

MERCURY SYSTEMS INC  
Form 10-Q  
February 04, 2016  
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 DECEMBER 31, 2015

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 January 31, 2016: 34,829,997 shares

MERCURY SYSTEMS, INC.  
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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## MERCURY SYSTEMS, INC.

## CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

(Unaudited)

	December 31, 2015	June 30, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$81,554	\$77,586
Accounts receivable, net of allowance for doubtful accounts of \$52 and \$56 at December 31, 2015 and June 30, 2015, respectively	35,468	31,765
Unbilled receivables and costs in excess of billings	24,645	22,021
Inventory	36,707	31,960
Deferred income taxes	12,363	12,407
Prepaid income taxes	2,880	3,747
Prepaid expenses and other current assets	5,361	8,678
Total current assets	198,978	188,164
Restricted cash	264	264
Property and equipment, net	13,324	13,226
Goodwill	173,749	168,146
Intangible assets, net	18,608	17,998
Other non-current assets	3,169	2,190
Total assets	\$408,092	\$389,988
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$11,858	\$6,928
Accrued expenses	8,719	9,005
Accrued compensation	11,409	9,875
Deferred revenues and customer advances	9,406	7,477
Total current liabilities	41,392	33,285
Deferred gain on sale-leaseback	350	929
Deferred income taxes	2,287	3,108
Income taxes payable	1,505	1,459
Other non-current liabilities	1,100	1,069
Total liabilities	46,634	39,850
Commitments and contingencies (Note I)		
Shareholders' equity:		
Preferred stock, \$0.01 par value; 1,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, \$0.01 par value; 85,000,000 shares authorized; 33,240,461 and 32,570,959 shares issued and outstanding at December 31, 2015 and June 30, 2015, respectively	332	326
Additional paid-in capital	259,140	254,568
Retained earnings	101,221	94,468
Accumulated other comprehensive income	765	776
Total shareholders' equity	361,458	350,138

Total liabilities and shareholders' equity	\$408,092	\$389,988
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The accompanying notes are an integral part of the consolidated financial statements.

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## MERCURY SYSTEMS, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(In thousands, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2015	2014	2015	2014
Net revenues	\$60,417	\$57,089	\$118,826	\$111,150
Cost of revenues	31,839	30,054	62,719	60,116
Gross margin	28,578	27,035	56,107	51,034
Operating expenses:				
Selling, general and administrative	12,583	12,677	24,709	24,967
Research and development	7,684	7,895	15,777	15,846
Amortization of intangible assets	1,638	1,762	3,351	3,524
Restructuring and other charges	221	1,162	559	2,430
Impairment of long-lived assets	231	—	231	—
Acquisition costs and other related expenses	(148	) —	1,980	—
Total operating expenses	22,209	23,496	46,607	46,767
Income from operations	6,369	3,539	9,500	4,267
Interest income	26	4	50	7
Interest expense	(5	) (8	) (7	) (16
Other income, net	83	398	154	392
Income from continuing operations before income taxes	6,473	3,933	9,697	4,650
Tax provision	1,680	1,047	2,944	1,047
Income from continuing operations	4,793	2,886	6,753	3,603
Loss from discontinued operations, net of income taxes	—	(2,621	) —	(2,839
Net income	\$4,793	\$265	\$6,753	\$764
Basic net earnings (loss) per share:				
Income from continuing operations	\$0.14	\$0.09	\$0.20	\$0.11
Loss from discontinued operations, net of income taxes	—	(0.08	) —	(0.09
Net income	\$0.14	\$0.01	\$0.20	\$0.02
Diluted net earnings (loss) per share:				
Income from continuing operations	\$0.14	\$0.09	\$0.20	\$0.11
Loss from discontinued operations, net of income taxes	—	(0.08	) —	(0.09
Net income	\$0.14	\$0.01	\$0.20	\$0.02
Weighted-average shares outstanding:				
Basic	33,120	32,052	33,047	31,880
Diluted	33,831	32,686	33,819	32,720
Comprehensive income:				
Net income	\$4,793	\$265	\$6,753	\$764
Foreign currency translation adjustments	(28	) (111	) (11	) (208
Total comprehensive income	\$4,765	\$154	\$6,742	\$556

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



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

	Six Months Ended December 31,	
	2015	2014
Cash flows from operating activities:		
Net income	\$6,753	\$764
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	6,559	7,150
Stock-based compensation expense	5,094	4,933
Benefit for deferred income taxes	(894)	(1,314)
Impairment of goodwill and long-lived assets	231	2,283
Excess tax benefit from stock-based compensation	(1,359)	(536)
Other non-cash items	(384)	(568)
Changes in operating assets and liabilities:		
Accounts receivable, unbilled receivables, and costs in excess of billings	(6,254)	(7,103)
Inventory	(4,677)	1,584
Prepaid income taxes	867	(3,587)
Prepaid expenses and other current assets	3,315	(182)
Other non-current assets	(860)	291
Accounts payable and accrued expenses	7,045	4,126
Deferred revenues and customer advances	2,034	2,458
Income taxes payable	47	123
Other non-current liabilities	(39)	(16)
Net cash provided by operating activities	17,478	10,406
Cash flows from investing activities:		
Acquisition of business, net of cash acquired	(9,764)	—
Purchases of property and equipment	(3,156)	(2,123)
(Increase) decrease in other investing activities	(185)	1
Net cash used in investing activities	(13,105)	(2,122)
Cash flows from financing activities:		
Proceeds from employee stock plans	2,297	1,313
Payments for retirement of common stock	(4,124)	—
Excess tax benefit from stock-based compensation	1,359	536
Payments of capital lease obligations	—	(320)
Net cash (used in) provided by financing activities	(468)	1,529
Effect of exchange rate changes on cash and cash equivalents	63	(113)
Net increase in cash and cash equivalents	3,968	9,700
Cash and cash equivalents at beginning of period	77,586	47,287
Cash and cash equivalents at end of period	\$81,554	\$56,987
Cash paid during the period for:		
Interest	\$7	\$16
Income taxes	\$1,759	\$5,512
Supplemental disclosures—non-cash activities:		
Issuance of restricted stock awards to employees	\$8,241	\$8,832

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





MERCURY SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands except per share data)

(Unaudited)

A. Description of Business

Mercury Systems, Inc. (the "Company" or "Mercury") is a leading commercial provider of secure processing subsystems designed and made in the U.S.A. Optimized for customer and mission success, Mercury's solutions power a wide variety of critical defense and intelligence programs. Headquartered in Chelmsford, Massachusetts, Mercury is pioneering a next-generation defense electronics business model specifically designed to meet the industry's current and emerging technology needs. The Company delivers innovative solutions, rapid time-to-value and service and support to its defense prime contractor customers. The Company's products and solutions have been deployed in more than 300 programs with over 25 different defense prime contractors. Key programs include Aegis, Patriot, Surface Electronic Warfare Improvement Program ("SEWIP"), Gorgon Stare, Predator, F-35 and Reaper. The Company's organizational structure allows it to deliver capabilities that combine technology building blocks and deep domain expertise in the defense sector.

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

In June 2014, the Company initiated a plan to divest the Mercury Intelligence Systems ("MIS") operating segment, based on the Company's strategic direction and investment priorities focusing on its core business. On January 23, 2015, the Company completed the sale of the MIS operating segment. See Note M to consolidated financial statements.

B. Summary of Significant Accounting Policies

BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to the Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures, normally included in annual consolidated financial statements have been condensed or omitted pursuant to those rules and regulations; however, in the opinion of management the financial information reflects all adjustments, consisting of adjustments of a normal recurring nature, necessary for fair presentation. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the fiscal year ended June 30, 2015 which are contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on August 13, 2015. The results for the three and six months ended December 31, 2015 are not necessarily indicative of the results to be expected for the full fiscal year. The Company is comprised of the following operating segments: MCE and MDS. See Note L of the Notes to consolidated financial statements for further discussion.

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

BUSINESS COMBINATIONS

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

Company also utilizes FASB ASC 805 for the initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in business combinations.

