

MERCURY SYSTEMS INC
Form 10-Q
February 07, 2019
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, 2018

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.)

50 MINUTEMAN ROAD 01810
ANDOVER, MA
(Address of principal executive offices) (Zip Code)
978-256-1300
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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, a smaller reporting company or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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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, 2019: 48,459,046 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, 2018 | June 30, 2018 |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 93,903 | \$ 66,521 |
| Accounts receivable, net of allowance for doubtful accounts of \$743 and \$359 at December 31, 2018 and June 30, 2018, respectively | 123,117 | 104,040 |
| Unbilled receivables and costs in excess of billings | 45,194 | 39,774 |
| Inventory | 126,402 | 108,585 |
| Prepaid income taxes | 766 | 3,761 |
| Prepaid expenses and other current assets | 9,923 | 9,062 |
| Total current assets | 399,305 | 331,743 |
| Property and equipment, net | 53,130 | 50,980 |
| Goodwill | 519,660 | 497,442 |
| Intangible assets, net | 176,671 | 177,904 |
| Other non-current assets | 7,873 | 6,411 |
| Total assets | \$ 1,156,639 | \$ 1,064,480 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 30,750 | \$ 21,323 |
| Accrued expenses | 16,875 | 16,386 |
| Accrued compensation | 23,064 | 21,375 |
| Deferred revenues and customer advances | 22,491 | 12,596 |
| Total current liabilities | 93,180 | 71,680 |
| Deferred income taxes | 12,202 | 13,635 |
| Income taxes payable | 2,880 | 998 |
| Long-term debt | 240,000 | 195,000 |
| Other non-current liabilities | 12,301 | 11,276 |
| Total liabilities | 360,563 | 292,589 |
| Commitments and contingencies (Note M) | | |
| 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; 47,248,881 and 46,924,238 shares issued and outstanding at December 31, 2018 and June 30, 2018, respectively | 472 | 469 |
| Additional paid-in capital | 594,670 | 590,163 |
| Retained earnings | 199,830 | 179,968 |
| Accumulated other comprehensive income | 1,104 | 1,291 |
| Total shareholders' equity | 796,076 | 771,891 |
| Total liabilities and shareholders' equity | \$ 1,156,639 | \$ 1,064,480 |

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

MERCURY SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(In thousands, except per share data)

(Unaudited)

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|----------------------------------------------|------------------------------------|------------|----------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Net revenues | \$ 159,089 | \$ 117,912 | \$ 303,145 | \$ 223,981 |
| Cost of revenues | 88,202 | 63,752 | 170,675 | 119,147 |
| Gross margin | 70,887 | 54,160 | 132,470 | 104,834 |
| Operating expenses: | | | | |
| Selling, general and administrative | 27,819 | 21,222 | 52,560 | 41,790 |
| Research and development | 16,192 | 15,187 | 31,140 | 28,929 |
| Amortization of intangible assets | 6,939 | 5,827 | 14,120 | 11,464 |
| Restructuring and other charges | 23 | 313 | 527 | 408 |
| Acquisition costs and other related expenses | 53 | 723 | 452 | 984 |
| Total operating expenses | 51,026 | 43,272 | 98,799 | 83,575 |
| Income from operations | 19,861 | 10,888 | 33,671 | 21,259 |
| Interest income | 71 | 3 | 137 | 22 |
| Interest expense | (2,196) | (107) | (4,455) | (110) |
| Other expense, net | (870) | (316) | (1,879) | (1,131) |
| Income before income taxes | 16,866 | 10,468 | 27,474 | 20,040 |
| Tax provision (benefit) | 4,483 | 1,335 | 7,612 | (7,046) |
| Net income | \$ 12,383 | \$ 9,133 | \$ 19,862 | \$ 27,086 |
| Basic net earnings per share | \$ 0.26 | \$ 0.20 | \$ 0.42 | \$ 0.58 |
| Diluted net earnings per share | \$ 0.26 | \$ 0.19 | \$ 0.42 | \$ 0.57 |
| Weighted-average shares outstanding: | | | | |
| Basic | 47,189 | 46,752 | 47,118 | 46,701 |
| Diluted | 47,705 | 47,447 | 47,696 | 47,538 |
| Comprehensive income: | | | | |
| Net income | \$ 12,383 | \$ 9,133 | \$ 19,862 | \$ 27,086 |
| Foreign currency translation adjustments | 205 | 22 | (157) | (56) |
| Pension benefit plan, net of tax | (15) | 10 | (30) | 40 |
| Total other comprehensive income, net of tax | 190 | 32 | (187) | (16) |
| Total comprehensive income | \$ 12,573 | \$ 9,165 | \$ 19,675 | \$ 27,070 |

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, | |
|-------------------------------------------------------------------------------------|----------------------------------|-----------|
| | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net income | \$ 19,862 | \$ 27,086 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 23,254 | 18,939 |
| Stock-based compensation expense | 9,963 | 9,448 |
| Benefit for deferred income taxes | (1,943) | (4,833) |
| Other non-cash items | 2,144 | 847 |
| Changes in operating assets and liabilities, net of effects of businesses acquired: | | |
| Accounts receivable, unbilled receivables, and costs in excess of billings | (20,845) | (9,181) |
| Inventory | (9,422) | (22,455) |
| Prepaid income taxes | 2,995 | 1,414 |
| Prepaid expenses and other current assets | (340) | (1,970) |
| Other non-current assets | 118 | (2,507) |
| Accounts payable, accrued expenses, and accrued compensation | 7,215 | 11,597 |
| Deferred revenues and customer advances | 9,480 | 1,976 |
| Income taxes payable | 1,872 | (11,284) |
| Other non-current liabilities | 977 | (2,270) |
| Net cash provided by operating activities | 45,330 | 16,807 |
| Cash flows from investing activities: | | |
| Acquisition of business, net of cash acquired | (45,029) | (5,798) |
| Purchases of property and equipment | (10,802) | (7,592) |
| Other investing activities | — | (375) |
| Net cash used in investing activities | (55,831) | (13,765) |
| Cash flows from financing activities: | | |
| Proceeds from employee stock plans | 1,677 | 2,049 |
| Borrowings under credit facilities | 45,000 | 15,000 |
| Payments under credit facilities | — | (15,000) |
| Payments for retirement of common stock | (6,932) | (14,909) |
| Payments of deferred financing and offering costs | (1,851) | — |
| Net cash provided by (used in) financing activities | 37,894 | (12,860) |
| Effect of exchange rate changes on cash and cash equivalents | (11) | 216 |
| Net increase (decrease) in cash and cash equivalents | 27,382 | (9,602) |
| Cash and cash equivalents at beginning of period | 66,521 | 41,637 |
| Cash and cash equivalents at end of period | \$ 93,903 | \$ 32,035 |
| Cash paid during the period for: | | |
| Interest | \$ 5,648 | \$ 111 |
| Income taxes | \$ 4,308 | \$ 9,928 |

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 sensor and safety-critical processing subsystems. Optimized for customer and mission success, its solutions power a wide variety of critical defense and intelligence programs. Headquartered in Andover, Massachusetts, it is pioneering a next-generation defense electronics business model specifically designed to meet the industry's current and emerging technology and business needs. The Company delivers affordable innovative solutions, rapid time-to-value and service and support primarily to defense prime contractor customers. The Company's products and solutions have been deployed in more than 300 programs with over 25 different defense prime contractors. Key programs include Aegis, Patriot, Surface Electronic Warfare Improvement Program (“SEWIP”), Gorgon Stare, Predator, F-35, Reaper, F-16 SABR, E2D Hawkeye, Paveway, Filthy Buzzard, PGK, ProVision, P1, AIDEWS, CDS, and Win-T. The Company's organizational structure allows it to deliver capabilities that combine technology building blocks and deep domain expertise in the aerospace and defense sector.

B. Summary of Significant Accounting Policies

BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared by the Company in accordance with Generally Accepted Accounting Principles (“GAAP”) in the United States of America 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, 2018 which are contained in the Company’s Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”) on August 16, 2018. The results for the three and six months ended December 31, 2018 are not necessarily indicative of the results to be expected for the full fiscal year. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

USE OF ESTIMATES

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

BUSINESS COMBINATIONS

The Company utilizes the acquisition method of accounting under ASC 805, Business Combinations, (“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 ASC 805 for the initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in business combinations.

FOREIGN CURRENCY

Local currencies are the functional currency for the Company’s subsidiaries in Switzerland, the United Kingdom, France, Japan, Spain and Canada. The accounts of foreign subsidiaries are translated using exchange rates in effect at period-end for assets and liabilities and at average exchange rates during the period for results of operations. The related translation adjustments are reported in accumulated other comprehensive income in shareholders’ equity. Gains (losses) resulting from non-U.S. currency transactions are included in other income (expense), net in the Consolidated Statements of Operations and Comprehensive Income and were immaterial for all periods presented.

REVENUE RECOGNITION

The Company recognizes revenue in accordance with ASC 606, Revenue from Contracts with Customers, (“ASC 606”), which was adopted on July 1, 2018, using the retrospective method. Revenue is recognized in accordance with the five step model set forth by ASC 606, which involves identification of the contract(s), identification of performance obligations in the contract, determination of the transaction price, allocation of the transaction price to the previously identified performance obligations, and revenue recognition as the performance obligations are satisfied. The adoption of ASC 606 did not have a material impact to the amount or timing of revenue recognition related to the Company's legacy accounting methods for contracts including ship and bill, multiple-deliverable, and contract accounting. Such adoption did not have a material impact, individually or in the aggregate, to any amounts in the Company's Consolidated Balance Sheets, Consolidated Statements of Operations and Comprehensive Income, Consolidated Statements of Shareholders' Equity or Consolidated Statements of Cash Flows. Refer to Note L for disaggregation of revenue for the period.

During step one of the five step model, the Company considers whether contracts should be combined or segmented, and based on this assessment, the Company combines closely related contracts when all the applicable criteria 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 contract, which should be combined to reflect an overall profit rate. Similarly, the Company may separate an arrangement, which may consist of a single contract or group of contracts, with varying rates of profitability, only if the applicable criteria are met. Judgment also is involved in determining whether a single contract or group of contracts may be segmented based on how the arrangement and the related performance criteria were negotiated. 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.

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when the performance obligation is satisfied. 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's contracts with customers generally do not include a right of return relative to delivered products. In certain cases, contracts are modified to account for changes in the contract specifications or requirements. In most instances, contract modifications are accounted for as part of the existing contract.

The Company is a leading provider of secure sensor and safety-critical processing subsystems. Revenues are derived from the sales of products that are grouped into one of the following three categories: (i) components; (ii) modules and sub-assemblies; and (iii) integrated subsystems. The Company also generates revenues from the performance of services, including analyst services and systems engineering support, consulting, maintenance and other support, testing and installation. Each promised good or service within a contract is accounted for separately under the guidance of ASC 606 if they are distinct, i.e., if a good or service is separately identifiable from other items in the contract and if a customer can benefit from it on its own or with other resources that are readily available to the customer. Promised goods or services not meeting the criteria for being a distinct performance obligation are bundled into a single performance obligation with other goods or services that together meet the criteria for being distinct. The appropriate allocation of the transaction price and recognition of revenue is then determined for the bundled performance obligation.

