

Signals to Knowledge

ANNUAL **2000** REPORT

MERCURY COMPUTER SYSTEMS, INC.

Mercury Computer Systems, Inc. (NASDAQ: MRCY) is the leading independent producer of high-performance embedded, real-time digital signal and image processing computer systems that transform sensor data to information for analysis and interpretation. Mercury's products play a critical role in a wide range of defense electronics and medical imaging applications. In air-, sea-, and land-based military platforms, these systems process real-time radar, sonar, and signals intelligence data. Mercury's systems are also used in state-of-the-art medical diagnostic devices, including magnetic resonance imaging (MRI), computed tomography (CT), positron emission tomography (PET), and the rapidly growing field of digital X-ray.

Based in Chelmsford, Massachusetts, Mercury serves customers in North America, Europe and Asia through a network of subsidiaries and distributors.

CLOCKSPEED

“When designing your supply chain, whatever the industry, it is important to understand that make versus buy decisions should not be made primarily on which supply option is a little bit cheaper or a little bit faster to market. Rather, supply chain design needs to be recognized as a strategic activity that can determine the fates of companies and industries and of profits and power.”

Charles H. Fine, the author of Clockspeed

Charles H. Fine is the Chrysler LFM Professor of Management at the Massachusetts Institute of Technology's Sloan School of Management and the author of *Clockspeed: Winning Industry Control in the Age of Temporary Advantage*, (Perseus Books, 1999). His web address is <http://www.clockspeed.com>.

Directory

Financial Highlights

01

Defense Electronics

06

2000 Financial Review

16

President's Letter

02

Medical Imaging

10

Directors & Management

46

Year In Review

04

Business Development

14

Corporate Information

47

THIS DOCUMENT CONTAINS CERTAIN FORWARD-LOOKING STATEMENTS INCLUDING THOSE DEALING WITH OVERALL BUSINESS AND SEGMENT GROWTH. THESE FORWARD-LOOKING STATEMENTS INVOLVE RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE PROJECTED OR ANTICIPATED. FACTORS THAT COULD CAUSE OR CONTRIBUTE TO SUCH RISKS AND UNCERTAINTIES INCLUDE, BUT ARE NOT LIMITED TO, GENERAL ECONOMIC AND BUSINESS CONDITIONS, COMPETITION, CHANGES IN TECHNOLOGY AND METHODS OF MARKETING, AND VARIOUS OTHER FACTORS BEYOND THE COMPANY'S CONTROL. THESE RISKS AND UNCERTAINTIES INCLUDE SUCH FACTORS AS ARE DESCRIBED IN THE COMPANY'S RECENTLY FILED REPORTS WITH THE SECURITIES AND EXCHANGE COMMISSION IN THE USA. THE COMPANY WISHES TO CAUTION READERS NOT TO PLACE UNDUE RELIANCE UPON ANY SUCH FORWARD-LOOKING STATEMENTS, WHICH SPEAK ONLY AS OF THE DATE MADE.

FINANCIAL HIGHLIGHTS

Years Ended June 30 (Dollar Amounts in Thousands)	2000	1999	1998	1997	1996
Total Revenues	\$140,944	\$106,571	\$85,544	\$64,574	\$58,300
Gross Profit	101,798	72,334	55,460	42,540	33,612
R&D Expense	28,862	20,709	14,476	12,837	9,776
R&D as a Percent of Revenues	20.5%	19.4%	16.9%	19.9%	16.8%
Operating Income	\$33,461	\$18,623	\$13,105	\$7,072	\$6,909
Net Income	24,896	13,462	8,731	4,611	4,428
Total Assets	144,217	97,511	73,569	44,848	33,264
Working Capital	68,198	42,312	32,794	27,547	23,554
Shareholders' Equity	\$108,360	\$77,440	\$61,040	\$33,322	\$28,529

Net Income



R&D Expense



Total Revenues



DEAR CUSTOMERS, ASSOCIATES AND SHAREHOLDERS,

The financial year ending June 30, 2000 was another record year for Mercury. In our second full year as a public company, we experienced strong results in

each segment of our business and continued to invest in existing and new markets to maintain our growth through the next decade.



Financial Summary

Fiscal 2000 was an outstanding year for the company with revenues increasing 32 percent to \$140.9 million. Defense electronics sales increased

by 21 percent and medical sales by 77 percent. Medical sales represented 19 percent of the company's revenue compared with 14 percent a year ago. With increased production volumes, good gross margins and a substantial productivity increase throughout the company, net income rose 85 percent to \$24.9 million. R&D spending increased to \$28.9 million, or 20.5 percent of revenues, an increase of \$8.2 million over 1999.

Defense Electronics

In fiscal 2000 Mercury doubled the previous year's number of new design wins. These 56 new program wins represent a combined five-year revenue potential of over \$200 million if all the programs continue to full deployment. Among notable programs for the year, the \$6.8 million contract from Northrop Grumman for radar and targeting computers for the F-16 fighter aircraft stands out for its long term potential. With over 4,000 F-16s in service around the world this contract has a future potential of tens of millions of dollars.

Mercury has been selected for its first set of major European design wins as the European defense community begins to fully embrace the benefits of commercial off-the-shelf (COTS) technology. BAE SYSTEMS will incorporate Mercury computers into the SAMPSON radar on the U.K. Navy's next generation destroyer and in the AR327 Commander radar for the Royal Air Force.

Medical Imaging

Growth in Mercury's medical imaging business was a resounding 77 percent, as a number of previous design wins entered production. A new design win from Philips Medical Systems in the Netherlands, one of the industry's leading diagnostic imaging system manufacturers, further solidifies Mercury's position as the industry's supplier of choice.

Mercury continues to execute a strategy of expanding business within the existing diagnostic modalities of MRI, CT, PET and digital X-ray, while at the same time developing new opportunities in advanced imaging systems targeted at minimally invasive surgical procedures.

Investments in Business Development

Mercury is an efficient cash-generating business with cash reserves nearly doubling in fiscal 2000 over the previous year. In addition, profits per associate have risen from \$37,000 in FY1997 to \$87,000 in FY2000. The business also enjoys high margins, allowing the company to pursue, through operating expenses, an active investment program in new products as well as existing and new markets.

In the defense electronics business Mercury is investing in the development of systems to be used for multi-spectral and hyper-spectral imaging, fire control radar, and ground and airborne processing interoperability. In medical imaging we are developing proprietary technology that will enable us to deliver a visual imaging platform to be used across all modalities. These investments in our current markets closely track the future demands of our customers and are intended to ensure the continued growth of these segments.

Our investment, together with Sarnoff Corporation, in the formation of AgileVision, a provider of digital television solutions servicing the broadcast, cable and Internet industries, is progressing well. We anticipate this investment will have a positive impact on our Profit and Loss statement in FY2002.

We have recently established a business unit to focus on sales into the semiconductor and digital video markets. Applications such as semiconductor wafer inspection, photomask generation and digital video watermarking represent strong growth opportunities for Mercury. The products ideally suited for these markets are either in production in Mercury today or will soon be released.

Apart from our core engineering expenditures, the largest investment we are making is in both product and market development for wireless 3G base stations. To increase user capacity and improve network operator profitability, 3G base stations will require signal processing that closely matches Mercury's existing competencies and architectures. This new segment represents a potential available market measuring in the hundreds of millions of dollars per year over the next decade.

Of course, Mercury's underlying investments in core hardware and software technology make most of these market thrusts possible. Among the significant planned investments are the interconnect fabric known as RapidIO™, pioneered by Mercury in conjunction with Motorola; products incorporating the next PowerPC "G4" microprocessor; architectural enhancements to support robust heterogeneous environments and integration of mainstream software development tools; and libraries to enhance the productivity of the application developer and improve time to market. RapidIO has already received strong support from manufacturers of equipment containing embedded processors.

Looking Forward

For fiscal 2001 the company expects both revenue and earnings growth from its core business to continue in the mid-20 percent range. The company's core business includes all business activities excluding wireless communications. Both gross and operating margins can be expected to hold above management's targets. It is anticipated that year-to-year growth in the defense sector will continue toward the high-end of the 20 to 25 percent range through fiscal 2001. Year-to-year growth in

medical imaging revenues will moderate from the 77 percent growth rate in fiscal 2000, and is expected to be in the 15 to 20 percent range for fiscal 2001, increasing when the recent design wins in digital X-ray systems from GE Medical Systems and Philips Medical Systems begin their respective production cycles. Management expects to see strong growth, in the range of 30 to 40 percent, in fiscal 2001 revenues coming from new commercial business initiatives.

Based on the strength of our core business, even with all the investments discussed above, fiscal 2001 promises to be another highly profitable year, generating approximately 16 percent of revenues in net income. While this will result in a lower year-to-year growth rate in reported earnings per share for fiscal 2001, management strongly believes it has adopted the correct strategy to maximize long-term growth potential and provide maximum return to shareholders.

The Real Engine for Growth

As in previous years the dedication and innovation of Mercury's engineers, manufacturing, sales and support people in all areas have delivered this record year. They will continue their vital role as we invest in existing and new markets. Our goal is to continue to provide a challenging and rewarding environment for our most valued resource—the Mercury Associate.

We thank them all for their continuing dedication to Mercury's success.



Jay Bertelli
President and CEO

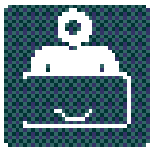
YEAR IN REVIEW

FIRST QUARTER



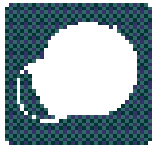
- Mercury commences shipments for airborne programs, including the ASARS-2 Improvement Program for the U-2 reconnaissance fleet radar upgrades, and the TESAR radar for the Predator Unmanned Vehicle used in reconnaissance and surveillance missions.
- Mercury receives orders and commences shipments for Navy programs, including APS-143 maritime radar systems for fixed-wing aircraft, helicopters and shipborne aerostats; Advanced Rapid COTS Insertion and Multi-Purpose Processor programs for sonar upgrades aboard the U.S. submarine fleets; and the SPS 1000-58 Intercept and Analysis (IntAna) systems for the Swedish Navy.
- Micronic Laser Systems AB of Sweden places an order for RACE® Series computers for photomask writing in the manufacture of television and computer displays, as well as semiconductors.
- Frank Russell Company includes Mercury in the Russell 2000® Index.
- Mercury enters a joint venture with Sarnoff Corporation, forming AgileVision LLC.
- Mercury receives Supplier of the Year Award from Northrop Grumman's Electronic Sensors and Systems Sector.

SECOND QUARTER



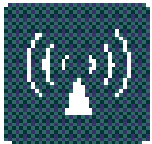
- Mercury receives design win from GE Medical Systems for advanced digital X-ray system.
- Mercury declares two-for-one split in its common stock effective December 6, 1999.
- Medical systems divisions of GE, Marconi and Siemens enter full production of latest computed tomography systems, increasing orders to Mercury.
- Mercury receives follow-up orders from General Dynamics Information Systems supporting the U.S. Air Force's Joint Surveillance and Target Attack Radar System (Joint-STARS) Computer Replacement Program (CRP).

THIRD QUARTER



- Mercury completes the sale of its Shared Storage Business Unit (SSBU) to IBM's Tivoli Systems. The cash-for-assets transaction amounts to \$23.5 million.
- AgileVision LLC, Mercury's joint venture with Sarnoff Corporation, launches its first product at the National Association of Broadcasters' Conference in Las Vegas.
- Mercury receives follow-up orders from Schlumberger Technologies, Inc. for integration into its new Odyssey 300 silicon wafer inspection system, and from Micronic Laser Systems SB for systems used in photomask writing.
- To meet the explosive demand for higher bandwidth within embedded computer systems, Mercury announces its collaboration with Motorola in developing the RapidIO™ switched-fabric interconnect architecture. Together with Motorola, Mercury spearheads the formation of the RapidIO Trade Association to drive the adoption of the new interconnect as an open standard.
- Standard & Poor's includes Mercury in the S&P SmallCap 600 Index.
- Ericsson Microwave Systems AB orders Mercury's RACE signal processing systems for the ERIEYE® Airborne Early Warning and Command radar system to be supplied to the Greek Air Force.
- Mercury ships evaluation and development units of new systems incorporating the Motorola PowerPC™ microprocessor, known as the "G4."

