PARTNER PASS
EXCLUSIVE REPORT

Porter & Co.

ActivistInvestor

ISSUE #4 | NOVEMBER 17, 2023

AN UNDER-THE-RADAR DEFENSE GIANT SET TO SOAR HIGHER

- Profit From the Tiny Tech That Powers Fighter Jets
- Activists Bet Big on a World at War

An Under-the-Radar Defense Giant Set to Soar Higher

Profit From the Tiny Tech That Powers Fighter Jets

Activists Bet Big on a World at War

Scott Swanson had Osama bin Laden in his crosshairs.

The young Air Force captain sat hunched over a joystick in front of two big screens at Creech Air Force Base in Nevada. But this wasn't a video game: Swanson was operating the experimental Predator drone – a 950-pound unmanned surveillance aircraft – and was looking at the bearded terrorist through the Predator's eyes.

It was September 7, 2000, a year before bin Laden's 9/11 attacks on the World Trade Center and the Pentagon. The terrorist leader – who'd recently made the FBI's "Ten Most Wanted" list – had been funding jihadi cells for the past decade. And in order to catch – or kill – him, the U.S. first had to find him.

That was the Predator's job.

Steered remotely by Swanson, the sleek drone hovered over a dusty, mud-walled compound near Kandahar, in Afghanistan. And suddenly, the camera zoomed in on a strikingly tall man in white robes...

As Swanson wrote years later, "[My sergeant] and I immediately knew we had bin Laden in our sights: the U.S. had been searching for [bin Laden] for years and now here he was, exquisitely framed on our screen. As he moved around the compound, we followed. As he entered a building on the farm, we watched. But watch was all we could do..."

That was because there was just one problem: Predator drones weren't armed.

Then bin Laden disappeared inside the building. All at once, an Afghan MiG-21 fighter jet spotted the Predator and gave chase, forcing Swanson to scramble the drone to get away. The remote-control pilots maneuvered quickly and steered the drone away from the compound.

After four hours and 23 minutes of surveillance, Osama bin Laden got away.

And just a year later, on September 11, 2001, the Twin Towers fell.

The Predator's close brush with bin Laden is one of those maddening "what if?" moments that could have changed the course of human history. The Predator wouldn't get a weapons upgrade for more than a year, during the post-9/11 "War on Terror," when a later version of the drone successfully incorporated a laser-guided anti-tank missile. (Osama bin Laden himself would evade capture until 2011, when Navy SEALs finally tracked him down and killed him in Pakistan.)

In the years since, remote-controlled drones have become an integral part of modern warfare.

Today, the U.S. Department of Defense operates 11,000 drones both domestically and for overseas operations across all military branches. Many countries use drones as reconnaissance and killing machines.

And the company we recommend in this issue is a key player in supplying technology that operates drones, fighter jets, and light tactical vehicles.

The Predator drone that found and spied on Osama Bin Laden in 2000 hangs in the National Air and Space Museum in Washington, D.C. Inside it are components made by this company. And today, similar components installed in other U.S. unmanned drones are circling Gaza in an effort to find Israeli hostages.

Despite tremendous growth, however, the business has faced management and supply chain issues over the past few years. But, in a world where war is a growth industry, we believe this company will see revenue and earnings continue to rise, leading it to become even more profitable.

The Activist Angle

In this issue, we're recommending **Mercury Systems (Nasdaq: MRCY)**, an off-the-radar high-tech company that produces a range of electronics in the defense and aerospace sectors.

It counts the U.S. Navy, along with defense giants Raytheon, Lockheed Martin, and Northrop Grumman, as key customers. In 2022, revenue approached $1 billion. This is more than double what it was five years before.

But this promising producer of high-tech weaponry has fallen on some tough times.

Despite improved revenue for the last several years, profitability has crumbled over the past two years, and the stock price has dropped. We believe this is attributable to mismanagement stemming from the integration of 15-plus acquisitions since 2015, a shift to build more complex products, and supply-chain problems during the pandemic.