Once the Company identifies the performance obligations, the Company then determines the transaction price, which includes estimating the amount of variable consideration to be included in the transaction price, if any. Variable consideration typically arises due to volume discounts, or other provisions that can either decrease or increase the transaction price. To the extent the transaction price includes variable consideration, the Company estimates the amount of variable consideration that should be included in the transaction price utilizing either the expected value method or the most likely amount method depending on the method the Company expects to better predict the amount

of consideration to which it will be entitled. The determination of the estimates for variable consideration require judgment, and are based on past history with similar contracts and anticipated performance. Further, variable consideration is only included in the determination of the transaction price if it is probable that a significant reversal in the amount of revenue recognized will not occur. There are no constraints on the variable consideration recorded. For contracts with multiple performance obligations, the transaction price is allocated to each performance obligation using the standalone selling price of each distinct good or service in the contract. Standalone selling prices of the Company's goods and services are generally not directly observable. Accordingly, the primary method used to estimate standalone selling price is the expected cost plus a margin approach, under which the Company forecasts the expected costs of satisfying a performance obligation and then adds an appropriate margin for that distinct good or service. The objective of the expected cost plus a margin approach 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 the expected cost plus a margin approach involves the consideration of several factors

based on the specific facts and circumstances of each contract. 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, often based on 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 standalone selling prices used in its allocation of transaction price on contracts at least annually. Standalone selling prices will be analyzed on a more frequent basis if a significant change in the Company's business necessitates a more frequent analysis or if the Company experiences significant variances in its selling prices. Revenue recognized at a point in time generally relates to contracts that include a combination of components, modules and sub-assemblies, integrated subsystems and related system integration or other services. Contracts with distinct performance obligations recognized at a point in time, with or without an allocation of the transaction price, totaled 76% and 78% of revenues for the three and six months ended December 31, 2018, respectively. Contracts with distinct performance obligations recognized at a point in time, with or without an allocation of the transaction price, totaled 76% and 79% of revenues for the three and six months ended December 31, 2017, respectively. Revenue is recognized at a point in time for these products and services (versus over time recognition) due to the following: (i) customers are only able to consume the benefits provided by the Company upon completion of the product or service; (ii) customers do not control the product or service prior to completion; and (iii) the Company does not have an enforceable right to payment at all times for performance completed to date. Accordingly, there is little judgment in determining when control of the good or service transfers to the customer, and revenue is generally recognized upon shipment (for goods) or completion (for services).

The Company engages in long-term contracts for development, production and services activities and recognizes revenue for performance obligations over time. These long-term contracts involve the design, development, manufacture, or modification of complex modules and sub-assemblies or integrated subsystems and related services. Revenue is recognized over time, due to the fact that: (i) the Company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; and (ii) the Company's performance creates an asset with no alternative use to the Company and the Company has an enforceable right to payment for performance completed to date. 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. These contracts include both fixed-price and cost reimbursable contracts. The Company's cost reimbursable contracts typically include cost-plus fixed fee and time and material ("T&M") contracts.

For long-term contracts, the Company typically leverages the input method, using a cost-to-cost measure of progress. The Company believes that this method represents the most faithful depiction of the Company's performance because it directly measures value transferred to the customer. Contract estimates and estimates of any variable consideration are based on various assumptions to project the outcome of future events that may span several years. These assumptions include: labor productivity and availability; the complexity of the work to be performed; the cost and availability of materials; the performance of subcontractors; and the availability and timing of funding from the customer. The Company bears the risk of changes in estimates to complete on a fixed-price contract which may cause profit levels to vary from period to period. For cost reimburseable contracts, the Company is reimbursed periodically for allowable costs and is paid a portion of the fee based on contract progress. In the limited instances where the Company enters into T&M contracts, revenue recognized 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 direct billable costs. For T&M contracts, the Company elected to use a practical expedient permitted by ASC 606 whereby revenue is recognized in the amount for which the Company has a right to invoice the customer based on the control transferred to the customer. For all types of contracts, the Company recognizes anticipated contract losses as soon as they become known and estimable.

Accounting for long-term contracts 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 as well as availability for 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.

Total revenue recognized under long-term contracts over time was 24% and 22% of total revenues for the three and six months ended December 31, 2018, respectively. Total revenue recognized under long-term contracts over time was 24% and 21% of total revenues for the three and six months ended December 31, 2017, respectively.

The Company generally does not provide its customers with rights of product return other than those related to assurance warranty provisions that permit repair or replacement of defective goods over a period of 12-36 months. The Company accrues for anticipated warranty costs upon product shipment. The Company does not consider activities related to such assurance warranties, if any, to be a separate performance obligation. The Company does offer separately priced extended warranties which

generally range from 12 to 36 months that are treated as separate performance obligations. The transaction price allocated to extended warranties is recognized over time in proportion to the costs expected to be incurred in satisfying the obligations under the contract.

On long-term contracts, the portion of the payments retained by the customer is not considered a significant financing component because most contracts have a duration of less than one year and payment is received as progress is made. On some contracts, the Company may be entitled to receive an advance payment, which is not considered a significant financing component because it is used to facilitate inventory demands at the onset of a contract and to safeguard the Company from the failure of the other party to abide by some or all of their obligations under the contract. All revenues are reported net of government assessed taxes (e.g., sales taxes or value-added taxes).

ACCOUNTS RECEIVABLE

Accounts receivable, net, represents amounts that have been billed and are currently due from customers. The Company maintains an allowance for doubtful accounts to provide for the estimated amount of receivables that will not be collected. The Company provides credit to customers in the normal course of business. The Company performs ongoing credit evaluations of its customers' financial condition and limits the amount of credit extended as necessary. The allowance is based upon an assessment of the customers' credit worthiness, history with the customer, and the age of the receivable balance. The Company typically invoices a customer upon shipment of the product (or completion of a service) for contracts where revenue is recognized at a point in time. For contracts where revenue is recognized over time, the invoicing events are typically based on specified performance obligation deliverables or milestone events, or quantifiable measures of performance.

COSTS TO OBTAIN AND FULFILL A CONTRACT

The Company has elected to use a practical expedient available under ASC 606 whereby sales commissions are expensed as incurred for contracts where the amortization period would have been one year or less. The Company has not deferred sales commissions for contracts where the amortization period is greater than one year because such amounts that would qualify for deferral are not significant.

The Company has elected to treat shipping and handling activities performed after the customer has obtained control of the related goods as a fulfillment cost. Such costs are accrued for in conjunction with the recording of revenue for the goods and are classified as cost of revenues.

CONTRACT BALANCES

Contract balances result from the timing of revenue recognized, billings and cash collections, and the generation of contract assets and liabilities. Contract assets represent revenue recognized in excess of amounts invoiced to the customer and the right to payment is not subject to the passage of time. Contract assets are presented as unbilled receivables and costs in excess of billings on the Company's Consolidated Balance Sheets. Contract liabilities consist of deferred product revenue, billings in excess of revenues, deferred service revenue, and customer advances. Deferred product revenue represents amounts that have been invoiced to customers, but are not yet recognizable as revenue because the Company has not satisfied its performance obligations under the contract. Billings in excess of revenues represents milestone billing contracts where the billings of the contract exceed recognized revenues. Deferred service revenue primarily represents amounts invoiced to customers for annual maintenance contracts or extended warranty contracts, which are recognized over time in proportion to the costs expected to be incurred in satisfying the obligations under the contract. Customer advances represent deposits received from customers on an order. Contract liabilities are included in deferred revenue and the long-term portion of deferred revenue is included within other non-current liabilities on the Company's Consolidated Balance Sheets. Contract balances are reported in a net position on a contract-by-contract basis.

The contract asset balances were \$45,194 and \$39,774 as of December 31, 2018 and June 30, 2018, respectively. These balances remained consistent period over period. The contract liability balances were \$23,304 and \$13,425 as of December 31, 2018 and June 30, 2018, respectively. The increase was driven primarily by a significant milestone billing on a classified missile program.

Revenue recognized for the three and six month period ended December 31, 2018 that was included in the contract liability balance at the beginning of the year was \$1,617 and \$8,983, respectively.

REMAINING PERFORMANCE OBLIGATIONS

The Company has elected to use a practical expedient available under ASC 606 whereby contracts with original expected durations of one year or less are excluded from the remaining performance obligations, while these contracts are included within backlog. The Company includes in its computation of remaining performance obligations customer orders for which it has accepted signed sales orders. The definition of remaining performance obligations excludes those contracts that provide the customer with the right to cancel or terminate the order with no substantial penalty, even if the Company's historical experience indicates the likelihood of cancellation or termination is remote. As of December 31, 2018, the aggregate amount of the transaction price allocated to remaining performance obligations was \$160,189. The Company expects to recognize approximately 69% of its remaining performance obligations as revenue in the next 12 months and the balance thereafter.

WEIGHTED-AVERAGE SHARES

Weighted-average shares were calculated as follows:

| | Three Months Ended December 31, 2018 | | Six Months Ended December 31, 2017 | |
|---------------------------------------------|-----------------------------------------------|--------|---------------------------------------------|--------|
| Basic weighted-average shares outstanding | 47,189 | 46,752 | 47,118 | 46,701 |
| Effect of dilutive equity instruments | 516 | 695 | 578 | 837 |
| Diluted weighted-average shares outstanding | 47,705 | 47,447 | 47,696 | 47,538 |

Equity instruments to purchase 31 and 481 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, 2018, respectively, because the equity instruments were anti-dilutive. Equity instruments to purchase 23 and 162 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, 2017, respectively, because the equity instruments were anti-dilutive.

C. Acquisitions**GERMANE SYSTEMS AQUISITION**

On July 31, 2018, the Company announced that it had entered into a membership interest purchase agreement (the "Purchase Agreement") and acquired Germane Systems, LC ("Germane") pursuant to the terms of the Purchase Agreement.

Based in Chantilly, Virginia, Germane is an industry leader in the design, development and manufacturing of rugged servers, computers and storage systems for command, control and information ("C2I") applications. The Company acquired Germane for an all cash purchase price of \$45,000, subject to net working capital and net debt adjustments. The Company funded the acquisition with borrowings obtained under its existing revolving credit facility. On December 12, 2018 the Company and former owners of Germane agreed to post-closing adjustments totaling \$1,244, which decreased the Company's net purchase price.

The following table presents the net purchase price and the fair values of the assets and liabilities of Germane on a preliminary basis:

| | Amounts |
|--------------------------------------------------------------------------|----------|
| Consideration transferred | |
| Cash paid at closing | \$46,973 |
| Working capital and net debt adjustment | (1,244) |
| Less cash acquired | (193) |
| Net purchase price | \$45,536 |
| Estimated fair value of tangible assets acquired and liabilities assumed | |
| Cash | \$193 |
| Accounts receivable | 4,277 |
| Inventory | 8,575 |
| Fixed assets | 867 |
| Other current and non-current assets | 596 |
| Accounts payable | (3,146) |
| Accrued expenses | (1,229) |
| Other current and non-current liabilities | (232) |
| Estimated fair value of net tangible assets acquired | 9,901 |
| Estimated fair value of identifiable intangible assets | 12,910 |
| Estimated goodwill | 22,918 |
| Estimated fair value of net assets acquired | 45,729 |
| Less cash acquired | (193) |
| Net purchase price | \$45,536 |

The amounts above represent the preliminary fair value estimates as of December 31, 2018 and are subject to subsequent adjustment as the Company obtains additional information during the measurement period and finalizes its fair value estimates. The preliminary identifiable intangible asset estimates include customer relationships of \$8,500 with a useful life of 11 years, developed technology of \$4,200 with a useful life of eight years and backlog of \$210 with a useful life of one year. Any subsequent adjustments to these fair value estimates occurring during the measurement period will result in an adjustment to goodwill.

The goodwill of \$22,918 largely reflects the potential synergies and expansion of the Company's offerings across product lines and markets complementary to the Company's existing products and markets. The goodwill from this acquisition is reported under the Mercury Defense Systems ("MDS") reporting unit. Since Germane was a limited liability company, the acquisition is treated as an asset purchase for tax purposes. 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, 2018, the Company had \$22,525 of goodwill deductible for tax purposes. The Company has not furnished pro forma information relating to Germane because such information is not material to the Company's financial results.