FOURTH QUARTER



- Mercury starts production shipments of its newest RACE++™ product line, systems incorporating the Motorola PowerPC "G4" microprocessor and a new version of its MC/OS™ real-time operating environment.
- Northrop Grumman awards Mercury a \$6.8 million contract for the advanced agile beam fire control radar and the forward-looking infrared and targeting systems on the F-16 fighter aircraft.
- Mercury receives orders valued at \$8.5 million from Lockheed Martin Corporation to provide RACE computer systems to support the Linear Search/Track Processor enhancement for the U.S. Navy's AEGIS program.
- BAE SYSTEMS selects Mercury to provide signal processing subsystems for the SAMPSON multifunction radar design. SAMPSON will be deployed as part of the Principal Anti-Air Missile Systems (PAAMS) for the Royal Navy's next-generation destroyer.
- Philips Medical Systems selects Mercury to be designed into Philips' digital X-ray systems.
- Mercury ranks number 19 overall in The Boston Globe's twelfth annual listing of the 100 best performing Massachusetts-based companies.

LOOKING AHEAD

Fiscal year 2001 promises to be another highly profitable year with sustained growth in our core businesses. Investments will be made in new applications within defense electronics and medical imaging. Business development activities will focus on sales into the semiconductor and digital video markets, and continued development of communications products for 3G base stations in the wireless industry.

MERCURY IN DEFENSE ELECTRONICS

Defense electronics prime contractors are focusing on their core competencies to better leverage their positions in the industry value chain, leading to greater efficiency and increased profits. As a result, companies like BAE SYSTEMS, Lockheed Martin, Northrop Grumman and Raytheon focus today more on the integration of complex modular components that constitute the majority of intelligence and reconnaissance programs, than on the research and development of a single element of a radar or sonar system. Modularizing a system's architecture breaks it down into simpler subsystems and enables a faster development pace.

Within the defense industry, high-performance computer systems for signal and image processing on aircraft, surface ships and submarines have been modularized and successfully outsourced to Mercury. The AEGIS naval defense system, the radars aboard F-16 fighter aircraft and U-2 reconnaissance planes, and the sonar systems of much of the Navy's submarine fleet will potentially all be equipped with Mercury's specialized computers. Such modularization and outsourcing

significantly reduced the product development time for the defense suppliers. As more powerful digital signal processing technology is developed, it will also facilitate frequent updates.

To fully leverage its position in the value chain to ensure its sustainable profitability, a company must understand that make vs. buy decisions should not be made based on which supplier provides a cheaper option, or will help push the time to market a bit faster. Rather, a company's management needs to make sure that the design of the supply chain is integrated into the company's core strategy since it can determine not only the fates of entire companies but indeed those of whole industries.¹ Having built its business model around the supplier-partnership benefits of outsourcing, Mercury understands this challenge exceptionally well.

¹ Summarized from: *Sourcing Strategies in the Age of Temporary Advantages* (Mercury Messenger, Spring 2000). This concept is described fully by Professor Charles H. Fine in his book, *Clockspeed: Winning Industry Control in the Age of Temporary Advantage* (Perseus Books, 1999).

NORTHROP GRUMMAN: F-16 RADAR

Northrop Grumman, a global leader in the development of sensors and radar detection systems, selected Mercury as a partner in the development and supply of RACE® multiprocessor technology for the advanced radar system to be deployed in the F-16 fighter aircraft. Mercury's signal processing computer technology will be used in the F-16 for both the advanced agile beam fire control radar and the forward-looking infrared and targeting system.

Mercury brought to the table a high level of expertise backed by an understanding of the long-term objectives of its partner. Mercury's engineering team works in

close cooperation with Northrop Grumman's design team to integrate Mercury's core technology and technical support, while maintaining an important focus on the system's performance.

The F-16 advanced radar gives pilots the ability to continuously search for and track multiple targets, simultaneously performing air-to-air search-and-track, air-to-ground targeting and aircraft terrain following. The radar has a highly programmable, modular architecture that has proven to be reliable under a broad range of threats.

“What Mercury brings to the table is a high level of expertise in digital signal processing and systems design backed by the ability to recognize our long-term objectives. They are able to work in perfect alignment with our design team and provide Mercury’s core technology and technical support. At the same time, they maintain an important focus on performance.”

Robert K. Savage, Manager, Procurement, Northrop Grumman's Electronic Sensors & Systems Sector

RAYTHEON: U-2 RADAR UPGRADE

Last year, Mercury shipped RACE® multicomputing systems to Raytheon Electronic Systems for the Advanced Synthetic Aperture Radar System-2 (ASARS-2) improvement program. The systems will be deployed aboard the fleet of U.S. Air Force U-2 reconnaissance aircraft. ASARS has been deployed on the U-2 since the early 1980s. It is a

multi-mode, high-resolution reconnaissance system with all-weather, day-night, long-range mapping and ground moving target indication capabilities. The use of leading-edge COTS technology for the radar improvement program enhances its capability and provides increased access to emerging technologies.

Mercury supported Raytheon engineers in system architecture design and configuration, focusing on software and hardware capabilities and performance.

SYSTEMS ENGINEERING

Designing the most cost-effective solution for a magnetic resonance imaging (MRI), radar detection or wafer inspection system takes an intimate knowledge of the application as well as extensive hardware, software and systems expertise. This is what Mercury's systems engineers bring to their partnership with our customers' design teams.

SUPPLIER PARTNERSHIP: THE BENEFITS

Since its inception in 1983, Mercury has gained a thorough understanding of its own position in the industry's value chain. Mercury's strength comes from a relentless focus on technological innovation in the development of ultimate performance signal and image processing computer systems. But the company's strength is significantly more comprehensive than technology alone.

The key to Mercury's success lies in its thorough understanding of the customer's needs. Working with the engineering teams of defense prime contractors, Mercury

contributes vital systems engineering and design of both software and hardware to ensure top performance (speed and functionality), upgradability and scalability. Working in close partnership with its customers enables Mercury to provide comprehensive solutions rather than a single product or technology. By focusing on integrated solutions, Mercury helps to reduce development risk and system integration time, thereby further strengthening the company's position in the value chain.

BAE SYSTEMS: SAMPSON RADAR

In support of the British Royal Navy, Mercury received an order from BAE SYSTEMS to provide signal processing subsystems for SAMPSON, one of the world's most advanced multifunction radar systems. SAMPSON will be deployed as part of the Principal Anti-Air Missile Systems (PAAMS) aboard the Royal Navy's next-generation Type 45 destroyer.

To allow the radar to perform several tasks that have traditionally required a number of separate systems, Mercury's RACE® system will provide the high-

performance, real-time signal processing necessary to enable the radar to electronically shape and point the radar beam instantaneously in any direction. Mercury's computers will also help to change or adapt the radar characteristics in real time in response to threats and operating conditions, making the system virtually immune to electronic jamming. Mercury's selection for this project by one of Europe's leading defense contractors underscores the globalization of Professor Fine's value chain management principles.

LOCKHEED MARTIN: AEGIS RADAR SYSTEM

Mercury's Battle Ready COTS™ digital signal processing technology accelerates the processing of vast amounts of data as enhancements to the AEGIS system are implemented and integrated into the total ship system. Using Mercury's RACE architecture, the Linear Search/Track Processor enhances the computer-based

radar signal processing element that helps the system receive and process information in real time. This increase in processing capacity enables the system to detect, track and engage an expanded set of target types.

SYSTEM ARCHITECTURE

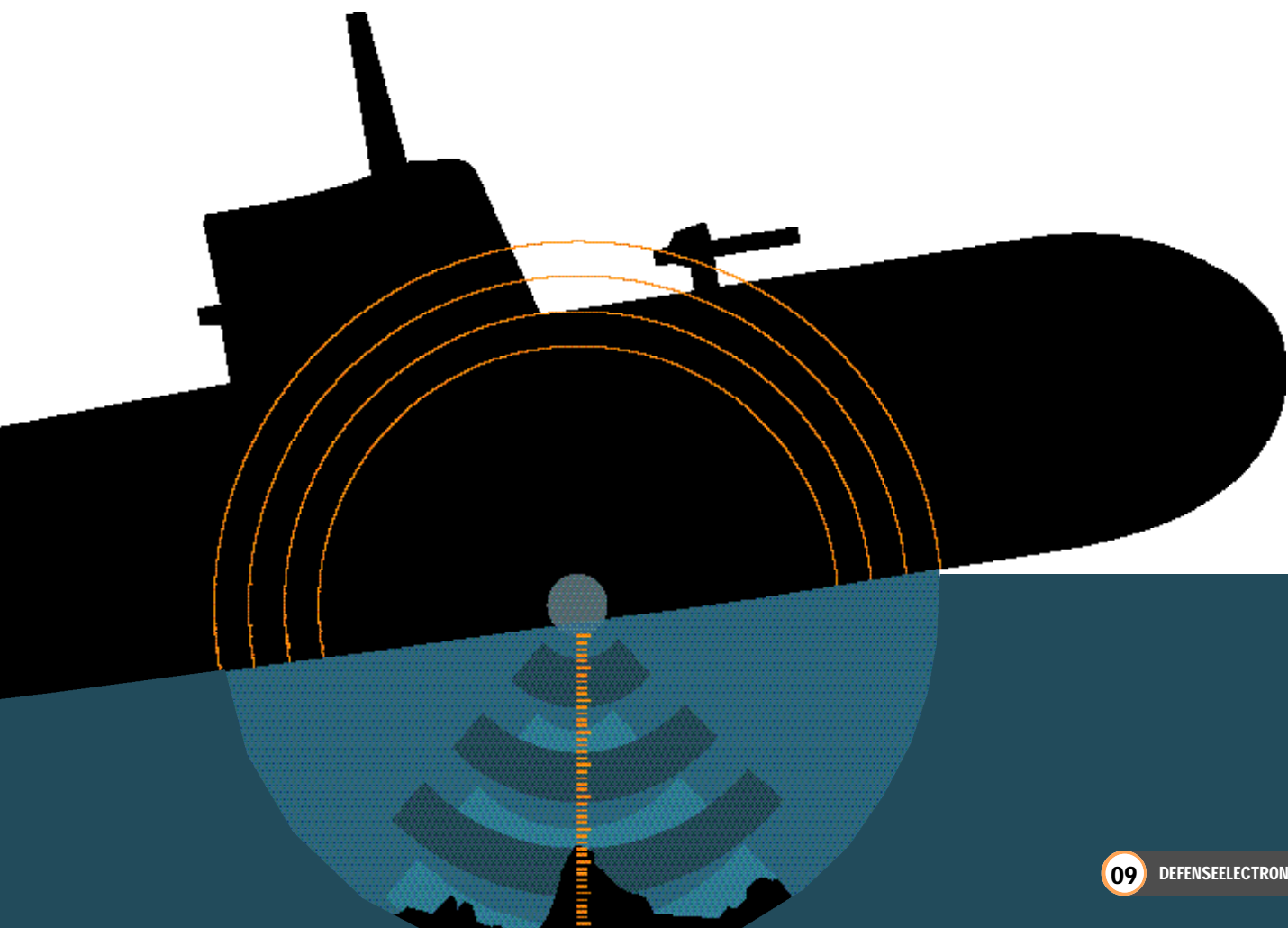
Creating a system architecture that simultaneously meets the demands of both today's and future generations of signal and image processing applications may seem an impossible task. That is exactly what Mercury's world-class team of designers has done. The architecture is designed to accommodate the frequent and rapid changes in technology and provides the scalability and flexibility required for unpredictable changes in customer requirements.

THE VALUE OF CORE COMPETENCIES

Industry consolidation and globalization trends have dramatically changed the landscape of the defense electronics industry. Today, the industry is dominated worldwide by fewer prime contractors who need to respond more quickly and more efficiently in order to compete for lucrative contracts.

The furious pace of technological innovation in the commercial electronics industry drives the requirement to rapidly integrate faster, more comprehensive systems into complex military projects in order to maintain weapons superiority. This constant drive forces all players in the defense electronics field to maintain a focus on their core competencies, opening the way for a major trend toward outsourcing.

Mercury has responded to this outsourcing trend with its core competence—architecting the most technologically-advanced signal and image processing computers—which perfectly complements the requirements of defense contractors building systems for signals intelligence, radar, sonar and multi-spectral imaging systems.



MERCURY IN MEDICAL IMAGING

Mercury's computers provide image processing for the world's leading manufacturers of magnetic resonance imaging (MRI), computed tomography (CT) and digital X-ray systems. The advances in MRI, CT and digital X-ray that enable emergency room doctors to scan for and diagnose head-to-toe injuries in a matter of seconds, require massive processing power. With the industry moving rapidly to real-time 3-dimensional imagery, the demand for digital image processing is likely to increase

further. Industry-leading companies including GE Medical Systems, Siemens Medical Engineering Group, Marconi Medical Systems and Philips Medical Systems are relying on Mercury to provide the subsystems necessary for the complex, real-time computations to transform vast amounts of data into images for rapid, accurate, and comprehensive medical diagnosis.