Long term, we and activist investors see scope for escalated defense spending, given worldwide geopolitical tensions. Mercury will benefit – as long as activists can steady the ship.

Activist investors JANA Partners, Elliott Investment Management, and Starboard Value have built positions. These activists seek:

- A refreshed board of directors
- New management
- The potential sale of the company

What is more, Elliott found the Mercury story so compelling that the investor made a bid to buy the company outright. Although the bid was eventually withdrawn, Elliott's interest put Mercury Systems on the map.

Let's dive in and lay this story out…

Finding Its Own Tech Niche

Mercury Systems is an electronics manufacturer for the defense and aerospace industry – primarily producing computer chips, radar sensors, and other components. These tiny elements provide super-computing power for software, missile-control systems, and information delivery aboard aircraft. Requiring dependability and versatility, the components that Mercury produces need to perform flawlessly while in the air, on the ground, and moving at hypersonic speeds.

Not many people have laid eyes on the components that Mercury makes. But everyone knows the planes that contain the equipment.

Tried and True U.S. Fighter Jets
The General Dynamics F-16 and the McDonnell Douglas F-18

Source: General Dynamics and Lockheed Martin

Tried and true fighter jets like the F-16 and the F-18 rely on products Mercury makes. The F-16 went into service in 1979 while the F-18 made its debut in 1983.

While Mercury will continue to supply technology for these jets, which will play an important defense role for years to come, the company also produces components of next-generation weapons. The F-35 stealth fighter jet, for example, contains much more advanced avionics. And unmanned drones like the Predator and its replacement, the Reaper, made by General Atomic, will be in the skies for decades. Below are the F-35 and a Reaper drone, which both contain Mercury Systems products.

Next Generation Weapons
The Lockheed Martin F-35 and the General Atomic Reaper Drone

Source: Lockheed Martin, General Atomic

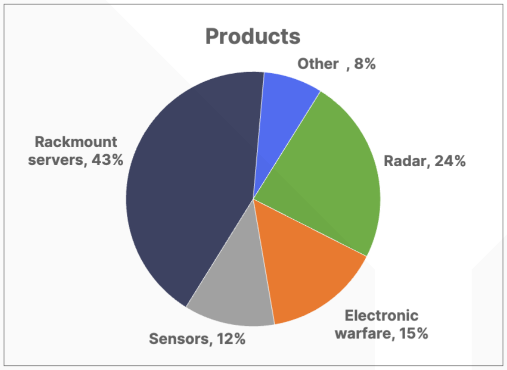
Mercury Systems components are found in the air, as well as at sea and on the ground. The company supplies the Patriot Missile (Raytheon); the Joint Light Tactical Vehicle (Oshkosh Defense), and the Aegis Weapon System (U.S. Navy).

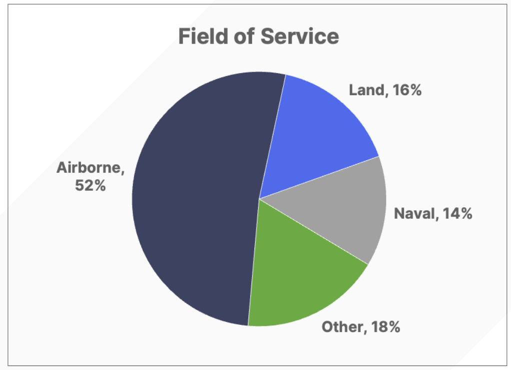
Mercury By Land and Sea
The Patriot Missile System, Joint Light Tactical Vehicle, and the Aegis Defense System

Source: Raytheon, Oshkosh Defense, U.S. Navy

The high-tech gadgetry that protects the U.S. and its allies is expensive. Mercury System products generated $974 million in revenue for fiscal year 2023, which ended on June 30. The chart below breaks down company revenue by products and where those products are used. A significant part of Mercury's product suite are rackmount servers – supercomputing servers, mounted on a rack, and reinforced for stability and physical compliance under duress.

