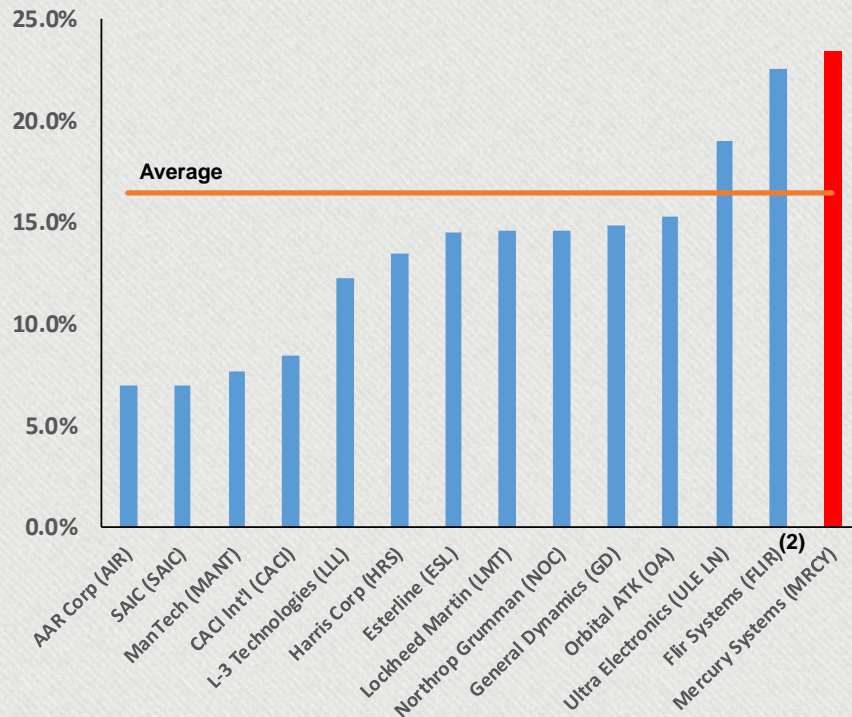
Source: Mercury Investor Presentation, 3/1/18

1) Mercury's CY 2017 reported revenues of \$446.9m are reduced by \$28.5m [Delta Microwave (\$9.5m, closed on 4/3/17) and Creative (\$19m, closed 11/2/16)]. Pro forma CY 2017 revenues excluding acquisitions are \$418.4m Themis CY 2017 revenues estimated at \$57m by Mercury and the deal closed 2/1/18. Wall St CY 2018 estimates for MRCY are \$501m. Removing \$52m of Themis revenue contribution and \$3.2m of Delta contribution equals \$445.7m of CY 2018 revenues. Therefore, pro forma organic revenue growth is estimated as $(\$445.8/\$418.4)-1 = 6.5\%$. Note: Analysis conservatively assumes no growth in Themis CY 2018 sales and excludes the small Richland acquisition which Mercury has not disclosed sales.

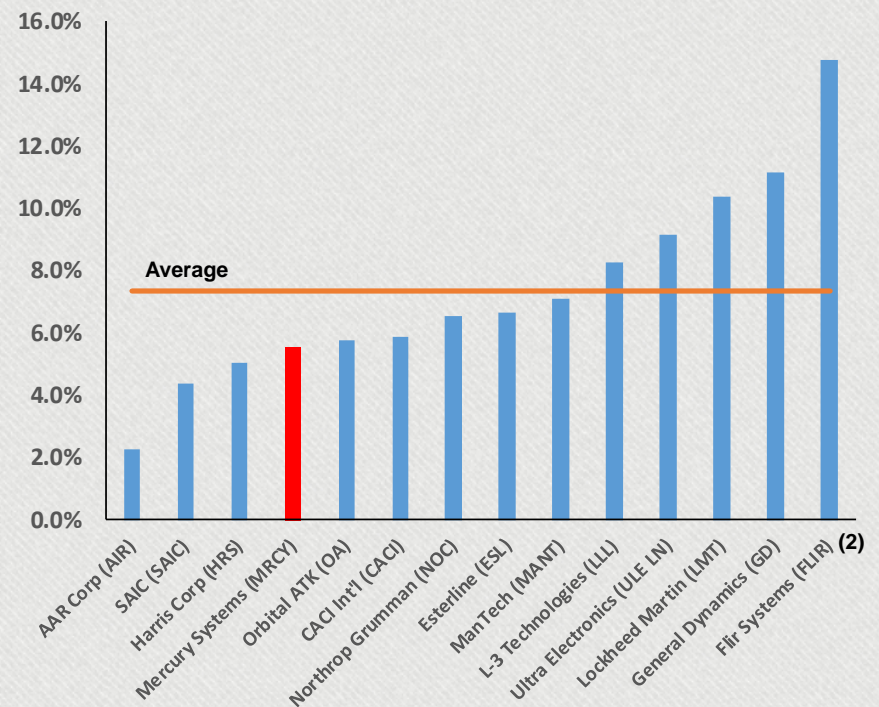
Highly Improbable Financial Model

Mercury acts as an outsourced Tier 2 provider of solutions for prime defense contractors (subcontractor). 96% of its business is to the federal government. Mercury reports the highest EBITDA margins in the aerospace and defense universe, well above its own customers. However, this does not correspond to the highest free cash flow margin. In fact, despite reporting a fairly low capex business model, Mercury's free cash flow margins are no better than the industry average. (1)

LTM EBITDA Margin



LTM Free Cash Flow Margin



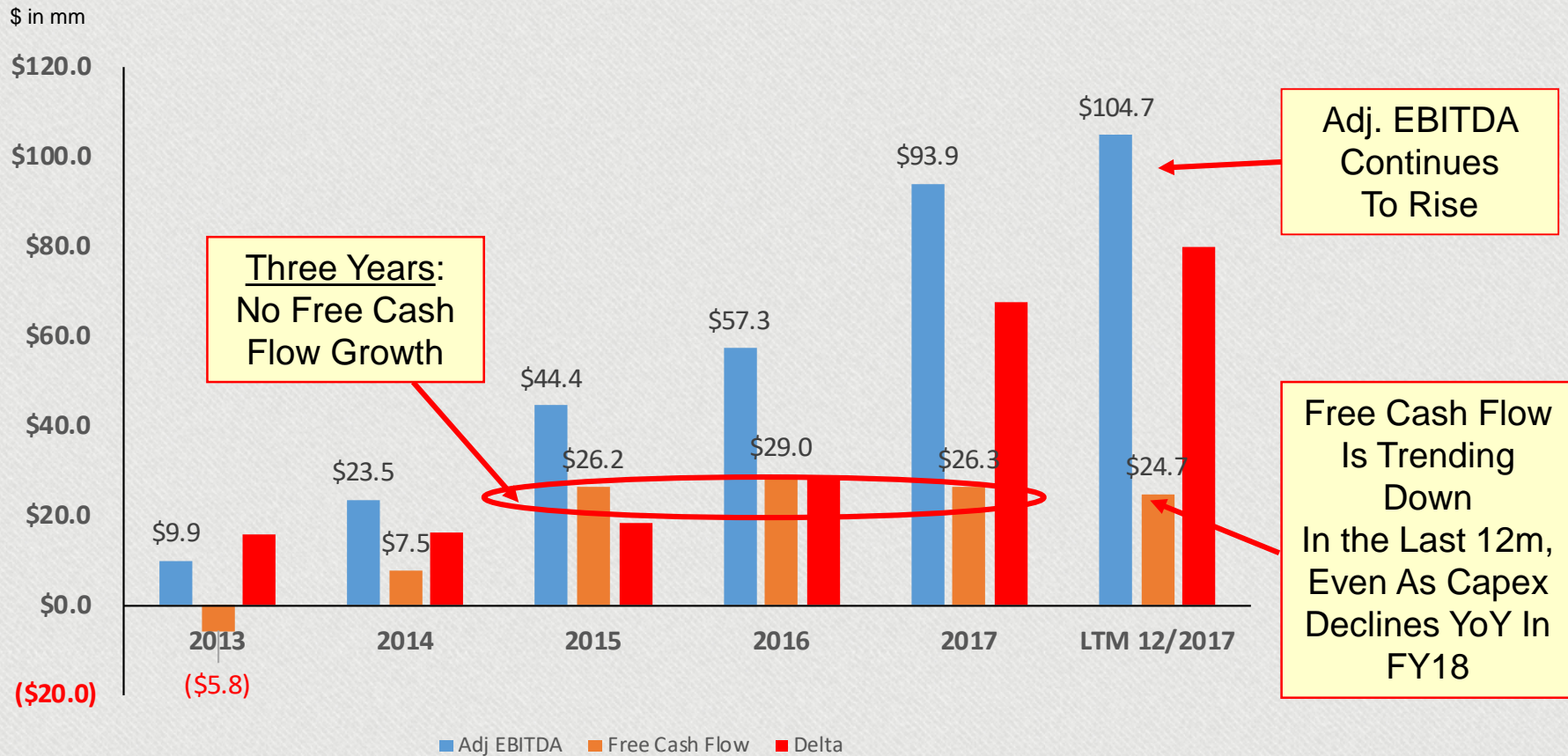
Source: Company filings

1) CFO comment on [Q2'18 conference call](#) says Mercury target "5% or less capex to sales"

2) We include FLIR in our analysis solely because some analysts reference them as a peer to MRCY. However, only 26% of FLIR's revenues are derived from federal gov't agencies and end markets vs. 96% for Mercury. Therefore, we do not believe FLIR to be a suitable comp due to its different economic characteristics

Significant And Growing Divergence: Adjusted EBITDA vs. Free Cash Flow

Investors should be worried that in three years from FY15 – FY17, Mercury’s EBITDA grew 112%, but its Free Cash Flow grew 0%. The growing delta (red bar in graph below) is accelerating, while in the LTM Dec 2017 period, Free Cash Flow is now declining. Management has made references to inventory build as the culprit on recent conference calls.