SUPPLIER PARTNERSHIPS: THE BENEFITS

Having worked closely with the engineering teams of our customers that are now in production with MRI, CT and digital X-ray machines, Mercury understands the challenges of designing to the highest performance, maintaining the lowest cost structure and achieving a rapid time-to-market. The partnership between Mercury and its customers is evident at every stage of the development process. Mercury frequently participates as an extension of the customer's design team.

In the early design stages, Mercury works alongside the customer's engineers, marrying Mercury's expertise in signal and image processing with the customer's knowledge of the specific medical application. As the development proceeds, Mercury's engineers are present at every stage to test, diagnose and improve the design of the hardware, software and real-time algorithms essential for maximum performance.

Mercury's supplier partnership approach yields significant benefits over the industry's earlier practice of attempting to complete the entire design in-house. These benefits include:

- Lower overall development and manufacturing costs
- Shorter time to market
- Ongoing technology upgrades with resulting revenue opportunities
- Lower development risk
- Top performance from the latest technology
- Custom hardware and software solutions to match specific application and environmental constraints

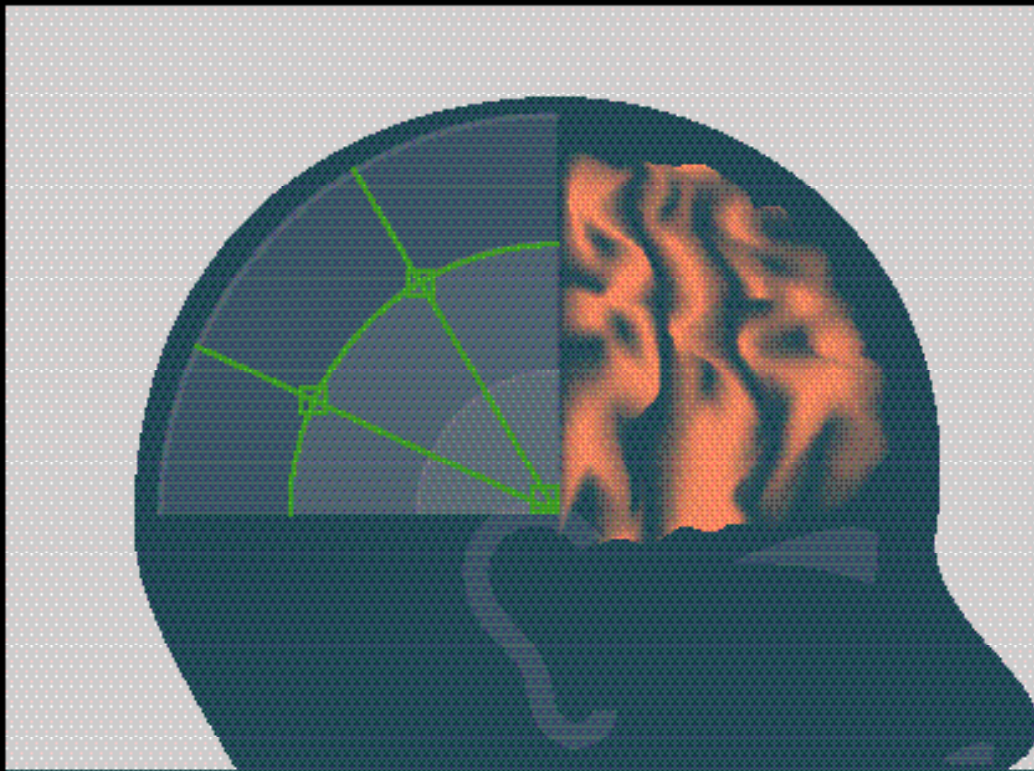
“The pace of advancement of image processing computers has made it no longer economical to attempt to develop the whole system in-house. With its high performance architecture and the competence of its staff, Mercury became a strong partner to our development team.”

Ekkehard Blanz, Vice President of CT Engineering, Siemens Medical Engineering Group

SIEMENS: CT SCANNER

Even though Mercury's technology is embedded inside the image reconstruction computer of a Siemens CT scanner, its benefits are far more visible on the outside. The average reconstruction time for a CT slice used to take several minutes per scan, an eternity for an immobile patient experiencing pain. Now, with Mercury's

PCI RACE configurations, reconstruction time has been reduced to a few seconds per scan. In addition, a patient is not restricted to an immobile position. These benefits substantially increase patient comfort and throughput as well as the percentage of accurate scans completed in a fraction of the time.



CUSTOM SOLUTIONS

Mercury specializes in designing computer systems to work inside other systems, from radar on board F-16 fighter jets to digital X-ray machines in hospitals around the world. Companies in a growing range of industries turn to Mercury for the ingenuity that is the trademark of our custom solutions.

THE VALUE OF CORE COMPETENCIES

The speed of advancements in computer processing technology has in the past few years eliminated the need to build specific computing solutions for the medical imaging industry. Mercury's customers were among the first to observe that the advances in signal processing computing eliminated the need for in-house development, making it no longer economical.

As Mercury's customers have pointed out, their core competencies lie in designing the algorithms and architecture of medical diagnostic systems and not in

designing signal and image processing computers—that's Mercury's competence.

Successfully integrating these core competencies into custom solutions for each medical imaging modality is the source of Mercury's solid reputation in this field.

OUTLOOK

Mercury's medical imaging business remains strong. The company continues to expand its business within the existing modalities of MRI, CT, PET and digital X-ray. At the same time the company is developing opportunities in advanced imaging systems targeted at minimally invasive surgical procedures. Mercury remains

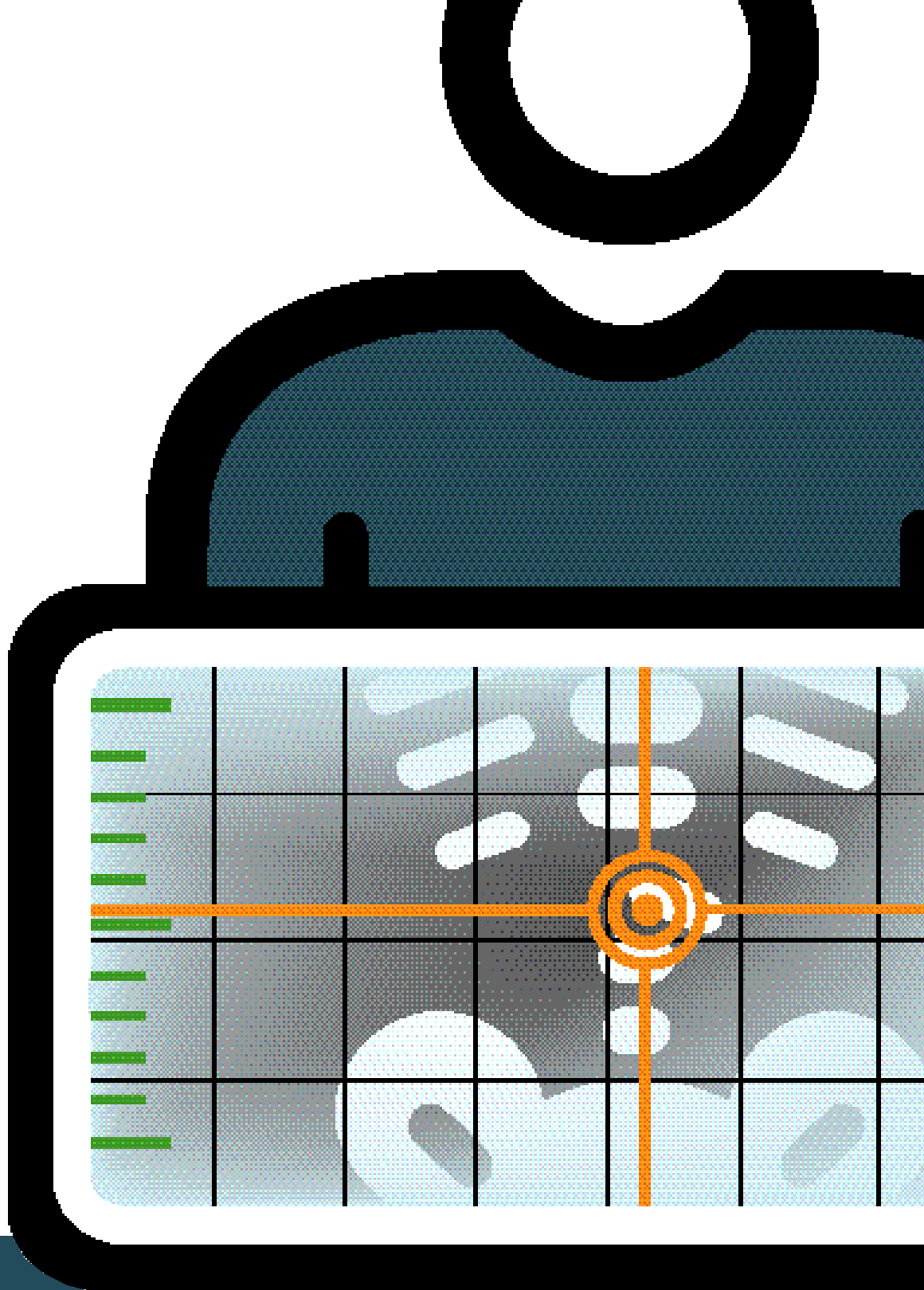
committed to maintaining a partnership relationship with its customers, anticipating their business and product goals and providing them with cutting-edge technology, expertise and service.

GEMS: MAGNETIC RESONANCE IMAGING AND DIGITAL X-RAY

Introduced in the early 1980s, MRI has been hailed as one of the greatest medical breakthroughs since the discovery of X-rays. Today many of the world's MRI research facilities use GE MRI systems that incorporate Mercury's computers. The power provided by Mercury's systems translates radio signals generated inside the MRI's strong magnetic field into clear images of the human body.

One of Mercury's largest customers, GE Medical Systems (GEMS), is a global leader in medical information and technology. GEMS' diagnostic imaging products include patient monitoring devices, conventional and digital X-ray, computed tomography, magnetic resonance, ultrasound, positron emission tomography and nuclear medicine.

“In our industry time to market is crucial so we truly have to focus on our core value. GEMS’ core competency is in developing systems for medical imaging applications. Mercury’s core competency lies in designing digital signal processing systems and they have been a valued partner in the development of our latest digital X-ray products - they consistently go the extra mile.”



PERFORMANCE ALGORITHMS

Websters defines algorithms as “a predetermined set of instructions for solving a specific problem in a limited number of steps.” Engineers and scientists at Mercury pride themselves in delivering industry-leading algorithms that do just that. In addition to providing unparalleled performance, they also ensure easy assimilation into the complex software programs of applications as diverse as cardiac analysis, sonar signal processing and wireless communications.

A LOOK AHEAD: BUSINESS DEVELOPMENT

Mercury is continually exploring new markets that can match the successful business model that led the company into a dominant position in its current markets. The four examples below, while in a formative stage, have the potential to develop into profitable future

segments of Mercury's business. They exhibit the clear characteristics of incorporating Mercury's core competencies in signal and image processing, and they accommodate the value-added business model that has worked successfully in our current businesses.

SEMICONDUCTOR WAFER INSPECTION

Yield management is a critical issue for the semiconductor industry. As the semiconductor roadmap moves to processes below 0.18 microns, wafer inspection becomes ever more complex. Older inspection technologies are no longer effective in providing the high yields necessary for an economically viable process. Manufacturers are

adopting real-time digital signal processing to increase the accuracy and speed of inspection and the yield of the overall process. During this year Schlumberger, a leader in semiconductor test equipment, chose to integrate Mercury's solution for its new Odyssey 300 wafer inspection system.

DIGITAL VIDEO AND THE ENTERTAINMENT INDUSTRY

The transition of the television industry to a fully digital infrastructure has created a significant new market opportunity for Mercury. This year we formed a joint venture, AgileVision L.L.C., with the Sarnoff Corporation, a world leader in innovative television technology. AgileVision's mission is to design and deliver to the television industry—broadcast studios, cable head-end operators and direct-to-home satellite service providers—digital video processing systems that make

the transition to digital both efficient and affordable. An allied application includes supplying a leading commercial electronics company with a system for designing and testing a digital watermarking system to provide intellectual property protection for Internet and DVD distribution of programming. These markets represent promising future opportunities for the application of Mercury's video processing capabilities.