The revenues and income before income taxes from Germane included in the Company's consolidated results for the three months ended December 31, 2018 were \$13,055 and \$1,306, respectively. The revenues and income before income taxes from Germane included in the Company's consolidated results for the six months ended December 31, 2018 were \$22,049 and \$906, respectively. The Germane results include expenses resulting from purchase accounting which include amortization of intangibles and inventory step-up.

THEMIS COMPUTER ACQUISITION

On December 21, 2017, the Company and Thunderbird Merger Sub, Inc., a newly formed, wholly-owned subsidiary of the Company (the "Merger Sub"), entered into a Merger Agreement (the "Merger Agreement") with Ceres Systems ("Ceres"), the holding company that owned Themis Computer ("Themis", and together with Ceres, collectively the "Acquired Company"). On February 1, 2018, the Company closed the transaction and the Merger Sub merged with and into Ceres with Ceres continuing as the surviving company and a wholly-owned subsidiary of Mercury (the "Merger").

By operation of the Merger, the Company acquired both Ceres and its wholly-owned subsidiary, Themis.

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Based in Fremont, California, Themis is a leading designer, manufacturer and integrator of commercial, SWaP-optimized rugged servers, computers and storage systems for U.S. and international markets. Under the terms of the Merger Agreement, the merger consideration (including payments with respect to outstanding stock options) consisted of an all cash purchase price of approximately \$180,000. The merger consideration is subject to post-closing adjustments based on a determination of closing net working capital, transaction expenses and net debt (all as defined in the Merger Agreement). The Company funded the acquisition with borrowings obtained under its existing revolving credit facility. On July 13, 2018, the Company and former owners of Ceres agreed to post-closing adjustments totaling \$700, which decreased the Company's net purchase price.

The following table presents the net purchase price and the fair values of the assets and liabilities of the Acquired Company on a preliminary basis:

| | Amounts |
|--------------------------------------------------------------------------|------------|
| Consideration transferred | |
| Cash paid at closing | \$ 187,089 |
| Working capital and net debt adjustment | (1,274) |
| Less cash acquired | (6,810) |
| Net purchase price | \$ 179,005 |
| | |
| Estimated fair value of tangible assets acquired and liabilities assumed | |
| Cash | \$ 6,810 |
| Accounts receivable | 7,713 |
| Inventory | 7,333 |
| Fixed assets | 479 |
| Other current and non-current assets | 2,896 |
| Accounts payable | (3,287) |
| Accrued expenses | (4,672) |
| Other current and non-current liabilities | (1,210) |
| Deferred tax liability | (14,115) |
| Estimated fair value of net tangible assets acquired | 1,947 |
| Estimated fair value of identifiable intangible assets | 71,720 |
| Estimated goodwill | 112,148 |
| Estimated fair value of net assets acquired | 185,815 |
| Less cash acquired | (6,810) |
| Net purchase price | \$ 179,005 |

The amounts above represent the preliminary fair value estimates as of December 31, 2018 and are subject to subsequent adjustment as the Company obtains additional information during the measurement period and finalizes its fair value estimates. The preliminary identifiable intangible asset estimates include customer relationships of \$52,600 with a useful life of 12.5 years, developed technology of \$17,150 with a useful life of 9.5 years and backlog of \$1,970 with a useful life of one year. Any subsequent adjustments to these fair value estimates occurring during the measurement period will result in an adjustment to goodwill.

The goodwill of \$112,148 largely reflects the potential synergies and expansion of the Company's offerings across product lines and markets complementary to the Company's existing products and markets. The goodwill from this acquisition is reported under the MDS reporting unit and is not tax deductible.

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, 2018:

| | Fair Value Measurements | | |
|-------------------|-------------------------|---------|---------|
| December 31, 2018 | Level 1 | Level 2 | Level 3 |

Assets:

| | | | | |
|-------------------------|-----------|------|-----------|------|
| Certificates of deposit | \$ 31,153 | \$ — | \$ 31,153 | \$ — |
| Total | \$ 31,153 | \$ — | \$ 31,153 | \$ — |

The carrying values of cash and cash equivalents, including money market funds, restricted cash, accounts receivable and payable, and accrued liabilities approximate fair value due to the short-term maturities of these assets and liabilities. The fair value of the Company's certificates of deposit are determined through quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable.

E. Inventory

Inventory is stated at the lower of cost (first-in, first-out) or net realizable 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, historical usage, product mix and possible alternative uses. Inventory was comprised of the following:

| | December 31, 2018 | June 30, 2018 |
|-----------------|-------------------|---------------|
| Raw materials | \$ 79,771 | \$ 61,748 |
| Work in process | 34,240 | 30,841 |
| Finished goods | 12,391 | 15,996 |
| Total | \$ 126,402 | \$ 108,585 |

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, 2018:

| | SMP | AMS | MDS | Total |
|------------------------------------------------|------------|------------|------------|------------|
| Balance at June 30, 2018 | \$ 119,560 | \$ 218,147 | \$ 159,735 | \$ 497,442 |
| Goodwill adjustment for the Themis acquisition | — | — | (700) | (700) |
| Goodwill arising from the Germane acquisition | — | — | 22,918 | 22,918 |
| Balance at December 31, 2018 | \$ 119,560 | \$ 218,147 | \$ 181,953 | \$ 519,660 |

In the six months ended December 31, 2018, there were no triggering events, as defined by ASC 350, Intangibles - Goodwill and Other, which required an interim goodwill impairment test. The Company performs its annual goodwill impairment test in the fourth quarter of each fiscal year.

G. Restructuring

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

| | Severance & Facilities Related | & Other | Total |
|----------------------------------------------|-----------------------------------|---------|----------|
| Restructuring liability at June 30, 2018 | \$ 1,801 | \$ — | \$ 1,801 |
| Restructuring and other charges | 525 | 18 | 543 |
| Cash paid | (2,068) | (2) | (2,070) |
| Reversals(*) | — | (16) | (16) |
| Restructuring liability at December 31, 2018 | \$ 258 | \$ — | \$ 258 |

(*) Reversals result from the unused outplacement services and operating costs.

During the six months ended December 31, 2018, the Company incurred net restructuring and other charges of \$527.

The increase was primarily driven by severance costs associated with the recently acquired Germane business.

Restructuring and other charges are typically related to acquisitions and organizational redesign programs initiated as part of discrete post-acquisition integration activities.

All of the restructuring and other charges are classified as operating expenses in the Consolidated Statements of Operations 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

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "Tax Act") was enacted by the U.S. government. The Tax Act has impacted the U.S. statutory Federal tax rate that the Company will use going forward, which has been reduced to 21% from 35%. The Tax Act also introduced a modified territorial tax system and a minimum tax on certain foreign earnings for tax years beginning after December 31, 2017.

In December 2017, the SEC staff issued Staff Accounting Bulletin 118 ("SAB 118"), which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, Income Taxes, ("ASC 740"). The Company has completed its analysis within fiscal 2019 consistent with the guidance provided in SAB 118, and any adjustments during this measurement period have been included in the Consolidated Statements of Operations and Comprehensive Income as an adjustment to income tax provision.

The Company recorded an income tax provision of \$4,483 and \$1,335 on income from operations before income taxes of \$16,866 and \$10,468 for the three months ended December 31, 2018 and 2017, respectively. The Company recorded an income tax provision of \$7,612 and an income tax benefit of \$7,046 on income from operations before income taxes of \$27,474 and \$20,040 for the six months ended December 31, 2018 and 2017, respectively.

During the three months ended December 31, 2018 and 2017, the Company recognized a discrete tax benefit and expense of \$67 and \$294, respectively, related to excess tax benefits on stock-based compensation. The discrete tax expense for the three months ended December 31, 2017 included the enactment of the Tax Act which revalued the excess tax benefit previously recorded in the three months ended September 30, 2017. The effective tax rate for the three months ended December 31, 2018 and 2017 differed from the Federal statutory rate primarily due to Federal research and development credits, excess tax benefits related to stock compensation, a modified territorial tax system and a minimum tax on certain foreign earnings, and state taxes.

During the six months ended December 31, 2018 and 2017, the Company recognized a discrete tax benefit of \$1,716 and \$7,579, respectively, related to excess tax benefits on stock-based compensation. The effective tax rate for the six months ended December 31, 2018 and 2017 differed from the Federal statutory rate primarily due to Federal research and development credits, excess tax benefits related to stock compensation, a modified territorial tax system and a minimum tax on certain foreign earnings, and state taxes.

On August 21, 2018, the Internal Revenue Service ("IRS") provided initial guidance on amendments made to the limitation on executive compensation by the Tax Act. During the three months ended September 30, 2018, the Company recorded an adjustment to its unrecognized tax positions of \$1,711 as a result of this guidance. During the three months ended December 31, 2018, there were no changes made to the Company's unrecognized tax positions.

I. Debt

REVOLVING CREDIT FACILITY

On September 28, 2018, the Company amended its revolving credit facility to increase and extend the borrowing capacity to \$750,000, 5-year revolving credit line, with the maturity extended to September 28, 2023 (“the Revolver”). As of December 31, 2018, the Company's outstanding balance of unamortized deferred financing costs was \$6,385, which is being amortized to other income (expense), net on a straight line basis over the new term of the Revolver.

The Company drew \$45,000 from the Revolver to facilitate the acquisition of Germane.

As of December 31, 2018, the Company was in compliance with all covenants and conditions under the Revolver and there were outstanding borrowings of \$240,000 against the Revolver, resulting in interest expense of \$2,196 and \$4,455 for the three and six months ended December 31, 2018, respectively. There were outstanding letters of credit of \$2,351 as of December 31, 2018.

J. Employee Benefit Plan

PENSION PLAN

The Company maintains a defined benefit pension plan (the "Plan") for its Swiss employees, which is administered by an independent pension fund. The Plan is mandated by Swiss law and meets the criteria for a defined benefit plan under ASC 715, Compensation—Retirement Benefits (“ASC 715”), because participants of the Plan are entitled to a defined rate of return on contributions made. The independent pension fund is a multi-employer plan with unrestricted joint liability for all participating companies for which the Plan’s overfunding or underfunding is allocated to each participating company based on an allocation key determined by the Plan.

The Company recognizes a net asset or liability for the Plan equal to the difference between the projected benefit obligation of the Plan and the fair value of the Plan’s assets as required by ASC 715. The funded status may vary from year to year due to changes in the fair value of the Plan’s assets and variations on the underlying assumptions of the projected benefit obligation of the Plan. The Plan's funded status at December 31, 2018 was a net liability of \$6,336, which is recorded in other non-current liabilities on the Consolidated Balance Sheet. The Company recorded a net loss of \$15 and \$30 in accumulated other comprehensive income during the three and six months ended December 31, 2018, respectively. The Company recorded a net gain of \$10 and \$40 in accumulated other comprehensive income during the three and six months ended December 31, 2017, respectively. The Company recognized net periodic benefit costs of \$200 and \$402 associated with the Plan for the three and six months ended December 31, 2018, respectively. The Company recognized net periodic benefit costs of \$201 and \$407 associated with the Plan for the three and six months ended December 31, 2017, respectively. The Company's total expected employer contributions to the Plan during fiscal 2019 are \$642.