2023 Mercury Revenue
By Product and Field of Service, $973.9 Million





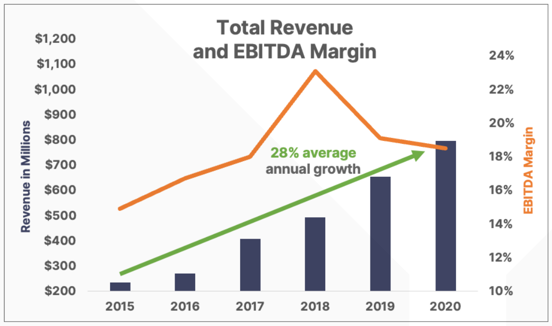
Source: Factset and company reports. Revenue for year ended June 2023.

Mercury makes products that will almost never go out of style or lack customers. But lately, the company has stumbled – and activist investors saw an opportunity.

All Systems Were Go…

From 2015 to 2020, Mercury revenues grew at an average annual rate of 28%. Earnings before interest, taxes, depreciation, and amortization ("EBITDA") as a percentage of revenue pushed higher as well – moving into the low 20% range. This was great for shareholders. The stock returned a fantastic 37% per year over this six-year period.

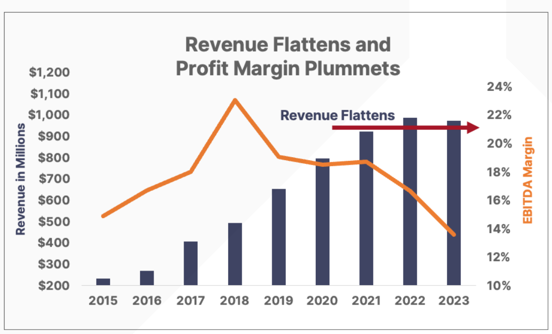
Mercury Systems

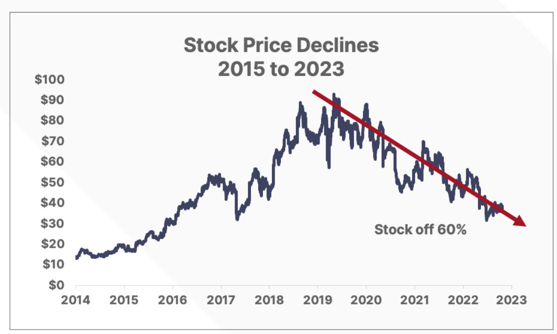


Source: Factset and company reports. Revenue for year ended June 2023.

But then that momentum fizzled.

From 2020 to today, revenue growth has slowed, EBITDA margins have plummeted, and the stock has declined more than 60% from its high of $93 to $34 on November 15.





Source: Factset and company reports. Revenue for year ended June 2023.

What happened? The business got more complex and supply-chain issues surfaced just as the pandemic was taking hold. Then, rising interest rates and elevated inflation added macro-level challenges.

Over the past several years, Mercury shifted strategy. It moved from making smaller individual components, like computer boards, semiconductor chips, and sensors, to building more complex, integrated electronic systems, like chips on top of chips embedded within other electronics.

Customers choose Mercury specifically to design and build these integrated systems – in many cases, making it the only manufacturer producing them – creating a strong competitive advantage for itself.

Being the only provider of certain items allows Mercury to build and sell more profitable products that become stickier with customers. Selling a ready-to-use integrated product with many components adds value to the customer. Mercury believes doing this rather than merely selling the individual building blocks enhances its competitive position in the market.

To facilitate the strategy, the company began a five-year period of robust M&A activities. Between 2015 and 2020, Mercury acquired 12 businesses – with more coming in subsequent years. The table below summarizes all those deals.