## USE OF ESTIMATES

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

## REVENUE RECOGNITION

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

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

The Company uses FASB Accounting Standards Update ("ASU") No. 2009-13 ("FASB ASU 2009-13"), Multiple-Deliverable Revenue Arrangements. FASB ASU 2009-13 establishes a selling price hierarchy for determining the selling price of a deliverable, which includes: (1) vendor-specific objective evidence ("VSOE") if available; (2) third-party evidence ("TPE") if VSOE is not available; and (3) best estimated selling price ("BESP"), if neither VSOE nor TPE 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 36% and 42% of total revenues in the three and six months ended December 31, 2015, respectively. Total revenue recognized under multiple-deliverable revenue arrangements was 26% and 28% of total revenues in the three and six months ended December 31, 2014, respectively.

In accordance with the provisions of FASB ASU 2009-13, the Company allocates arrangement consideration to each deliverable in an arrangement based on its relative selling price. The Company generally expects that it will not be able to establish VSOE or TPE due to limited single element transactions and the nature of the markets in which the Company competes, and, as such, the Company typically determines its relative selling price using BESP. The objective of BESP is to determine the price at which the Company would transact if the product or service were sold by the Company on a standalone basis.

The Company's determination of BESP involves the consideration of several factors based on the specific facts and circumstances of each arrangement. Specifically, the Company considers the cost to produce the deliverable, the anticipated margin on that deliverable, the selling price and profit margin for similar parts, the Company's ongoing pricing strategy and policies (as evident from the price list established and updated by management on a regular basis), the value of any enhancements that have been built into the deliverable and the characteristics of the varying markets in which the deliverable is sold.

The Company analyzes the selling prices used in its allocation of arrangement consideration at a minimum on an annual basis. Selling prices will be analyzed on a more frequent basis if a significant change in the Company's business necessitates a more timely analysis or if the Company experiences significant variances in its selling prices. Each deliverable within the Company's multiple-deliverable revenue arrangements is accounted for as a separate unit of accounting under the guidance of FASB ASU 2009-13 if both of the following criteria are met: the delivered item or items have value to the customer on a standalone basis; and for an arrangement that includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. The Company's revenue arrangements generally do not include a general

right of return relative to delivered products. The Company considers a deliverable to have standalone value if the item is sold separately by the Company or another vendor or if the item could be resold by the customer.

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

The Company also engages in long-term contracts for development, production and services activities which it accounts for consistent with FASB ASC 605-35, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, and other relevant revenue recognition accounting literature. The Company considers the nature of these contracts and the types

of products and services provided when determining the proper accounting for a particular contract. Generally for fixed-price contracts, other than service-type contracts, revenue is recognized primarily under the percentage of completion method or, for certain short-term contracts, by the completed contract method. Revenue from service-type fixed-price contracts is recognized ratably over the contract period or by other appropriate input or output methods to measure service provided, and contract costs are expensed as incurred. The Company establishes billing terms at the time project deliverables and milestones are agreed. The risk to the Company on a fixed-price contract is that if estimates to complete the contract change from one period to the next, profit levels will vary from period to period. For time and materials contracts, revenue reflects the number of direct labor hours expended in the performance of a contract multiplied by the contract billing rate, as well as reimbursement of other billable direct costs. For all types of contracts, the Company recognizes anticipated contract losses as soon as they become known and estimable. The Company also considers whether contracts should be combined or segmented in accordance with the applicable criteria under GAAP. The Company combines closely related contracts when all the applicable criteria under GAAP are met. The combination of two or more contracts requires judgment in determining whether the intent of entering into the contracts was effectively to enter into a single project, which should be combined to reflect an overall profit rate. Similarly, the Company may separate a project, which may consist of a single contract or group of contracts, with varying rates of profitability, only if the applicable criteria under GAAP are met. Judgment also is involved in determining whether a single contract or group of contracts may be segmented based on how the arrangement was negotiated and the performance criteria. The decision to combine a group of contracts or segment a contract could change the amount of revenue and gross profit recorded in a given period. The use of contract accounting requires significant judgment relative to estimating total contract revenues and costs, including assumptions relative to the length of time to complete the contract, the nature and complexity of the work to be performed, anticipated increases in wages and prices for subcontractor services and materials, and the availability of subcontractor services and materials. The Company's estimates are based upon the professional knowledge and experience of its engineers, program managers and other personnel, who review each long-term contract monthly to assess the contract's schedule, performance, technical matters and estimated cost at completion. Changes in estimates are applied retrospectively and when adjustments in estimated contract costs are identified, such revisions may result in current period adjustments to earnings applicable to performance in prior periods. Contract costs also may include estimated contract recoveries for matters such as contract changes and claims for unanticipated contract costs. The Company records revenue associated with these matters only when the amount of recovery can be estimated reliably and realization is probable.

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

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

#### WEIGHTED-AVERAGE SHARES

Weighted-average shares were calculated as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2015	2014	2015	2014
Basic weighted-average shares outstanding	33,120	32,052	33,047	31,880
Effect of dilutive equity instruments	711	634	772	840
Diluted weighted-average shares outstanding	33,831	32,686	33,819	32,720

Equity instruments to purchase 2 and 25 shares of common stock were not included in the calculation of diluted net earnings per share for the three and six months ended December 31, 2015 because the equity instruments were

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

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## C.Acquisitions

## LEWIS INNOVATIVE TECHNOLOGIES ACQUISITION

On December 16, 2015, the Company entered into a share purchase agreement (the “Share Purchase Agreement”) with Lewis Innovative Technologies, Inc. (“LIT”) and the holders of the equity interests of LIT. Pursuant to the Share Purchase Agreement, the Company completed its purchase of all of the equity interests in LIT, and LIT became a wholly-owned subsidiary of the Company. Based in Decatur, Alabama, LIT provides advanced security technology and development services necessary for protecting systems critical to national security while meeting strict Department of Defense (“DoD”) program protection requirements. LIT is included in the MDS operating segment. The Company acquired LIT for a cash purchase price of \$9,764. The Company funded the purchase with cash on hand. The purchase price was subject to a post-closing adjustment based on a determination of LIT's closing net working capital. In accordance with the Share Purchase Agreement, \$1,000 of the purchase price was placed into escrow to support the post-closing working capital adjustment and the sellers' indemnification obligations. The escrow is available for indemnification claims through June 16, 2017. The Company acquired LIT free of bank debt.

The following table presents the net purchase price and the preliminary fair values of the assets and liabilities of LIT:

	Amounts	
Consideration transferred		
Cash paid at closing	\$10,290	
Working capital adjustment	(236)	)
Less cash and cash equivalents acquired	(290)	)
Net purchase price	\$9,764	
Estimated fair value of tangible assets acquired and liabilities assumed		
Cash and cash equivalents	\$290	
Accounts receivable and cost in excess of billings	290	
Other current and non-current assets	175	
Current liabilities	(264)	)
Estimated fair value of net tangible assets acquired	491	
Estimated fair value of identifiable intangible assets	3,960	
Estimated fair value of goodwill	5,603	
Estimated fair value of assets acquired	10,054	
Less cash and cash equivalents acquired	(290)	)
Net purchase price	\$9,764	

The amounts above represent the preliminary fair value estimates as of December 31, 2015 and are subject to subsequent adjustment as the Company obtains additional information during the measurement period and finalizes its fair value estimates. The preliminary identifiable intangible asset estimates include completed technology of \$3,240, customer relationships of \$590 and backlog of \$130. Any subsequent adjustments to these fair value estimates occurring during the measurement period will result in an adjustment to goodwill or income, as applicable.

The goodwill of \$5,603 arising from the LIT acquisition largely reflects the potential synergies and expansion of the Company's service offerings across product segments and markets complementary to the Company's existing products and markets. The LIT acquisition provides the Company with additional capabilities and expertise related to secure embedded processing applications. The acquisition is directly aligned with the Company's strategy of assembling critical and differentiated capabilities across the entire sensor processing chain. The goodwill from the LIT acquisition is included in the Company's MDS reporting unit.

The Company and the shareholders of LIT have agreed to treat the acquisition of LIT as an asset purchase for tax purposes by filing the required election forms under IRC Section 338(h)(10). The Company has estimated the tax value of the intangible assets from this transaction and is amortizing the amount over 15 years for tax purposes. As of December 31, 2015, the Company had \$5,603 of goodwill deductible for tax purposes.