1) [Q2'18 earnings conference call](#): "Our cash flow reflects the buildup of inventory associated with our expanded in-house manufacturing capabilities offset in part by a 9 day decrease in day sales outstanding in Q2 compared"

Warning: Management Paid Only On Adjusted EBITDA Margin

It should be no surprise that Mercury's Adjusted EBITDA is rising rapidly. Management is solely incentivized by its compensation program to hit Adjusted EBITDA margin targets. It also has a very unusual compensation structure whereby targets are semiannual. Based on changes to the executive program in FY 2018, expect even more aggressive EBITDA expansion!

Fiscal 2017 Executive Bonus Plan Performance				
July 1, 2016 - December 31, 2016 (H1)		January 1, 2017 - June 30, 2017 (H2)		Full Fiscal 2017 Over-Achievement Pool
Adjusted EBITDA/ Revenue		Adjusted EBITDA/ Revenue		Adjusted EBITDA/ Revenue
Threshold	Target	Threshold	Target	Above Target - Maximum
Company Financial Performance (Adjusted EBITDA % of Revenue)				
21%	23%	21%	23%	23% - 24%
% Payout of Bonus				
50%	100%	50%	100%	Up to 100%
87.5% H1 Actual Payout		100% H2 Actual Payout + 12.5% H1 Catch Up for Achieving Full-Year Results		0% FY17 Actual
H1 (Paid in January 2017)		H2 (Paid in August 2017)		Unearned

Source: [Proxy statement](#)

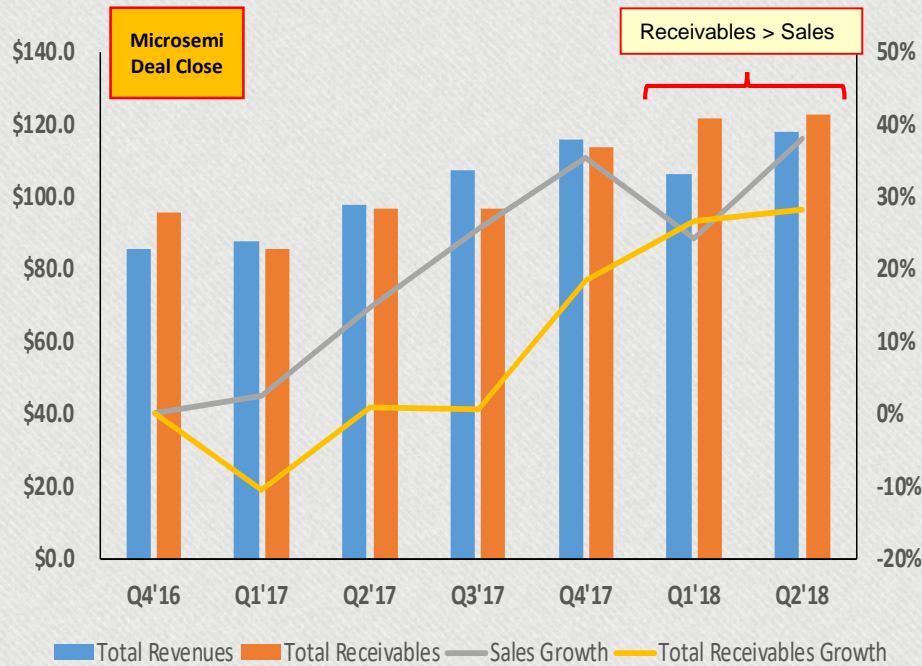
Executive Bonus Program for Fiscal 2018

In establishing the executive bonus program for fiscal 2018, the Compensation Committee reviewed our multi-year performance and noted that **our annual financial goals have been very aggressive relative to the financial performance of our peer group**, with achievement of our strategic operating plan consistently positioning us in the top quartile. In order to provide incentives for continued top quartile performance going forward, **the Committee increased the potential cash bonus payout for fiscal 2018, thereby putting an even larger percentage of an executive's overall potential compensation at risk based on performance**. For fiscal 2018, the target bonus as a percentage of base salary for the Chief Executive Officer under the executive bonus program is 150%; for the Executive Vice President, Chief Operating Officer is 110%; for each of the Executive Vice President, General Counsel and the Executive Vice President, Chief Financial Officer is 90%; and for the Vice President, Controller, and Chief Accounting Officer is 50%. For fiscal 2018, the performance targets are based on the amount of our actual adjusted EBITDA measured in dollars compared to budgeted adjusted EBITDA as set forth in our strategic operating plan for fiscal 2018, with targets again relating to the first and second halves of the fiscal year.

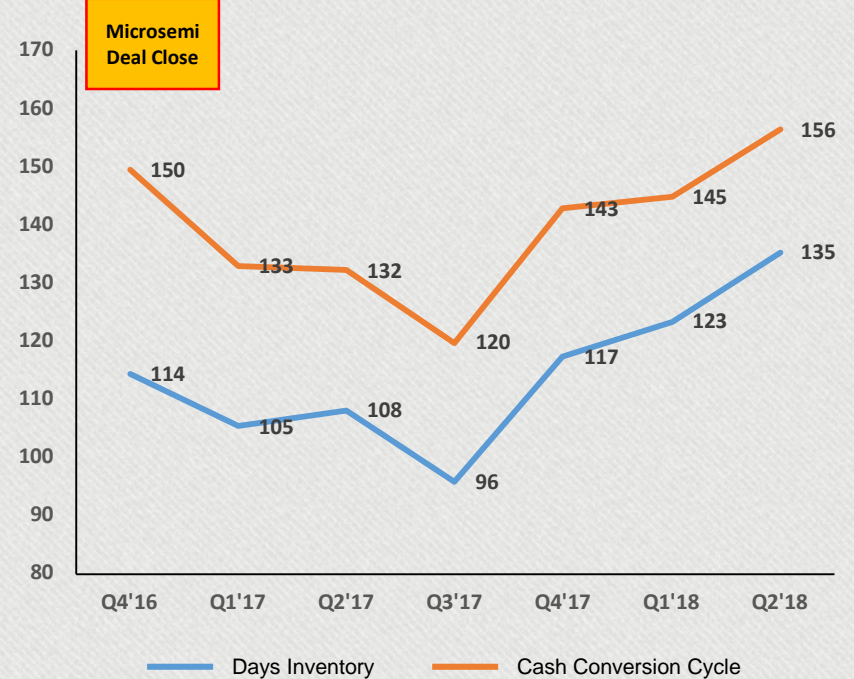
Financials Showing Strain

Post the acquisition of Microsemi's carve out business in Q4'16, revenues grew faster than receivables. In light of Mercury's difficulty generating cash flow growth (days inventory and cash conversion cycle at highs), and that receivables are now greater than revenues in Q1 and Q2 2018, we worry that the Company was aggressively booking revenues.

Sales Growing Faster Than Receivables



Days Inventory and Cash Collection Cycle



Note: Includes accounts receivables and unbilled receivables and costs in excess of billings

Source: Company financials, Bloomberg

Warning: Reclassification To Boost Gross Margins Suggest Pressures

Mercury first disclosed a reclassification of costs from COGS to R&D expense in the Q1'2017 10-Q. This tactic served to increase its gross margin reporting, and bolsters our argument that Mercury is covering up financial strains. We also observe that Mercury provided backward looking reclassification information, but not enough to determine the magnitude of the benefit it received in FY2017 when it first disclosed the reclassification.

Reclassification: *“The Company included costs related to the sustainment of its product portfolio as research and development expense, which was previously included as costs of revenues on the Consolidated Statements of Operations and Comprehensive Income. For comparative purposes, for the fiscal years ended June 30, 2016 and 2015, the Company has reclassified \$2,845 and \$3,981, respectively, from costs of revenues to research and development expense.”* Source: FY17 [10-K](#), p.52

	FY 2016						FY 2017					FY 2018	
	FY 2015	Sept 15 Q1'16	Dec 15 Q2'16	March 16 Q3'16	June 16 Q4'16	FY 2016	Sept 16 Q1'17	Dec 17 Q2'17	March 17 Q3'17	June 17 Q4'17	FY 2017	Sept 17 Q1'18	Dec 17 Q2'18
Gross Profit	\$110.2	\$27.5	\$28.6	\$30.5	\$38.2	\$124.8	--	--	--	--	--	--	--
% margin	46.9%	47.1%	47.3%	46.3%	44.7%	46.2%	--	--	--	--	--	--	--
Reclassified to R&D Expense	\$4.0	\$0.8	\$1.2	\$0.9	\$0.0	\$2.8	--	--	--	--	--	--	--
Gross Profit (adjusted)	\$114.2	\$28.3	\$29.7	\$31.4	\$38.2	\$127.6	\$39.4	\$47.4	\$50.8	\$53.9	\$191.5	\$55.4	\$54.2
% margin (adjusted)	48.6%	48.5%	49.2%	47.7%	44.7%	47.2%	45.0%	48.4%	47.3%	46.6%	46.9%	47.8%	45.9%
Margin Boost	+1.7%	+1.4%	+1.9%	+1.4%	+0.0%	+1.0%	--	--	--	--	--	--	--

Source: Mercury financial statements

Pay Attention To Gross Margin Estimate Misses and Contraction

Notice that Mercury's Gross Margins are slowly contracting (Q2'17: 48.8% vs Q2'18: 45.9%)
Mercury's first miss on its gross margin guidance came in Sept 2017 (Q2'18). This is the same month that:
 1) Mercury first disclosed in its proxy filing how to submit anonymous tips for accounting concerns;
 2) Its Chief Accounting Officer resigned, and
 3) The month before in August 2017, insiders quietly entered a 10b5-1 stock sale program