Twelve Acquisitions Over Five Years

Deal Announced	Company Purchased	Deal Value ($m)	Specialty Acquired
Dec-20	Physical Optics Corp.	$310	Aerospace & Defense
Jul-19	American Panel Corp	$101	Computer Peripherals
Apr-19	The Athena Group, Inc.	$34	Semiconductors
Apr-19	Syntonic Microwave, Inc.	Unknown	Electronic Production Equipment
Jan-19	GECO, Inc.	$37	Computer Processing Hardware
Jul-18	Germane Systems LC	$45	Data Processing Services
Dec-17	Trusted Mission Solutions, Inc.	$180	Computer Peripherals
Jun-17	Richland Technologies LLC	$6	Packaged Software
Apr-17	Delta Microwave LLC	$41	Electronic Production Equipment
Nov-16	CES Creative Electronic Systems SA	$39	Information Technology Services
Mar-16	Microsemi Corp. /Defense Business/	$300	Semiconductors
Dec-15	Lewis Innovative Technologies, Inc.	$10	Engineering & Construction

Source: Company Reports and Factset

These deals ranged from $6 million to $310 million and brought added capability into the Mercury ecosystem, powering new products, revenue, and earnings.

But with more products come more operational challenges.

...Then Things Got Complicated

Mercury's business fits into two categories: Design/development work and production work.

In the design phase, profit margins are lower. The customer is paying Mercury to design and develop the product. By its nature, this stage takes time and effort, with back and forth with the customer as the final product gets created.

Next, Mercury moves into the production phase – the newly developed product is manufactured and sold to the customer for final use. Profit margins are substantially higher.

As the company moved to selling integrated systems, it tipped the business into more design work than it had been doing. Historically, 80% of Mercury's work has been in the production stage and 20% in design. But over the last three years, design has increased to 40% and higher margin production phase work has fallen to 60%. This is primarily what drove the downturn in EBITDA margins.

But management had another challenge over this time that likely added to pressure on profit margins.

Not only were the company's products getting more complex, but leadership was working to integrate all the people and processes that come with acquisitions. Merging businesses, payroll, benefits, and cultures is not an easy task, and often distracts management from the core business.

Now throw in a global pandemic that drastically impacted supply chains. Mercury relies on complex building blocks from around the world to create its electronics. This flow of supply dramatically slowed in 2020.

Growth Started to Catch Up With Management

The first sign of trouble appeared in November 2021 during the company's first fiscal quarter earnings report. Those financials beat expectations but the outlook for the next quarter was weak. Fortunately, that second quarter came in slightly above the forecast.

But a trend had started.

The next 10 quarters – from Q2 2021 to Q4 2023 – included declining financial outlooks mixed with earnings reports that mostly missed those weaker expectations. That's when the stock plummeted 60% from its highs.

While this performance is not good for longtime shareholders, we believe now is the time to buy this stock.

We would point to four reasons why things are getting better.

1. Mercury Systems has a strong base of established customers.
2. The activists have made progress and will make more.
3. The financial outlook for the business is improving.
4. The world is at war. This is good for defense stocks.

An Established and Steady Customer Base

Mercury counts some of the biggest defense companies in the world as its customers. In the table below we highlight the largest and their revenue contribution over three years.

Mercury's Top Customers Are Household Names

Customer	2023	2022	2021
Raytheon Corporation	14%	14%	19%
Lockheed Martin	13%	10%	15%
Northrop Grumman	11%	8%	8%
U.S. Navy	8%	14%	12%
Top Four	46%	46%	54%
All others	54%	54%	46%
Total	100%	100%	100%