The Company's consolidated results for the three and six months ended December 31, 2015 include \$30 and \$(40) of revenue and net loss, respectively, for LIT's operating results between the acquisition date and December 31, 2015.

Pursuant to the completion

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of the LIT acquisition, the Company incurred \$231 of impairment expense related to a pre-existing relationship. LIT acquisition costs and other related expenses were immaterial during the three and six months ended December 31, 2015. Additionally, the Company has not furnished pro forma financial information relating to LIT because such information is not material to the Company's financial results.

#### D. Fair Value of Financial Instruments

The following table summarizes the Company's financial assets measured at fair value on a recurring basis at December 31, 2015:

	Fair Value Measurements			
	December 31, 2015	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$51,529	\$51,529	\$—	\$—
Certificates of deposit	30,025	—	30,025	—
Restricted cash	264	264	—	—
Cost-method investment	500	—	—	500
Total	\$82,318	\$51,793	\$30,025	\$500

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. The value of the certificates of deposit is based on the quoted price for identical or similar instruments in markets that are not active or are directly or indirectly observable. The cost-method investment does not have a readily determinable fair value, as such the Company recorded the investment as a long term asset at cost and will continue to evaluate the asset for impairment.

The change of the fair value of the Company's cost-method investment is as follows:

Balance at June 30, 2015	Fair Value \$500
Changes in fair value	—
Balance at December 31, 2015	\$500

#### E. Inventory

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

	December 31, 2015	June 30, 2015
Raw materials	\$15,994	\$15,864
Work in process	13,916	11,190
Finished goods	6,797	4,906
Total	\$36,707	\$31,960

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

#### F. Goodwill

The following table sets forth the changes in the carrying amount of goodwill by reporting unit for the six months ended December 31, 2015:

	MCE	MDS	Total
Balance at June 30, 2015	\$ 134,378	\$ 33,768	\$ 168,146
Goodwill arising from the LIT acquisition	—	5,603	5,603
Balance at December 31, 2015	\$ 134,378	\$ 39,371	\$ 173,749

In the six months ended December 31, 2015, 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 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 and MDS.

#### G. Restructuring

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

	Severance & Related	Facilities & Other	Total
Restructuring liability at June 30, 2015	\$ 657	\$ 1,335	\$ 1,992
MCE restructuring and other charges	424	207	631
MDS restructuring and other charges	—	—	—
Cash paid	(724	) (529	) (1,253
Reversals(*)	(72	) —	(72
Restructuring liability at December 31, 2015	\$ 285	\$ 1,013	\$ 1,298

(\*) Reversals result from unused outplacement services.

During the three and six months ended December 31, 2015, the Company incurred net restructuring and other charges of \$221 and \$559, respectively. In the event that the Company is unable to sublease the unoccupied portion of its headquarters complex in Chelmsford, Massachusetts, it will incur nominal, periodic restructuring charges through fiscal 2017 in its MCE reportable segment.

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

#### H. Income Taxes

The Company recorded an income tax provision of \$1,680 and \$1,047 on income from continuing operations before income taxes of \$6,473 and \$3,933 for the three months ended December 31, 2015 and 2014, respectively. The Company recorded an income tax provision of \$2,944 and \$1,047 on income from continuing operations before income taxes of \$9,697 and \$4,650 for the six months ended December 31, 2015 and 2014, respectively. The effective tax rates for the three and six months ended December 31, 2015 differed from the federal statutory rate primarily due to federal research and development credits, domestic manufacturing deduction, stock compensation, and state taxes. The effective tax rates for the three and six months ended December 31, 2014 differed from the federal statutory rate primarily due to the impact of federal research and development credits, domestic manufacturing deduction, stock compensation, and state taxes.

On December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 was enacted, which retroactively reinstated and made permanent the federal research and development tax credit effective January 1, 2015. Based on the indefinite extension, the Company estimates that there was an additional \$1,568 credit earned during the period January 1, 2015 through June 30, 2016, of which \$568 relating to fiscal year 2015 was recognized as a discrete benefit in the three months ended December 31, 2015.

No material changes in the Company's unrecognized tax positions occurred during the six months ended December 31, 2015. The Company is currently under audit by the Internal Revenue Service for fiscal year 2013. There have been no

significant

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changes to the status of this examination during the six months ended December 31, 2015. It is reasonably possible that within the next 12 months the Company's unrecognized tax benefits, exclusive of interest, may decrease by up to \$757 at the conclusion of the audit. The Company expects that the decrease, if recognized, would not affect the effective tax rate.

#### I. 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.

On January 26, 2016, the Company received cash of \$175 based on the lapse of the indemnity escrow period associated with the sale of the Company's former MIS operating segment in January of 2015. The Company provided indemnification to the buyer of the MIS business, generally covering pre-closing tax liabilities of the business and buyer damages resulting from breaches of representations, warranties and covenants contained in the purchase and sale agreement. The Company's indemnification obligations regarding the MIS operating segment are generally subject to caps. No claims were made against the escrow.

##### PURCHASE COMMITMENTS

As of December 31, 2015, 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 \$24,191.

##### LEASE COMMITMENTS

On September 1, 2015, the Company entered into a lease agreement for a new headquarters location in Andover, Massachusetts. The Company expects to occupy the new office space by May 2017. The Company's total obligation for the base rent is \$21,070 based on utilization of not less than 114 square feet over the twelve year term of the lease. The Company has an option to expand its footprint to 145 square feet, or the entire facility, which would increase its corresponding total base rent obligation. This option must be exercised by the Company on or before December 31, 2018.

##### OTHER

As part of the Company's strategy for growth, the Company continues to explore acquisitions or strategic alliances. The associated acquisition costs incurred in the form of professional fees and services may be material to the future periods in which they occur, regardless of whether the acquisition is ultimately completed.

The Company may elect from time to time to purchase and subsequently retire shares of common stock in order to settle an individual employees' tax liability associated with vesting of a restricted stock award or exercise of stock options. These transactions would be treated as a use of cash in financing activities in the Company's statement of cash flows.

#### J. Debt

##### SENIOR UNSECURED CREDIT FACILITY

As of December 31, 2015, there was \$162,697 of borrowing capacity available under the Company's credit agreement with a syndicate of commercial banks, with Key Bank National Association acting as the administrative agent. The Company can borrow up to \$200,000 based on the Company's consolidated EBITDA for the trailing four quarters and

subject to compliance with the financial covenants in the credit agreement. There were no borrowings outstanding on the credit agreement; however, there were outstanding letters of credit of \$5,113. The Company was in compliance with all covenants and conditions under the credit agreement.

## K. Stock-Based Compensation

## STOCK OPTION PLANS

The number of shares authorized for issuance under the Company's 2005 Stock Incentive Plan, as amended and restated (the "2005 Plan"), is 15,252 shares at December 31, 2015. On October 21, 2015, the Company's number of shares authorized for issuance under the 2005 Plan increased 2 shares as a result of cancellations, forfeitures or terminations under 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 2,786 shares available for future grant under the 2005 Plan at December 31, 2015.

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

## EMPLOYEE STOCK PURCHASE PLAN

The number of shares authorized for issuance under the Company's 1997 Employee Stock Purchase Plan, as amended and restated ("ESPP"), is 1,800 shares. On December 8, 2015, the Company's shareholders approved an increase in the number of shares authorized for issuance under the ESPP to 1,800, an increase of 400. 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 46 and 41 shares issued under the ESPP during the six months ended December 31, 2015 and 2014, respectively. Shares available for future purchase under the ESPP totaled 440 at December 31, 2015.