Quarter Guidance Was Given:	<u>Q1'17</u>	<u>Q2'17</u>	<u>Q3'17</u>	<u>Q4'17</u>	<u>Q1'18</u> First Guidance Miss	<u>Q2'18</u>
Next Quarter Gross Margin Guidance vs. Actual Result (Delta at mid)	46.0% -- 47.0% vs. 48.4% +1.9%	47.0% vs. 47.3% +0.3%	45% -- 46% vs. 46.6% +1.1%	46% -- 47% vs. 47.8% +1.3%	46.1% -- 46.7% vs. 45.9% -0.5%	46.6% -- 47.0% vs. ? ?
FY 2018 Gross Margin Estimate By CFO Haines Continue To Contract				"We estimate that it's going to be somewhere in the neighborhood of the middle of our target range, which is the target range being <u>45% to 50%</u> gross margin."	"Currently gross margins for the year are expected to be between <u>46.8% and 47.3%</u> "	"Currently gross margins for the year are expected to be between <u>46.5% and 46.8%</u> "

Note: Mercury gives gross margin guidance on its conference calls

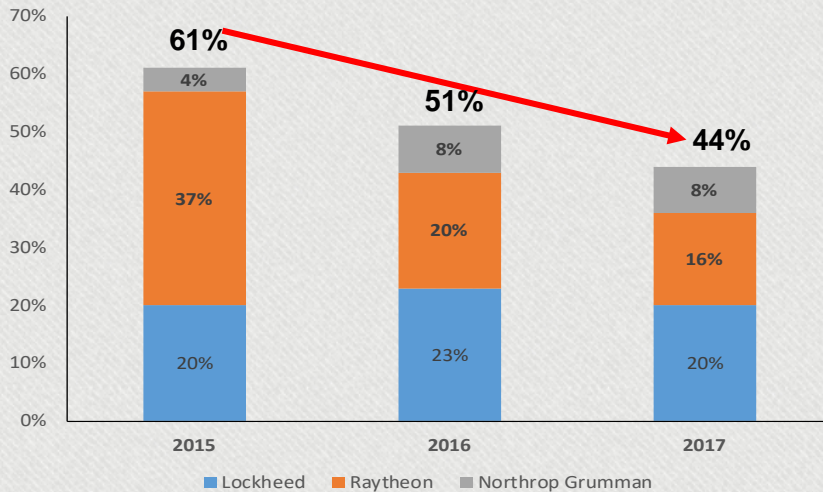
Major Risk Factors Being Realized

Mercury's traditional top three customers are becoming a smaller part of its business, while its historical business strength in radar becomes less relevant.
Investors should be concerned that "Other" revenues are Mercury's fastest growing segment.

Key Disclosures From Mercury's FY 2017 Annual Report:

- “As part of our strategy, we are focusing on being a commercial outsourcing partner to the large defense prime contractors as they seek the more rapid design, development and delivery of affordable, commercially developed, specialized processing solutions within the markets we serve”
- “We are dependent on a **small number of customers for a large portion of our revenues**. A significant decrease in the sales to or loss of any of our major customers would have a material adverse effect on our business and results of operations.”
- “**We are dependent on sales for radar applications for a large portion of our revenues**. While our radar sales relate to multiple different platforms and defense programs, our revenues are largely dependent upon our customers incorporating our products into radar applications.”

Top Three Customers
(% of Total Mercury Net Revenues)



Not Encouraging That "Other Revenues" Is Mercury's Fastest Growing Category

\$ in mm	Fiscal Year Net Sales			Percentage of Total		
	2015	2016	2017	2015	2016	2017
Radar % growth	\$143.5 29.7%	\$140.3 -2.2%	\$150.4 7.2%	61%	52%	37%
Electronic Warfare % growth	\$51.4 N/A	\$72.1 40.3%	\$106.4 47.6%	22%	27%	26%
Other % growth	\$39.9 N/A	\$57.7 44.5%	\$151.7 162.7%	17%	21%	37%
Total	\$234.8	\$270.2	\$408.6	100%	100%	100%

Note: Total revenues to the top 3 declined from \$143m to \$137m between 2015-16, but increased to \$179m from 2016-17 after three acquisitions, so it is difficult to determine how much of the growth is acquired revenues (the acquired Microsemi business had all three primes as customers per the [deal](#) presentation)

Note: Mercury just started disclosing net revenue by end market application in [FY 2017 10-K](#), Note P.

Major Risk Factors Being Realized (Cont'd)

In the Q2'18 10-Q filing, Mercury started breaking out "Other Revenue" in slightly more detail, and the results are not encouraging. Two of its three largest segments are declining, including Radar, its largest market. Mercury now makes reference to "Effector" without any elaboration or prior mention on earnings conference calls. Not surprisingly, management is calling out the growth in C4I on its last conference call, while downplaying Radar's decline (a)

What is Effector? It has never been mentioned before by Mercury. The [dictionary](#) meaning relates to biology

Two of the larger segments are now declining, including Radar, its historical strength

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
Radar (1)	\$ 44,678	\$ 44,803	\$ 81,218	\$ 82,292
Electronic Warfare (2)	29,411	21,304	57,419	42,284
Other Sensor & Effector (3)	10,992	4,661	20,741	9,307
Total Sensor & Effector	85,081	70,768	159,378	133,883
C4I (4)	13,562	6,613	26,388	10,953
Other (5)	19,269	20,633	38,215	40,827
Total Net Revenue	\$ 117,912	\$ 98,014	\$ 223,981	\$ 185,663

- (1) Radar includes end-use applications where radio frequency signals are utilized to detect, track, and identify objects.
- (2) Electronic Warfare includes end-use applications comprising the offensive and defensive use of the electromagnetic spectrum.
- (3) Other Sensor & Effector products include all Sensor & Effector end markets other than Radar and Electronic Warfare.
- (4) C4I includes rugged secure rackmount servers that are designed to drive the most powerful military processing applications.
- (5) Other products include all component and other sales where the end use is not specified.

Source: Q2'18 [10-Q](#)

(a) Q2'18: conference call, Mercury highlighted upfront the C4I growth "Mercury C4I revenues have grown 290% over the past 12 months compared with the prior period and now represent 12% of total company's revenue. In Q2 our C4I revenues grew 105% year-over-year."

Major Risk Factor Being Realized (Cont'd)

Mercury slipped in one sentence in its last Annual Report that has gone almost unnoticed by analysts and investors that represents a looming Material Adverse Effect on its business. We believe the major implications are that Mercury will lose out on business opportunities and increase its costs of doing business.

Mercury reported 1,159 employees as of June 30, 2017 in its 10-K Annual Report. We estimate Richland (acquired July 2017) contributed approximately 12 employees and Themis Computer (acquired Feb 2018) has between 50 to 200 employees.(1)

Therefore, we believe Mercury is likely to be very close to the 1,250 employee limit.

We face other risks and uncertainties associated with defense-related contracts, which may have a material adverse effect on our business.

We qualify as a “small business” for government contracts purposes under the definition of that term in an applicable NAICS code because we have fewer than 1,250 employees. As we grow and potentially have a rolling 12-month average of over 1,250 employees in the future, we would no longer qualify as a small business. Loss of our small business status could negatively impact us, including our customers purchases from us would not qualify as purchases from a small business, customers may flow down additional Federal Acquisition Regulation, or FAR, clauses in their contracts with us that are less favorable than our existing contract terms and conditions. **We expect to lose our status as a small business during fiscal 2018.**

Source: 2017 Annual Report [10-K](#), p. 14

1) Richland Technologies (Source: [SBIR](#)) and Themis Computer (Source: [Glassdoor](#))



*Mercury's Promotion of the SEWIP
Program and Undisclosed Cost
Overrun Allegations*

Mercury Promotes Its SEWIP Program, Expected To Be Material To Future Revenues

Key FY 2017 Annual Report Disclosures on SEWIP ([Source](#))

Diverse Mix of Stable, Growth Programs Aligned with DoD Funding Priorities. Our products and solutions have been deployed on more than 300 different programs and over 25 different defense prime contractors. We serve high priority markets for the DoD and foreign militaries, such as UAVs, ballistic missile defense, guided missiles and precision munitions, airborne reconnaissance, EW, and have secured positions on mission-critical programs including Aegis, Predator and Reaper UAVs, F-35 Joint Strike Fighter, Patriot missile, **SEWIP**, and Paveway

For the fiscal year ended June 30, 2016, the **Surface Electronic Warfare Improvement Program ("SEWIP") program individually comprised 12% of our revenues.**

Going forward, we believe the SEWIP, AEGIS, F-35, F-16 and the Patriot missile defense programs could be a large portion of our future revenues in the coming years, and the loss or cancellation of these programs could adversely affect our future results.

Key CEO Quotes on SEWIP (Surface Electronic Warfare Improvement Program) – Notably Block 3

CEO Aslett – Jefferies Conf (Aug 17): *“Three to four years ago, SEWIP was an emerging program. This past fiscal year, SEWIP was actually our largest bookings and revenue program, and that is really largely only SEWIP Block 2 today. As you probably know and as we've talked about, we're also now a part of the SEWIP Block 3 team with Northrop Grumman, and that's still in the engineering phase. So we do expect additional growth from that program. So the program has gone from zero to being our largest program in a relatively short space of time.”*

CEO Aslett – [Q3'2017 \(April 2017\) Earnings Call](#): *“Mercury is a very innovative company and we've seen that on existing programs, such as Patriot where we continuing to chip away and win more business on the program, likewise on SEWIP, where again, we're continuing to win more content on both Block 2, as well as Block 3.”*

CEO Aslett – [Q1'2017 \(Oct 2016\) Earnings Call](#): *“Lockheed Martin just received their five year production contract on SEWIP Block 2 and we continue to do important work with Northrop Grumman and SEWIP Block 3.”*

CEO Aslett [Q2'2016 \(Jan 2016\) Earnings Call](#): *“We've had a longstanding relationship with Northrop and I would characterize it's been a strategic relationship. We weren't part of that team prior to the award mainly because I think we were working extremely closely with both Lockheed and Raytheon who were competing against Northrop for the SEWIP Block 3 business. However since they were awarded the business, we've engaged or reengaged with them and we obviously know the SEWIP program well and we've got multiple sets of technologies and capabilities that are applicable for Block 3. And so I think its result of our capabilities, our relationships, our knowledge of the program that allowed us to basically win a pretty significant piece of the business on the program going forward.”*

No surprise to us that Mercury no longer presents this slide in any of its investor presentations. The slide was marketed heavily in 2016 while Mercury was out promoting the Microsemi transaction and raising equity.