PHOTOMASK WRITING

Microlithography, used in the creation of photomasks for manufacturing television and computer monitors, flat screen displays and semiconductors, requires computing engines that can handle vast streams of data. Micronic Laser Systems AB of Sweden selected Mercury to provide

the high-performance signal processing system to power their new Omega6000 series laser pattern generator. Announced in September, 1999, the Omega6000 is one of the industry's most advanced photomask writing systems.

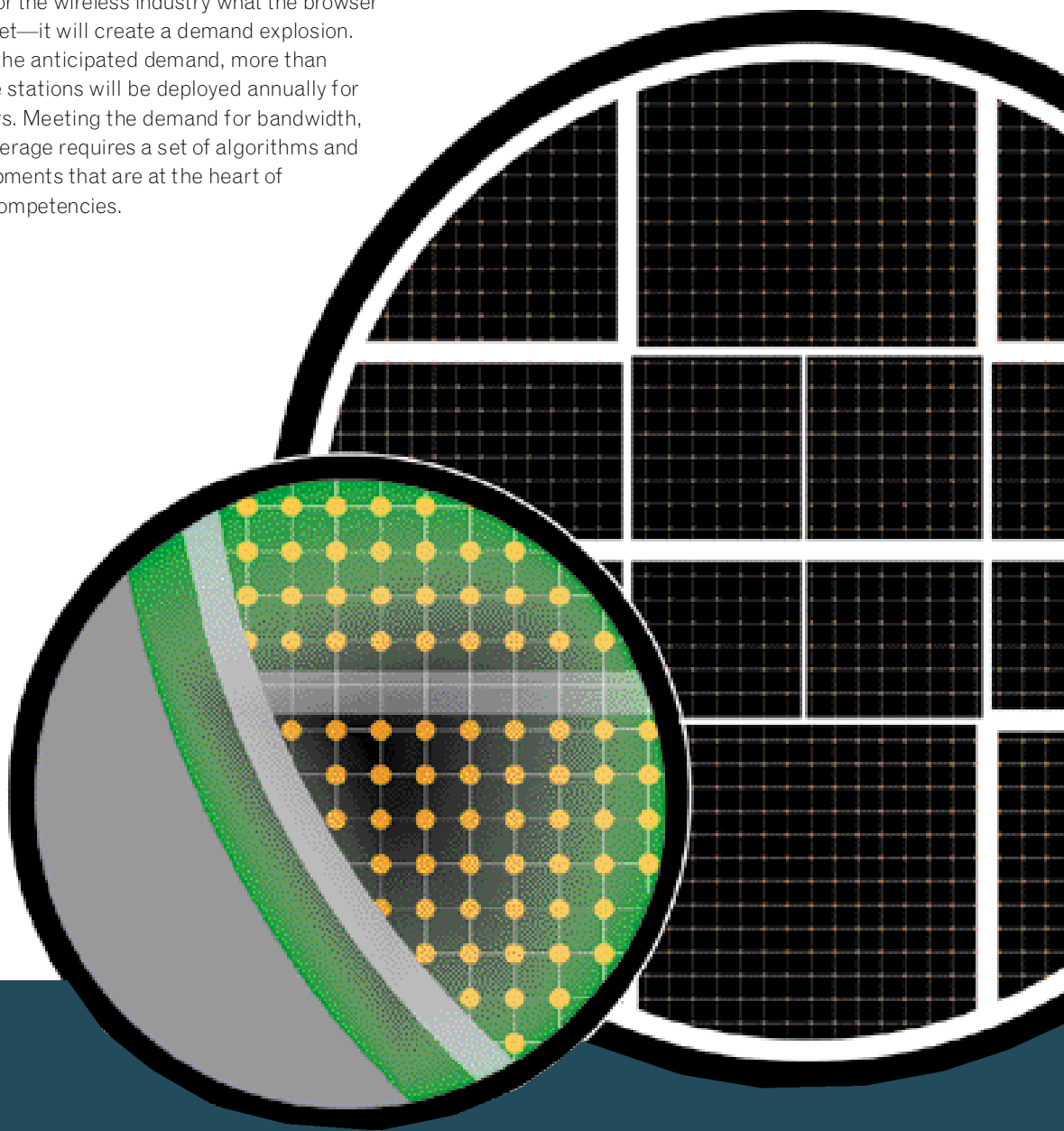
FOCUS ON CUSTOMER SUCCESS

Whether it's structuring a strategic partnership, flying in systems engineering experts, conducting a custom design review or debugging the customer's code, Mercury's focus is the success of the customer's project. As one customer phrased it, "Mercury always goes the extra mile."

WIRELESS COMMUNICATIONS

Mercury is applying its core competence in signal processing to the wireless communications industry and expects to complete the development of products for delivery in 2002. Analysts are predicting that by 2005 there will be over 1 billion cellular and PCS subscribers worldwide compared to today's 300 million. By 2003 there will be more wireless devices attached to the Internet than PCs. Experts expect that wireless Internet access services will do for the wireless industry what the browser did for the Internet—it will create a demand explosion. To keep up with the anticipated demand, more than 100,000 new base stations will be deployed annually for the next five years. Meeting the demand for bandwidth, capacity and coverage requires a set of algorithms and technical developments that are at the heart of Mercury's core competencies.

The company's value proposition to this industry is exactly the same as that in our other markets. We will partner with the base station manufacturer to provide the ultimate performance signal processing subsystem, keeping them on the leading edge of technology, lowering their overall system life-cycle costs and providing them with a faster time to market than if they develop the system in-house.



2000 FINANCIAL REVIEW



Directory

Selected Financial Data	17	Consolidated Statements of Operations	28	Notes to Consolidated Financial Statements	31
Management's Discussion and Analysis	18	Consolidated Statements of Changes in Stockholders' Equity	29	Report of Independent Accountants	44
Market Information	26	Consolidated Statements of Cash Flows	30	Supplementary Information (Unaudited)	45

SELECTED FINANCIAL DATA

The following table summarizes certain historical consolidated financial data, which should be read in conjunction with the Company's financial statements and related notes included elsewhere herein (in thousands except per share data):

Year Ended June 30,	2000	1999	1998	1997	1996
Statement of Operations Data:					
Revenues	\$140,944	\$106,571	\$85,544	\$64,574	\$58,300
Cost of revenues	39,146	34,237	30,084	22,034	24,688
Gross profit	101,798	72,334	55,460	42,540	33,612
Operating expenses:					
Selling, general and administrative	39,475	33,002	27,879	22,631	16,927
Research and development	28,862	20,709	14,476	12,837	9,776
Total operating expenses	68,337	53,711	42,355	35,468	26,703
Income from operations	33,461	18,623	13,105	7,072	6,909
Interest income, net	1,699	1,285	1,084	560	548
Equity loss in joint venture	(3,721)	—	—	—	—
Gain on sale of division, net	4,820	—	—	—	—
Other income (expense), net	86	185	(30)	(88)	(77)
Income before income taxes	36,345	20,093	14,159	7,544	7,380
Provision for income taxes	11,449	6,631	5,428	2,933	2,952
Net income	\$ 24,896	\$ 13,462	\$ 8,731	\$ 4,611	\$ 4,428
Net income per common share ⁽¹⁾					
Basic	\$ 1.19	\$ 0.66	\$ 0.60	\$ 0.45	\$ 0.44
Diluted	\$ 1.10	\$ 0.62	\$ 0.47	\$ 0.29	\$ 0.28
Weighted average number of common and common equivalent shares outstanding ^(1,3)					
Basic	21,000	20,336	14,470	10,282	10,100
Diluted	22,703	21,600	18,540	15,794	15,966
June 30,	2000	1999	1998	1997	1996
Balance Sheet Data:					
Working capital	\$ 68,198	\$ 42,312	\$32,794	\$27,547	\$23,554
Total assets	144,217	97,511	73,569	44,848	33,264
Long term obligations	14,052	590	—	—	—
Convertible preferred stock ⁽²⁾	—	—	—	1,200	1,200
Total stockholders' equity	108,360	77,440	61,040	33,322	28,529

(1) Note: Previously published financial data have been restated to give effect to the two-for-one stock split effected in the form of a 100% stock dividend distributed on December 21, 1999.

(2) Upon completion of the Company's initial public offering on January 29, 1998, the Company's series A convertible preferred stock was converted into 2,556,792 shares of common stock.

(3) See Note B of Notes to Consolidated Financial Statements for an explanation of the determination of the weighted average common and common equivalent shares used to compute basic and diluted net income per common share.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain Factors That May Affect Future Results

In this report, as well as oral statements made by the Company, phrases that are prefaced with the words "may," "will," "expect," "anticipate," "continue," "estimate," "project," "intend," "designed" and similar expressions, are intended to identify forward-looking statements regarding events, conditions and financial trends that may affect the Company's future plans of operations, business strategy, results of operations and financial position. These statements are based on the Company's current expectations and estimates as to prospective events and circumstances about which the Company can give no firm assurance. Further, any forward-looking statement speaks only as of the date on which such statement is made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made. As it is not possible to predict every new factor that may emerge, forward-looking statements should not be relied upon as a prediction of actual future financial condition or results. These forward-looking statements, like any 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 certain factors identified in the following discussion as well as the risk factors reported in the Company's Form 10-K filed with the Securities and Exchange Commission.

Overview

Mercury designs, manufactures and markets high performance, real-time digital signal processing computer systems that transform sensor-generated data into information which can be displayed as images for human interpretation or subjected to additional computer analysis. These multicomputer systems are heterogeneous and scalable, allowing them to accommodate several microprocessor types and to scale from several to hundreds of microprocessors within a single system.

During the past several years, the majority of the Company's revenues have been generated from sales of its products to the defense electronics market, generally for use in intelligence gathering electronic warfare systems. The Company's activities in this area have focused on the proof of concept, development and deployment of advanced military applications in radar, sonar and airborne surveillance. Medical diagnostic imaging is the other primary market currently served by the Company. Mercury's computer systems are embedded principally in Magnetic Resonance Imaging ("MRI"), and Computed Tomography ("CT") machines. The remaining revenues are derived from computer systems used in such commercial applications as baggage scanning, seismic analysis and automatic testing equipment, and, until the sale of the Company's shared storage business unit ("SSBU") in January 2000, shared storage products, SANergy® software and related products and services.

Mercury uses a direct sales force to sell its computer systems to the defense electronics markets in the U.S., Japan, the United Kingdom and France. Defense electronics sales to other countries are achieved through distributors. The Company also uses a direct sales force to sell its computer systems to the U.S. and international medical imaging markets. The Company sells its products to OEMs, value added re-sellers and end-users. Over the past three fiscal years, the Company has expanded its sales force to support growing revenues and has made significant expenditures to recruit additional technical and professional staff, to invest in information technology and to improve the Company's financial, administrative and management infrastructure.

Revenues are generated from the sale of hardware and software products, development contracts, services such as maintenance, training, engineering consulting and system integration of Mercury software with third-party hardware. Revenues from maintenance, training, engineering consulting services and system integration historically have not constituted a material portion of total revenues. Revenue from product sales is recorded upon receipt of customer purchase order or where applicable, a signed contract by both parties provided that delivery has occurred, customer acceptance is not uncertain, and collectability is deemed probable. The Company accrues for anticipated warranty costs upon shipment. Service revenue is recognized ratably over applicable contract periods or as the services are performed. Revenue from contracts involving significant product modification or customizations that are eligible for the percentage-of-completion accounting method are recognized on an efforts expended basis. Changes to total estimated costs and anticipated losses, if any, are recognized in the period in which determined.

Cost of revenues includes the cost of materials, component assembly, internal labor and related overhead. Cost of revenues also can include engineering and other technical labor and related overhead incurred in development and engineering consulting contracts.

Gross profit as a percentage of revenues ("gross margin") varies from period to period depending upon numerous variables including the mix of revenues from hardware, software, development and engineering consulting contracts; the mix of revenues among the markets served by the Company; the cost of raw materials; the cost of outsourced services and labor; operational efficiencies; actual production volume compared to planned volume; and the mix of applications for which the Company's computer systems are sold. Historically, the Company's gross margins on service revenues have been lower than on product revenues. In addition, the Company's gross margins from development contract revenues are typically lower than the Company's gross margins from standard product revenues. The Company intends to continue to enter into development contracts and anticipates that the gross margins associated with development contract revenues will continue to be lower than its gross margins on standard product revenues.

