print | close

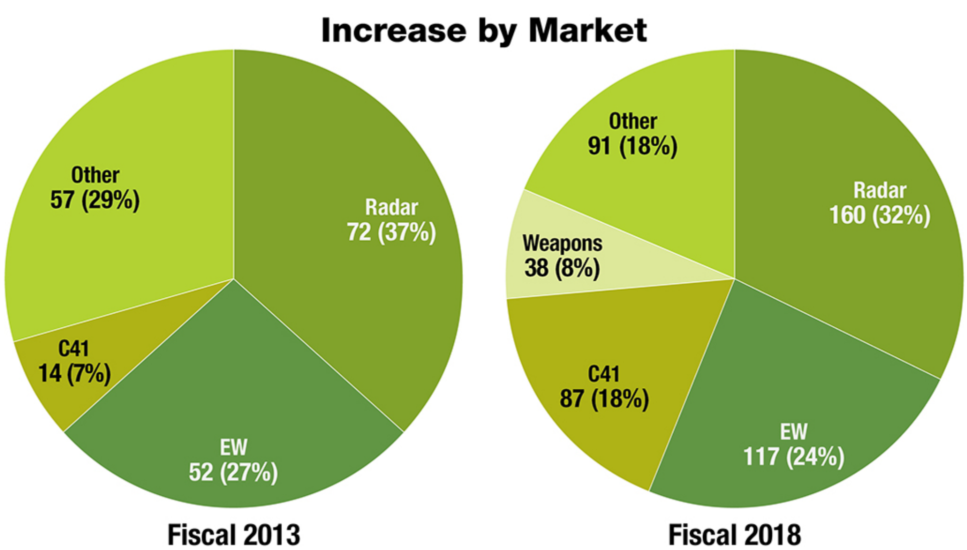
Small-Cap Defense Specialists Like Mercury Systems Are On The Rise

Aviation Week & Space Technology
Michael Bruno
Thu, 2018-11-22 04:00

Shares of major defense companies are down as a group 3% this year. Looking ahead, investors see only a growing list of challenges to primes and top-tier defense suppliers, from plateauing defense budgets to increasing competitive pressures such as low-ball bidding.

Then there is Mercury Systems, a small-cap defense electronics specialist that recently outlined a credible plan to double its business within five years. Not surprisingly, financial analysts are taking note, and investors are buying in—while the year-to-date stock price remains roughly the same at around $50 along with a flat Russell 2000 index—Mercury's shares have grown about fivefold in the last five years.

The momentum at Andover, Massachusetts-based Mercury could be emblematic of who may be the real winners of the Trump era in defense spending. They are smaller public companies (some currently private) whose annual revenues reach only a few billion dollars but which can leverage their niche technology supplier roles during this bow wave of spending while staying far enough out of the bull's-eye of acquisition reform efforts.



Note: Numbers are rounded and do not add to 100% due to other non categorized revenue.

What is more, these defense small-caps are becoming the textbook examples of highly innovative, secure-and-reliable U.S.-based suppliers for customers both up the industry food chain and in government. In turn, they are emerging as some of the leading employers, acquirers and providers of choice.

Mercury's path was described in a Nov. 6 investor briefing. "We are developing technology at the speed at which it moves inside of the commercial world," says Mark Aslett, CEO, president and a director. "However, our end market is the aerospace and defense electronics industry, and we understand the nuances associated with that, specifically the [call for] domestically developed [and] manufactured products here in the U.S."

The plan is ambitious, note Jefferies analysts. Mercury's management is aiming to double its business, with annual revenue reaching almost $1.3 billion by fiscal 2023, with pretax margins of 22-26%. To get there, Mercury is focusing on the C4I market (command, control, computers, communications and intelligence) while riffing on its traditional market of sensor and mission systems. Mercury's legacy has been in addressing electronic warfare, radar, electro-optical, infrared, acoustics and weapons markets. Programs are increasing (see charts).

But end-markets are just one element of Mercury's business strategy, and Aslett likes to point to the company's investment model, talent recruitment and supplier position as other success factors. In mergers and acquisitions (M&A), the company has spent $620 million on seven deals of various sizes over the last three years, starting before the current wave of deal-making.

Similarly, while the defense industry as a whole is spending roughly 2-3% of its revenue on research and development, Mercury is devoting 10-13%.

But what Aslett seems particularly proud of is how the 1,200-employee company ranks with workers. According to Glassdoor, a job-search website that lets current and former employees anonymously rate companies and management, Mercury is the highest-rated defense company, with a 4.1 rating on a 1-5 scale, 92% approval of CEOs and 88% saying they would recommend it to a friend.

This is crucial as an aging workforce, low unemployment and competition for workers skilled in science, technology, engineering and math heats up, and larger aerospace-and-defense companies struggle to hire. "That's part of the reason why we see our customers are actually outsourcing more of the work for the things that they used to do in-house to companies such as Mercury," Aslett says.

Of course, there are risks to the scenario, say the Jefferies analysts. Mercury's plan to double its business rests on roughly 10% organic revenue growth, compared with 6% over the last year, and more from future M&A for a total compound annual growth rate of 20%.

There is also the fact that Mercury and several other small-cap defense cohorts are targets of activist short-interest investor Spruce Point Capital Management. While Spruce's attacks have not cratered any companies to date, the activist's thick reports of negative arguments stand as enduring counterpoints to management assertions.

But for now, analysts are giving Mercury the benefit of the doubt. "While difficult to quantify, we remain intrigued by Mercury Systems' capacities to address the Defense Department's focus on 'trusted sources' of defense electronic systems," says Capital Alpha Partners defense analyst Byron Callan. "The outsourcing story is not new, but an era of slowing U.S. defense spending and even more Defense Department focus on weapons systems costs, coupled with 'need for speed' in acquisition, are trends that could favor the company."

Source URL: http://aviationweek.com/going-concerns/small-cap-defense-specialists-mercury-systems-are-rise