K. Stock-Based Compensation

STOCK INCENTIVE PLANS

The Board of Directors approved the Company’s 2018 Stock Incentive Plan (the “2018 Plan”) on July 23, 2018. The 2018 Plan became effective upon the approval of shareholders at the Company’s annual meeting held on October 24, 2018. The aggregate number of shares authorized for issuance under the 2018 Plan is 2,862 shares, with an additional 710 shares rolled into the 2018 Plan that were available for future grant under the Company’s 2005 Stock Incentive Plan, as amended and restated (the “2005 Plan”) at the time of shareholder approval of the 2018 Plan. The 2018 Plan replaced the 2005 Plan. The shares authorized for issuance under the 2018 Plan will be increased by any future cancellations, forfeitures or terminations (other than by exercise) of awards under the 2005 Plan. The foregoing does not affect any outstanding awards under the 2005 Plan, which remain in full force and effect in accordance with their terms. The 2018 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 3,563 shares available for future grant under the 2018 Plan at December 31, 2018.

As part of the Company's ongoing annual equity grant program for employees, the Company grants performance-based restricted stock awards to certain executives and employees pursuant to the 2018 Plan.

Performance awards vest based on the requisite service period subject to the achievement of specific financial

performance targets. Based on the performance targets, some of these awards require graded vesting which results in more rapid expense recognition compared to traditional time-based vesting over the same vesting period. The Company monitors the probability of achieving the performance targets on a quarterly basis and may adjust periodic stock compensation expense accordingly based on its determination of the likelihood for reaching

targets. The performance targets include: (i) the achievement of internal performance targets only, and (ii) the achievement of internal performance targets in relation to a peer group of companies.

EMPLOYEE STOCK PURCHASE PLAN

The aggregate number of shares authorized for issuance under the Company's 1997 Employee Stock Purchase Plan, as amended and restated ("ESPP"), is 1,800 shares. Under the ESPP, rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at either the beginning or the end of each six-month offering period. The ESPP permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee's compensation as defined in the ESPP. There were 51 and 39 shares issued under the ESPP during the six months ended December 31, 2018 and 2017, respectively. Shares available for future purchase under the ESPP totaled 169 at December 31, 2018.

STOCK OPTION AND AWARD ACTIVITY

The following table summarizes activity of the Company's stock option plans since June 30, 2018:

| | Options Outstanding | | Weighted Average Remaining Contractual Term (Years) |
|----------------------------------|---------------------|---------------------------------|-----------------------------------------------------|
| | Number of Shares | Weighted Average Exercise Price | |
| Outstanding at June 30, 2018 | 4 | \$ 5.52 | 3.13 |
| Granted | — | — | — |
| Exercised | — | — | — |
| Canceled | — | — | — |
| Outstanding at December 31, 2018 | 4 | \$ 5.52 | 2.63 |

The following table summarizes the status of the Company's non-vested restricted stock awards since June 30, 2018:

| | Non-vested Restricted Stock Awards | |
|----------------------------------|------------------------------------|----------------------------------------|
| | Number of Shares | Weighted Average Grant Date Fair Value |
| Outstanding at June 30, 2018 | 1,135 | \$ 27.26 |
| Granted | 386 | 49.15 |
| Vested | (414) | 49.17 |
| Forfeited | (49) | 33.32 |
| Outstanding at December 31, 2018 | 1,058 | \$ 38.95 |

STOCK-BASED COMPENSATION EXPENSE

The Company recognizes expense for its share-based payment plans in the Consolidated Statements of Operations and Comprehensive Income in accordance with ASC 718, Compensation - Stock Compensation ("ASC 718"). The Company had \$266 and \$317 of capitalized stock-based compensation expense on the Consolidated Balance Sheets as of December 31, 2018 and June 30, 2018, respectively. Under the fair value recognition provisions of 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 included in the Company's Consolidated Statements of Operations and Comprehensive Income:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---------------------------------------------|---------------------------------|----------|-------------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| Cost of revenues | \$159 | \$47 | \$411 | \$195 |
| Selling, general and administrative | 4,542 | 4,270 | 8,426 | 8,246 |
| Research and development | 583 | 510 | 1,126 | 1,007 |
| Stock-based compensation expense before tax | 5,284 | 4,827 | 9,963 | 9,448 |
| Income taxes | (1,427) | (1,593) | (2,690) | (3,118) |

Stock-based compensation expense, net of income taxes \$3,857 \$3,234 \$7,273 \$6,330

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 is comprised of one operating and reportable segment. The Company utilized the management approach for determining its operating segment in accordance with ASC 280, Segment Reporting.

The geographic distribution of the Company's revenues as determined by order origination based on the country in which the Company's legal subsidiary is domiciled is summarized as follows:

| | U.S. | Europe | Asia Pacific | Eliminations | Total |
|---------------------------------------------|------------|-----------|--------------|--------------|------------|
| THREE MONTHS ENDED DECEMBER 31, 2018 | | | | | |
| Net revenues to unaffiliated customers | \$ 145,669 | \$ 13,200 | \$ 220 | \$ — | \$ 159,089 |
| Inter-geographic revenues | 803 | 345 | — | (1,148) | — |
| Net revenues | \$ 146,472 | \$ 13,545 | \$ 220 | \$ (1,148) | \$ 159,089 |
| THREE MONTHS ENDED DECEMBER 31, 2017 | | | | | |
| Net revenues to unaffiliated customers | \$ 105,687 | \$ 9,417 | \$ 2,808 | \$ — | \$ 117,912 |
| Inter-geographic revenues | 3,169 | 43 | — | (3,212) | — |
| Net revenues | \$ 108,856 | \$ 9,460 | \$ 2,808 | \$ (3,212) | \$ 117,912 |
| SIX MONTHS ENDED DECEMBER 31, 2018 | | | | | |
| Net revenues to unaffiliated customers | \$ 277,018 | \$ 24,638 | \$ 1,489 | \$ — | \$ 303,145 |
| Inter-geographic revenues | 2,450 | 703 | — | (3,153) | — |
| Net revenues | \$ 279,468 | \$ 25,341 | \$ 1,489 | \$ (3,153) | \$ 303,145 |
| SIX MONTHS ENDED DECEMBER 31, 2017 | | | | | |
| Net revenues to unaffiliated customers | \$ 203,402 | \$ 16,895 | \$ 3,684 | \$ — | \$ 223,981 |
| Inter-geographic revenues | 4,916 | 65 | — | (4,981) | — |
| Net revenues | \$ 208,318 | \$ 16,960 | \$ 3,684 | \$ (4,981) | \$ 223,981 |

Effective July 1, 2018, the Company adopted the requirements of ASC 606 using the retrospective method. As previously mentioned, such adoption did not have a material impact to the Company's consolidated financial statements. The following tables present disaggregated revenue consistent with the Company's strategy of expanding its technological capabilities and program content. As additional information related to the Company's products by end user, application and/or product grouping is attained, the categorization of these products can vary over time. When this occurs, the Company reclassifies revenue by end user, application and/or product grouping for prior periods. Such reclassifications typically do not materially change the sizing of, or the underlying trends of results within, each revenue category.

The following table below presents the Company's net revenue by end user for the periods presented:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|------------------------------------------|---------------------------------|------------|-------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Domestic (1) | \$ 142,906 | \$ 89,969 | \$ 273,485 | \$ 179,647 |
| International/Foreign Military Sales (2) | 16,183 | 27,943 | 29,660 | 44,334 |
| Total Net Revenue | \$ 159,089 | \$ 117,912 | \$ 303,145 | \$ 223,981 |

(1) Domestic revenues consist of sales where the end user is within the U.S., as well as sales to prime defense contractor customers where the ultimate end user location is not defined.

(2) International/Foreign Military Sales consist of sales to U.S. prime defense contractor customers where the end user is known to be outside the U.S., foreign military sales through the U.S. government, and direct sales to non-U.S. based customers intended for end use outside of the U.S.

The following table below presents the Company's net revenue by end application for the periods presented:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|-----------------------------|---------------------------------------|-----------|----------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Radar (1) | \$42,008 | \$44,678 | \$82,987 | \$81,218 |
| Electronic Warfare (2) | 25,697 | 29,411 | 49,751 | 57,419 |
| Other Sensor & Effector (3) | 21,455 | 10,992 | 35,113 | 20,741 |
| Total Sensor & Effector | 89,160 | 85,081 | 167,851 | 159,378 |
| C4I (4) | 47,276 | 13,562 | 91,500 | 26,388 |
| Other (5) | 22,653 | 19,269 | 43,794 | 38,215 |
| Total Net Revenue | \$159,089 | \$117,912 | \$303,145 | \$223,981 |

(1) Radar includes end-use applications where radio frequency signals are utilized to detect, track, and identify objects.

(2) Electronic Warfare includes end-use applications comprising the offensive and defensive use of the electromagnetic spectrum.

(3) Other Sensor & Effector products include all Sensor & Effector end markets other than Radar and Electronic Warfare.

(4) C4I includes rugged secure rackmount servers that are designed to drive the most powerful military processing applications.

(5) Other products include all component and other sales where the end use is not specified.

The following table below presents the Company's net revenue by product grouping for the periods presented:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--------------------------------|---------------------------------------|-----------|----------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Components (1) | \$40,914 | \$39,908 | \$81,314 | \$72,720 |
| Modules and Sub-assemblies (2) | 42,397 | 41,728 | 93,989 | 89,460 |
| Integrated Subsystems (3) | 75,778 | 36,276 | 127,842 | 61,801 |
| Total Net Revenue | \$159,089 | \$117,912 | \$303,145 | \$223,981 |

(1) Components include technology elements typically performing a single, discrete technological function, which when physically combined with other components may be used to create a module or sub-assembly. Examples include but are not limited to power amplifiers and limiters, switches, oscillators, filters, equalizers, digital and analog converters, chips, MMICs (monolithic microwave integrated circuits), and memory and storage devices.

(2) Modules and Sub-assemblies include combinations of multiple functional technology elements and/or components that work together to perform multiple functions but are typically resident on or within a single board or housing. Modules and sub-assemblies may in turn be combined to form an integrated subsystem. Examples of modules and sub-assemblies include but are not limited to embedded processing modules, embedded processing boards, switch fabric boards, high speed input/output boards, digital receiver boards, graphics and video processing and Ethernet and IO (input-output) boards, multi-chip modules, integrated radio frequency and microwave multi-function assemblies, tuners, and transceivers.

(3) Integrated Subsystems include multiple modules and/or sub-assemblies combined with a backplane or similar functional element and software to enable a solution. These are typically but not always integrated within a chassis and with cooling, power and other elements to address various requirements and are also often combined with additional technologies for interaction with other parts of a complete system or platform. Integrated subsystems also include spare and replacement modules and sub-assemblies sold as part of the same program for use in or with integrated subsystems sold by the Company.

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

| U.S. | Europe | Asia Pacific | Eliminations | Total |
|------|--------|--------------|--------------|-------|
|------|--------|--------------|--------------|-------|

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| | | | | | |
|-------------------|----------|---------|-------|----|-----------|
| December 31, 2018 | \$48,872 | \$4,241 | \$ 17 | \$ | —\$53,130 |
| June 30, 2018 | \$47,997 | \$2,974 | \$ 9 | \$ | —\$50,980 |

Identifiable long-lived assets exclude goodwill and intangible assets.