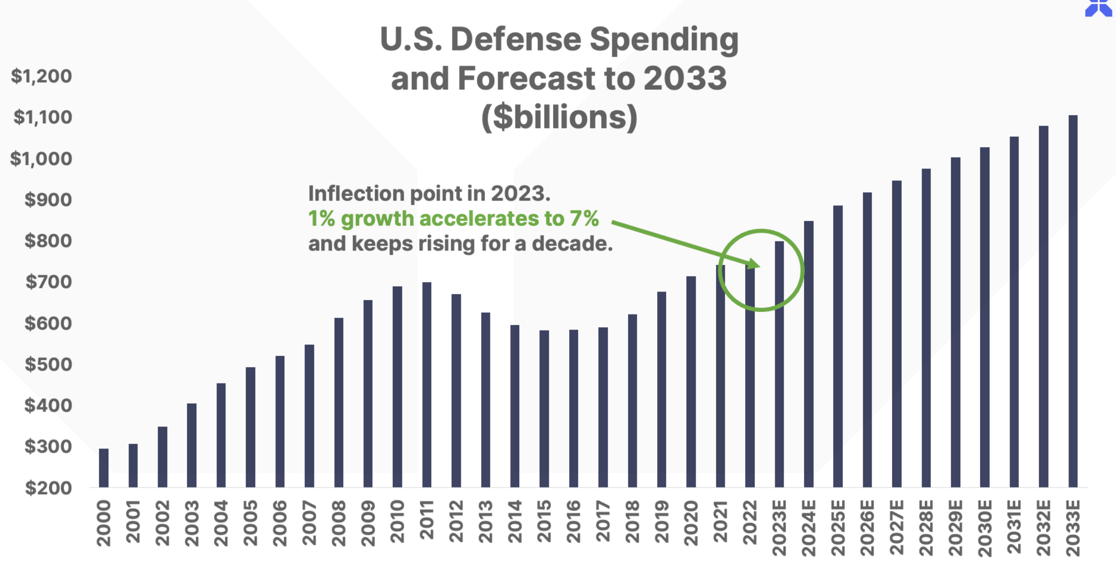
Source: Company Reports

These defense clients account for about half of Mercury's revenue over the past three years and show stickiness – an impressive bucket of repeat business from top defense firms.

Interestingly, revenue concentration is declining slightly with the big customers as the company's acquisitions add diversity to its sources of revenue. Quite simply, the big customers are getting diluted a bit – even though their overall contributions are growing.

This is a good trend as more diversity of revenue comes onboard. Overall, the big, core customers will continue to drive a large percentage of business.

Importantly, these top customers are likely to spend more in the coming decade than they did in the prior. The chart below illustrates U.S. defense spending from 2000 to the forecast in 2033. Note the acceleration in spending that begins in 2023 – it grew 1% into 2022 and is expected to rise 7% into 2023. This begins a period of anticipated increased average annual spending growth for the next decade. From now through 2033, defense spending is expected to grow 4% a year on average. In comparison, average growth for the prior decade was 1%.



Source: U.S. Congressional Budget Office via Statista, P&Co. research.

Specific to Mercury, spending on high-tech electronic systems is expected to grow 6% to 8% a year. Mercury's management team believes its revenue will increase at least in line with this average.

Second, important progress has been made…

Activists Are Well On Their Way…

Activist investors have seen the sluggish profit margins and falling stock price and have gotten involved. JANA Partners, Starboard Value, and Elliott Investment Management have been using their investment leverage since late 2021 and have added more stock to their holdings. All three of these investors are known activists and have been involved in other of our recommendations. This effort has not been wasted. A number of activist-influenced improvements – including a refreshed board and management – are leading to a well-positioned company today.

As we detail below, many of the new additions instigated by the activists worked in leadership roles at all the large customers mentioned above.

Mercury management originally did not want activists involved. Fearing a takeover or loss of their jobs, one of the first things leadership did was to put a shareholder-rights agreement in place. Also known as a "poison pill," it had a duration of one year and provided lucrative deals to management and the board should a change of control occur. But Starboard moved quickly and successfully in January 2022 to get the agreement thrown out.

This paved the way for Elliott to move: a couple months later the investor made a bid for the entire company. As mentioned already, this deal was withdrawn (and terms not disclosed), but the activist influence was clearly being felt.