Mercury has made significant investments in research and development in an effort to maintain its technology leadership in digital signal processing. Mercury invested \$14.5 million, \$20.7 million and \$28.9 million in fiscal years 1998, 1999 and 2000, respectively, in development activities associated with the Company's key technology competencies as well as in activities that are targeted at developing new technologies and products. The Company expects research and development expenses to continue to increase as the Company continues to develop products to serve its markets, all of which are subject to rapidly changing technology, frequent product performance improvements and evolving industry standards. The ability to deliver superior technological performance on a timely and cost-effective basis is a critical factor in securing design wins for future generations of defense electronics and medical imaging systems. Significant research and development spending by the Company does not ensure that the Company's computer systems will be designed into a customer's system. Because future production orders are usually contingent upon securing a design win, the Company's operating results may fluctuate due to either obtaining or failing to obtain design wins for significant customer systems.

Results of Operations

The following table sets forth, for the periods indicated, certain financial data as a percentage of total revenues.

Year Ended June 30,	2000	1999	1998
Revenues	100.0%	100.0%	100.0%
Cost of revenues	27.8	32.1	35.2
Gross profit	72.2	67.9	64.8
Operating expenses:			
Selling, general and administrative	28.0	31.0	32.6
Research and development	20.5	19.4	16.9
Total operating expenses	48.5	50.4	49.5
Income from operations	23.7	17.5	15.3
Other income, net	2.1	1.4	1.3
Income before income taxes	25.8	18.9	16.6
Provision for income taxes	8.1	6.3	6.4
Net income	17.7%	12.6%	10.2%

Fiscal 1999 vs. Fiscal 2000

Revenues

Total revenues increased 32% from \$106.6 million during the year ended June 30, 1999 to \$140.9 million during the year ended June 30, 2000.

Defense electronics revenues increased 21% from \$82.6 million or 77% of total revenues during the year ended June 30, 1999 to \$100.3 million or 71% of total revenues during the year ended June 30, 2000. This increase in revenue was primarily due to the increased unit demand for defense electronics products, largely comprised of advanced military applications in radar, sonar, and airborne surveillance.

Medical imaging revenues increased 77% from \$15.3 million or 14% of total revenues during the year ended June 30, 1999 to \$27.1 million or 19% of total revenues during the year ended June 30, 2000. The increase in medical imaging revenues reflects the increase in production volume of products in the CT application.

Other revenues increased 55% from \$8.7 million or 8% of total revenues during the year ended June 30, 1999 to \$13.5 million or 10% of total revenues during the year ended June 30, 2000. The increase in other revenues was due primarily to the addition of a new commercial customer, offset in part by the sale of the SSBU in January 2000.

Cost of Revenues

Cost of revenues increased 14% from \$34.2 million during the year ended June 30, 1999 to \$39.1 million during the year ended June 30, 2000. Cost of revenues as a percentage of total revenues decreased from 32% during the year ended June 30, 1999 to 28% during the year ended June 30, 2000. The decrease in costs as a percentage of total revenues was primarily due to a decline in component costs and tighter control over manufacturing spending.

Selling, General and Administrative

Selling, general and administrative expenses increased 20% from \$33.0 million during the year ended June 30, 1999 to \$39.5 million during the year ended June 30, 2000. Selling, general and administrative expenses as a percentage of total revenues were 31% during the year ended June 30, 1999 and 28% during the year ended June 30, 2000. The increase in expense dollars reflects the hiring of additional sales and administrative personnel, increased commissions related to increased revenues, investment in an enterprise resource planning system, as well as the ongoing development of the Company's financial, administrative and management infrastructure to support the Company's growth.

Research and Development

Research and development expenses increased 39% from \$20.7 million during the year ended June 30, 1999 to \$28.9 million during the year ended June 30, 2000. Research and development expenses as a percentage of total revenues were 19% during the year ended June 30, 1999 and 20% during the year ended June 30, 2000. The increase in research and development expenses was due primarily to the hiring of additional software and hardware engineers to develop and enhance the features and functionality of the Company's products and an increased level of introduction of new products in response to a high demand for next generation products. Engineering expenses currently are running higher than management's target levels as the Company is working on several major development programs to deliver important new technology to its customers. Management believes that higher engineering spending will continue through fiscal 2001.

The Company's future success and ability to make the appropriate engineering investments will depend to a significant extent on its ability to attract, train, motivate and retain highly skilled technical professionals, particularly project managers, engineers and other senior technical personnel. The Company believes that there is a shortage of, and significant competition for, technical development professionals with the skills and experience necessary to perform the services offered by the Company. The Company's ability to maintain and renew existing engagements and obtain new business depends, in large part, on its ability to hire and retain technical personnel with the skills that keep pace with continuing changes in industry standards, technologies and client preferences. The inability to hire additional qualified personnel could impair the Company's ability to satisfy its growing client base, requiring an increase in the level of responsibility for both existing and new personnel. There can be no assurance that the Company will be successful in retaining current or future employees and therefore able to continue to make the investments in engineering at the projected higher expenditure levels. Furthermore, the Company's inability to retain or hire technical personnel may require contracting or outsourcing engineering activities. This factor could result in higher than planned engineering expenses and therefore, a possible fluctuation in the Company's operating results.

Income from Operations

Income from operations increased 80% from \$18.6 million during the year ended June 30, 1999 to \$33.5 million during the year ended June 30, 2000. This increase is primarily associated with higher sales volume and lower cost of goods sold.

Included in income from operations during the year ended June 30, 2000 were \$1.8 million in hardware and software revenues and \$2.4 million in direct expenses related to the activities of the SSBU. Included in income from operations during the year ended June 30, 1999 were \$2.2 million in hardware and software revenues and \$4.0 million in direct expenses related to the SSBU. The direct expenses include expenses from marketing and engineering activities, primarily related to compensation, trade shows, prototype development and direct costs related to the sale of the product.

Gain on Sale of Business Unit

On January 18, 2000, the Company completed the sale of the SBBU to IBM. Payments are structured with an initial payment of \$4,500,000 (excluding \$1,000,000 to be held in escrow and payable on a contingent basis), followed by 12 quarterly contingent payments of \$1,500,000 plus interest. The quarterly payments are contingent upon IBM's continued use of the technology. If IBM defaults, Mercury has the right to recover the assets, including the patent and other intellectual property. The Company has recorded a \$4,820,000 gain on the sale of this division which includes cash received of \$6,100,000 less legal and advisory costs of \$581,000, costs reimbursable to IBM of \$499,000, and the net book value of equipment and inventories sold of \$200,000.

Equity Loss in Joint Venture

In September, 1999, the Company formed AgileVision as a joint venture with Sarnoff Corporation, the developer of color television and a pioneer in the creation of digital television ("DTV"). AgileVision provides broadcasters and cable providers equipment to optimize their DTV investment and develop new broadband media commerce revenue streams, including master control systems that permit broadcasters to perform multiple functions on a single platform that previously would have required the engineering and integration of numerous discrete products and systems. The Company's contribution to AgileVision was \$3.5 million in cash. During the year ended June 30, 2000, the Company recognized \$3.7 million in expenses related to the operation of AgileVision. No expenses were recognized during the year ended June 30, 1999.

Interest Income, Net

The Company earned \$1.3 million in interest income, net, during the year ended June 30, 1999 and \$1.7 million during the year ended June 30, 2000. This increase primarily reflects higher average cash balances.

Provision for Income Taxes

The Company's provision for income taxes was \$6.6 million during the year ended June 30, 1999 and \$11.4 million during the year ended June 30, 2000. The Company's effective tax rate was 33.0% during the year ended June 30, 1999 and 31.5% during the year ended June 30, 2000. During fiscal 2000, the tax rate was reduced primarily due to a reduction in state taxes.

Fiscal 1998 vs. Fiscal 1999

Revenues

Total revenues increased 25% from \$85.5 million during the year ended June 30, 1998 to \$106.6 million during the year ended June 30, 1999.

Defense electronics revenues increased 23% from \$67.2 million or 79% of total revenues during the year ended June 30, 1998 to \$82.6 million or 77% of total revenues during the year ended June 30, 1999. The increase in revenues was due primarily to increased unit demand for defense electronics products.

Medical imaging revenues increased 36% from \$11.2 million or 13% of total revenues during the year ended June 30, 1998 to \$15.3 million or 14% of total revenues during the year ended June 30, 1999. The increase in revenues was due primarily to the expansion of the business into new applications.

Other revenues increased 22% from \$7.1 million or 8% of total revenues during the year ended June 30, 1998 to \$8.7 million or 8% of total revenues during the year ended June 30, 1999. The increase was due to the shared storage business unit revenue increasing by 152% while the other commercial businesses remained relatively flat over the year.

Cost of Revenues

Cost of revenues increased 14% from \$30.1 million during the year ended June 30, 1998 to \$34.2 million during the year ended June 30, 1999. Cost of revenues as a percentage of total revenues decreased from 35% during the year ended June 30, 1998 to 32% during the year ended June 30, 1999. The decrease in costs as a percentage of total revenues was primarily due to a decline in component costs and tighter control over manufacturing spending.

Selling, General and Administrative

Selling, general and administrative expenses increased 18% from \$27.9 million during the year ended June 30, 1998 to \$33.0 million during the year ended June 30, 1999. Selling, general and administrative expenses as a percentage of total revenues were 33% during the year ended June 30, 1998 and 31% during the year ended June 30, 1999. The increase in expense dollars reflects the hiring of additional sales and administrative personnel, increased commissions and marketing communication related to increased revenues, as well as the ongoing development of the Company's financial, administrative and management infrastructure to support the Company's growth.

Research and Development

Research and development expenses, excluding capitalized software expenditures, increased 43% from \$14.5 million during the year ended June 30, 1998 to \$20.7 million during the year ended June 30, 1999. Research and development expenses as a percentage of total revenues were 17% during the year ended June 30, 1998 and 19% during the year ended June 30, 1999. The increase in research and development expenses was due primarily to the hiring of additional software and hardware engineers to develop and enhance the features and functionality of the Company's products in response to increased demand for next generation products. Engineering expenses currently are running higher than management's target levels as the Company is working on some major development programs to deliver important new technology to its customers.

Income from Operations

Income from operations increased 42% from \$13.1 million during the year ended June 30, 1998 to \$18.6 million during the year ended June 30, 1999. Included in income from operations during the year ended June 30, 1999 were \$2.2 million in hardware and software revenues and \$4.0 million in direct expenses related to the shared storage business. The expenses include direct expenses from marketing and engineering activities, primarily related to compensation, trade shows, prototype development and direct costs related to the sale of the product. Included in income from operations during the year ended June 30, 1998 were \$885,000 in hardware and software revenues and \$4.3 million in direct expenses related to the shared storage business. Revenues from the shared storage business increased substantially year over year due primarily to the expanding distribution base and the availability of fiber channel interconnect technology.

Interest Income, Net

The Company earned \$1.1 million in interest income, net, during the year ended June 30, 1998 and \$1.3 million during the year ended June 30, 1999. This increase reflects higher average cash balances primarily as a result of proceeds received from the Company's initial public offering in mid fiscal 1998. Offsetting the effect of higher average cash balances were lower yields achieved on the Company's cash. These lower yields were the result of a shift in investment strategy from taxable money market instruments to non-taxable securities.

Provision for Income Taxes

The Company's provision for income taxes was \$5.4 million during the year ended June 30, 1998 and \$6.6 million during the year ended June 30, 1999. The Company's effective tax rate was 38% during the year ended June 30, 1998 and 33% during the year ended June 30, 1999. During fiscal 1999, the tax rate was reduced primarily due to a one-time state investment tax credit ("ITC") benefit resulting from the purchase of two facilities during the year, increase in research and development credits, and a shift in investment strategy from taxable to non-taxable securities.

Liquidity and Capital Resources

As of June 30, 2000 the Company had cash and marketable securities of approximately \$68.3 million. During the year ended June 30, 2000 the Company generated approximately \$29.9 million in cash from operations compared to \$9.1 million generated during the year ended June 30, 1999. The increase in cash generated from operations is attributable primarily to the Company's improved profitability.

The Company's days sales, based on revenues of each calendar quarter, decreased from 88 days at the end of 1999 to 70 days at the end of 2000. This decrease in days sales was due to the resolution of a supplier issue at the end of fiscal year 1999, which had delayed shipments until the last few weeks of the fourth quarter. Consequently, the accounts receivable balance at June 30, 1999 was inflated.