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

| | Three Months Ended December 31, 2018 | | Six Months Ended December 31, 2017 | |
|------------------------------|--------------------------------------|--------|------------------------------------|--------|
| Raytheon Company | 25 % | 17 % | 22 % | 19 % |
| Lockheed Martin Corporation | 13 % | 20 % | 11 % | 19 % |
| Northrop Grumman Corporation | * 38 % | * 49 % | * 33 % | * 49 % |

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

While the Company typically has customers from which it derives 10% or more of its revenue, the sales to each of these customers are spread across multiple programs and platforms. Programs comprising 10% or more of the Company's revenues for the periods shown below are as follows:

| | Three Months Ended December 31, 2018 | | Six Months Ended December 31, 2017 | |
|------|--------------------------------------|--------|------------------------------------|--------|
| F-35 | 11 % | * 11 % | * 11 % | * 11 % |
| | 11 % | —% | 11 % | —% |

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

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

INDEMNIFICATION OBLIGATIONS

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

PURCHASE COMMITMENTS

As of December 31, 2018, 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 \$68,695.

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 employees' tax liabilities 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.

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.

On January 11, 2019, the Company entered into an interest rate swap (the "Swap") with Bank of America, N.A. for a notional amount of \$175,000. The Swap matures on September 28, 2023, coterminous with the maturity of the Revolver. The Swap effectively converts \$175,000 of the Company's Revolver obligation from a variable interest rate to a fixed rate of 2.54%.

On January 29, 2019, the Company acquired GECO Avionics, LLC ("GECO"). Based in Mesa, Arizona, GECO has over twenty years of experience designing and manufacturing affordable safety-critical avionics and mission computing solutions. GECO's DO-254 certified hardware solutions include mission processors, airborne displays, video processing and aviation networking. GECO also specializes in DO-178 avionics software design up to DAL-A, the highest level of design assurance for flight management, aircraft condition monitoring, display and electronic flight instrumentation applications. GECO's technologies are deployed on numerous military platforms such as the AH-64 Apache attack helicopter and the KC-46A Pegasus widebody multirole tanker, among others. The Company acquired GECO for an all cash purchase price of \$36,500, subject to net working capital and net debt adjustments. The acquisition was funded through the Revolver.

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 ("SEC") 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 any U.S. Federal government shutdown or extended continuing resolution, 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 or unanticipated expenses 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, increases in interest rates, changes to cyber-security regulations and requirements, changes in tax rates or tax regulations, 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, 2018. We caution readers not to place undue reliance upon any such forward-looking statements, which speak only as of the date made.

OVERVIEW

Mercury Systems, Inc. is a leading commercial provider of secure sensor and safety-critical processing subsystems. Optimized for customer and mission success, our solutions power a wide variety of critical defense and intelligence programs. Headquartered in Andover, Massachusetts, we are pioneering a next-generation defense electronics business model designed to meet the industry's current and emerging business needs. We deliver affordable innovative solutions, rapid time-to-value and service and support primarily to 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, Reaper, F-16 SABR, E2D Hawkeye, Paveway, Filthy Buzzard, PGK, ProVision, P1, AIDEWS, CDS, and Win-T. Our organizational structure allows us to deliver capabilities that combine technology building blocks and deep domain expertise in the defense sector.

Our technologies and capabilities include secure embedded processing modules and subsystems, mission computers, safety-critical avionics, radio frequency ("RF") components, multi-function assemblies and subsystems. We utilize leading edge, high performance computing technologies architected by leveraging open standards and open architectures to address highly data-intensive applications that include data signal, sensor and image processing while addressing the packaging challenges, often referred to as "SWaP" (size, weight, and power), that are common in military applications. We have design, development, and manufacturing capabilities in mission computing, safety-critical avionics and platform management. In addition, we design and manufacture RF, microwave and millimeter wave components and subsystems to meet the needs of the radar, electronic warfare ("EW"), signals intelligence ("SIGINT") and other high bandwidth communications requirements and applications.

We also provide significant capabilities relating to pre-integrated EW, electronic attack ("EA") and electronic counter measure ("ECM") subsystems, SIGINT and electro-optical/infrared ("EO/IR") processing technologies, and radar environment test and simulation systems. We deploy these solutions on behalf of defense prime contractors and the

Department of Defense (“DoD”), leveraging commercially available technologies and solutions (or “building blocks”) from our business and other commercial suppliers. We leverage this technology to design and build integrated sensor processing subsystems, often including classified application-specific software and intellectual property (“IP”) for the C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance), EW, and ECM markets. We bring significant domain expertise to customers, drawing on over 25 years of experience in EW, SIGINT, and radar environment test and simulation.

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

As of December 31, 2018, we had 1,504 employees. During fiscal 2018, the growth in our headcount resulted in us exceeding the threshold for qualifying as a "small business" for government contract purposes. The revenues received as a result of small business set aside funding are not considered material.

Our consolidated revenues, acquired revenues, net income, net earnings per share, adjusted earnings per share ("adjusted EPS"), and adjusted EBITDA for the three months ended December 31, 2018 were \$159.1 million, \$28.8 million, \$12.4 million, \$0.26, \$0.47, and \$37.0 million, respectively. Our consolidated revenues, acquired revenues, net income, net earnings per share, adjusted EPS, and adjusted EBITDA for the six months ended December 31, 2018 were \$303.1 million, \$60.0 million, \$19.9 million, \$0.42, \$0.86, and \$68.6 million, respectively. See the Non-GAAP Financial Measures section for a reconciliation to our most directly comparable GAAP financial measures.

As previously announced, effective July 1, 2018, we adopted the requirements of ASU No. 2014-09, Revenue from Contracts with Customers ("ASC 606") using the retrospective method as discussed in Note B in the accompanying consolidated financial statements. All amounts and disclosures set forth in this Form 10-Q reflect these changes. Such adoption did not have a material impact to our consolidated financial statements.

RESULTS OF OPERATIONS:

Results of operations for the three months ended December 31, 2018 includes full period results from the acquisition of Themis Computer ("Themis") and Germane Systems, LC ("Germane"). Results of operations for the six months ended December 31, 2018 includes full period results from the acquisition of Themis and only results from the acquisition date for Germane, which was acquired subsequent to June 30, 2018. Accordingly, the periods presented below are not directly comparable.

Three months ended December 31, 2018 compared to the three months ended December 31, 2017

The following tables set forth, for the three month periods indicated, financial data from the Consolidated Statements of Operations and Comprehensive Income:

| (In thousands) | December 31, 2018 | As a % of Total Net Revenue | December 31, 2017 | As a % of Total Net Revenue |
|----------------------------------------------|----------------------|-----------------------------------|----------------------|-----------------------------------|
| Net revenues | \$159,089 | 100.0 % | \$117,912 | 100.0 % |
| Cost of revenues | 88,202 | 55.4 | 63,752 | 54.1 |
| Gross margin | 70,887 | 44.6 | 54,160 | 45.9 |
| Operating expenses: | | | | |
| Selling, general and administrative | 27,819 | 17.5 | 21,222 | 18.0 |
| Research and development | 16,192 | 10.2 | 15,187 | 12.9 |
| Amortization of intangible assets | 6,939 | 4.4 | 5,827 | 4.9 |
| Restructuring and other charges | 23 | — | 313 | 0.3 |
| Acquisition costs and other related expenses | 53 | — | 723 | 0.6 |
| Total operating expenses | 51,026 | 32.1 | 43,272 | 36.7 |
| Income from operations | 19,861 | 12.5 | 10,888 | 9.2 |
| Interest income | 71 | — | 3 | — |
| Interest expense | (2,196) | (1.4) | (107) | (0.1) |
| Other expense, net | (870) | (0.5) | (316) | (0.3) |
| Income before income taxes | 16,866 | 10.6 | 10,468 | 8.8 |
| Tax provision | 4,483 | 2.8 | 1,335 | 1.1 |
| Net income | \$12,383 | 7.8 % | \$9,133 | 7.7 % |

REVENUES

The increase in total revenues is primarily attributed to \$28.8 million of acquired revenues from the Themis and Germane acquisitions primarily driven by the CPS and CDS programs. These acquisitions have generated increases in demand for integrated subsystems across our C4I applications. Total revenues also increased due to \$12.4 million of organic revenues which primarily related to increases in demand for integrated subsystems across our other sensor and effector applications. The fluctuations in organic revenues across all applications were primarily driven by increases in the F-35, as well as a classified missile program and the UAV Predator program, which were offset by decreases in the Aegis and SEWIP Block II programs. See the Non-GAAP Financial Measures section for a reconciliation to our most directly comparable GAAP financial measures.

International revenues, which consist of foreign military sales through the U.S. government, sales to prime defense contractor customers where the end user is known to be outside of the U.S., and direct sales to non-U.S. based customers, decreased \$11.7 million during the three months ended December 31, 2018 as compared to the same period in fiscal 2018, primarily due to lower Aegis program revenues.

GROSS MARGIN

Gross margin was 44.6% for the three months ended December 31, 2018, a decrease of 130 basis points from the 45.9% gross margin achieved during the same period in fiscal 2018. The lower gross margin was primarily driven by the acquired businesses of Themis and Germane, which historically generated gross margins below our target model. Lower gross margins are also attributed to increases in Customer Funded Research and Development (“CRAD”), which primarily represents engineering labor associated with long-term contracts for customized development, production and service activities of certain products. These products are predominately grouped within integrated subsystems and to a lesser extent modules and sub-assemblies. Lower gross margins for the three months ended December 31, 2018 were partially offset by additional F-35 royalty revenue.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased \$6.6 million, or 31.1%, to \$27.8 million during the three months ended December 31, 2018, compared to \$21.2 million in the same period in fiscal 2018. The increase was primarily related to higher compensation related costs due to added headcount from the acquisitions of Themis and Germane, as well as increased headcount within the organic business. Selling, general and administrative expenses decreased as a percentage of revenue to 17.5% for the three months ended December 31, 2018 from 18.0% during the same period in fiscal 2018 primarily due to improved operating leverage.

RESEARCH AND DEVELOPMENT

Research and development expenses increased approximately \$1.0 million, or 6.6%, to \$16.2 million during the three months ended December 31, 2018, compared to \$15.2 million during the same period in fiscal 2018. The increase was primarily due to increased headcount from our recent acquisitions driving higher compensation related costs, partially offset by increased CRAD. Research and development expenses accounted for 10.2% and 12.9% of our revenues for the three months ended December 31, 2018 and 2017, respectively. The decrease as a percentage of revenue was primarily driven by higher revenues and additional CRAD for the three months ended December 31, 2018 as compared to the same period in fiscal 2018.

RESTRUCTURING AND OTHER CHARGES

Restructuring and other charges decreased \$0.3 million during the three months ended December 31, 2018, compared to the same period in fiscal 2018. Restructuring and other charges are typically related to acquisitions and organizational redesign programs initiated as part of discrete post-acquisition integration activities.

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, 2018, compared to \$0.7 million during the same period in fiscal 2018. The increase in acquisition costs and other related expenses incurred during the three months ended December 31, 2017, related to the acquisition of Themis. We expect to incur acquisition costs and other related expenses periodically in the future as we continue to seek acquisition opportunities to expand our capabilities and new end markets within the sensor processing chain. Transaction costs incurred by the acquiree prior to the consummation of an acquisition would not be reflected in our historical results of operations.

INTEREST EXPENSE

Interest expense increased \$2.1 million to \$2.2 million during the three months ended December 31, 2018 compared to \$0.1 million in the same period in fiscal 2018. The three months ended December 31, 2018 included \$2.2 million interest expense on the revolving credit facility ("the Revolver"), which facilitated the acquisition of Themis during the third quarter of fiscal 2018 and Germane during the first quarter of fiscal 2019.

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OTHER EXPENSE, NET

Other expense, net increased \$0.6 million to \$0.9 million during the three months ended December 31, 2018, as compared to \$0.3 million in the same period in fiscal 2018. The increase was primarily due to \$0.2 million of litigation and settlement expenses incurred during the three months ended December 31, 2018. The three months ended December 31, 2018 also included \$0.1 million of additional financing and registration fees as compared to the same period in fiscal 2018. The impact of foreign exchange was consistent for both the three months ended December 31, 2018 and 2017.