In June 2022, Starboard and JANA succeeded in getting two new independent board members appointed.

Starboard appointed Howard Lance, the former CEO of Maxar Technologies, to the board. Maxar is a leading company focused on space technology and intelligence. Lance's experience (and connections) at Maxar are a great fit at Mercury.

JANA Partners pushed to get William Ballhaus on the board. A trained aerospace engineer, he was CEO at DynaCorp International, a prominent military contractor, and also held senior leadership roles with BAE Systems, Boeing, and Hughes Networks. These are all major high-tech defense contractors who have former senior leaders (Lance and Ballhaus) on Mercury's board and are now incentivized via stock and cash to get Mercury back on track.

Finally, Roger Krone was appointed to the board, bringing the number of new members to three. Krone was previously CEO of Leidos, a defense, aviation, and information-technology company.

Next came management changes. Over the course of five months, the activists ousted both CEO Mark Aslett and CFO Michael Ruppert.

In March, Christine Fox Harbison came over from Northrop Grumman as the chief growth officer and is responsible for identifying and executing revenue growth.

In May, new board member Ballhaus took over as the interim CEO. Ballhaus has deep defense experience and was made permanent CEO in August 2023. David Farnsworth joined as CFO – previously holding that title at two defense companies – Hawkeye360 and Mercury's largest customer, Raytheon. Their appointments refreshed Mercury's management team.

From early 2022 through mid-2023, the activist team placed incredibly experienced board members and a new leadership team at the company.

And their presence is having an impact…

As a result of these activist changes, the financial outlook of the company is expected to improve. In addition to talking with company management we spoke with analysts who believe the company is on the mend.

Mercury's Outlook Is Improving…

Following these leadership changes, the company completed a full strategic review and operational plan for the company between January and June 2023. It yielded two primary points of investor interest that in turn are moving profits higher.

The company should not be sold (yet). Investment bankers conducted a detailed process to evaluate interest from potential acquirers. Forty organizations showed interest. Of these, half signed non-disclosure agreements ("NDAs"). An NDA legally binds a potential buyer to confidentiality that is enforceable in court and expresses a deep level of interest that allows them to dive into Mercury's operations.

From this process, the board determined that the company should not be sold just yet. Given operational uncertainty, it is clear that no one offered a price that maximized shareholder returns.

Opportunities for operational improvements identified. The refreshed board and management team outlined an operational improvement plan on the August 2023 earnings call – and said it would kick off the plan immediately.

The company had identified 20 customer programs (out of 300) that were massively underperforming from a financial perspective. A program is a project that Mercury is working on with the customer – such as the Reaper drone electronics. In 2023 alone, these underperforming programs sapped $56 million from EBITDA targets. Excluding these, EBITDA would likely have been 42% higher.

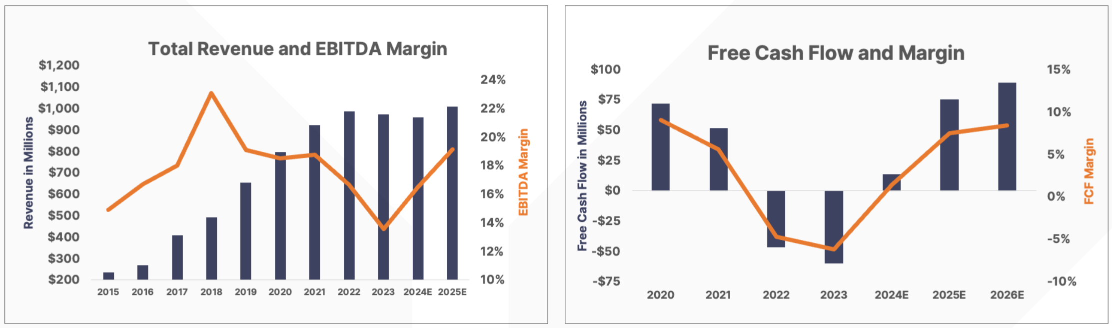
Efforts are now in place to streamline these troubled projects, reduce company-wide operating costs, target a 20% operating profit margin, and return to positive free cash flow generation – which we examine in a chart below.