Program focus driving substantial growth potential

Mercury's perspective on phase, timing and potential value

EMD LRIP FRP FMS

		FY15	FY16	FY17	Production Years	Probable Bid vs. Won	Expansion		Probable Total (\$M)	Possible Total (\$M)
							Process	RFM		
Aegis	Sensor Processing	[Timeline bar]			FRP: FY14-25	Won	✓		209	504
	Processing Expansion			[Timeline bar]	FRP: FY19-25	Won	✓		29	59
	RFM	[Timeline bar]	[Timeline bar]			FRP: FY16-25	Won/Bid	✓	46	168
SEWIP	Block 2	[Timeline bar]	[Timeline bar]			FRP: FY16-26	Won	✓	199	294
	Small Ship	[Timeline bar]			[Timeline bar]	FRP: FY18-26	Won	✓	67	94
	Block 3	[Timeline bar]				LRIP: FY18-20	Won	✓	58	144
F-35	Existing	[Timeline bar]				LRIP: Up to FY21	Won	✓	152	196
	Processing			[Timeline bar]	LRIP: FY19-21	Bid	✓		104	210
	RFM		[Timeline bar]	[Timeline bar]	LRIP: FY19-21	Bid	✓	2	121	
Radar Programs ⁽¹⁾					LRIP/FRP	Bid/Won	✓	✓	416	873
EW Programs ⁽²⁾					LRIP/FRP	Bid/Won	✓	✓	253	575
Missiles/Guided Munitions ⁽³⁾					LRIP/FRP	Bid/Won	✓	✓	212	378
C4I Programs ⁽⁴⁾					LRIP/FRP	Bid/Won	✓	✓	23	189

(1) Radar includes Predator/Reaper, E-2D Hawkeye, F-16 SABR, BAMS/Triton, AWACS, LRDR, TFAL, Patriot, Classified
 (2) EW includes F-15 EW, SIRFC/AIDEWS, DEWS, EPAWWS, ADAP, ProVision
 (3) Missiles/Guided Munitions includes PGK, MALD, SDBII
 (4) C4I includes P-8, Gorgon Stare, Classified

Note: Refer to Appendix for definitions of "Bid", "Won", "Probable" and "Possible". Probable and Possible values are as of FYE 2016. Numbers are rounded.

Total:	\$1,770	\$3,805
vs. Nov. 2012	1,138	1,593
% Growth:	56%	139%

Inspector General Report on SEWIP: Allegations of Substantial Cost Overruns

On November 9, 2017 the Inspector General of the US DoD reported seven defense hotline allegations on Northrop Grumman's SEWIP Block 3 program. Three allegations were substantiated, two were partially substantiated, and two were dismissed. While the exact amount of cost overruns have been redacted, the amount must have been material enough to merit of full investigation. Mercury has said it expects SEWIP to be material driver of its future revenues. The Company should explain to investors the materiality of the issues presented here.



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Results in Brief

Defense Hotline Allegations on the Surface Electronic Warfare Improvement Program Block 3 Costs

November 9, 2017

Objective

We conducted this audit in response to allegations made to the Defense Hotline. We determined whether the Surface Electronic Warfare Improvement Program (SEWIP) Block 3 experienced significant cost increases over original estimates.

Background

The DoD Office of Inspector General received three Defense Hotline complaints alleging SEWIP Block 3 experienced significant cost increases over original Engineering and Manufacturing Development (EMD) phase estimates. The EMD phase is to develop, build, and test a product to verify that all operational requirements have been met, and to support production or deployment decisions. Within the complaints, we reviewed seven allegations related to cost increases, under bidding, scope increases, and program baseline approval and determined that:

- three of seven allegations were substantiated,
- two of seven allegations were partially substantiated, and
- two of seven allegations were not substantiated.

We address the primary allegation of cost increases over the original EMD phase estimates in the body of this report. See Appendix B for a detailed description of each allegation and whether it was substantiated.

Background (cont'd)

The Program Executive Office Integrated Warfare Systems Above Water Sensors (PEO IWS 2.0) reports to Program Executive Office Integrated Warfare System (PEO IWS) and manages the \$5.7 billion SEWIP procurement. SEWIP is an upgrade to the AN/SLQ-32 electronic warfare system (AN/SLQ-32). The AN/SLQ-32 provides early detection, signal analysis, threat warning, and protection from anti-ship missiles. PEO IWS 2.0 is modernizing the AN/SLQ-32 with four incremental upgrades, Blocks 1 through 4. SEWIP Block 3 will provide an improved electronic attack capability. Electronic attack neutralizes anti-access systems; suppresses adversarial integrated air defense systems; denies adversarial battlespace awareness sensors; degrades adversarial offensive capabilities; and denies effective adversarial command, control, and communications. On February 12, 2015, the Naval Sea Systems Command (NAVSEA) awarded a contract to Northrop Grumman to design and develop SEWIP Block 3. The contract included an option for the EMD phase with an original value of \$91.7 million.

Finding

(FOUO) SEWIP Block 3 experienced significant cost increases. Specifically, between August 2014 and March 2017, Northrop Grumman's original SEWIP Block 3 proposed cost estimate significantly increased from [REDACTED] to potentially [REDACTED] for the EMD phase. The cost increases occurred because PEO IWS 2.0 officials had NAVSEA award the contract based on Northrop Grumman's technical proposal that ultimately contained [REDACTED]. Additionally, PEO IWS 2.0 officials did not approve an EMD phase cost baseline estimate. As a result, PEO IWS 2.0 officials may pay up to [REDACTED] more than the original estimated cost to complete fewer deliverables than agreed to in the original contract during the EMD phase. A deliverable is any item developed by the contractor and delivered as part of the contract. Additionally, PEO IWS 2.0 officials may complete the EMD phase at least [REDACTED] behind schedule and may complete initial production later than planned.

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Results in Brief

Defense Hotline Allegations on the Surface Electronic Warfare Improvement Program Block 3 Costs

Finding (cont'd)

(FOUO) Finally, PEO IWS 2.0 officials could incur a program deviation by exceeding the Acquisition Program Baseline (APB) maximum research, development, test, and evaluation cost of [REDACTED], which could result in the Department of the Navy requesting additional funds to provide the SEWIP Block 3 improved electronic attack capability. The APB documents the performance requirements, schedules, and estimated program costs. A program deviation occurs when the program manager believes costs in the APB will exceed the maximum cost set by the program office.

Recommendations

We recommend that the Program Executive Officer, PEO IWS:

- finalize discussions with Northrop Grumman and, if appropriate, issue a contract modification, with NAVSEA assistance, agreeing to the restructured EMD phase;
- establish an approved EMD phase cost baseline estimate to consistently measure and control costs for SEWIP Block 3;
- verify that Northrop Grumman adequately meets the established EMD phase baseline estimate to minimize existing or future problems;
- (FOUO) continue to document Northrop Grumman's contract performance, including Northrop Grumman's [REDACTED], in the Contractor Performance Assessment Reporting System (CPARS) to assist agencies in evaluating contractor past performance and awarding future contracts; and

- continue to monitor actual research, development, test, and evaluation costs and report to the Principal Military Deputy, Assistant Secretary of the Navy (Research, Development, and Acquisition), if PEO IWS 2.0 officials anticipate a program deviation requiring an APB revision.

Management Comments and Our Response

The Commander, NAVSEA, responding for the Program Executive Officer, PEO IWS, addressed the specifics of the recommendations.

The Commander, NAVSEA, agreed in principle with our recommendation to finalize discussions with Northrop Grumman. On September 29, 2017, NAVSEA issued a partial termination of the EMD phase; therefore, we consider this recommendation closed.

The Commander, NAVSEA, agreed with our recommendation to establish an approved EMD phase cost baseline estimate. The Commander stated that PEO IWS 2.0 plans to establish an EMD phase cost baseline by December 28, 2017. We consider this recommendation resolved and open. We will close this recommendation when PEO IWS demonstrates that it established a SEWIP Block 3 EMD phase cost baseline.

The Commander, NAVSEA, agreed with our recommendation to verify that Northrop Grumman adequately meets the established EMD phase cost baseline estimate. The Commander stated that after the EMD cost baseline is established and approved, PEO IWS will continue to review earned value management data and cost reports on a monthly basis to monitor contract performance. We consider this recommendation resolved and open. We will close this recommendation when PEO IWS demonstrates that it reviewed earned value management data and cost reports on a monthly basis to monitor contract performance.

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More Evidence To Suggest A Cover-Up By Mercury of SEWIP Problems

As of Mercury's last quarterly report, SEWIP mysteriously disappeared from a discussion of material programs despite the CEO claiming on the conference call it was the second largest revenue program. Recall from the [previous slide](#), just months earlier in August 2017 the CEO said in reference to SEWIP "So we do expect additional growth from that program. So the program has gone from zero to being our largest program in a relatively short space of time." Therefore, it appears something went horribly wrong; from Sept 30th to Dec 31st SEWIP declined and was no longer reported as material.