INCOME TAXES

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "Tax Act") was enacted by the U.S. government. The Tax Act has impacted the U.S. statutory Federal tax rate that we will use going forward, which has been reduced to 21% from 35%. The Tax Act introduced a modified territorial tax system and a minimum tax on certain foreign earnings for tax years beginning after December 31, 2017.

We recorded an income tax provision of \$4.5 million and \$1.3 million on income from operations before income taxes of \$16.9 million and \$10.5 million for the three months ended December 31, 2018 and 2017, respectively. During the three months ended December 31, 2018 and 2017, we recognized a discrete tax benefit and expense of \$0.1 million and \$0.3 million, respectively, related to excess tax benefits on stock-based compensation. The discrete tax expense for the three months ended December 31, 2017 included the enactment of the Tax Act which revalued the excess tax benefit previously recorded in the three months ended September 30, 2017.

The effective tax rate for the three months ended December 31, 2018 differed from the Federal statutory rate of 21% primarily due to Federal research and development credits, excess tax benefits related to stock-based compensation, a modified territorial tax system and a minimum tax on certain foreign earnings, and state taxes. These provisions have been included in the income tax expense for the three months ended December 31, 2018.

The effective tax rate for the three months ended December 31, 2017 differed from the Federal statutory rate of 28% primarily due to Federal research and development credits, domestic manufacturing deduction, excess tax benefits related to stock-based compensation, and state taxes. During the second quarter of fiscal 2018, the Federal statutory rate transitioned to a blended 28% as a result of the Tax Act.

Within the calculation of our annual effective tax rate we have used assumptions and estimates that may change as a result of future guidance and interpretation from the Internal Revenue Service, SEC, and FASB.

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Six months ended December 31, 2018 compared to the six months ended December 31, 2017

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

| (In thousands) | December 31, 2018 | As a % of Total Net Revenue | December 31, 2017 | As a % of Total Net Revenue |
|----------------------------------------------|-------------------|-----------------------------|-------------------|-----------------------------|
| Net revenues | \$303,145 | 100.0 % | \$223,981 | 100.0 % |
| Cost of revenues | 170,675 | 56.3 | 119,147 | 53.2 |
| Gross margin | 132,470 | 43.7 | 104,834 | 46.8 |
| Operating expenses: | | | | |
| Selling, general and administrative | 52,560 | 17.3 | 41,790 | 18.7 |
| Research and development | 31,140 | 10.3 | 28,929 | 12.9 |
| Amortization of intangible assets | 14,120 | 4.7 | 11,464 | 5.1 |
| Restructuring and other charges | 527 | 0.2 | 408 | 0.2 |
| Acquisition costs and other related expenses | 452 | 0.1 | 984 | 0.4 |
| Total operating expenses | 98,799 | 32.6 | 83,575 | 37.3 |
| Income from operations | 33,671 | 11.1 | 21,259 | 9.5 |
| Interest income | 137 | — | 22 | — |
| Interest expense | (4,455) | (1.4) | (110) | — |
| Other expense, net | (1,879) | (0.6) | (1,131) | (0.5) |
| Income before income taxes | 27,474 | 9.1 | 20,040 | 9.0 |
| Tax provision (benefit) | 7,612 | 2.5 | (7,046) | (3.1) |
| Net income | \$19,862 | 6.6 % | \$27,086 | 12.1 % |

REVENUES

The increase in total revenues is primarily attributed to \$60.0 million of acquired revenues from the Themis and Germane acquisitions primarily driven by the Win-T and CDS programs. These acquisitions have generated increases in demand for integrated subsystems across our C4I applications. Total revenues also increased due to \$19.2 million of organic revenues which primarily related to increases in demand for components and integrated subsystems across our other sensor and effector applications and, to a lesser extent, C4I applications. The fluctuations in organic revenues across all applications were primarily driven by increases in the F-35, UAV Predator and Stormbreaker, which were offset by decreases in the Aegis and SEWIP Block II programs. See the Non-GAAP Financial Measures section for a reconciliation to our most directly comparable GAAP financial measures.

International revenues, which consist of foreign military sales through the U.S. government, sales to prime defense contractor customers where the end user is known to be outside of the U.S., and direct sales to non-U.S. based customers, decreased \$14.6 million during the six months ended December 31, 2018 as compared to the same period in fiscal 2018, primarily due to lower Aegis program revenues.

GROSS MARGIN

Gross margin was 43.7% for the six months ended December 31, 2018, a decrease of 310 basis points from the 46.8% gross margin achieved during the same period in fiscal 2018. The lower gross margin during the six months ended December 31, 2018 was impacted by lower margin Themis and Germane acquired businesses and program mix including higher CRAD. The six months ended December 31, 2018 and 2017 both included inventory step-up amortization of \$0.6 million related to our acquired businesses.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased \$10.8 million, or 26%, to \$52.6 million during the six months ended December 31, 2018, compared to \$41.8 million in the same period in fiscal 2018. The increase was primarily related to higher compensation related costs due to added headcount from the acquisitions of Themis and Germane, as well as increased headcount within the organic business. Selling, general and administrative expenses decreased as a percentage of revenues to 17.3% during the six months ended December 31, 2018 from 18.7% during the same period in fiscal 2018 primarily due to improved operating leverage.

RESEARCH AND DEVELOPMENT

Research and development expenses increased \$2.2 million, or 8%, to \$31.1 million during the six months ended December 31, 2018, compared to \$28.9 million during the same period in fiscal 2018. The increase was primarily due to increased headcount from our recent acquisitions, driving higher compensation related costs. Research and development expenses decreased as a percentage of revenues to 10.3% during the six months ended December 31, 2018 from 12.9% during the same period in fiscal 2018. The decrease was primarily due to higher revenues and additional CRAD in the six months ended December 31, 2018, as compared to the same period in fiscal 2018.

RESTRUCTURING AND OTHER CHARGES

Restructuring and other charges were \$0.5 million for the six months ended December 31, 2018, compared to \$0.4 million during the same period in fiscal 2018. The increase was primarily driven by severance costs associated with the acquired Germane business compared to the same period in fiscal 2018. Restructuring and other charges are typically related to acquisitions and organizational redesign programs initiated as part of discrete post-acquisition integration activities.

ACQUISITION COSTS AND OTHER RELATED EXPENSES

We incurred \$0.5 million of acquisition costs and other related expenses during the six months ended December 31, 2018, compared to \$1.0 million during the same period in fiscal 2018. The acquisition costs and other related expenses we incurred during the six months ended December 31, 2018 were primarily related to the acquisition of the Germane business. The acquisition costs and other related expenses for the same period in fiscal 2018 were primarily related to the acquisition of Themis. We expect to incur acquisition costs and other related expenses periodically in the future as we continue to seek acquisition opportunities to expand our capabilities and new end markets within the sensor processing chain. Transaction costs incurred by the acquiree prior to the consummation of an acquisition would not be reflected in our historical results of operations.

INTEREST EXPENSE

Interest expense increased \$4.4 million, to \$4.5 million during the six months ended December 31, 2018 compared to \$0.1 million during the same period in fiscal 2018. The six months ended December 31, 2018 included \$4.5 million interest expense on the Revolver, which facilitated the acquisitions of Themis during the third quarter of fiscal 2018 and Germane during the first quarter of fiscal 2019.

OTHER EXPENSE, NET

Other expense, net was \$1.9 million during the six months ended December 31, 2018, compared to \$1.1 million during the same period in fiscal 2018. The increase in other expense was primarily due to increased foreign exchange losses of \$0.4 million during the six months ended December 31, 2018, compared to the same period in fiscal 2018. The increase also included an additional \$0.2 million of financing and registration fees during the six months ended December 31, 2018 compared to the same period in fiscal 2018. The six months ended December 31, 2018 included \$0.2 million of litigation and settlement expenses incurred during the period.

INCOME TAXES

On December 22, 2017, the Tax Act was enacted by the U.S. government. The Tax Act has impacted the U.S. statutory Federal tax rate that we will use going forward, which has been reduced to 21% from 35%. The Tax Act introduced a modified territorial tax system and a minimum tax on certain foreign earnings for tax years beginning after December 31, 2017.

We recorded an income tax provision of \$7.6 million and an income tax benefit of \$7.0 million on income from operations before income taxes of \$27.5 million and \$20.0 million for the six months ended December 31, 2018 and 2017, respectively. During the six months ended December 31, 2018 and 2017, we recognized discrete tax benefits of \$1.7 million and \$7.6 million, respectively, related to excess tax benefits on stock-based compensation.

The effective tax rate for the six months ended December 31, 2018 differed from the Federal statutory rate of 21% primarily due to Federal research and development credits, excess tax benefits related to stock-based compensation, a modified territorial tax system and a minimum tax on certain foreign earnings, and state taxes. These provisions have been included in the income tax expense for the six months ended December 31, 2018.

The effective tax rate for the six months ended December 31, 2017 differed from the Federal statutory rate of 28% primarily due to the one-time impact of the Tax Act, Federal research and development credits, domestic

manufacturing deduction, excess tax benefits related to stock compensation, and state taxes. During the second quarter of fiscal 2018, the Federal statutory rate transitioned to a blended 28% as a result of the Tax Act.

Within the calculation of our annual effective tax rate we have used assumptions and estimates that may change as a result of future guidance and interpretation from the Internal Revenue Service, SEC, and FASB.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity come from existing cash and cash generated from operations, our revolving credit facility and our ability to raise capital under our universal shelf registration statement. Our near-term fixed commitments for cash expenditures consist primarily of payments under operating leases and inventory purchase commitments. We do not currently have any material commitments for capital expenditures.

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

Shelf Registration Statement

On August 28, 2017, we filed a shelf registration statement on Form S-3ASR with the SEC. The shelf registration statement, which was effective upon filing with the SEC, registered each of the following securities: debt securities, preferred stock, common stock, warrants and units. We intend to use the proceeds from financings 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.

We have an unlimited amount available under the shelf registration statement. Additionally, as part of the shelf registration statement, we have entered into an equity distribution agreement which allows us to sell an aggregate of up to \$200.0 million of our common stock from time to time through our agents. The actual dollar amount and number of shares of common stock we sell pursuant to the equity distribution agreement will be dependent on, among other things, market conditions and our fund raising requirements. The agents may sell the common stock by any method deemed to be an “at the market offering” as defined in Rule 415 of the Securities Act of 1933, as amended, including without limitation sales made directly on NASDAQ, on any other existing trading market for the common stock or to or through a market maker. In addition, our common stock may be offered and sold by such other methods, including privately negotiated transactions, as we and the agents may agree.

Revolving Credit Facility

On September 28, 2018, we amended the Revolver to increase and extend the borrowing capacity to \$750.0 million, 5-year revolving credit line, with the maturity extended to September 2023. In connection with the amendment, we repaid the remaining outstanding interest on the Revolver using cash on hand. On July 31, 2018, we drew \$45.0 million from the Revolver to facilitate the acquisition of Germane. The Revolver had an outstanding balance of \$240.0 million at December 31, 2018. See Note I in the accompanying consolidated financial statements for further discussion of the Revolver.

On January 11, 2019, we entered into an interest rate swap (the “Swap”) with Bank of America, N.A. for a notional amount of \$175.0 million. The Swap matures on September 28, 2023, coterminous with the maturity of the Revolver. The Swap effectively converts \$175.0 million of our Revolver obligation from a variable interest rate to a fixed rate of 2.54%.