## STOCK OPTION AND AWARD ACTIVITY

The following table summarizes activity of the Company's stock option plans since June 30, 2015:

	Options Outstanding		Weighted Average Remaining Contractual Term (Years)
	Number of Shares	Weighted Average Exercise Price	
Outstanding at June 30, 2015	830	\$ 13.43	1.66
Granted	—	—	
Exercised	(175	) 9.82	
Cancelled	(24	) 17.25	
Outstanding at December 31, 2015	631	\$ 14.29	1.42

The following table summarizes the status of the Company's non-vested restricted stock awards since June 30, 2015:

	Non-vested Restricted Stock Awards	
	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at June 30, 2015	1,866	\$ 10.72
Granted	518	15.90
Vested	(703	) 10.78
Forfeited	(84	) 10.79
Outstanding at December 31, 2015	1,597	\$ 12.37



## 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 and six months ended December 31, 2015 and 2014 in accordance with FASB ASC 718. During the three and six months ended December 31, 2015, the Company capitalized \$153 of stock-based compensation expense on the consolidated balance sheets. In the prior years, the Company did not capitalize any such costs on the consolidated balance sheets, as such costs were not material. Under the fair value recognition provisions of FASB ASC 718, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the service period, net of estimated forfeitures. The following table presents share-based compensation expenses from continuing operations included in the Company's consolidated statements of operations:

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2015	2014	2015	2014
Cost of revenues	\$6	\$115	\$155	\$266
Selling, general and administrative	2,063	1,778	4,191	3,744
Research and development	323	363	748	797
Share-based compensation expense before tax	2,392	2,256	5,094	4,807
Income tax benefit	(992 )	(839 )	(2,033 )	(1,759 )
Share-based compensation expense, net of income taxes	\$1,400	\$1,417	\$3,061	\$3,048

## L. 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 utilizes the management approach for determining reportable segments in accordance with the authoritative guidance. 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 designs, develops and builds open sensor processing products and subsystems that include embedded processing modules and subsystems, RF and microwave multi-function assemblies as well as subsystems, and RF and microwave components. MCE also provides technology building blocks to Mercury Defense Systems on key classified and unclassified programs.

Mercury Defense Systems ("MDS"): this operating segment provides significant capabilities relating to pre-integrated, open, affordable EW, EA and ECM subsystems, significant capabilities in signals intelligence, EO/IR processing technologies, and radar environment test and simulation systems, leveraging commercially available technologies and solutions (or "building blocks") from the MCE business and other commercial suppliers. Recently, MDS has added advanced security technology and development services related to secure embedded processing applications.

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 determined that both MCE and MDS met the quantitative thresholds for reporting.

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.

Adjusted EBITDA is defined as income from continuing operations before interest income and expense, income taxes, depreciation, amortization of intangible assets, restructuring and other charges, impairment of long-lived assets, acquisition and financing costs, fair value adjustments from purchase accounting, litigation and settlement expenses, and stock-based compensation expense. 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:





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	MCE	MDS	Eliminations	Total
<b>THREE MONTHS ENDED DECEMBER 31, 2015</b>				
Net revenues to unaffiliated customers	\$53,015	\$7,947	\$(545 )	\$60,417
Intersegment revenues	1,344	77	(1,421 )	—
Net revenues	\$54,359	\$8,024	\$(1,966 )	\$60,417
Adjusted EBITDA	\$12,873	\$(418 )	\$124	\$12,579
<b>THREE MONTHS ENDED DECEMBER 31, 2014</b>				
Net revenues to unaffiliated customers	\$51,806	\$4,767	\$516	\$57,089
Intersegment revenues	923	72	(995 )	—
Net revenues	\$52,729	\$4,839	\$(479 )	\$57,089
Adjusted EBITDA	\$10,510	\$284	\$(87 )	\$10,707
<b>SIX MONTHS ENDED DECEMBER 31, 2015</b>				
Net revenues to unaffiliated customers	\$103,021	\$15,964	\$(159 )	\$118,826
Intersegment revenues	4,360	105	(4,465 )	—
Net revenues	\$107,381	\$16,069	\$(4,624 )	\$118,826
Adjusted EBITDA	\$24,329	\$64	\$27	\$24,420
<b>SIX MONTHS ENDED DECEMBER 31, 2014</b>				
Net revenues to unaffiliated customers	\$100,362	\$10,147	\$641	\$111,150
Intersegment revenues	1,425	211	(1,636 )	—
Net revenues	\$101,787	\$10,358	\$(995 )	\$111,150
Adjusted EBITDA	\$17,799	\$770	\$141	\$18,710

The following table reconciles the Company's income from continuing operations, the most directly comparable GAAP financial measure, to its adjusted EBITDA:

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2015	2014	2015	2014
Income from continuing operations	\$4,793	\$2,886	\$6,753	\$3,603
Interest (income) expense, net	(21 )	4	(43 )	9
Income taxes	1,680	1,047	2,944	1,047
Depreciation	1,620	1,590	3,208	3,290
Amortization of intangible assets	1,638	1,762	3,351	3,524
Restructuring and other charges	221	1,162	559	2,430
Impairment of long-lived assets	231	—	231	—
Acquisition and financing costs	25	—	2,323	—
Fair value adjustments from purchase accounting	—	—	—	—
Litigation and settlement expenses	—	—	—	—
Stock-based compensation expense	2,392	2,256	5,094	4,807
Adjusted EBITDA	\$12,579	\$10,707	\$24,420	\$18,710

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

	US	Europe	Asia Pacific	Eliminations	Total
<b>THREE MONTHS ENDED DECEMBER 31, 2015</b>					
Net revenues to unaffiliated customers	\$58,211	\$653	\$1,553	\$—	\$60,417
Inter-geographic revenues	1,949	371	—	(2,320)	) —
Net revenues	\$60,160	\$1,024	\$1,553	\$(2,320)	) \$60,417
<b>THREE MONTHS ENDED DECEMBER 31, 2014</b>					
Net revenues to unaffiliated customers	\$55,625	\$355	\$1,109	\$—	\$57,089
Inter-geographic revenues	964	179	—	(1,143)	) —
Net revenues	\$56,589	\$534	\$1,109	\$(1,143)	) \$57,089
<b>SIX MONTHS ENDED DECEMBER 31, 2015</b>					
Net revenues to unaffiliated customers	\$115,573	\$1,111	\$2,142	\$—	\$118,826
Inter-geographic revenues	3,203	402	—	(3,605)	) —
Net revenues	\$118,776	\$1,513	\$2,142	\$(3,605)	) \$118,826
<b>SIX MONTHS ENDED DECEMBER 31, 2014</b>					
Net revenues to unaffiliated customers	\$108,710	\$701	\$1,739	\$—	\$111,150
Inter-geographic revenues	1,547	179	—	(1,726)	) —
Net revenues	\$110,257	\$880	\$1,739	\$(1,726)	) \$111,150

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:

	US	Europe	Asia Pacific	Eliminations	Total
December 31, 2015	\$13,215	\$83	\$26	\$—	\$13,324
June 30, 2015	\$13,127	\$68	\$31	\$—	\$13,226

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		Six Months Ended		
	December 31,		December 31,		
	2015	2014	2015	2014	
Raytheon Company	29	% 36	% 33	% 35	%
Lockheed Martin Corporation	26	% 18	% 21	% 24	%
	55	% 54	% 54	% 59	%

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

	Three Months Ended		Six Months Ended		
	December 31,		December 31,		
	2015	2014	2015	2014	
SEWIP	16	% *	12	% 13	%
F-35	13	% 11	% *	11	%
Patriot	11	% 18	% 14	% 18	%
Aegis	*	10	% *	10	%
	40	% 39	% 26	% 52	%

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



### M. Discontinued Operations

During the third quarter of fiscal 2015, the Company completed the sale of the MIS operating segment. The MIS operating results have been reported as a discontinued operation for all periods presented. The Company does not have continuing involvement in the operations of MIS after its divestiture.

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

	Three Months Ended December 31, 2014	Six Months Ended December 31, 2014
Net revenues of discontinued operations	\$1,321	\$3,160
Costs of discontinued operations:		
Cost of revenues	951	2,176
Selling, general and administrative	600	1,247
Research and development	105	276
Amortization of intangible assets	124	248
Acquisition costs and other related expenses	76	109
Impairment of goodwill	2,283	2,283
Loss from discontinued operations before income taxes	(2,818)	(3,179)
Tax benefit	(197)	(340)
Loss from discontinued operations, net of income taxes	\$(2,621)	\$(2,839)

There were no balances for the assets and liabilities of the discontinued operations for the periods ending December 31, 2015 and June 30, 2015.