F-35 Not Included In 10-Q Despite CEO Claiming It's The Second Largest Program Q'18

Three Months Ended September 30,		
	2017	2016
SEWIP	11%	*
Aegis	*	14%
	11%	14%

Source: Q1'2018 [10-Q](#) filed 11/2/17

SEWIP Excluded From 10-Q Despite CEO Saying It's The Second Largest Revenue Program In Q2'18

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
F-35	*	11%	*	*
Aegis	*	*	*	10%
	—%	11%	—%	10%

Source: Q2'2018 [10-Q](#), Filed 2/2/18

Note: * Denotes less than 10% of revenues

[CEO Aslett Q1'18 Conference Call \(10/24/17\):](#)

"Our largest revenue programs in the quarter was SEWIP, F-35, Aegis, F-16 SABR and Filthy Buzzard."

[CEO Aslett Q2'18 Conference Call \(1/21/18\):](#)

"Our largest revenue programs in the quarter were Aegis, SEWIP, F-35, E2D Hawkeye and Filthy Buzzard."



Accounting and Financial Presentation Concerns

Background on Mercury's Accounting Methods

Mercury reports using three different revenue accounting methods: Ship and Bill, Multiple Deliverable Arrangements and Contract Accounting. Ship and Bill is fairly straight forward, and mirrors standard revenue recognition criteria such as persuasive evidence of a sale arrangement (fixed price and collection assured), with title and risk passing to the customer. The other two methods used are more complex and leave significant judgement in the hands of management.




Mercury appears to be moving towards more complex accounting methods

- Contract accounting is often abused by companies, because revenues can be prematurely recognized, and costs can be underestimated, leading to gross margin inflation. When problems emerge, gross margins typically contract
- Anticipated contract losses are typically accrued and reported in the financial footnotes
- Moreover, best financial disclosure practices suggest a detailed accounting of favorable, unfavorable and the “net” impact of contract changes or estimate revisions



- We observe that Mercury's gross margins are contracting and it missed its Q2'18 guidance (the first miss in many quarters)
- We observe that Mercury reports a de minimis \$0.50m of loss accrual costs in accrued expenses. Hard to believe it is so low given \$447m of sales
- We observe that Mercury does not disclose its net adjustments. The next slide shows Mercury's customers abide by this best practice. How much of Mercury's EBITDA is being juiced by favorable contract accounting changes?

Percentage of Mercury Revenues By Accounting Method

Accounting Method	Spruce Point Assessment of Accounting Method	FY2014	FY2015	FY2016	FY2017	LTM Dec 2017
Ship and Bill	Simple	35%	47%	35%	44%	 15% (1)
Multiple Deliverable Arrangements	Complex, Significant Management Judgement Required	37%	24%	37%	33%	
Contract Accounting (POC, Completed Contracts, and Time and Materials Method)	Complex, Significant Management Judgement Required	28%	29%	28%	23%	

1) CEO on [Q2'18 call](#) "So we've obviously worked extremely diligently since fiscal 2013 to reduce our dependency on what we would describe as book ship revenue...If you look on an LTM basis, the amount of book ship revenue that we have is around about 15% of total revenue"

Mercury's Defense Prime Customers Report Impact From Contract Adjustments



Why doesn't Mercury disclose net favorable accounting adjustments in accordance with defense industry best practices?

Prime Contractor	Favorable Adjustment % of Operating Income	Disclosure																																							
Raytheon	13%	<p>Net EAC adjustments had the following impact on our operating results:</p> <table border="1"> <thead> <tr> <th>(In millions, except per share amounts)</th> <th>2017</th> <th>2016</th> <th>2015</th> </tr> </thead> <tbody> <tr> <td>Operating income</td> <td>\$ 442</td> <td>\$ 418</td> <td>\$ 392</td> </tr> <tr> <td>Income from continuing operations attributable to Raytheon Company</td> <td>287</td> <td>283</td> <td>255</td> </tr> <tr> <td>Diluted EPS from continuing operations attributable to Raytheon Company</td> <td>\$ 0.98</td> <td>\$ 0.95</td> <td>\$ 0.84</td> </tr> </tbody> </table>	(In millions, except per share amounts)	2017	2016	2015	Operating income	\$ 442	\$ 418	\$ 392	Income from continuing operations attributable to Raytheon Company	287	283	255	Diluted EPS from continuing operations attributable to Raytheon Company	\$ 0.98	\$ 0.95	\$ 0.84																							
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Lockheed Martin	29%	<p>"Our consolidated net adjustments not related to volume, including net profit booking rate adjustments and other matters, net of state income taxes, increased segment operating profit by approximately \$1.5 billion in both 2017 and 2016 and \$1.7 billion in 2015.... The consolidated net adjustments for 2017 are inclusive of approximately \$790 million in unfavorable items, which include reserves for performance matters on the EADGE-T contract, Vertical Launching System (VLS) program and other programs at RMS and on commercial satellite programs at Space."</p>																																							
Northrop Grumman	11%	<table border="1"> <thead> <tr> <th rowspan="2">\$ in millions</th> <th colspan="3">Year Ended December 31</th> </tr> <tr> <th>2017</th> <th>2016</th> <th>2015</th> </tr> </thead> <tbody> <tr> <td>Favorable EAC adjustments</td> <td>\$ 668</td> <td>\$ 765</td> <td>\$ 924</td> </tr> <tr> <td>Unfavorable EAC adjustments</td> <td>(305)</td> <td>(271)</td> <td>(344)</td> </tr> <tr> <td>Net EAC adjustments</td> <td>\$ 363</td> <td>\$ 494</td> <td>\$ 580</td> </tr> </tbody> </table>	\$ in millions	Year Ended December 31			2017	2016	2015	Favorable EAC adjustments	\$ 668	\$ 765	\$ 924	Unfavorable EAC adjustments	(305)	(271)	(344)	Net EAC adjustments	\$ 363	\$ 494	\$ 580																				
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SAIC	15%	<p>Changes in contract estimates were:</p> <table border="1"> <thead> <tr> <th rowspan="2"></th> <th colspan="3">Year Ended</th> </tr> <tr> <th>February 3, 2017</th> <th>January 29, 2016</th> <th>January 30, 2015</th> </tr> </thead> <tbody> <tr> <td colspan="4">(in millions, except per share amounts)</td> </tr> <tr> <td>Favorable adjustments</td> <td>\$ 42</td> <td>\$ 29</td> <td>\$ 23</td> </tr> <tr> <td>Unfavorable adjustments</td> <td>(20)</td> <td>(16)</td> <td>(12)</td> </tr> <tr> <td>Net favorable adjustments</td> <td>22</td> <td>13</td> <td>11</td> </tr> <tr> <td>Income tax effect</td> <td>(7)</td> <td>(5)</td> <td>(4)</td> </tr> <tr> <td>Net favorable adjustments, after tax</td> <td>15</td> <td>8</td> <td>7</td> </tr> <tr> <td>Basic EPS impact</td> <td>\$0.34</td> <td>\$0.17</td> <td>\$0.15</td> </tr> <tr> <td>Diluted EPS impact</td> <td>\$0.33</td> <td>\$0.17</td> <td>\$0.14</td> </tr> </tbody> </table>		Year Ended			February 3, 2017	January 29, 2016	January 30, 2015	(in millions, except per share amounts)				Favorable adjustments	\$ 42	\$ 29	\$ 23	Unfavorable adjustments	(20)	(16)	(12)	Net favorable adjustments	22	13	11	Income tax effect	(7)	(5)	(4)	Net favorable adjustments, after tax	15	8	7	Basic EPS impact	\$0.34	\$0.17	\$0.15	Diluted EPS impact	\$0.33	\$0.17	\$0.14
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Percentage-of-Completion Schemes Common In Aerospace and Defense And A Current SEC Focus

[SEC Enforcement Director Speech](#) (2013): “Revenue recognition issues will remain a staple of our financial fraud caseload – this fraud often takes many forms, whether by recognizing revenue through sham transactions, prematurely recognizing revenue, distorting percentage of completion accounting, using schemes to inflate sales numbers, or billing for uncompleted products through a “pre-booking” scheme.”

[Former Mercury CFO Haines](#) (Oct 2017): “And then often some of those large subsystems are actually scoring revenue on a percentage of completion basis. And there can be timing issues around when we are recognizing the revenue as we are working through it and when we actually convert that revenue into cash over time.”

Recent Accounting Restatements and SEC Investigations of Percentage-of-Completion Accounting Cases

Company / Industry	Year	Note
Orbital ATK / Aerospace	2016	The Restatement is primarily a result of a non-cash error in the application of purchase accounting with respect to a limited number of long-term contracts, which are accounted for under the percentage-of-completion method
Toshiba / Diversified	2015	Toshiba Corp. must correct at least 152 billion yen (\$1.2 billion) of pretax earnings over a six year period after an internal accounting probe revealed the company overstated profits. The company initially uncovered irregularities related to “percentage of completion” estimates used on infrastructure projects, including nuclear, hydroelectric, wind-power equipment, air-traffic control and railway systems
L-3 Communications / Aerospace	2014	Receives SEC subpoena and DOJ investigation and pays fine of \$1.6m and \$4.6m, respectively to each agency (source). The cases relate to improper revenue accounting at L3’s aerospace systems segment that resulted in the contractor’s correcting financial results over a roughly four-year period starting in 2011 and firing at least four employees.
Cubic Corp / Aerospace	2012 and 2014	Changes will result in an increase in revenues and net income cumulatively over the period
Computer Sciences / IT Services	2011	The anticipated result of the restatement is to reduce net income by ~\$50 in FY 2010 and ~\$3.69 billion in FY 2011 and to increase net income in FY 2012 by ~\$3.90 billion. Settled with the SEC for \$190m



Troubling Insider Behavior and Governance Concerns

Troubling Signs Suggesting An Accounting Scandal Cover-Up

Is it more than a coincidence that Mercury's Chief Accounting Officer resigned right after the Company started to highlight it has methods for reporting accounting problems anonymously? The CFO, a lawyer by background and not a seasoned financial professional, also resigned.