On January 29, 2019, we acquired GECO Avionics, LLC (“GECO”). Based in Mesa, Arizona, GECO has over twenty years of experience designing and manufacturing affordable safety-critical avionics and mission computing solutions. GECO’s DO-254 certified hardware solutions include mission processors, airborne displays, video processing and aviation networking. GECO also specializes in DO-178 avionics software design up to DAL-A, the highest level of design assurance for flight management, aircraft condition monitoring, display and electronic flight instrumentation applications. GECO’s technologies are deployed on numerous military platforms such as the AH-64 Apache attack helicopter and the KC-46A Pegasus widebody multirole tanker, among others. We acquired GECO for an all cash purchase price of \$36.5 million, subject to net working capital and net debt adjustments. The acquisition was funded through the Revolver.

CASH FLOWS

| (In thousands) | As of and For the Six Month Period Ended December 31, | |
|------------------------------------------------------|-------------------------------------------------------------|------------|
| | 2018 | 2017 |
| Net cash provided by operating activities | \$45,330 | \$16,807 |
| Net cash used in investing activities | \$(55,831) | \$(13,765) |
| Net cash provided by (used in) financing activities | \$37,894 | \$(12,860) |
| Net increase (decrease) in cash and cash equivalents | \$27,382 | \$(9,602) |
| Cash and cash equivalents at end of period | \$93,903 | \$32,035 |

Our cash and cash equivalents increased by \$27.4 million from June 30, 2018 to December 31, 2018, primarily as the result of \$45.3 million provided by operating activities and net borrowings under the credit facility of \$45.0 million. These increases were offset by \$45.0 million used in acquisition activities, \$10.8 million invested in purchases of property and equipment, \$6.9 million used in the retirement of common stock used to settle individual employees' tax liabilities associated with vesting of restricted stock awards, and \$1.9 million related to the fees incurred to increase the borrowing capacity of our existing revolving credit facility.

Operating Activities

During the six months ended December 31, 2018, we generated \$45.3 million in cash from operating activities, an increase of \$28.5 million when compared to the same period in fiscal 2018. The increase in cash generated by operating activities was primarily the result of less cash paid for income taxes and inventory, as well as increased deferred revenue and customer advances. These increases were partially offset lower comparable net income and cash uses for accounts receivable, accounts payable and accrued expenses.

Investing Activities

During the six months ended December 31, 2018, we invested \$55.8 million compared to \$13.8 million during the same period in fiscal 2018. The increase was driven by the acquisition of Germane during the six months ended December 31, 2018 compared to the acquisition of RTL in the same period of fiscal 2018. The increase was also driven by \$3.2 million in higher purchases of property and equipment during fiscal 2019.

Financing Activities

During the six months ended December 31, 2018, we had \$37.9 million cash provided by financing activities compared to \$12.9 million cash used in financing activities during the same period in fiscal 2018. The \$50.8 million increase was primarily due to the \$45.0 million of net borrowings that were drawn against the Revolver to facilitate the acquisition of Germane during the six months ended December 31, 2018. The increase included fewer payments of \$8.0 million related to the retirement of common stock used to settle individual employees' tax liabilities associated with vesting of restricted stock awards as compared to the same period of fiscal 2018. These increases were partially offset by \$1.9 million of payments for deferred financing fees related to the amendment of the Revolver.

COMMITMENTS, CONTRACTUAL OBLIGATIONS AND CONTINGENCIES

The following is a schedule of our commitments and contractual obligations outstanding at December 31, 2018:

| (In thousands) | Total | Less Than 1 Year | 1-3 Years | 3-5 Years | More Than 5 Years |
|----------------------|-----------|---------------------|--------------|--------------|----------------------|
| Purchase obligations | \$68,695 | \$68,695 | \$— | \$— | \$— |
| Operating leases | 61,182 | 9,420 | 16,936 | 14,109 | 20,717 |
| | \$129,877 | \$78,115 | \$16,936 | \$14,109 | \$20,717 |

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 \$68.7 million at December 31, 2018.

We have a liability at December 31, 2018 of \$2.9 million for uncertain tax positions that have been taken or are expected to be taken in various income tax returns. 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.

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.

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 employees' tax liabilities 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.

OFF-BALANCE SHEET ARRANGEMENTS

Other than our lease commitments incurred in the normal course of business and certain indemnification provisions, we do not have any off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity.

We do not have any majority-owned subsidiaries that are not consolidated in the financial statements. Additionally, we do not have an interest in, or relationships with, any special purpose entities.

NON-GAAP FINANCIAL MEASURES

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

Adjusted EBITDA is defined as net income before other non-operating adjustments, 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 income and expense, and stock-based and other non-cash compensation expense. We use adjusted EBITDA as an important indicator of the operating performance of our business. We use adjusted EBITDA in internal forecasts and models when establishing internal operating budgets, supplementing the financial results and forecasts reported to our board of directors, determining a component of bonus and equity compensation for executive officers based on operating performance and evaluating short-term and long-term operating trends in our operations. We believe the adjusted EBITDA financial measure assists in providing a more complete understanding of our underlying operational measures to manage our business, to evaluate our performance compared to prior periods and the marketplace, and to establish operational goals. We believe that these non-GAAP financial adjustments are useful to investors because they allow investors to evaluate the effectiveness of the methodology and information used by management in our financial and operational decision-making.

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

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

| (In thousands) | Three Months | | Six Months | |
|-----------------------------------------------------|--------------|--------------|--------------|--------------|
| | Ended | | Ended | |
| | December 31, | December 31, | December 31, | December 31, |
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$12,383 | \$9,133 | \$19,862 | \$27,086 |
| Other non-operating adjustments, net (1) | (18) | (326) | 347 | (104) |
| Interest expense (income), net | 2,125 | 104 | 4,318 | 88 |
| Income taxes | 4,483 | 1,335 | 7,612 | (7,046) |
| Depreciation | 4,769 | 3,775 | 9,134 | 7,475 |
| Amortization of intangible assets | 6,939 | 5,827 | 14,120 | 11,464 |
| Restructuring and other charges (2) | 23 | 313 | 527 | 408 |
| Impairment of long-lived assets | — | — | — | — |
| Acquisition and financing costs | 762 | 1,366 | 1,805 | 2,220 |
| Fair value adjustments from purchase accounting (3) | — | 84 | 620 | 593 |
| Litigation and settlement expense (income), net | 179 | — | 179 | — |
| Stock-based and other non-cash compensation expense | 5,338 | 4,941 | 10,081 | 9,637 |
| Adjusted EBITDA | \$36,983 | \$26,552 | \$68,605 | \$51,821 |

(1) As of July 1, 2018, we have revised our definition of adjusted EBITDA to incorporate other non-operating adjustments, net, which includes gains or losses on foreign currency remeasurement and fixed assets sales and disposals among other adjustments. Adjusted EBITDA for prior periods has been recast for comparative purposes.

(2) Restructuring and other charges are typically related to acquisitions and organizational redesign programs initiated as part of discrete post-acquisition integration activities. We believe these items are non-routine and may not be indicative of ongoing operating results.

(3) Fair value adjustments from purchase accounting for the six months ended December 31, 2018 relate to Germane inventory step-up amortization. Fair value adjustments from purchase accounting for the three and six months ended December 30, 2017 relate to CES and Delta inventory step-up amortization.

Adjusted income 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 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 as income 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 income and expense, and stock-based and other non-cash compensation expense. The impact to income taxes includes the impact to the effective tax rate, current tax provision and deferred tax provision. Adjusted EPS expresses adjusted income on a per share basis using weighted average diluted shares outstanding.

Adjusted income 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 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 tables reconcile net income and diluted earnings per share, the most directly comparable GAAP measures, to adjusted income and adjusted EPS:

| (In thousands, except per share data) | Three Months Ended December 31, | | | |
|-----------------------------------------------------|---------------------------------|---------|----------|---------|
| | 2018 | | 2017 | |
| Net income and diluted earnings per share | \$12,383 | \$ 0.26 | \$9,133 | \$ 0.19 |
| Amortization of intangible assets | 6,939 | | 5,827 | |
| Restructuring and other charges (1) | 23 | | 313 | |
| Impairment of long-lived assets | — | | — | |
| Acquisition and financing costs | 762 | | 1,366 | |
| Fair value adjustments from purchase accounting (2) | — | | 84 | |
| Litigation and settlement expenses (income), net | 179 | | — | |
| Stock-based and other non-cash compensation expense | 5,338 | | 4,941 | |
| Impact to income taxes (3) | (3,009) | | (8,615) | |
| Adjusted income and adjusted earnings per share | \$22,615 | \$ 0.47 | \$13,049 | \$ 0.28 |

| | | |
|---------------------------------------------|--------|--------|
| Diluted weighted-average shares outstanding | 47,705 | 47,447 |
|---------------------------------------------|--------|--------|

(1) Restructuring and other charges are typically related to acquisitions and organizational redesign programs initiated as part of discrete post-acquisition integration activities. We believe these items are non-routine and may not be indicative of ongoing operating results.

(2) Fair value adjustments from purchase accounting for the three months ended December 31, 2017 relate to CES inventory step-up amortization.

(3) Impact to income taxes is calculated by recasting income before income taxes to include the add-backs involved in determining adjusted income and recalculating the income tax provision using this adjusted income from operations before income taxes. The impact to income taxes includes the impact to the effective tax rate, current tax provision and deferred tax provision.

| (In thousands, except per share data) | Six Months Ended | | | |
|-----------------------------------------------------|------------------|---------|-----------|---------|
| | December 31, | | | |
| | 2018 | | 2017 | |
| Net income and diluted earnings per share | \$19,862 | \$ 0.42 | \$27,086 | \$ 0.57 |
| Amortization of intangible assets | 14,120 | | 11,464 | |
| Restructuring and other charges (1) | 527 | | 408 | |
| Impairment of long-lived assets | — | | — | |
| Acquisition and financing costs | 1,805 | | 2,220 | |
| Fair value adjustments from purchase accounting (2) | 620 | | 593 | |
| Litigation and settlement expenses (income), net | 179 | | — | |
| Stock-based and other non-cash compensation expense | 10,081 | | 9,637 | |
| Impact to income taxes (3) | (6,082) | | (20,566) | |
| Adjusted income and adjusted earnings per share | \$41,112 | \$ 0.86 | \$30,842 | \$ 0.65 |

| | | |
|---------------------------------------------|--------|--------|
| Diluted weighted-average shares outstanding | 47,696 | 47,538 |
|---------------------------------------------|--------|--------|

(1) Restructuring and other charges are typically related to acquisitions and organizational redesign programs initiated as part of discrete post-acquisition integration activities. We believe these items are non-routine and may not be indicative of ongoing operating results.

(2) Fair value adjustments from purchase accounting for the six months ended December 31, 2018 relate to Germane inventory step-up amortization. Fair value adjustments from purchase accounting for the six months ended December 30, 2017 relate to CES and Delta inventory step-up amortization.

(3) Impact to income taxes is calculated by recasting income before income taxes to include the add-backs involved in determining adjusted income and recalculating the income tax provision using this adjusted income from operations before income taxes. The impact to income taxes includes the impact to the effective tax rate, current tax provision

and deferred tax provision.

Free cash flow, a non-GAAP measure for reporting cash flow, is defined as cash provided by operating activities less capital expenditures for property and equipment, which includes capitalized software development costs. 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 can be valuable indicators of our operating performance and liquidity.