Progress is being made on this front. During the most recent earnings conference call, management indicated that four of the 20 underperforming projects are completely fixed, alluded to finalizing another program during this current quarter, and planned to resolve the majority of the remaining by the end of the fiscal year.

Management has indicated to shareholders that these things will take time and that this fiscal year – ending June 30, 2024 – should be viewed as a rebuilding one.

These efforts are starting to show up in company and analyst forecasts.

**Improving Financials
Revenue Growing, Profitability Returning
and Free Cash Flow Trending Higher**



Source: Company reports, P&Co. estimates.

Profitability seems to have bottomed out in fiscal 2023. From here, revenue is trending higher and EBITDA margins are rising. Importantly, free cash flow will turn positive this year. We expect free cash flow to swing $74 million during the year. This moves the measure from -$60 million in 2023 to $14 million in 2024, before leaping fivefold in 2025.

Progress is already being seen on a quarterly basis. In the quarter ended June 2022, free cash flow was -$28 million. A year later, in June 2023, quarterly free cash flow measured positive $4 million. And in June 2024, expectations are for $65 million.

We will be watching closely for progress to be made in line with these forecasts. As good news is reported by the company, we expect the stock to move higher.

But let’s conclude with one last analysis that supports outperformance in the stock.

Conflict Is (Unfortunately) Everywhere...

The world is currently at war on many fronts, including relatively young conflicts in both Ukraine and the Middle East. And the threat of China engaging in some sort of military conflict with neighboring Taiwan – from a small attack to an outright take over – gets increasingly real.

Unsurprisingly, defense-related stocks tend to perform well during times of increased global conflict. Look at the performance of stocks of three prominent defense and aerospace companies during times of war.

Defense Stocks Outperform During Times of War

Company	Ticker	Conflict*				
		Iraq/Kuwait 8/2/90	9 / 11 9/11/01	Persian Gulf 3/20/03	Ukraine 2/24/22	Israel / Gaza 10/7/23
General Dynamics	GD	416%	34%	141%	17%	12%
Lockheed Martin	LMT	173%	47%	72%	18%	11%
Northrop Grumman	NOC	218%	29%	72%	21%	10%
Average Return		269%	37%	95%	19%	11%
S&P500	SP50	41%	8%	57%	8%	5%

** Timeframe is start of conflict plus 3 years when available.*
Source: Factset, P&Co. research.

These stocks handily outperformed the S&P 500 Index from the start of the conflict to three years later – in all cases where applicable.

Russia's war in Ukraine is in the early stages while recent events in Israel are just getting started. Additionally, the U.S. has seen attacks on its bases in Syria and Iraq. And let's not forget China. Increased tensions leading to conflict are possible between China and Taiwan. The U.S. government will likely ramp spending for defense in support of these conflicts.

Given the prominent activist investors involved with Mercury Systems, their progress over the prior two years, a world at war, and stock that remains depressed, we believe an investment in Mercury Systems looks very attractive right now.

We Expect Shares to Rise...

Where could the stock move in the coming years? Let's look at valuation to figure out a target price for Mercury shares.

Illustrated in the table below are average annual valuation multiples for both enterprise value-to-earnings before interest, taxes, depreciation, and amortization ("EV/EBITDA") and price-to-sales ("P/S"). EV/EBITDA represents the company's market value excluding capital and tax strategy as a multiple of its EBITDA earnings. P/S is the market value of the company per unit of its sales.

From 2018 to 2022, the company average was 23.4x and 4.5x, respectively. As shown, both measures are below the five-year averages.