In September, 1999, the Company formed AgileVision as a joint venture with Sarnoff Corporation, the developer of color television and a pioneer in the creation of digital television ("DTV"). AgileVision provides broadcasters and cable providers equipment to optimize their DTV investment and develop new broadband media commerce revenue streams, including master control systems that permit broadcasters to perform multiple functions on a single platform that previously would have required the engineering and integration of numerous discrete products and systems. The Company's total contribution to AgileVision was \$3.5 million in cash. During the year ended June 30, 2000, the Company recognized \$3.7 million in expenses related to the operation of AgileVision. The Company has funded the losses of AgileVision to date and as of June 30, 2000 intends to continue to fund this venture. No expenses were recognized during the year ended June 30, 1999.

On January 18, 2000, the Company completed the sale of the SSBU to IBM. Payments are structured with an initial payment of \$4.5 million (excluding \$1.0 million to be held in escrow and payable on a contingent basis), followed by 12 quarterly contingent payments of \$1.5 million plus interest. The quarterly payments are contingent upon IBM's continued use of the technology. If IBM defaults, Mercury has the right to recover the assets, including the patent and other intellectual property.

The Company used approximately \$45.9 million in investing activities during the year ended June 30, 2000 compared to \$12.7 million during the year ended June 30, 1999. During the year ended June 30, 2000, the Company's investing activities consisted of \$40.8 million for the purchase of marketable securities (net of sales), \$3.5 million for investment in AgileVision, \$1.1 million for the purchase of land adjacent to its existing headquarters and \$5.5 million for computers, furniture and equipment. These payments were partially offset by the receipt of \$5.0 million, net of selling costs from sale of a division. During the year June 30, 1999, the Company's investing activities consisted

of \$15.1 million for the purchase of an existing office building and construction of an adjacent building, \$4.3 million for computers, furniture, equipment and leasehold improvements, and \$810,000 for capitalized software. These cash outflows were partially offset by the net sale of marketable securities of \$7.2 million and a repayment of notes receivable from related parties amounting to \$325,000.

The Company generated approximately \$17.4 million in cash from financing activities during the year ended June 30, 2000 compared to \$1.4 million during the year ended June 30, 1999. During the year ended June 30, 2000 the Company's financing activities consisted primarily of \$14.5 million in proceeds received upon the issuance of two 7.30% senior secured financing notes. These notes are due November 2014. In addition, \$3.7 million in cash was generated from the employee stock purchase plan and the exercise of stock options. These cash inflows were partially offset by the payment of debt and capital lease obligations amounting to approximately \$828,000. During the year ended June 30, 1999, \$1.7 million in cash was generated from the employee stock purchase plan and the exercise of stock options and \$303,000 was used for the payment of capital lease obligations.

Management believes that the Company's available cash, marketable securities, cash generated from operations, and from the arrangement related to the sale of the SSBU, will be sufficient to provide for the Company's working capital and capital expenditure requirements for at least the next twenty four months. If the Company acquires one or more businesses or products, the Company's capital requirements could increase substantially. In the event of such an acquisition or in the event that unanticipated circumstances arise which significantly increase the Company's capital requirements, there can be no assurance that necessary additional capital will be available on terms acceptable to the Company, if at all.

Year 2000 Compliance

As of the date of this report, the Company has not experienced nor does it expect to experience any business disruption resulting from any Year 2000 failures from either its Products, IT Systems, or non-IT Systems.

Recent Accounting Pronouncements

See Note B to the Company's Consolidated Financial Statements for a description of the impact on the Company of recent accounting pronouncements.

Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk Management

Due to the short-term duration, the fair value of the Company's cash and investment portfolio at June 30, 2000 approximated carrying value. Interest rate risk is estimated as the potential decrease in fair value resulting from a hypothetical 10% increase in interest rates for issues contained in the investment portfolio. The resulting hypothetical fair value was not materially different from the year-end carrying value.

MARKET INFORMATION

The Company's Common Stock is traded in the over-the-counter market and is quoted on the Nasdaq National Market under the symbol MRCY. The following table sets forth, for the periods indicated, the high and low transactions per share during such periods. Such over-the-counter market quotations reflect inter-dealer prices without retail markup, markdown or commission.

	High	Low
1999 First quarter	17 $\frac{3}{8}$	9 $\frac{3}{4}$
Second quarter	28 $\frac{5}{8}$	12 $\frac{1}{2}$
Third quarter	28 $\frac{1}{4}$	17 $\frac{1}{8}$
Fourth quarter	33 $\frac{3}{8}$	15 $\frac{1}{8}$
2000 First quarter	17 $\frac{1}{4}$	11 $\frac{3}{8}$
Second quarter	35	16
Third quarter	68 $\frac{1}{8}$	27 $\frac{1}{8}$
Fourth quarter	48 $\frac{7}{8}$	24 $\frac{1}{4}$

As of August 31, 2000 the Company had approximately 15,000 shareholders including record and nominee holders.

The Company has never declared or paid cash dividends on shares of its Common Stock and does not expect to declare or pay cash dividends on its Common Stock in the foreseeable future. The Company currently intends to retain any earnings for future growth.

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) June 30,

	2000	1999
Assets		
Current assets:		
Cash and cash equivalents	\$ 5,850	\$ 3,676
Marketable securities	36,784	12,762
Trade accounts receivable, net of allowance for doubtful accounts of \$308 and \$376 at June 30, 2000 and 1999, respectively	27,408	28,915
Inventory	15,975	12,431
Deferred income taxes, net	1,909	2,617
Income tax receivable	722	—
Prepaid expenses and other current assets	1,355	1,392
Total current assets	90,003	61,793
Marketable securities	25,705	8,978
Property and equipment, net	27,574	25,325
Deferred income taxes, net	787	668
Other assets	148	747
Total assets	<u>\$144,217</u>	<u>\$97,511</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 9,231	\$ 5,580
Accrued expenses	2,486	3,694
Accrued compensation	6,143	4,292
Capital lease – short term	580	434
Notes payable – short term	577	—
Billings in excess of revenues and customer advances	2,788	3,169
Income taxes payable	—	2,312
Total current liabilities	21,805	19,481
Commitments and Contingencies (Note F)	—	—
Capital lease – long term	447	590
Notes payable – long term	13,605	—
Stockholders' Equity		
Common stock, \$.01 par value; 40,000,000 shares authorized; 21,395,137 and 10,310,877 shares issued and outstanding at June 30, 2000 and 1999, respectively	214	103
Additional paid-in capital	34,446	28,515
Retained earnings	73,841	48,945
Accumulated other comprehensive income	(141)	(123)
Total stockholders' equity	108,360	77,440
Total liabilities and stockholders' equity	<u>\$144,217</u>	<u>\$97,511</u>

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

CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands, Except Per Share Data) Year Ended June 30,

	2000	1999	1998
Net revenues	\$140,944	\$106,571	\$85,544
Cost of revenues	39,146	34,237	30,084
Gross profit	101,798	72,334	55,460
Operating expenses:			
Selling, general and administrative	39,475	33,002	27,879
Research and development	28,862	20,709	14,476
Total operating expenses	68,337	53,711	42,355
Income from operations	33,461	18,623	13,105
Interest income	2,430	1,336	1,084
Interest expense	(731)	(51)	—
Equity loss in joint venture	(3,721)	—	—
Gain on sale of division, net	4,820	—	—
Other income (expense), net	86	185	(30)
Income before income tax provision	36,345	20,093	14,159
Income tax provision	11,449	6,631	5,428
Net income	<u>\$ 24,896</u>	<u>\$ 13,462</u>	<u>\$ 8,731</u>
Net income per common share:			
Basic	<u>\$ 1.19</u>	<u>\$ 0.66</u>	<u>\$ 0.60</u>
Diluted	<u>\$ 1.10</u>	<u>\$ 0.62</u>	<u>\$ 0.47</u>
Weighted average number of common and common equivalent shares outstanding:			
Basic	<u>21,000</u>	<u>20,336</u>	<u>14,470</u>
Diluted	<u>22,703</u>	<u>21,600</u>	<u>18,540</u>

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

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended June 30, 2000, 1999 and 1998 (In Thousands)	Series A Convertible Preferred Stock		Common Stock		Add'l Paid-In Capital	Retained Earnings	Accumulated Other Compre- hensive Income	Compre- hensive Income	Subscriptions and Related Parties Notes Receivable	Total Stock- holder's Equity
	Shares	Amount	Shares	Amount						
Balance, June 30, 1997	\$852	\$1,200	5,202	\$ 52	\$ 5,703	\$26,752	\$ (60)		\$(325)	\$ 33,322
Exercise of common stock options			204	2	506					508
Issuance of common stock pursuant to initial public offering, net of issuance costs of \$952			2,000	20	18,558					18,578
Conversion of series A convertible preferred stock into common stock	(852)	(1,200)	2,557	26	1,174					—
Exercise of common stock warrants			10		20					20
Comprehensive income:										
Net income						8,731		8,731		8,731
Foreign currency translation							(119)	(119)		(119)
Comprehensive income								<u>\$ 8,612</u>		
Balance June 30, 1998	—	—	9,973	100	25,961	35,483	(179)		(325)	61,040
Exercise of common stock options			309	3	1,213					1,216
Issuance of common stock in conjunction with employee stock purchase plan			29		469					469
Tax benefit from disqualified dispositions					826					826
Stock compensation					46					46
Payment of notes by related parties									325	325
Comprehensive income:										
Net income						13,462		13,462		13,462
Unrealized loss on securities							(30)	(30)		(30)
Foreign currency translation							86	86		86
Comprehensive income								<u>\$13,518</u>		
Balance June 30, 1999	—	—	10,311	103	28,515	48,945	(123)		—	77,440
Exercise of common stock options			169	1	1,148					1,149
Two-for-one stock split			10,480	105	(105)					—
Exercise of common stock options			396	4	1,851					1,855
Issuance of common stock in conjunction with employee stock purchase plan			39	1	736					737
Tax benefit from disqualified dispositions					1,877					1,877
Stock compensation					424					424
Comprehensive income:										
Net income						24,896		24,896		24,896
Unrealized loss on securities							(41)	(41)		(41)
Foreign currency translation							23	23		23
Comprehensive income								<u>\$24,878</u>		
Balance June 30, 2000	—	—	21,395	\$214	\$34,446	\$73,841	\$(141)		—	\$108,360

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) Year Ended June 30,	2000	1999	1998
Cash flows from operating activities:			
Net income	\$ 24,896	\$ 13,462	\$ 8,731
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization of property and equipment	4,786	3,916	2,829
Gain on sale of division, net	(4,820)	—	—
Amortization of capitalized software development costs	313	602	490
Equity loss in joint venture	3,721	—	—
Provision for inventory write-downs	1,012	2,786	1,583
Stock option compensation expense	424	46	—
Provision for doubtful accounts	—	249	99
Deferred income taxes	590	(1,187)	(1,133)
Tax benefit from disqualified dispositions	1,877	826	—
Changes in assets and liabilities:			
Trade accounts receivable	1,504	(11,871)	(4,596)
Contracts in progress	—	—	1,096
Inventory	(4,673)	(6,048)	(2,398)
Prepaid expenses and other current assets	(690)	(108)	(560)
Other assets	71	(98)	(69)
Accounts payable	3,654	2,216	570
Accrued expenses and compensation	674	1,874	1,908
Billings in excess of revenues and customer advances	(366)	2,151	(1,847)
Income taxes payable	(2,311)	284	411
Net cash provided by operating activities	30,662	9,100	7,114
Cash flows from investing activities:			
Purchase of marketable securities	(127,019)	(114,574)	(73,571)
Sale of marketable securities	86,230	121,768	44,605
Purchases of property and equipment	(6,637)	(19,440)	(6,336)
Investment in joint venture	(3,500)	—	—
Proceeds from sale of division, net of selling costs	5,032	—	—
Capitalized software development costs	—	(810)	(111)
Note receivable from related parties	—	325	—
Net cash used in investing activities	(45,894)	(12,731)	(35,413)
Cash flows from financing activities:			
Proceeds from employee stock purchase program	737	469	—
Proceeds from exercise of stock options	3,004	1,216	508
Proceeds from issuance of common stock	—	—	18,578
Proceeds from exercise of stock warrants	—	—	20
Proceeds from issuance of notes	14,500	—	—
Payments of debt	(318)	—	—
Principal payments under capital lease obligations	(510)	(303)	—
Net cash provided by financing activities	17,413	1,382	19,106
Net decrease in cash and cash equivalents	2,181	(2,249)	(9,193)
Effect of exchange rate changes on cash and cash equivalents	(7)	(129)	54
Cash and cash equivalents at beginning of year	3,676	6,054	15,193
Cash and cash equivalents at end of year	\$ 5,850	\$ 3,676	\$ 6,054
Cash paid during the year for:			
Interest	\$ 685	\$ 51	\$ —
Income taxes	12,692	7,155	6,166
Non-cash transactions:			
Equipment acquired under capital leases	\$ 513	\$ 1,327	\$ —
Series A convertible preferred stock converted to common stock	—	—	1,200

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tables in thousands except for share and per share data)

A. Description of Business:

Mercury Computer Systems, Inc. (the "Company") designs, manufactures and markets high-performance real-time digital signal processing computer systems, which transform sensor-generated data into information that can be displayed as images for human interpretation or subjected to additional computer analysis. These multicomputer systems are heterogeneous and scalable, allowing them to accommodate several different microprocessor types and to scale from a few to hundreds of microprocessors within a single system. The two primary markets for the Company's products are defense electronics and medical diagnostic imaging. Both of these markets have computing needs, which benefit from the unique system architecture developed by the Company.