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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 December 31, | | Six Months Ended December 31, | |
|---------------------------------------|---------------------------------|----------|-------------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| Cash provided by operating activities | \$25,301 | \$8,779 | \$45,330 | \$16,807 |
| Purchase of property and equipment | (7,075) | (3,964) | (10,802) | (7,592) |
| Free cash flow | \$18,226 | \$4,815 | \$34,528 | \$9,215 |

Organic revenue and acquired revenue are non-GAAP measures for reporting financial performance of our business. We believe this information provides investors with insight to our ongoing business performance. Organic revenue represents total company revenue excluding net revenue from acquired companies for the first four full quarters since the entities' acquisition date (which excludes intercompany transactions). Acquired revenue represents revenue from acquired companies for the first four full quarters since the entities' acquisition date (which excludes intercompany transactions). After the completion of four full fiscal quarters, acquired revenue is treated as organic for current and comparable historical periods.

The following table reconciles the most directly comparable GAAP financial measure to the non-GAAP financial measure for the three months ended December 31, 2018 and 2017.

| (In thousands) | December 31, 2018 | As a % of Total Net Revenue | December 31, 2017 | As a % of Total Net Revenue | \$ Change | % Change |
|------------------|-------------------|-----------------------------|-------------------|-----------------------------|-----------|----------|
| Organic revenue | \$130,326 | 82 % | \$117,912 | 100 % | \$12,414 | 11 % |
| Acquired revenue | 28,763 | 18 % | — | — % | 28,763 | 100 % |
| Total revenues | \$159,089 | 100 % | \$117,912 | 100 % | \$41,177 | 35 % |

The following table reconciles the most directly comparable GAAP financial measure to the non-GAAP financial measure for the six months ended December 31, 2018 and 2017.

| (In thousands) | December 31, 2018 | As a % of Total Net Revenue | December 31, 2017 | As a % of Total Net Revenue | \$ Change | % Change |
|------------------|-------------------|-----------------------------|-------------------|-----------------------------|-----------|----------|
| Organic revenue | \$243,127 | 80 % | \$223,981 | 100 % | \$19,146 | 9 % |
| Acquired revenue | 60,018 | 20 % | — | — % | 60,018 | 100 % |
| Total revenues | \$303,145 | 100 % | \$223,981 | 100 % | \$79,164 | 35 % |

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), an amendment of the FASB Accounting Standards Codification. This ASU requires lessees to recognize a right-of-use asset and lease liability for most lease arrangements. The new standard is effective for us on July 1, 2019. The standard mandates a modified retrospective transition method for all entities and early adoption is permitted. We are currently evaluating the ASU's expected impact on our financial statements. As of December 31, 2018, the Company had \$61.2 million of future minimum lease payments under non-cancelable operating leases, primarily for facilities. The future minimum lease payments have not yet been adjusted to the present value, as we are still assessing the impact of each applicable discount rate. We will leverage the rate implicit in the lease unless that rate cannot be readily determined, in which case we will use our incremental borrowing rate to determine the discount rate applicable for the calculation of our lease liabilities. See Commitments, Contractual Obligations and Contingencies of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q for more information about the timing and amount

of future operating lease payments, which we believe is indicative of the materiality of adoption of the ASU to our financial statements.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment, an amendment of the FASB Accounting Standards Codification. This ASU eliminates the requirement to measure the implied fair value of goodwill by assigning the fair value of a reporting unit to all assets and liabilities within that unit (“the Step 2 test”) from the goodwill impairment test. Instead, if the carrying amount of a reporting unit exceeds its fair value,

an impairment loss is recognized in an amount equal to that excess, limited by the amount of goodwill in that reporting unit. For public business entities, the new standard is effective for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. The ASU requires prospective adoption and permits early adoption for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. We do not expect this guidance to have a material impact to our consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities, an amendment of the FASB Accounting Standards Codification. This ASU provides improved financial reporting of hedging relationships to better portray the economic result of an entity's risk management activities in its financial statements. In addition, the amendments in this update make certain targeted improvements to simplify the application of hedge accounting guidance. The ASU is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. The ASU requires modified retrospective adoption and permits early adoption in any interim period after issuance of the ASU. We are evaluating the effect that ASU 2017-12 will have on our consolidated financial statements and related disclosures.

In March 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220) Reclassification of Certain Tax Effects for Accumulated Other Comprehensive Income, an amendment of the FASB Accounting Standards Codification. This ASU permits a company to reclassify the disproportionate income tax effects of the Tax Cuts and Jobs Act of 2017 on items within accumulated other comprehensive income ("AOCI") to retained earnings. The amounts applicable for reclassification should include the effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of the enactment of the Tax Cuts and Jobs Act of 2017 related to the items remaining in AOCI. The effect of the change in the U.S. federal corporate income tax rate on gross valuation allowances that were originally charged to income from continuing operations shall not be included. For all entities, the new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within that annual period, and early adoption is permitted. We are evaluating the effect that ASU 2018-02 will have on our consolidated financial statements and related disclosures.

In August 2018, the FASB issued ASU No. 2018-14, Compensation—Retirement Benefits—Defined Benefit Plans—General (Topic 715) Changes to the Disclosure Requirements for Defined Benefit Plans, an amendment of the FASB Accounting Standards Codification. The amendments in this ASU remove disclosures that no longer are considered cost-beneficial, clarify the specific requirements of disclosures, and add disclosure requirements identified as relevant. For public business entities, the standard is effective for fiscal years ending after December 15, 2020. The ASU requires retrospective adoption and permits early adoption for all entities. We do not expect this guidance to have a material impact to our consolidated financial statements or related disclosures.

In August 2018, the FASB issued ASU No. 2018-15, Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40), an amendment of the FASB Accounting Standards Codification. The ASU provides guidance to determine whether to capitalize implementation costs of cloud computing arrangement that is a service contract or expense as incurred. Costs of arrangements that do not include a software license should be accounted for as a service contract and expensed as incurred. This ASU is effective for fiscal years beginning after December 15, 2019, with early adoption permitted. The ASU permits two methods of adoption: prospectively to all implementation costs incurred after the date of adoption, or retrospectively to each prior reporting period presented. We do not expect this guidance to have a material impact to our consolidated financial statements or related disclosures.

In August 2018, the SEC issued SEC Final Rule 33-10532, Disclosure Update and Simplification, which requires disclosure of the changes in each caption of shareholders' equity for the current and comparative year-to-date periods, with subtotals for each interim period and the amount of dividends per share for each class of shares. This rule is effective for interim periods, beginning after November 5, 2018, with early adoption permitted. The Company plans to make the new required disclosures starting with its fiscal quarter ending March 31, 2019.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

Effective July 1, 2018, we adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), 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 replaces most existing revenue recognition guidance in GAAP.

The new standard permits adoption by using either (i) a retrospective approach for all periods presented in the period of adoption or (ii) a modified retrospective approach with the cumulative effect of initially applying the new standard recognized at the date of initial application and providing certain additional disclosures. In accordance with this standard, we have adopted the new standard using the retrospective method. We have completed the assessment phase and implemented the new standard accordingly. Further, we have evaluated our policies in relation to our internal controls framework. This assessment included identification, consideration, and quantification of the impact of the new standard on our financial statements, accounting policies, processes, control environment and systems. The outcome of this assessment included implementation of supporting processes

and systems that enable timely and accurate reporting under the new standard. Adoption of the new standard did not result in a significant change in our control environment. Such adoption has resulted in additional disclosures around the nature and timing of our performance obligations, contract liabilities, deferred contract cost assets, as well as significant judgments and practical expedients used by us. We have applied the standard's practical expedient that permits the omission of prior-period information about our remaining performance obligations. We also elected to use a practical expedient available under the new standard whereby contracts with original expected durations of one year or less are excluded from our remaining performance obligations.

Adoption of the new standard did not have a material impact to the amount or timing of revenue recognition related to our legacy accounting methods for contracts including ship and bill, multiple-deliverable, and contract accounting, which encompassed the legacy percentage-of-completion, completed contract and time and materials methods. For T&M contracts, we elected to use a practical expedient permitted by the new standard whereby revenue is recognized in the amount for which the Company has a right to invoice the customer based on the control transferred to the customer. Such adoption did not have a material impact to our consolidated financial statements.

In connection with the adoption of the new standard, there is a requirement to capitalize certain incremental costs of obtaining a contract, which for us primarily comprises commission expenses for internal and external sales representatives. Any such costs required to be capitalized would be amortized over the period of performance for the underlying contracts. We have elected the practical expedient under the new standard whereby costs associated with contracts that have a duration less than one year are expensed as incurred. We have completed the evaluation of capitalizing costs to obtain a contract, noting that the impact related to these costs would be limited to commissions on contracts with a duration exceeding one year. The impact was not material to our consolidated financial statements. Effective July 1, 2018, we adopted ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments, an amendment of the FASB Accounting Standards Codification. This ASU will reduce diversity in practice for classifying cash payments and receipts in the statement of cash flows for a number of common transactions. It will also clarify when identifiable cash flows should be separated versus classified based on their predominant source or use. Such adoption has not and will not have any impact to our consolidated financial statements.

Effective July 1, 2018, we adopted ASU No. 2016-16, Intra-Entity Transfers of Assets Other Than Inventory, an amendment of the FASB Accounting Standards Codification. This ASU requires the seller and buyer to recognize at the transaction date the current and deferred income tax consequences of intercompany asset transfers (except transfers of inventory). Under current U.S. GAAP, the seller and buyer defer the consolidated tax consequences of an intercompany asset transfer from the period of the transfer to a future period when the asset is transferred out of the consolidated group, or otherwise affects consolidated earnings. This standard will cause volatility in companies' effective tax rates, particularly for those that transfer intangible assets to foreign subsidiaries. Such adoption has not and will not have any impact to our consolidated financial statements.

Effective July 1, 2018, we adopted ASU No. 2017-07, Compensation Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost, an amendment of the FASB Accounting Standards Codification. This ASU requires employers that sponsor defined benefit pension and/or other post-retirement benefit plans to report the service cost component of net benefit cost in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. Employers are required to present the other components of net benefit costs in the income statement separately from the service cost component and outside a subtotal of income from operations. Additionally, only the service cost component of net periodic pension cost will be eligible for asset capitalization. The ASU should be applied retrospectively for the presentation of the service cost component and the other components of net periodic pension cost and net periodic postretirement benefit cost in the income statement and prospectively, on and after the effective date, for the capitalization of the service cost component of net periodic pension cost and net periodic postretirement benefit in assets. Such adoption has not and will not have a material impact to our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There were no material changes in our exposure to market risk from June 30, 2018 to December 31, 2018.

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, 2018. 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, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. However, management is in the process of integrating the recently acquired Germane business into our overall internal control over financial reporting environment.

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.

On July 10, 2018, a securities class action complaint was filed against us, Mark Aslett, and Gerald M. Haines II in the U.S. District Court for the District of Massachusetts. The complaint asserted Section 10(b) and 20(a) securities fraud claims on behalf of a purported class of purchasers and sellers of our stock from October 24, 2017 to April 24, 2018. The complaint alleged that our public disclosures in SEC filings and on earnings calls were false and/or misleading. On September 27, 2018, The City of Daytona Beach Police & Fire Pension Fund was designated as the lead plaintiff and Levi & Korsinsky was designated as lead counsel in the matter. The Court granted plaintiff leave to amend and restate the complaint, which was due on December 10, 2018. On December 10, 2018, the plaintiff filed a notice of voluntary dismissal without prejudice and the case was terminated by the Court and is no longer pending.

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, 2018. There have been no material changes from the factors disclosed in our 2018 Annual Report on Form 10-K filed on August 16, 2018, 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, 2018 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 Andover, Massachusetts, on February 7, 2019.
MERCURY SYSTEMS, INC.

By: /S/ MICHAEL D. RUPPERT
Michael D. Ruppert
Executive Vice President,
Chief Financial Officer, and Treasurer

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