2017 Proxy Adds New Discussion of Reporting Anonymous Accounting Concerns

Does Mercury have a method for the anonymous reporting of accounting concerns?

Yes. Our Code of Business Conduct and Ethics includes a means for the anonymous reporting of any concerns about accounting, internal accounting controls, or auditing matters. Any employee, supplier, customer, shareholder, or other interested party can submit a report via the following anonymous methods:

- by telephone voicemail at 866-277-5739;
- by emailing directly to mrcy@openboard.info; or
- by submitting a complaint via the internet at www.openboard.info/mrcy/websubmit.cfm.

Executive	Appointed	Resigns	Concerns
Gerald Haines CFO	Sept 2014	Feb 2018	<ul style="list-style-type: none"> • Haines' bio discloses he worked at Cabletron and Enterasys Networks, while his LinkedIn bio omits the Cabletron reference or that he was Chief Legal Officer and named executive • He was SVP and General Counsel (Chief Legal Officer) of Enterasys/Cabletron from 2000-2001 during the early part of the Enterasys financial scandal unwinding • Haines resigned from Mercury abruptly after closing Themis (Feb 2018) • Note: Haines, a lawyer by background, had always served as General Counsel at prior jobs (Verenium, Enterasys, Applied Extrusion Tech), never as a CFO
Charles Speicher Chief Accounting Officer	Sept 2010	Sept 26, 2017	<ul style="list-style-type: none"> • Speicher's resignation came approximately 3 weeks after the proxy filing disclosure about reporting of accounting concerns

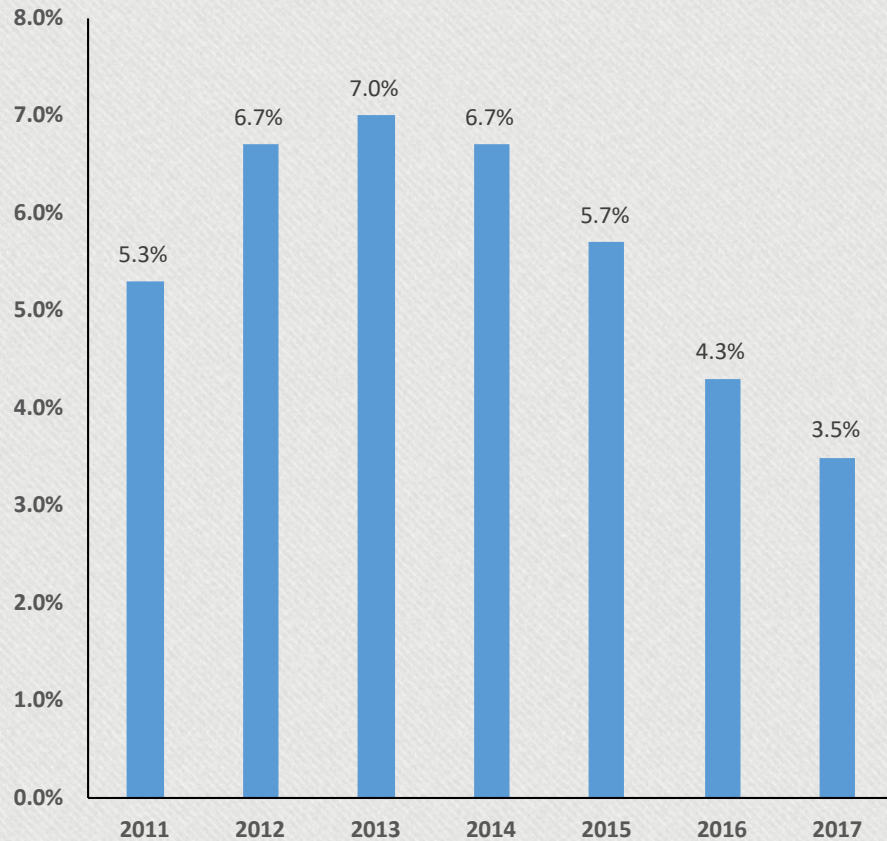
Source: [2017 Mercury Proxy](#) – Filed September 5, 2017

Note: Prior [2016 Proxy](#) excludes the above statement

Troubling Insider Behavior

Insiders (CEO, CFO and COO) have been net sellers of Mercury's shares. What's most disturbing is that the CEO and CFO started a 10b5-1 stock sale program and discarded shares before the FY 2017 10-K filing on Aug 18, 2017 and the Inspector General Report on SEWIP 3 in November 2017. The 10b5-1 program was not disclosed until an October 2017 Form 4 footnote.

Total Insider Beneficial Ownership



Source: Mercury proxy statements

CEO Aslett Stock Sales

Date	Shares	Price	Proceeds
8/17/2017	14,256	\$45.63	\$650,501
8/17/2017	7,128	\$45.63	\$325,251
9/11/2017	4,800	\$47.42	\$227,616
9/12/2017	4,800	\$47.22	\$226,656
10/30/2017	4,800	\$49.92	\$239,606
10/31/2017	4,800	\$50.57	\$242,750
11/15/2017	4,800	\$49.64	\$238,267
11/16/2017	4,800	\$50.58	\$242,765
11/29/2017	4,800	\$52.11	\$250,140
11/30/2017	4,800	\$52.22	\$250,670
12/11/2017	4,800	\$49.77	\$238,911
12/12/2017	4,800	\$48.29	\$231,784
1/30/2018	4,800	\$48.14	\$231,060
1/31/2018	4,800	\$48.07	\$230,714
2/14/2018	4,800	\$44.33	\$212,777
3/14/2018	5,600	\$48.35	\$464,199
Total:	98,184	\$48.05	\$4,717,515

Source: Form 4 filings
10b5-1 program first disclosure ([CEO](#) and [CFO](#))

CFO Haines Stock Sales

Date	Shares	Price	Proceeds
8/17/2017	4,277	\$45.63	\$195,160
8/17/2017	2,139	\$45.63	\$97,603
9/3/2017	2,745	\$48.36	\$132,748
9/3/2017	2,745	\$48.36	\$132,748
10/2/2017	2,500	\$51.93	\$129,825
11/1/2017	2,500	\$50.41	\$126,016
12/1/2017	2,500	\$51.62	\$129,050
1/2/2018	2,500	\$51.07	\$127,675
2/1/2018	2,500	\$47.69	\$119,225
Total:	24,406	\$48.76	\$1,190,049

Other Hints Management Wants More Perks On Its Way Out The Door

Paying close attention to Mercury's recent 10-K, we find at the very end of the document it discloses that the Compensation Committee approved beneficial changes to executive departure terms. Also, Mercury explicitly defined what the condition for termination for "Cause" would be, calling out "Fraud" and "Dishonesty"

On August 14, 2017, the Compensation Committee approved (and with respect to matters for the Company's Chief Executive Officer, the independent directors on the Company's Board of Directors approved) the following executive compensation matters:

- an increase for the annual perquisite for the Company's executive officers from up to \$2,000 annually for personal tax and financial planning to a \$4,000 annual allowance for personal tax and financial planning;
- an amendment to Mr. Aslett's employment agreement to provide that he is entitled to continue to participate in the Company's group health, dental, and vision programs for 24 months following a termination of his employment by the Company without "cause" or by him for "good reason" (as defined in his employment agreement); and
- an agreement for each of the Company's non-CEO named executive officers that provides for termination and severance benefits in the case of a termination of the executive's employment by the Company without "cause" or by the executive for "good reason."

For the agreements for the Company's non-CEO named executive officers, the following terms and conditions apply.

"Cause" is defined in the agreement to include: (1) the willful and continued failure by the executive to perform substantially the duties and responsibilities of his position with the Company after written demand; (2) the conviction of the executive by a court of competent jurisdiction for felony criminal conduct or a plea of nolo contendere to a felony; or (3) the willful engaging by the executive in fraud, dishonesty, or other misconduct which is demonstrably and materially injurious to the Company or its reputation, monetarily, or otherwise. No act, or failure to act, on the executive's part will be deemed "willful" unless committed or omitted by the executive in bad faith and without reasonable belief that his act or failure to act was in, or not opposed to, the best interest of the Company.

"Good Reason" is defined in the agreement to include: (1) a material diminution in the executive's responsibilities, authority, or duties as in effect on the date of the agreement; (2) a material diminution in the executive's annual base salary, except for across-the-board salary reductions based on the Company's financial performance similarly affecting all or substantially all senior management employees of the Company; or (3) a material change in the geographic location at which the executive provides services to the Company.

Under the agreement, if the Company terminates the executive's employment without "cause" or the executive his employment for "good reason," then the Company will pay the executive a severance amount equal to one times his annual base salary. In such event, the Company also will pay for certain insurance benefits and outplacement services

Highest Audit Fees In The Industry

Mercury has the highest audit fees among midcap aerospace, defense, and gov't contractors. We observe that its audit fee per employee matches only Aerovironment (AVAV), a company we profiled last year in a detailed [report](#). Our report noted a whistleblower complaint filed by a senior AVAV executive charging the Company with fraud.