B. Summary of Significant Accounting Policies:

Basis of Presentation

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

Use of Estimates

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

Revenue Recognition

Revenue from product sales is recorded upon receipt of a customer purchase order or where applicable, a signed contract executed by both parties, provided that delivery has occurred and customer acceptance is not uncertain and collectability is deemed probable. The Company accrues for anticipated warranty costs upon shipment. Service revenue is recognized ratably over applicable contract periods or as the services are performed. Revenue from contracts involving significant product modification or customization that are eligible for the percentage-of-completion accounting method are recognized on an efforts-expended basis. Changes to total estimated costs and anticipated losses, if any, are recognized in the period in which determined. There was no revenue recognized for years ended June 30, 2000 and 1999 under the percentage-of-completion method while \$3,835,000 of revenue was recognized under the percentage-of-completion method for the fiscal year ended June 30, 1998. There were no retainages at June 30, 2000, 1999, or 1998.

Billings in Excess of Revenues and Customer Advances

Billings in excess of revenues and customer advances include amounts billed on uncompleted contracts and amounts billed on annual maintenance contracts.

Cash and Cash Equivalents

Cash equivalents, consisting of money market funds and U.S. government and U.S. government agency issues with original maturities of 90 days or less, are carried at fair value.

Marketable Securities

The Company classifies investments in marketable securities as either trading, available-for-sale or held-to-maturity at the time of purchase and periodically re-evaluates such classification. There were no securities classified as trading or held-to-maturity as of June 30, 2000 and 1999. Securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at cost with corresponding

premiums or discounts amortized over the life of the investment to interest income. Securities classified as available-for-sale are reported at fair market value. Unrealized gains or losses on available-for-sale securities are included, net of tax, in accumulated other comprehensive income in shareholder's equity until disposition. Realized gains and losses and declines in value judged to be other than temporary on available-for-sale securities are included in other income. The cost of securities sold is based on the specific identification method.

The fair market value of cash equivalents and short-term and long-term investments in marketable securities represents the quoted market prices at the balance sheet dates. The short-term marketable securities have original maturities greater than 90 days and remaining maturities less than one year. Long-term marketable securities have remaining maturities greater than one year. Long-term marketable securities have maturities of one to three years. At June 30, 2000 and 1999, marketable securities were classified as follows:

	2000 Available- For-Sale	1999 Available- For-Sale
Short-term marketable securities:		
Municipal/tax free bonds & money market instruments	\$36,784	\$12,762
Long-term marketable securities:		
Municipal/tax free bonds	\$25,705	\$8,978

Concentration of Credit Risk

Financial instruments that potentially expose the Company to concentrations of credit risk consist principally of cash, marketable securities and trade accounts receivable. The Company places its cash and cash equivalents with financial institutions which management believes are of high credit quality. At June 30, 2000 and 1999, the Company had approximately \$3,088,000 and \$2,904,000, respectively, on deposit or invested with its primary financial and lending institution

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

Year Ended June 30,	2000	1999
Customer A	25%	3%
Customer B	6%	27%
Customer C	5%	17%
Customer D	8%	11%

Inventory

Inventory is stated at the lower of cost, determined on the first-in, first-out (FIFO) basis, or market.

Property and Equipment

Property and equipment are recorded at cost. Equipment under capital lease is recorded at the present value of the minimum lease payments required during the lease period. Depreciation is based on the following estimated useful lives of the assets using the straight-line method:

Computer equipment	3 years
Machinery and equipment	5 years
Furniture and fixtures	5 years
Buildings	15 – 30 years
Building improvements	10 years
Leasehold improvements	Shorter of the lease term or economic life

Expenditures for additions, renewals and betterment of property and equipment are capitalized. Expenditures for repairs and maintenance are charged to expense as incurred. As assets are retired or sold, the related cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the results of operations.

Capitalized Software Development Costs

The Company capitalizes software development costs incurred after a product's technological feasibility has been established and before it is available for general release to customers. Amortization of capitalized software costs is computed on an individual product basis and is the greater of a) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product, or b) the straight-line method over the estimated economic life of the product. The Company uses an estimated economic life of 2 years or less for all capitalized software costs. No costs were eligible for capitalization during the year ended June 30, 2000.

Research and Development Costs

Research and development costs are expensed as incurred.

Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the Company's consolidated financial statements. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax basis of assets and liabilities using currently enacted tax rates for the year in which the differences are expected to reverse. The Company records a valuation allowance against net deferred tax assets if, based upon the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

Net Income Per Common Share

The Company previously adopted SFAS No. 128, "Earnings per Share" (Statement 128). Statement 128 specifies the calculation and presentation of basic and diluted net income per share. Basic net income per common share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is calculated by dividing net income by the sum of the weighted average number of common shares plus additional common shares that would have been outstanding if potential dilutive common shares had been issued for granted stock options.

Foreign Currency

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 local currency for all foreign subsidiaries is the functional currency. The related translation adjustments are reported in accumulated other comprehensive income in stockholders' equity. Gains (losses) resulting from foreign currency transactions are included in other income (expense) and are immaterial for all periods presented.

Reclassification

Certain reclassifications have been made to the prior years' financial statements to conform to the current year's presentation.

New Accounting Pronouncements

In June 1999, the Financial Accounting Standards Board issued SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective Date of FASB Statement No. 133." SFAS No. 137 amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" which was issued in June 1998. SFAS No. 137 defers the effective date of SFAS No. 133 to the first quarter of fiscal years beginning after June 15, 2000.

SFAS No. 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in either current earnings or accumulated other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and the type of hedge transaction. As of July 1, 2000, the Company did not hold any derivative instruments.

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 summarizes the staff's view in applying generally accepted accounting principles to selected revenue recognition issues. The application of the guidance in SAB 101 will be required in the Company's fourth quarter of fiscal year 2001. The effects of applying this guidance will be reported as a cumulative effect adjustment resulting from a change in accounting principle. The Company has not completed its evaluation of SAB 101 and therefore is unable to determine its impact.

C. Net Income per Common Share:

The following table sets forth the computation of basic and diluted net income per common share:

For the Years Ended June 30	2000	1999	1998
Net income	\$24,896	\$13,462	\$ 8,731
Shares used in computation of net income per share – basic	21,000	20,336	14,470
effect of dilutive securities:			
Convertible preferred stock	–	–	2,984
Stock options	1,703	1,264	1,084
Warrants	–	–	2
Dilutive potential common shares	1,703	1,264	4,070
Shares used in computation of diluted net income per share	22,703	21,600	18,540
Net income per share – basic	\$ 1.19	\$ 0.66	\$ 0.60
Net income per share – dilutive	\$ 1.10	\$ 0.62	\$ 0.47

Options to purchase 141,000 shares of common stock in 2000, 222,000 shares in 1999, and 58,000 in 1998 were outstanding during the years then ended but were not included in the year-to-date calculation of diluted net income per share because the options' exercise price was greater than the average market price of the common shares during those periods.

D. Inventory:

Inventory consists of the following:

June 30,	2000	1999
Raw materials	\$ 4,252	\$ 3,508
Work in process	7,415	6,841
Finished goods	4,308	2,082
Total	\$15,975	\$12,431

E. Property and Equipment:

Property and equipment consists of the following:

June 30,	2000	1999
Computer equipment and software	\$ 22,406	\$ 17,280
Buildings	15,819	15,819
Land	2,985	1,852
Machinery and equipment	605	404
Furniture and fixtures	3,709	3,365
Building and leasehold improvements	1,585	1,334
	<u>47,109</u>	<u>40,054</u>
Less: accumulated depreciation and amortization	(19,535)	(14,729)
	<u>\$ 27,574</u>	<u>\$ 25,325</u>

During the fiscal year ended June 30, 1999, the Company purchased its existing headquarters building and an adjacent newly constructed facility, including land for \$15,058,000. In addition, during the fiscal year ended June 30, 1999, \$1,289,000 of property and equipment was retired of which \$1,260,000 was fully depreciated.

During the fiscal year ended June 30, 2000 the Company invested \$1.1 million for the purchase of land adjacent to its existing headquarters.

F. Commitments and Contingencies:

Longterm Debt Financing Arrangement

Longterm Debt at June 30, 2000 and 1999 consisted of the following:

	2000	1999
Notes payable	\$14,182	—
Less current maturities	577	—
	<u>\$13,605</u>	<u>—</u>

On November 3, 1999, the Company completed a lending agreement with a commercial financing company, issuing two 7.30% senior secured financing notes (the "Notes"), due November 2014. The original principle value of the Notes amounted to \$14,500,000. The Notes are collateralized by the Company's corporate headquarters which consists of two buildings. The Notes' agreements contain certain covenants, which, among other provisions, require the Company to maintain a minimum tangible net worth. As of June 30, 2000, the Company was in compliance with the covenants of the Notes' agreements.

Maturities of long term debt are as follows:

Year Ending June 30,	
2001	\$ 577
2002	621
2003	667
2004	718
2005	772
Thereafter	<u>10,827</u>
	<u>\$14,182</u>

During the fiscal year ended June 30, 1999, the Company had a credit agreement with a commercial bank to borrow up to \$5,000,000 at an interest rate equal to the prime rate or, at the election of the Company, two and one-quarter percentage points above the London InterBank Offered Rate, payable monthly. The credit agreement contained certain covenants, including restrictions on incurrence of additional indebtedness and liens on its assets, capital expenditures, disposition of assets, investments and acquisitions, limitations on distributions, and required the Company to meet certain financial tests pertaining to current and debt ratios and income before tax provision. During the fiscal year ended June 30, 1999, the Company terminated this financing arrangement. Accordingly, there were no borrowings outstanding at June 30, 2000 or 1999.

Legal

In July 1999, a former employee brought a wrongful termination action against the Company and certain officers of the Company. The plaintiff seeks severance pay, the right to purchase 60,000 shares of the Company's common stock at a price of \$2.00 per share, the right to 60,000 shares of the Company's commonstock at a price of \$2.00 per share, the right to exercise 96,000 stock options at an exercise price of \$2.00 per share and other financial consideration. Discovery has commenced and the action has been referred to binding arbitration. The position of the Company's management after consultation with external counsel, is that it is not possible to estimate the amount of a probable loss, if any, to the Company that might result from this action. Accordingly, no loss accrual has been recorded. If the plaintiff were to prevail on its claims, depending on the price of the Company's common stock, a judgement for material amount could be awarded against the Company. The Company has objected to the claims and is aggressively defending the matter.

Lease Commitments

The Company leases certain of its facilities and machinery and equipment under capital and operating leases expiring in various years through 2003. The leases contain various renewal options. Rental charges are subject to escalation for increases in certain operating costs of the lessor.

Minimum lease payments under operating and capital leases are as follows:

Year Ending June 30,	Operating lease		Capital Lease
	Real Estate	Equipment	Equipment
2001	191	264	679
2002	175	—	325
2003	<u>40</u>	<u>—</u>	<u>100</u>
Total minimum lease payments	<u>\$406</u>	<u>\$264</u>	<u>\$1,104</u>
Less: amounts representing interest			<u>77</u>
Present value of minimum lease payments			1,027
Less: current portion			<u>580</u>
Long-term portion			<u>\$ 447</u>

Rental expense during the fiscal years ended June 30, 2000, 1999 and 1998 was approximately \$524,000, \$1,116,000 and \$1,029,000, respectively.

G. Stockholders' Equity:

The Company is authorized to issue 1,000,000 shares of preferred stock with a par value of \$.01 per share.