Mercury Systems
Valuation Summary

Year	EV/EBITDA	P / S
2018	17.0	3.7
2019	25.2	5.9
2020	28.5	5.5
2021	21.9	4.0
2022	24.5	3.8
Average	**23.4**	**4.6**
Current	18.7	2.1

Source: FactSet, P&Co. estimates.

Should improvements continue to bear fruit, we expect the stock to trade in line with these averages. Considering revenue and earnings potential in 2025, these multiples imply a target price between $70 and $79 per share. Let's call it $75.

Currently, Mercury shares are trading around $34, suggesting 121% upside over the next 18 months. Even at half that return, Mercury shares seem like a good bet right now.

Action to Take: Buy Mercury Systems (Nasdaq: MRCY) up to $70 per share.

Portfolio Update

The Porter & Co. Activist Investor Portfolio

	Ticker	Description	Purchase Date	Cost Basis	Closing Price	Yield	Income Received	Total Return	Status
SPORTSMAN'S WAREHOUSE HOLDINGS	SPWH	Sporting Goods Stores	09-22-2023	$3.53	$4.98	0.00%	$0.00	41.08%	Buy Under $15
CATALENT INC.	CTLT	Health Care Services	09-22-2023	$45.34	$39.56	0.00%	$0.00	-12.75%	Buy Under $100
MERCURY SYSTEMS	MRCY	Defense Technologies	11-15-2023	$34.78	$34.78	0.00%	$0.00	0.00%	Buy Under $70

Disclaimer: this hypothetical portfolio should not be considered investment advice or a recommendation to buy/sell any financial instrument. For informational purposes only. Investors should perform their own due diligence before buying or selling any financial instrument. No express or implied guarantee of accuracy or applicability to real-world trading. Risk Ratings are based on a security's fundamentals and business model rather than its current valuation.

Catalent (Nasdaq: CTLT) has had a rough go of it lately. Shares fell 10% during the week ended November 3.

On October 30, one Catalent customer announced that its new drug did not meet a critical target during the final stages of its clinical trial.

The drug is gene therapy Elevidys, made by Sarepta Pharmaceuticals to treat Duchenne muscular dystrophy (DMD), a devastating muscle disease that robs young boys of their ability to walk.

Hopes were high for this drug, as the FDA granted it accelerated approval last summer pending a confirmation trial to ensure everything works. The primary target was increased mobility based on a 34-point system. The study did not show statistical significance over the control group (kids not receiving the treatment). Boys taking the drug improved but not significantly enough versus others.

There was good news. Studies like this look at several targets. While the primary target was not achieved, a number of secondary targets were met. For example, patients' conditions not deteriorating is considered a win as DMD is a degenerative disease.

We continue to believe Elevidys will reach blockbuster levels of sales that measure in the billions. The FDA said it is open to looking at approval of the drug to target the secondary benefits it provides – such as maintaining muscle function versus improving it.

Catalent was contracted to manufacture the drug for Sarepta. Sales were expected to start in 2023 and grow significantly over the next two years. We believe Catalent will eventually drive earnings from this contract, but the timing is less certain. Analysts following the company reduced revenue expectations by about $50 million over the next three years. For context, that is 1% of total revenue.

More pressure came from another item as well. Again, unrelated to Catalent's operations.

A third company was hired by Novo Nordisk to manufacture Ozempic and Wegovy – the popular diabetes and weight-loss drugs. While we continue to believe this class of drugs will become the biggest selling of all time, Catalent will see some of its business diluted by this addition.

Such is the investment life of activist investors. Remember, we recommend good companies that have stumbled and setbacks such as this are not unusual. In this case, the biggest issue was not even caused by Catalent itself.

Fortunately, the shares have rebounded 23% since then. As we expected, this proved to be an opportunity to lower your cost basis or make a profitable short term trade. That said, we believe shares remain undervalued.

Action to Take: Buy Catalent (Nasdaq: CTLT) up to $100 a share.