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

	Three Months Ended December 31, 2014	Six Months Ended December 31, 2014
Depreciation	\$45	\$89
Amortization of intangible assets	\$124	\$248
Impairment of goodwill	\$2,283	\$2,283
Stock-based compensation expense	\$62	\$126

### N. 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.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF 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. You can identify these statements by the use of the words "may," "will," "could," "should," "would," "plans," "expects," "anticipates," "continue," "estimate," "project," "intend," "probable," "potential," and similar expressions. These forward-looking statements 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, the timing and amounts of such funding, general economic and business conditions, including unforeseen weakness in the Company's markets, effects of continued geopolitical unrest and regional conflicts, competition, changes in technology and methods of marketing, delays in completing engineering and manufacturing programs, changes in customer order patterns, changes in product mix, continued success in technological advances and delivering technological innovations, changes in, or in the U.S. Government's interpretation of, federal export control or procurement rules and regulations, market acceptance of the Company's 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, 2015. 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

We are a leading commercial provider of secure processing subsystems designed and made in the U.S.A. Optimized for customer and mission success, our solutions power a wide variety of critical defense and intelligence programs. Headquartered in Chelmsford, Massachusetts, we are pioneering a next-generation defense electronics business model specifically designed to meet the industry's current and emerging technology needs. We deliver innovative solutions, rapid time-to-value and 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"), Gorgon Stare, Predator, F-35 and Reaper. Our organizational structure allows us to deliver capabilities that combine technology building blocks and deep domain expertise in the defense sector. We believe our total portfolio of services and solutions is unique in the industry for a commercial company. We operate across a broad spectrum of defense programs and deliver our solutions and services via two operating segments: (i) Mercury Commercial Electronics; and (ii) Mercury Defense Systems. During the third quarter of fiscal 2015, we completed the sale of the Mercury Intelligence Systems ("MIS") operating segment. Consequently, its operating results are included in discontinued operations for all periods presented (see Note M to the consolidated financial statements).

As of December 31, 2015, we had 682 employees. Our revenue, income from continuing operations, adjusted earnings per share ("adjusted EPS"), and adjusted EBITDA for the three months ended December 31, 2015 were \$60.4 million, \$4.8 million, \$0.23, and \$12.6 million, respectively. Our revenue, income from continuing operations, adjusted EPS, and adjusted EBITDA for the six month period ended December 31, 2015 were \$118.8 million, \$6.8 million, \$0.42, and \$24.4 million, respectively. See the Non-GAAP Financial Measures section for a reconciliation to our most directly comparable GAAP financial measures.

Our operations are organized in the following two reportable segments: (i) Mercury Commercial Electronics ("MCE") and (ii) Mercury Defense Systems ("MDS").

Mercury Commercial Electronics, or MCE, designs, develops and builds open sensor processing products and subsystems that include embedded processing modules and subsystems, radio frequency ("RF") and microwave multi-function assemblies as well as subsystems, and RF and microwave components.

For the six months ended December 31, 2015, MCE accounted for 87% of our total net revenues.

Mercury Defense Systems, or MDS, provides significant capabilities relating to pre-integrated, open, affordable electronic warfare ("EW"), electronic attack ("EA") and electronic counter measure ("ECM") subsystems, significant capabilities in signals intelligence ("SIGINT"), electro-optical/infrared ("EO/IR") and secure processing technologies, and radar environment test and simulation systems. Recently, MDS added advanced security technology and development services related to secure embedded processing applications.

For the six months ended December 31, 2015, MDS accounted for 13% of our total net revenues. Since we are an OEM supplier and conduct much of our business with our defense customers as commercial item sales on commercial terms, 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 have limited ability to identify sequential quarterly trends, even within our operating segments.

**RESULTS OF OPERATIONS:**

Three months ended December 31, 2015 compared to the three months ended December 31, 2014

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

(In thousands)	December 31, 2015	As a % of Total Net Revenue	December 31, 2014	As a % of Total Net Revenue	
Net revenues	\$60,417	100.0	% \$57,089	100.0	%
Cost of revenues	31,839	52.7	30,054	52.6	
Gross margin	28,578	47.3	27,035	47.4	
Operating expenses:					
Selling, general and administrative	12,583	20.8	12,677	22.2	
Research and development	7,684	12.7	7,895	13.9	
Amortization of intangible assets	1,638	2.7	1,762	3.1	
Restructuring and other charges	221	0.4	1,162	2.0	
Impairment of long-lived assets	231	0.4	—	—	
Acquisition costs and other related expenses	(148	) (0.2	) —	—	
Total operating expenses	22,209	36.8	23,496	41.2	
Income from operations	6,369	10.5	3,539	6.2	
Other income, net	104	0.2	394	0.7	
Income from continuing operations before income taxes	6,473	10.7	3,933	6.9	
Tax provision	1,680	2.8	1,047	1.8	
Income from continuing operations	4,793	7.9	2,886	5.1	
Loss from discontinued operations, net of income taxes	—	0.0	(2,621	) (4.6	)
Net income	\$4,793	7.9	% \$265	0.5	%

**REVENUES**

(In thousands)	December 31, 2015	December 31, 2014	\$ Change	% Change	
MCE	\$53,015	\$51,806	\$1,209	2	%
MDS	7,947	4,767	3,180	67	%
Eliminations	(545	) 516	(1,061	) (206	)%
Total revenues	\$60,417	\$57,089	\$3,328	6	%

Total revenues increased \$3.3 million, or 6%, to \$60.4 million during the three months ended December 31, 2015 as compared to the same period in fiscal 2015. This increase was driven by higher defense sales of \$5.7 million, partially offset by lower commercial sales of \$2.4 million. The increase in total revenues is primarily attributed to higher revenues from the SEWIP, DEWS and an airborne surveillance programs, partially offset by lower Global Hawk revenue. International revenues, which consist of foreign military sales through prime defense contractor customers and direct sales to non-U.S. based customers, decreased \$1.9 million to \$12.7 million during the three months ended December 31, 2015, compared to \$14.6 million in the same period in the prior fiscal year. The decrease was primarily



driven by lower revenues from the Global Hawk program. International revenues represented 21% and 26% of total revenues during the three months ended December 31, 2015 and 2014, respectively.

Net MCE revenues increased \$1.2 million, or 2%, during the three months ended December 31, 2015 as compared to the same period in the prior fiscal year. This increase was primarily driven by higher SEWIP and DEWS program revenues, partially offset by lower Global Hawk revenue.

Net MDS revenues increased \$3.2 million, or 67%, during the three months ended December 31, 2015 as compared to the same period in the prior fiscal year. This increase was primarily driven by strength in an airborne surveillance program in the most recent quarter.

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 47.3% for the three months ended December 31, 2015, a decrease of 10 basis points from the 47.4% gross margin achieved during the same period in fiscal 2015. Despite the consistency in gross margin period over period, we had increased high margin F-35 royalty revenues during the three months ended December 31, 2015, partially offset by increased revenues from lower margin programs and a \$1.5 million increase to our inventory reserve at MDS during the three months ended December 31, 2015.

#### SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses decreased \$0.1 million, or 1%, to \$12.6 million during the three months ended December 31, 2015, compared to \$12.7 million in the same period in fiscal 2015. The decrease was primarily due to operating leverage. Selling, general and administrative expenses decreased as a percentage of revenues to 20.8% during the three months ended December 31, 2015 from 22.2% during the same period in fiscal 2015. The decrease was due to higher revenues in the second quarter of fiscal 2016, as compared to the same period in fiscal 2015.

#### RESEARCH AND DEVELOPMENT

Research and development expenses decreased approximately \$0.2 million, or 3%, to \$7.7 million during the three months ended December 31, 2015, compared to \$7.9 million during the same period in fiscal 2015. The decrease was primarily due to higher customer funded development during fiscal 2016.

#### RESTRUCTURING AND OTHER CHARGES

Restructuring and other charges decreased approximately \$0.9 million, or 81%, to \$0.2 million during the three months ended December 31, 2015, compared to \$1.1 million during the same period in fiscal 2015. The decrease was driven by lower severance and facility costs in the second quarter of fiscal 2016 as our acquisition integration activities were completed during fiscal 2015. The second quarter of fiscal 2015 included the final phase of the Chelmsford, Massachusetts headquarters consolidation and related severance activities. We will incur nominal, periodic restructuring charges through fiscal 2017 in our MCE reportable segment if we are unable to sublease the unoccupied portion of our headquarters.

#### IMPAIRMENT OF LONG-LIVED ASSETS

We recorded an impairment charge of \$0.2 million during the three months ended December 31, 2015, compared to \$0.0 million during the same period in fiscal 2015. Pursuant to the completion of the LIT acquisition, we incurred \$231 of impairment expense related to a pre-existing relationship.