\$ in millions, except audit fee per employee

Company / Ticker	FY Sales	Last FY Audit Fee	Employees	Audit Fee / Employee	Audit Fee / Sales	Auditor
Mercury (MRCY)	\$409	\$1.70	1,159	\$1,467	0.42%	KPMG
AeroVironment (AVAV)	\$265	\$0.97	661	\$1,467	0.37%	E&Y
VSE Corp (VSEC)	\$691	\$1.92	2,523	\$761	0.28%	E&Y
Kratos (KTOS)	\$669	\$2.02	2,900	\$698	0.30%	Deloitte
Cubic (CUB)	\$1,486	\$5.07	8,700	\$583	0.34%	E&Y
AAR Corp (AIR)	\$1,768	\$1.62	4,600	\$352	0.09%	KPMG
Triumph Group (TGI)	\$3,533	\$4.20	14,309	\$294	0.12%	E&Y
SAIC (SAI)	\$4,450	\$3.75	15,000	\$250	0.08%	Deloitte
ManTech (MANT)	\$1,602	\$1.68	7,000	\$240	0.10%	Deloitte
CSRA (CSRA)	\$4,993	\$3.70	18,500	\$200	0.07%	Deloitte
CACI Int'l (CACI)	\$4,354	\$2.20	18,600	\$118	0.05%	E&Y
Booz Allen (BAH)	\$5,804	\$3.90	24,700	\$158	0.07%	E&Y
Average	\$2,502	\$2.73	9,888	\$549	0.19%	








Source: Company proxy and financial statements



Valuation and Downside Risk

Institutional Support Declining

Ownership of Mercury's stock by long-term fundamental owners has been on the decline. The only real buyers of the stock are Vanguard and Blackrock's index funds, neither of which have any regard for valuation or fundamentals.

Investor:	Blackrock	Vanguard	Royce & Associates	Barrow, Hanley, Mewhinney and Strauss	Invesco	Trigran Investments	Baron Capital
Investment Style:	Index, ETF	Index, ETF	Fundamental Growth Mutual Fund	Fundamental Value	Fundamental Growth Mutual	Hedge Fund	Fundamental Growth Mutual Fund
Ownership Trend:							
2011	6.3%	--	9.6%	5.0%	--	--	--
2012	7.3%	--	--	5.3%	--	--	5.4%
2013	7.3%	--	--	5.3%	--	--	5.4%
2014	8.9%	5.5%	6.1%	8.3%	5.6%	--	0.3%
2015	8.9%	6.1%	7.5%	7.3%	--	6.3%	0.3%
2016	8.0%	6.0%	5.3%	6.1%	--	--	1.6%
2017	10.8%	6.7%	--	--	--	--	2.5%

Terrible Risk/Reward Owning MRCY: Analysts See 25% Upside

Mercury is covered by a roster of smaller brokers.
Not surprisingly, the majority are “Buy” on the stock.
We expect a substantial re-rating lower in the share price once investors critically analyze its financials.

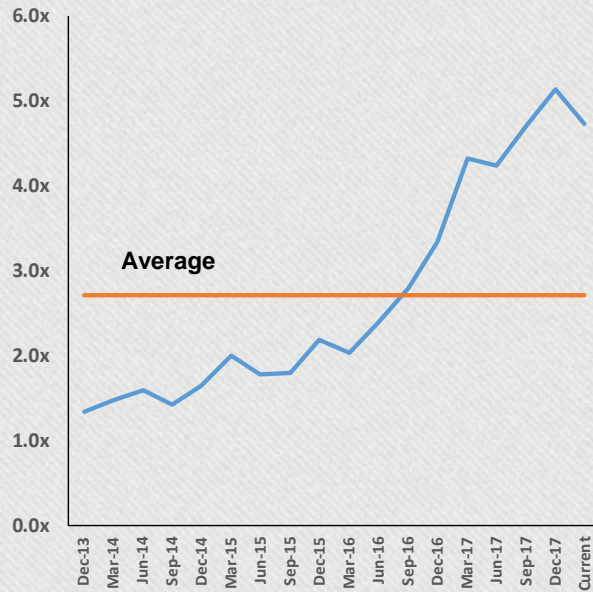
Analyst	Recent Action	Recommendation	Price Target
SunTrust	Inc Target in Jan 2018 from \$58	Buy	\$61.00
Baird	Inc Target Oct 2017 from \$48	Outperform	\$59.00
Drexel Hamilton	Inc Target Oct 2017 from \$50	Buy	\$58.00
JP Morgan	Inc Target in Jan 2018 from \$53	Overweight	\$58.00
Jefferies	Dec Target from \$51	Hold	\$50.00
Noble		Hold	--
William Blair		Outperform	--
Cowen	Discontinued – Jan 2018		
Average Price Target			\$57.20
% Implied Upside (1)			+25%

1) Upside based on \$46.00 share price

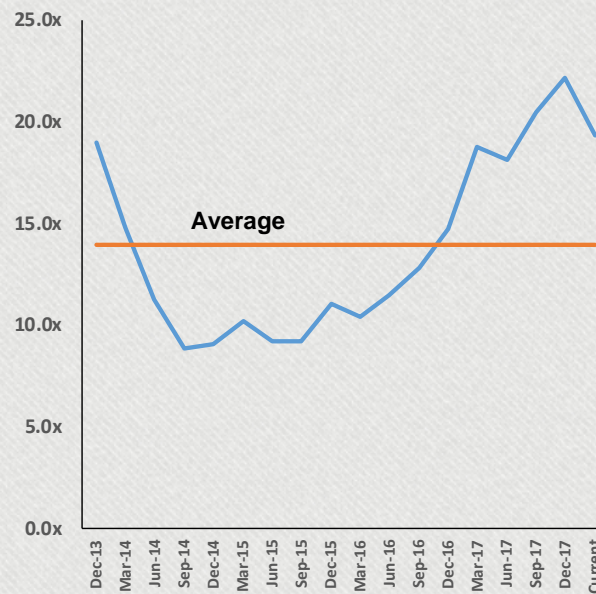
Irrational Valuation Expansion

Current investors are paying a significant premium to the Company's historical valuation. Spruce Point finds it difficult to explain its valuation expansion in light of the Company's signs of financial strain, pending loss of its small business designation, allegations of cost overruns at its biggest revenue program, abrupt management departures and insider selling.

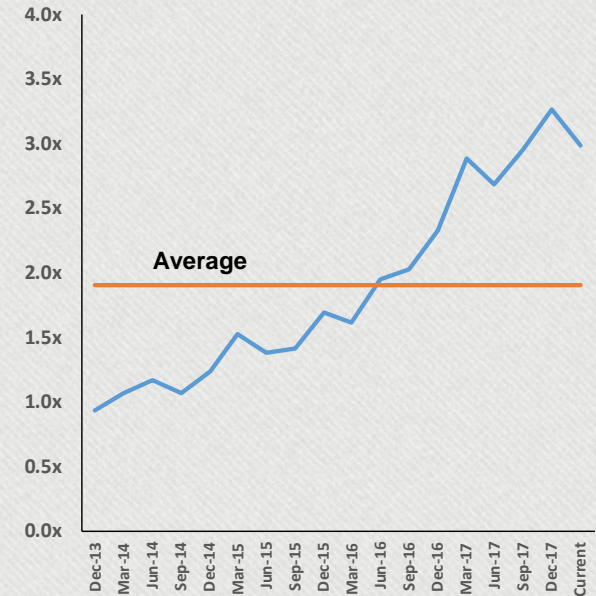
Enterprise Value / NTM Revenues



Enterprise Value / NTM EBITDA



Price / Book Value



Source: MRCY Financial Statements, CapitalIQ

Mercury Trading At An Unjustified Premium To Its Peers

Mercury's valuation is by far the highest in the aerospace and defense industry. We believe the valuation is being driven by the belief its EBITDA margins and revenue growth rate are superior to peers. However, we have detailed our concerns about margin overstatement, and believe most of the revenue growth is acquired (inorganic), which should not be valued at the same rate as pure organic growth.