#### ACQUISITION COSTS AND OTHER RELATED EXPENSES

We incurred (\$0.1) million of acquisition costs and other related expenses during the three months ended December 31, 2015, compared to \$0.0 million during the same period in fiscal 2015. During the three months ended December 31, 2015, we incurred less than \$0.1 million in LIT related acquisition costs, which were offset by a \$0.2 million reduction associated with a change in estimate to accrued acquisition related fees. We expect to incur acquisition costs and other related expenses periodically as we continue to seek acquisition opportunities to expand our capabilities within RF, microwave and embedded processing with a goal to assemble differentiated capabilities across the entire sensor processing chain.

#### OTHER INCOME, NET

Other income, net decreased \$0.3 million during the three months ended December 31, 2015, as compared to the same period in fiscal 2015. Both periods include \$0.3 million related to the amortization of the gain on the sale leaseback of our corporate headquarters. These gains were offset by \$0.2 million in bank fees during the three months ended

December 31, 2015 which were classified as selling, general, and administrative expenses in periods prior to the third quarter of fiscal 2015.

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## INCOME TAXES

We recorded an income tax provision of \$1.7 million during the three months ended December 31, 2015 as compared to \$1.0 million for the same period in the prior fiscal year. Our effective tax rates for the three months ended December 31, 2015 and 2014 differed from the federal statutory tax rate of 35% primarily due to federal research and development credits, domestic manufacturing deduction, stock compensation, and state taxes.

## DISCONTINUED OPERATIONS

We completed the sale of our MIS operating segment during the third quarter of fiscal 2015 and have ceased continuing involvement in the operations of MIS after its divestiture. During the three months ended December 31, 2014, we incurred a loss from discontinued operations of \$2.6 million, including a \$2.3 million goodwill impairment of our MIS reporting unit.

## SEGMENT OPERATING RESULTS

We use adjusted EBITDA as the profitability measure for our segment reporting. Adjusted EBITDA for MCE increased \$2.4 million during the three months ended December 31, 2015 to \$12.9 million as compared to \$10.5 million for the comparable period in fiscal 2015. The increase in adjusted EBITDA was driven by higher revenues of \$1.2 million primarily from the SEWIP and DEWS programs, coupled with higher margins from a change in product mix.

Adjusted EBITDA for MDS decreased \$0.7 million to (\$0.4) million during the three months ended December 31, 2015 as compared to \$0.3 million for the comparable period in fiscal 2015. The decrease in adjusted EBITDA was primarily driven by a \$1.5 million increase in our inventory reserve, partially offset by higher revenues related to an airborne surveillance program.

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

Six months ended December 31, 2015 compared to the six months ended December 31, 2014

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

(In thousands)	December 31, 2015	As a % of Total Net Revenue	%	December 31, 2014	As a % of Total Net Revenue	%
Net revenues	\$ 118,826	100.0		\$ 111,150	100.0	
Cost of revenues	62,719	52.8		60,116	54.1	
Gross margin	56,107	47.2		51,034	45.9	
Operating expenses:						
Selling, general and administrative	24,709	20.7		24,967	22.5	
Research and development	15,777	13.3		15,846	14.2	
Amortization of intangible assets	3,351	2.8		3,524	3.2	
Restructuring and other charges	559	0.5		2,430	2.2	
Impairment of long-lived assets	231	0.2		—	—	
Acquisition costs and other related expenses	1,980	1.7		—	—	
Total operating expenses	46,607	39.2		46,767	42.1	
Income from operations	9,500	8.0		4,267	3.8	
Other income, net	197	0.2		383	0.4	
Income from continuing operations before income taxes	9,697	8.2		4,650	4.2	
Tax provision	2,944	2.5		1,047	0.9	
Income from continuing operations	6,753	5.7		3,603	3.3	
Loss from discontinued operations, net of income taxes	—	—		(2,839)	(2.6)	
Net income	\$6,753	5.7	%	\$764	0.7	%



## REVENUES

(In thousands)	December 31, 2015	December 31, 2014	\$ Change	% Change	
MCE	\$103,021	\$100,362	\$2,659	3	%
MDS	15,964	10,147	5,817	57	%
Eliminations	(159)	) 641	(800)	) (125)	)%
Total revenues	\$118,826	\$111,150	\$7,676	7	%

Total revenues increased \$7.7 million, or 7%, to \$118.8 million during the six months ended December 31, 2015 as compared to the same period in fiscal 2015. This increase was driven by higher defense sales of \$12.1 million, partially offset by a \$4.4 million decrease in commercial sales. The increase in total revenues is primarily attributed to increases in the P8, Reaper and DEWS programs, and an airborne surveillance program that were partially offset by lower revenues from the Global Hawk and Patriot programs. International revenues, which consist of foreign military sales through prime defense contractor customers and direct sales to non-U.S. based customers, decreased \$3.9 million to \$21.1 million during the six months ended December 31, 2015, compared to \$25.0 million in the same period in the prior fiscal year. The decrease was primarily driven by lower revenues from the Global Hawk program. International revenues represented 18% and 23% of total revenues during the six months ended December 31, 2015 and 2014, respectively.

Net MCE revenues increased \$2.7 million, or 3%, during the six months ended December 31, 2015 as compared to the same period in fiscal 2015. This increase was primarily driven by higher defense sales of \$7.1 million related to increases in the P8, Reaper and DEWS programs, partially offset by a \$4.4 million decrease in commercial sales.

Net MDS revenues increased \$5.8 million, or 57%, during the six months ended December 31, 2015 as compared to the same period in fiscal 2015. This increase was primarily driven by higher revenues related to an airborne surveillance program.

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 47.2% for the six months ended December 31, 2015, as compared to a 45.9% gross margin during the same period in fiscal 2015. The higher gross margin year over year was due to a favorable product mix, primarily driven by stronger revenues in our higher margin digital processing programs and products within MCE.

## SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses decreased \$0.3 million, or 1%, to \$24.7 million during the six months ended December 31, 2015, compared to \$25.0 million in the same period in fiscal 2015. The decrease was primarily due to operating leverage. Selling, general and administrative expenses decreased as a percentage of revenues to 20.7% during the six months ended December 31, 2015 from 22.5% during the same period in fiscal 2015. The decrease was due to higher revenues in the first six months of fiscal 2016 coupled with overall expense reductions, as compared to the same period in fiscal 2015.

## RESEARCH AND DEVELOPMENT

Research and development expenses decreased \$0.1 million, to \$15.8 million during the six months ended December 31, 2015, compared to \$15.9 million during the same period in fiscal 2015. The decrease was primarily due to higher customer funded development offset by increased compensation expenses during fiscal 2016.

## RESTRUCTURING AND OTHER CHARGES

Restructuring and other charges were \$0.6 million for the six months ended December 31, 2015, as compared to \$2.4 million during the same period in fiscal 2015. The decrease was driven by lower severance and facility costs in the first half of fiscal 2016 as our acquisition integration activities were completed during fiscal 2015. The first half of fiscal 2015 included the second and final phases of the Chelmsford, Massachusetts headquarters consolidation and related severance activities. We will incur nominal, periodic restructuring charges through fiscal 2017 in our MCE reportable segment if we are unable to sublease the unoccupied portion of our headquarters.

## IMPAIRMENT OF LONG-LIVED ASSETS

We recorded an impairment charge of \$0.2 million during the six months ended December 31, 2015, compared to \$0.0 million during the same period in fiscal 2015. Pursuant to the completion of the LIT acquisition, we incurred \$231 of impairment expense related to a pre-existing relationship.

#### ACQUISITION COSTS AND OTHER RELATED EXPENSES

We incurred \$2.0 million of acquisition costs and other related expenses during the six months ended December 31, 2015, compared to \$0.0 million during the same period in fiscal 2015. We expect to incur acquisition costs and other related expenses periodically as we continue to seek acquisition opportunities to expand our capabilities within RF, microwave, and embedded processing with a goal to assemble differentiated capabilities across the entire sensor processing chain.

#### OTHER INCOME, NET

Other income, net decreased \$0.2 million during the six months ended December 31, 2015, as compared to the same period in fiscal 2015. Both periods include \$0.6 million related to the amortization of the gain on the sale leaseback of our corporate headquarters. These gains were offset by \$0.4 million in bank fees during the six months ended December 31, 2015 which were classified as selling, general, and administrative expenses in periods prior to the third quarter of fiscal 2015, and a \$0.3 million write off of an escrow receivable in the first quarter of fiscal 2015.

#### INCOME TAXES

We recorded an income tax provision of \$2.9 million during the six months ended December 31, 2015 as compared to a \$1.0 million income tax provision for the same period in fiscal 2015. Our effective tax rates for the six months ended December 31, 2015 and 2014 differed from the federal statutory tax rate of 35% primarily due to federal research and development tax credits, domestic manufacturing deduction, stock compensation, state taxes and the realization of previously unrecognized tax benefits.

#### DISCONTINUED OPERATIONS

We completed the sale of our MIS operating segment during the third quarter of fiscal 2015 and have ceased continuing involvement in the operations of MIS after its divestiture. During the six months ended December 31, 2014, we incurred a loss from discontinued operations of \$2.8 million, including a \$2.3 million goodwill impairment of our MIS reporting unit.

#### SEGMENT OPERATING RESULTS

We use adjusted EBITDA as the profitability measure for our segment reporting. Adjusted EBITDA for MCE increased \$6.5 million during the six months ended December 31, 2015 to \$24.3 million as compared to \$17.8 million for the same period in fiscal 2015. The increase in adjusted EBITDA is primarily driven by higher revenues of \$2.7 million primarily from the P8 and Reaper programs, coupled with higher gross margins from a change in product mix. Adjusted EBITDA for MDS decreased \$0.7 million during the six months ended December 31, 2015 to \$0.1 million as compared to \$0.8 million for the same period in fiscal 2015. The decrease in adjusted EBITDA was primarily due to a \$1.5 million increase in our inventory reserve, partially offset by higher revenues related to an airborne surveillance program.

See Note L 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 currently do not 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.



### Shelf Registration Statement

On August 15, 2014, 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 \$500.0 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.

### Senior Unsecured Credit Facility

As of December 31, 2015, there was \$162.7 million of borrowing capacity available under our credit agreement with a syndicate of commercial banks, with Key Bank National Association acting as the administrative agent. The credit agreement provides for borrowing up to a maximum \$200.0 million based on the Company's consolidated EBITDA for the trailing four quarters and subject to compliance with the financial covenants in the credit agreement. There were no borrowings outstanding on the credit agreement; however, there were outstanding letters of credit of \$5.1 million. We were in compliance with all covenants and conditions under the credit agreement.

### CASH FLOWS

(In thousands)	As Of and For the Six Month Period Ended December 31,	
	2015	2014
Net cash provided by operating activities	\$17,478	\$10,406
Net cash used in investing activities	\$(13,105)	\$(2,122)
Net cash (used in) provided by financing activities	\$(468)	\$1,529
Net increase in cash and cash equivalents	\$3,968	\$9,700
Cash and cash equivalents at end of period	\$81,554	\$56,987

Our cash and cash equivalents increased by \$4.0 million from June 30, 2015 to December 31, 2015, primarily as a result of \$17.5 million in cash generated from operating activities, partially offset by \$9.8 million used for the acquisition of LIT, and \$4.1 million in payments for the retirement of common stock.

#### Operating Activities

During the six months ended December 31, 2015, we generated \$17.5 million in cash from operating activities, an increase of \$7.1 million when compared to \$10.4 million in cash generated from operating activities during the same period in fiscal 2015. During the six months ended December 31, 2015, we generated \$6.0 million in higher comparable net income, used \$8.0 million less cash for prepaid expenses and other current assets, and generated \$2.9 million more cash from the timing of payables as compared to the same period in the prior year. These increases were partially offset by \$6.3 million higher inventory purchase, \$2.7 million less in non-cash activities and used \$1.2 million more in other non-current assets as compared to the same period in fiscal 2015. Our ability to generate cash from 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 six months ended December 31, 2015, we used \$13.1 million in investing activities compared to \$2.1 million during the same period in fiscal 2015. The increase was primarily driven by \$9.8 million used for the acquisition of LIT and \$1.0 million higher capital expenditures in fiscal 2016.

#### Financing Activities

During the six months ended December 31, 2015, we used \$0.5 million in financing activities compared to \$1.5 million generated from financing activities during the same period in fiscal 2015. The \$2.0 million increase in cash used in financing activities was primarily due to \$4.1 million for the retirement of common stock, partially offset by a \$1.0 million increase in



proceeds from our employee stock plan and a \$0.8 million increase in excess tax benefits from stock-based compensation during the six months ended December 31, 2015.

#### COMMITMENTS, CONTRACTUAL OBLIGATIONS AND CONTINGENCIES

The following is a schedule of our commitments and contractual obligations outstanding at December 31, 2015:

(In thousands)	Total	Less Than 1 Year	2-3 Years	4-5 Years	More Than 5 Years
Purchase obligations	\$24,191	\$24,191	\$—	\$—	\$—
Operating leases	40,329	4,735	7,424	6,872	21,298
	\$64,520	\$28,926	\$7,424	\$6,872	\$21,298

We have a liability at December 31, 2015 of \$2.3 million for uncertain tax positions that have been taken or are expected to be taken in various income tax returns. It is reasonably possible that within the next 12 months this liability, exclusive of interest, may decrease by up to \$0.8 million upon the conclusion of the Internal Revenue Service audit of fiscal year 2013. We do not know the ultimate resolution on these uncertain tax positions and as such, do not know the ultimate timing of payments related to this liability. Accordingly, these amounts are not included in the above table.

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 \$24.2 million at December 31, 2015.

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 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.

On January 26, 2016, we received cash of \$0.2 million based on the lapse of the indemnity escrow period associated with the sale of our former MIS operating segment in January of 2015. We provided indemnification to the buyer of the MIS business, generally covering pre-closing tax liabilities of the business and buyer damages resulting from breaches of representations, warranties and covenants contained in the purchase and sale agreement. Our indemnification obligations regarding the MIS operating segment are generally subject to caps. No claims were made against the escrow.

As part of our strategy for growth, we continue to explore acquisitions or strategic alliances. The associated acquisition costs incurred in the form of professional fees and services may be material to the future periods in which they occur, regardless of whether the acquisition is ultimately completed.

We may elect from time to time to purchase and subsequently retire shares of common stock in order to settle an individual employees' tax liability associated with vesting of a restricted stock award or exercise of stock options. These transactions would be treated as a use of cash in financing activities in our statement of cash flows.

#### Deferred Tax Assets

As of December 31, 2015, we had approximately \$11.5 million in net deferred tax assets. Each quarter, we determine the probability of realizing these assets, using significant judgments and estimates with respect to historical operating results, expectations of future earnings, tax planning strategies and other matters. 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 adjust the valuation allowance accordingly. We continue to conclude that it is more likely than not that most domestic deferred tax assets would be realizable based on current financial performance, projected future taxable income and the reversal of existing deferred tax liabilities.

We continue to record a full valuation allowance on certain state research and development and investment tax credits, and capital loss carryforwards as of December 31, 2015 as management continues to believe that it is not more likely than not that these deferred tax assets would be realized. Any future reversals of the valuation allowance will impact income tax expense.

#### 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.

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## NON-GAAP FINANCIAL MEASURES

In our periodic communications, we discuss four important measures that are not calculated according to U.S. generally accepted accounting principles ("GAAP"), adjusted EBITDA, free cash flow, adjusted income from continuing operations, and adjusted earnings per share ("adjusted EPS").

Adjusted EBITDA, the profitability measure for our segment reporting, is defined as income from continuing operations before interest income and expense, income taxes, depreciation, amortization of intangible assets, restructuring and other charges, impairment of long-lived assets, acquisition and financing costs, fair value adjustments from purchase accounting, litigation and settlement expenses and stock-based compensation expense. We use adjusted EBITDA as an important indicator of the operating performance of our business. We exclude the above-described items from our internal forecasts and models when establishing internal operating budgets, supplementing the financial results and forecasts reported to our board of directors, determining the portion of bonus compensation for executive officers and other key employees based on operating performance, evaluating short-term and long-term operating trends in our operations, and allocating resources to various initiatives and operational requirements. We believe the adjusted EBITDA financial measure permits a comparative assessment of our operating performance, relative to our performance based on our GAAP results, while isolating the effects of charges that may vary from period to period without any correlation to underlying operating performance. 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. We believe that trends in our adjusted EBITDA are valuable indicators of our operating performance.