\$ in millions except per share figures

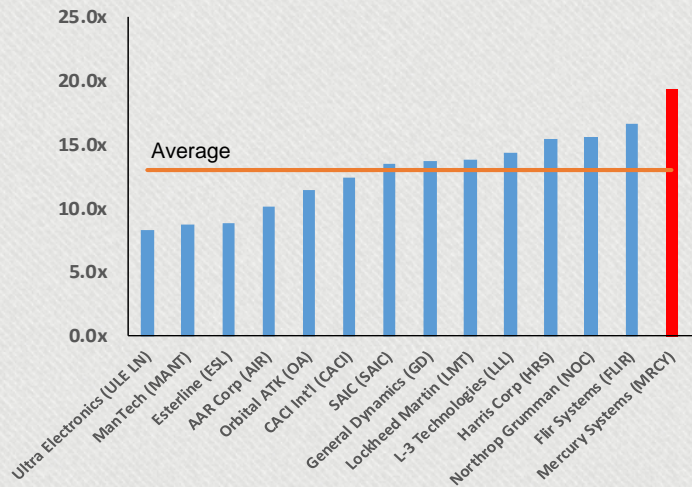
Tier	Name (Ticker)	Stock Price 4/18/2018	% of 52-wk High	Ent. Value	'18E-'19E		LTM Free Cash Flow Margin	2018E EBITDA Margin	P/E		Enterprise Value					Price/ Book	Net Debt/ 18E EBITDA	Dividend Yield
					Sales Growth	EPS Growth			2018E	2019E	EBITDA	Sales	FCF					
Tier 1	Lockheed Martin (LMT)	\$349.14	97%	\$110,556	4.7%	16.0%	10.4%	15.6%	22.4x	19.3x	13.9x	12.8x	2.2x	2.1x	20.9x	NM	1.4x	2.3%
Tier 1	General Dynamics (GD)	\$221.40	96%	\$66,734	9.1%	12.0%	11.1%	14.4%	19.8x	17.6x	13.7x	12.5x	2.0x	1.8x	19.3x	5.8x	0.2x	1.7%
Tier 1	Northrop Grumman (NOC)	\$355.04	98%	\$65,859	10.1%	14.8%	6.5%	15.0%	22.6x	19.7x	15.6x	13.9x	2.3x	2.1x	39.1x	8.8x	1.0x	1.2%
Tier 1	Harris Corp (HRS)	\$166.96	100%	\$23,316	6.7%	17.0%	5.0%	23.9%	23.4x	20.0x	15.4x	14.1x	3.7x	3.5x	43.7x	6.6x	2.3x	1.4%
Tier 1	L-3 Technologies (LLL)	\$213.92	98%	\$19,384	5.9%	13.8%	8.3%	13.4%	22.3x	19.6x	14.4x	13.2x	1.9x	1.8x	22.1x	3.3x	2.0x	1.5%
Tier 1	Orbital ATK (OA)	\$132.73	99%	\$8,950	6.2%	10.9%	5.8%	15.9%	19.5x	17.6x	11.4x	10.9x	1.8x	1.7x	32.5x	3.7x	1.6x	1.0%
Tier 2	Flir Systems (FLIR)	\$52.95	99%	\$7,321	5.1%	10.4%	14.8%	25.1%	25.3x	23.0x	16.6x	15.4x	4.2x	4.0x	27.5x	3.9x	0.0x	1.2%
Tier 1	SAIC (SAIC)	\$84.12	94%	\$4,503	3.6%	9.1%	4.4%	7.3%	19.6x	18.0x	13.5x	12.7x	1.0x	1.0x	23.1x	11.2x	2.7x	1.5%
Tier 2	CACI Int'l (CACI)	\$157.45	99%	\$4,967	3.4%	12.2%	5.9%	8.8%	19.3x	17.2x	12.4x	11.9x	1.1x	1.1x	19.2x	2.0x	2.7x	0.0%
Tier 2	Esterline (ESL)	\$75.60	74%	\$2,690	2.2%	20.1%	6.7%	14.6%	19.2x	16.0x	8.9x	8.2x	1.3x	1.3x	19.9x	1.3x	1.5x	0.0%
Tier 2	AAR Corp (AIR)	\$44.72	98%	\$1,688	9.1%	22.5%	2.3%	8.2%	19.0x	15.5x	10.2x	8.9x	0.8x	0.8x	40.3x	1.7x	1.0x	0.7%
Tier 2	Ultra Electronics (ULE LN)	\$19.67	70%	\$1,580	4.0%	8.5%	9.1%	17.0%	12.0x	11.0x	8.3x	7.9x	1.4x	1.4x	17.3x	2.1x	0.5x	3.6%
Tier 2	ManTech (MANT)	\$60.53	97%	\$1,413	7.2%	10.6%	7.1%	8.4%	30.0x	27.2x	8.8x	8.3x	0.7x	0.7x	11.6x	1.9x	-0.9x	1.7%
				Max	10.1%	22.5%	14.8%	25.1%	30.0x	27.2x	16.6x	15.4x	4.2x	4.0x	43.7x	11.2x	2.7x	3.6%
				Average	6.0%	13.7%	7.5%	14.4%	21.1x	18.6x	12.6x	11.6x	1.9x	1.8x	25.9x	4.3x	1.2x	1.4%
				Min	2.2%	8.5%	2.3%	7.3%	12.0x	11.0x	8.3x	7.9x	0.7x	0.7x	11.6x	1.3x	-0.9x	0.0%
Tier 2	Mercury Systems (MRCY)	\$46.00	84%	\$2,367	16.2%	10.3%	5.5%	24.4%	31.5x	28.6x	19.4x	16.8x	4.7x	4.1x	39.2x	3.0x	1.2x	0.0%

Source: Company filings, Wall St and Spruce Point estimates

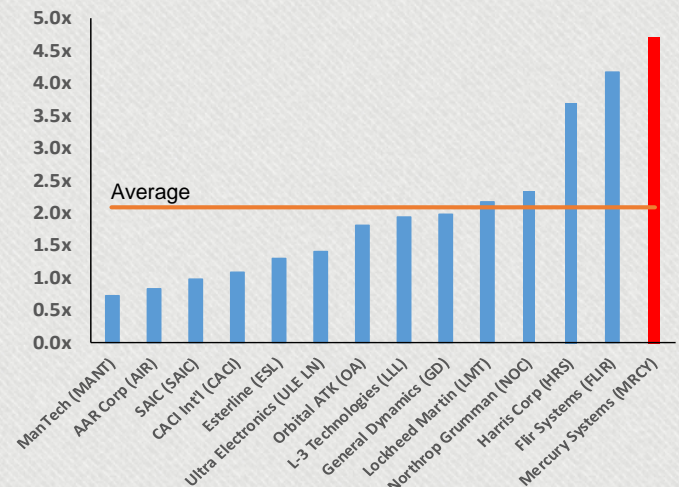
Mercury Trading At An Unjustified Premium To Its Peers (Cont'd)

MRCY's valuation premium relative to its average organic revenue growth, and low free cash flow margin, make little sense

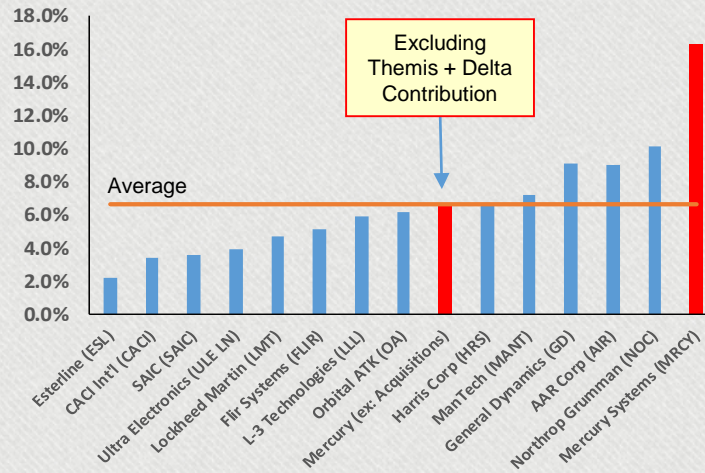
EV / 2018E EBITDA



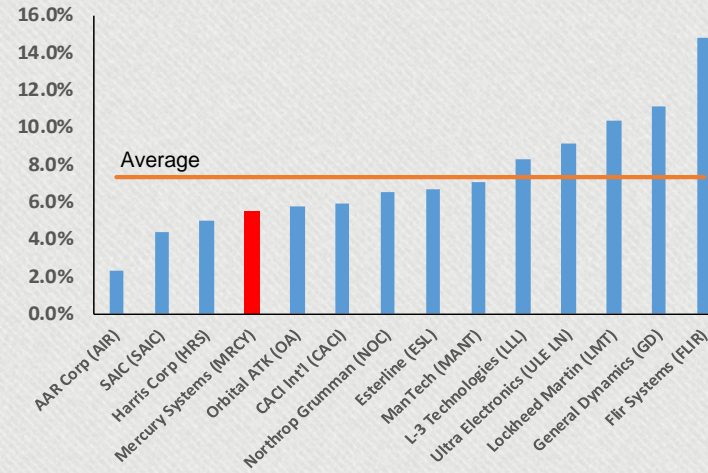
EV / 2018E Sales



2018E Revenue Growth



LTM Free Cash Flow Margin



Spruce Point Estimates 50% – 85% Downside

Given our concerns about the reliability of Mercury's Adjusted EBITDA, we believe the most conservative way to value the Company is on its stagnant free cash flow.

\$ in millions, except per share amounts

Valuation	Low Price	High Price	Note
Sales Multiple CY 2018E Sales Enterprise Value Plus: Cash Less: Debt Dil. Shares Price Target % Downside	1.5x <u>\$495.0</u> \$705.0 \$40.9 (\$188.9) <u>48.2</u> \$12.32/sh -73%	2.5x <u>\$505.0</u> \$1,225.0 \$40.9 (\$188.9) <u>48.2</u> \$23.10/sh -50%	Mercury's current EV/2018E sales multiple of 4.7x is astronomically high relative to peers on the belief that its ~16% revenue growth is the fastest in the industry. However, a majority of the growth in 2018 is coming from the acquisition of Themis. In our opinion, Mercury overpaid for Themis to cover-up financial problems. Excluding contributions from Themis (and to a lesser extent Delta Microwave), we estimate just <u>6.5%</u> underlying organic growth in CY 2018, below the long-term average of 9.5% (1)
Multiple of Free Cash Flow CY 2018E Free Cash Flow Enterprise Value Plus: Cash Less: Debt Dil. Shares Price Target % Downside	20.0x <u>\$26.0</u> \$520.0 \$40.9 (\$188.9) <u>48.2</u> \$7.71/sh -83%	25.0x <u>\$28.0</u> \$700.0 \$40.9 (\$188.9) <u>48.2</u> \$11.44/sh -75%	We estimate Themis contributes net \$2.7m of free cash flow (\$7.2m of free cash flow, reduced by \$4.5m of incremental interest expense) per Mercury's pro forma disclosures . We also adjust for incremental rent expense of \$1.7m. Peers trade at an average of 25x EV/FCF, but <u>MRCY should trade at a discount given its inability to increase free cash flow for three years</u>

1) Mercury's CY 2017 reported revenues of \$446.9m are reduced by \$28.5m [Delta Microwave (\$9.5m, closed on 4/3/17) and Creative (\$19m, closed 11/2/16)]. Pro forma CY 2017 revenues excluding acquisitions are \$418.4m. Themis CY 2017 revenues estimated at \$57m by Mercury and the deal closed 2/1/18. Wall St CY 2018 estimates for MRCY are \$501m. Removing \$52m of Themis revenue contribution and \$3.2m of Delta contribution equals \$445.7m of CY 2018 revenues. Therefore, pro forma organic revenue growth is estimated as $(\$445.8/\$418.4) - 1 = 6.5\%$. Note: Analysis conservatively assumes no growth in Themis CY 2018 sales and excludes the small Richland acquisition which Mercury has not disclosed sales.

Note: Downside Based on \$46/share