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 income from continuing operations, the most directly comparable GAAP financial measure, to our adjusted EBITDA:

(In thousands)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2015	2014	2015	2014
Income from continuing operations	\$4,793	\$2,886	\$6,753	\$3,603
Interest (income) expense, net	(21	) 4	(43	) 9
Income taxes	1,680	1,047	2,944	1,047
Depreciation	1,620	1,590	3,208	3,290
Amortization of intangible assets	1,638	1,762	3,351	3,524
Restructuring and other charges	221	1,162	559	2,430
Impairment of long-lived assets	231	—	231	—
Acquisition and financing costs	25	—	2,323	—
Fair value adjustments from purchase accounting	—	—	—	—
Litigation and settlement expenses	—	—	—	—
Stock-based compensation expense	2,392	2,256	5,094	4,807
Adjusted EBITDA	\$12,579	\$10,707	\$24,420	\$18,710

Free cash flow is defined as cash provided by operating activities less capital expenditures. 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		Six Months Ended	
	December 31,		December 31,	
	2015	2014	2015	2014
Cash provided by operating activities	\$11,865	\$8,229	\$17,478	\$10,406
Purchase of property and equipment	(1,289	) (1,218	) (3,156	) (2,123
Free cash flow	\$10,576	\$7,011	\$14,322	\$8,283

Adjusted income from continuing operations and adjusted EPS exclude the impact of certain items and, therefore, have not been calculated in accordance with GAAP. We believe that exclusion of these items assists in providing a more complete understanding of our underlying continuing operations results and trends and allows for comparability with our peer company index and industry. We use these measures along with the corresponding GAAP financial measures to manage our business and to evaluate our performance compared to prior periods and the marketplace. We define adjusted income from continuing operations as income from continuing operations before amortization of intangible assets, restructuring and other charges, impairment of long-lived assets, acquisition and financing costs, fair value adjustments from purchase accounting, litigation and settlement expenses, stock-based compensation expense, and the tax impact of those items. Adjusted EPS expresses adjusted income from continuing operations on a per share basis using weighted average diluted shares outstanding.

Adjusted income from continuing operations and adjusted EPS are non-GAAP financial measures and should not be considered in isolation or as a substitute for financial information provided in accordance with GAAP. These non-GAAP financial measures 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 income from continuing operations and adjusted EPS financial adjustments described above, and investors should not infer from our presentation of these non-GAAP financial measures that these costs are unusual, infrequent or non-recurring.

The following table reconciles income from continuing operations and diluted net earnings per share, the most directly comparable GAAP measures, to adjusted income from continuing operations and adjusted EPS:

(In thousands, except per share data)	Three Months Ended			
	December 31,			
	2015		2014	
Income from continuing operations and earnings per share	\$4,793	\$0.14	\$2,886	\$0.09
Amortization of intangible assets	1,638		1,762	
Restructuring and other charges	221		1,162	
Impairment of long-lived assets	231		—	
Acquisition and financing costs	25		—	
Fair value adjustments from purchase accounting	—		—	
Litigation and settlement expenses	—		—	
Stock-based compensation expense	2,392		2,256	
Impact to income taxes	(1,475	)	(1,658	)
Adjusted income from continuing operations and adjusted earnings per share	\$7,825	\$0.23	\$6,408	\$0.20
Diluted weighted-average shares outstanding		33,831		32,686

(In thousands, except per share data)	Six Months Ended			
	December 31,			
	2015		2014	
Income from continuing operations and earnings per share	\$6,753	\$0.20	\$3,603	\$0.11
Amortization of intangible assets	3,351		3,524	
Restructuring and other charges	559		2,430	
Impairment of long-lived assets	231		—	
Acquisition and financing costs	2,323		—	
Fair value adjustments from purchase accounting	—		—	
Litigation and settlement expenses	—		—	
Stock-based compensation expense	5,094		4,807	
Impact to income taxes	(4,045 )		(3,615 )	
Adjusted income from continuing operations and adjusted earnings per share	\$14,266	\$0.42	\$10,749	\$0.33
Diluted weighted-average shares outstanding		33,819		32,720

#### RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for us on July 1, 2018 and can be early adopted for the fiscal year beginning July 1, 2017. The standard permits the use of either the retrospective or cumulative effect transition method. We are evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

In August 2014, the FASB issued ASU No. 2014-15, Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern, an amendment of the FASB Accounting Standards Codification. The ASU has added additional disclosure requirements to the codification. It requires management to assess, at each interim and annual reporting period, whether substantial doubt exists about the company's ability to continue as a going concern. Substantial doubt exists if it is probable (the "probable" threshold under U.S. GAAP has generally been interpreted to be between 75 and 80 percent) that the company will be unable to meet its obligations as they become due within one year after the date the financial statements are issued or available to be issued (assessment date). The ASU is effective for annual reporting periods beginning after December 15, 2016, and interim periods thereafter, with early adoption permitted. We do not expect a going concern uncertainty in the foreseeable future, and therefore this guidance is not expected to have a material impact to our consolidated financial statements.

In January 2015, the FASB issued ASU No. 2015-01, Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items, an amendment of the FASB Accounting Standards Codification. This ASU eliminates the separate presentation of extraordinary items, net of tax and the related earnings per share, but does not affect the requirement to disclose material items that are unusual in nature or infrequently occurring. The ASU aligns U.S. GAAP more closely with IFRS (International Financial Reporting Standards). Entities will continue to evaluate whether items are unusual in nature or infrequent in their occurrence for disclosure purposes and when estimating the annual effective tax rate for interim reporting purposes. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The ASU allows prospective or retrospective applications. Early adoption is permitted if applied from the beginning of the fiscal year of adoption. We do not expect this guidance to have a material impact to our consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, Simplifying the Measurement of Inventory, an amendment of the FASB Accounting Standards Codification. This ASU changes the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value for entities that do not measure inventory using the last-in, first-out or retail inventory method. The ASU also eliminates the requirement for these entities to consider



replacement cost or net realizable value less an approximately normal profit margin when measuring inventory. The ASU is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those years. The ASU requires prospective adoption and permits early adoption. We are evaluating the effect that ASU 2015-11 will have on our consolidated financial statements.

In September 2015, the FASB issued ASU No. 2015-16, Simplifying the Accounting for Measurement-Period Adjustments, an amendment of the FASB Accounting Standards Codification. This ASU eliminates the requirement for an acquirer to retrospectively adjust the financial statements for measurement-period adjustments that occur in periods after a business

combination is consummated. The ASU is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. Early adoption is permitted. We do not expect this guidance to have a material impact to our consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes, an amendment of the FASB Accounting Standards Codification. This ASU simplifies the presentation of deferred taxes by requiring deferred tax assets and liabilities be classified as non-current on the balance sheet. The ASU is effective for us on July 1, 2016 and can be early adopted as of the beginning of an interim or annual reporting period. The ASU allows prospective or retrospective applications. We intend to early adopt the ASU in the period beginning January 1, 2016, and do not expect this guidance to have a material impact to our consolidated financial statements.

#### RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

Effective October 1, 2015, we adopted FASB ASU No. 2014-17, Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force), an amendment of the FASB Accounting Standards Codification. This ASU allows an acquired entity to elect to apply pushdown accounting in its separate financial statements on a change-in-control event. The acquired entity elects whether to apply pushdown accounting individually for each change-in-control event, and may apply pushdown accounting during the reporting period in which the change-in-control event occurs. Such adoption did not have any 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, 2015 to December 31, 2015.

**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 December 31, 2015. 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 December 31, 2015 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, 2015. There have been no material changes from the factors disclosed in our 2015 Annual Report on Form 10-K filed on August 13, 2015, 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 December 31, 2015 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 February 4, 2016.

MERCURY SYSTEMS, INC.

By:                    /S/ GERALD M. HAINES II  
                         Gerald M. Haines II  
                         Executive Vice President,  
                         Chief Financial Officer, and Treasurer

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