Common Stock

On November 18, 1999, the Company's Board of Directors authorized a two-for-one stock split effected in the form of a 100% stock dividend distributed on December 21, 1999 to shareholders of record as of December 6, 1999. As a result of the stock split, the accompanying consolidated financial statements reflect an increase in the number of outstanding shares of common stock and the transfer of the par value of these additional shares from paid-in capital. All share and per share amounts have been restated to reflect the retroactive effect of the stock split, except the capitalization of the Company.

Series A Convertible Preferred Stock

The series A convertible preferred stock had a liquidation preference of \$1.41 per share and voting rights similar to the common stock. Each of the preferred stockholders had one vote for each share of common stock into which the series A convertible preferred stock was convertible. On January 29, 1998, the series A convertible preferred stock was converted into common stock on a three-for-one basis.

H. Stock Based Compensation

At June 30, 2000, the Company had both stock option plans and a stock purchase plan. In fiscal year 1997, the Company adopted SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123 requires that companies either recognize compensation expense for grants of stock, stock options and other equity instruments based on fair value or provide pro forma disclosure of net income and earnings per share in the notes to the financial statements. The Company adopted the disclosure provisions of SFAS No. 123 in fiscal 1997 and has applied APB Opinion No. 25 and related interpretations in accounting for all of its stock option and employee stock purchase plans. Compensation cost is measured as the excess, if any, of the fair market value of the Company's stock at the date of grant over the amount an individual must pay to acquire the stock. Compensation expense recognized for stock based compensation amounted to \$424,000, \$46,000, and \$0 for the fiscal year ended June 30, 2000, 1999, and 1998, respectively.

Stock Option Plans

The Company has five stock option plans. The 1982, 1991, and 1993 Stock Option Plans (the "Plans") provide for the granting of options to purchase an aggregate of not more than 1,950,000 shares of the Company's common stock to employees and directors. Under these plans, options are granted at not less than the fair value of the stock on the date of grant as determined by the Board. The terms of the options are established by the Board on an individual basis. The options generally vest between three and five years and have a maximum term of ten years.

The 1997 Stock Option Plan (the "1997 Plan"), which the Board approved in June 1997, provides for the granting of options to purchase an aggregate of not more than 1,325,000 shares of the Company's common stock. The Plan provides for the grant of non-qualified and incentive stock options to employees. Incentive stock options are granted at a price set by the Board of Directors not to be less than 100% of the fair value at the date of the grant. Non-qualified stock options are granted at not less than 50% of the fair value of the stock on the date of grant as determined by the Board. The options vest over five years and have a maximum term of ten years. In 1999, an amendment to the plan was adopted by the Board of Directors of the Corporation, which provided for an increase in the number of shares reserved for issuance under the Plan from 1,325,000 shares of common Stock to 2,325,000 and a reduction in the vesting period for future options from five to four years. With the implementation of the 1997 Plan, no further stock options were granted under the 1982 and 1991 Stock Option Plans.

The 1998 Stock Option Plan (the "1998 Plan"), which the Board approved in September 1998, provides for the granting of options to purchase an aggregate of not more than 50,000 shares of the Company's common stock. The Plan provides for the grant of non-qualified stock options to non-employee directors. Non-qualified stock options are granted at fair value of the stock at the date of the grant as determined by the Board of Directors. The options vest over three years and have a maximum term of ten years. With the implementation of the 1998 Plan, no further stock options were granted under the 1993 Stock Option Plan.

	Number of Shares	Weighted Average Exercise Price	Weighted Average Fair Value of Options Granted
Outstanding at June 30, 1997	1,689,184	1.71	
Granted	942,262	4.71	\$2.64
Exercised	(408,936)	1.24	
Canceled	<u>(33,386)</u>	3.56	
Outstanding at June 30, 1998	<u>2,189,124</u>	3.06	
Granted	1,271,410	9.65	\$6.04
Exercised	(618,324)	1.97	
Canceled	<u>(76,454)</u>	5.18	
Outstanding at June 30, 1999	<u>2,765,756</u>	6.27	
Granted	928,684	26.42	\$19.03
Exercised	(734,592)	4.09	
Canceled	<u>(258,000)</u>	8.67	
Outstanding at June 30, 2000	<u>2,701,848</u>	13.56	

Information related to the stock options outstanding as of June 30, 2000, is as follows:

Range of Exercise Prices	Number of of Options	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Exercisable Number of Options	Exercisable Weighted Average Exercise Price
\$ 1.25 – \$ 4.00	701,578	6.73	\$ 2.99	253,778	\$2.72
\$ 5.00 – \$ 8.625	462,686	8.21	7.73	60,961	7.64
\$ 8.844 – \$ 9.563	139,400	8.04	9.03	32,030	8.96
\$11.688	473,900	8.63	11.69	57,900	11.69
\$12.00 – \$23.438	604,684	9.28	20.13	4,360	12.66
\$24.25 – \$48.00	<u>319,600</u>	9.65	37.50	<u>—</u>	<u>—</u>
\$ 1.25 – \$48.00	<u>2,701,848</u>	8.30	13.56	<u>409,029</u>	5.32

There were 605,612 and 754,480 options exercisable at June 30, 1999 and 1998, respectively, with weighted average exercise prices of \$2.77 and \$1.79. The fair value of each option granted during fiscal years ended June 30, 2000, 1999 and 1998, is estimated on the date of grant using the Black-Scholes option-pricing model utilizing the following weighted-average assumptions: (1) expected risk-free interest rate of 6.34% in 2000, 4.90% in 1999 and 6.25% in 1998; (2) expected option life of 6 years; (3) expected stock volatility of 77% for June 30, 2000, 63% for June 30, 1999 and 50% for June 30, 1998; and (4) expected dividend yield of 0.0.%.

Employee Stock Purchase Plan

During 1997, the Company adopted the 1997 Employee Stock Purchase Plan ("ESPP") and authorized 250,000 shares for future issuance under which 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 plan permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee's compensation as defined in the plan. During the two offerings in fiscal 2000, the Company issued 22,923 and 15,868 shares of common stock to employees who participated in the plan at prices of \$13.39 and \$27.47, respectively. Shares available for future purchase under the ESPP totaled 404,761 at June 30, 2000.

The weighted-average fair value of purchase rights granted in fiscal 2000 and 1999 was \$8.40 and \$3.23, respectively. The fair value of the employees' purchase rights was estimated using the Black-Scholes model with the following assumptions; dividend yield of 0.0%, an expected life of 6 months, expected volatility of 77% for June 30, 2000, and 63% for June 30, 1999, and risk-free interest rate of 5.25% for June 30, 2000, and 4.90% for June 30, 1999.

Had compensation cost for the Company's stock option grants and stock issued in conjunction with the ESPP been determined based on the fair value at the grant dates, as calculated in accordance with SFAS No. 123, the Company's net income and net income per common share for the fiscal years ended June 30, 2000, 1999 and 1998, would approximate the following pro forma amounts as compared to the amounts reported:

	Net Income	Net Income per Common Share – Basic	Net Income per Common Share – Diluted
As reported:			
2000	\$24,896	\$1.19	\$1.10
1999	\$13,462	\$0.66	\$0.62
1998	\$ 8,731	\$0.60	\$0.47
Pro forma:			
2000	\$20,791	\$0.99	\$0.92
1999	\$11,950	\$0.59	\$0.55
1998	\$ 8,244	\$0.57	\$0.44

The effects of applying SFAS No. 123 in this disclosure are not indicative of future amounts. SFAS No. 123 does not apply to awards prior to 1995 and additional awards in future years are anticipated.

I. Income Taxes:

Income tax expense consisted of the following:

Year Ended June 30,	2000	1999	1998
Federal:			
Current	\$10,081	\$6,377	\$5,680
Deferred	544	(479)	(1,172)
	<u>10,625</u>	<u>5,898</u>	<u>4,508</u>
State:			
Current	755	1,295	925
Deferred	46	(708)	(111)
	<u>801</u>	<u>587</u>	<u>814</u>
Foreign – current	23	146	106
	<u>\$11,449</u>	<u>\$6,631</u>	<u>\$5,428</u>

The following is a reconciliation between the statutory provision for federal income taxes and the effective income tax expense:

Year Ended June 30,	2000	1999	1998
Income taxes at federal statutory rates	35.0%	35.0%	35.0%
State income tax, net of federal tax benefit and credits	1.3	1.9	3.7
Research and development credits utilized	(3.4)	(3.8)	(2.2)
Tax-exempt interest income	(1.6)	(1.8)	–
Other	0.2	1.7	1.8
	<u>31.5%</u>	<u>33.0%</u>	<u>38.3%</u>

The components of the net deferred tax asset are as follows:

June 30,	2000	1999
Receivables, allowances and inventory reserves	\$1,083	\$1,654
Accrued vacation	402	368
Property and equipment	167	301
Capitalized software development costs	–	(125)
State tax credit carryforwards	620	491
Other temporary differences	424	596
Total deferred tax asset, net	<u>\$2,696</u>	<u>\$3,285</u>

No valuation allowance was deemed necessary for the deferred tax asset. Management believes it is more likely than not that all of the deferred tax asset will be realized.

At June 30, 2000, the Company had state research and development tax credit carry forwards of approximately \$954,000 which begin to expire in 2014.

J. Employee Benefit Plans:

The Company maintains a qualified 401(k) Plan and up until December 31, 1999, maintained a qualified profit sharing 401(a) plan. The plan covers employees who have attained the age of 21. Employee contributions to the 401(k) Plan may range from 1% to 15% of compensation with a discretionary matching Company contribution. Effective January 1, 2000, the Company began matching up to 3% of compensation. Previously, the company matched up to 2% of compensation. The Company may also make optional contributions to the plan for any plan year at its discretion. The Company terminated its 401 (a) plan as December 31, 1999.

Expense recognized by the Company under the 401(a) and 401(k) plans was approximately \$788,000, \$1,000,000 and \$710,000 during the years ended June 30, 2000, 1999 and 1998, respectively.

The Company maintains a bonus plan, which provides cash awards to employees based upon operating results and employee performance. Bonus expense to employees was approximately \$4,499,000, \$2,753,000, and \$1,988,000 during the years ended June 30, 2000, 1999 and 1998, respectively.

K. Operating Segment and Geographic Information:

The Company adopted SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information" (Statement No. 131), in fiscal 1999. This Statement supersedes SFAS No. 14 "Financial Reporting for Segments of a Business Enterprise," but retains the requirement to report information about major customers. This statement establishes standards for reporting information about operating segments in annual financial statements and requires selected information about operating segments in interim financial reports issued to stockholders. It also establishes standards for related disclosures about products and services and geographic areas.

Operating segments are defined as components of an enterprise evaluated regularly by the Company's senior management in deciding how to allocate resources and in assessing performance. The Company has eight principal operating segments; North American defense and commercial, international defense and commercial segment, medical imaging, shared storage, wireless communications, digital video, research and development, and other commercial businesses. These operating segments were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment, and the Company's management structure. The Company has six reportable segments; North American defense and commercial segment, international defense and commercial segment, medical imaging segment, shared storage segment, other defense and commercial segment, and research and development segment. The other commercial segment is comprised of wireless communications, digital video and other commercial businesses unrelated to the defense, medical imaging or shared storage businesses. These operating segments are not separately reported, as they do not meet any of Statement No. 131's quantitative thresholds. Effective January 18, 2000 the Company sold its shared storage division, see Note L.

The accounting policies of the business segments are the same as those described in "Note B: Summary of Significant Accounting Policies."

	North American Defense and Commercial Segment(2)	International Defense and Commercial Segment(2)	Medical Imaging Segment	Shared Storage Segment	Other Commercial Segment	Research and Development Segment	Corporate	Consolidated
2000								
Sales to unaffiliated customers	\$96,901	\$14,326	\$27,093	\$ 1,841	\$ 783	\$ -	\$ -	\$140,944
Income (loss) before taxes(1)	66,889	8,016	10,510	(582)	(3,289)	(27,740)	(17,459)	36,345
Depreciation/ amortization expense	427	170	41	59	103	1,218	3,081	5,099
1999								
Sales to unaffiliated customers	\$79,906	\$ 8,894	\$15,295	\$ 2,232	\$ 244	\$ -	\$ -	\$106,571
Income (loss) before taxes(1)	53,174	(1,090)	6,353	(1,775)	3,837	(19,639)	(20,767)	20,093
Depreciation/ amortization expense	191	11	70	102	-	1,263	2,881	4,518
1998								
Sales to unaffiliated customers	\$66,074	\$ 7,096	\$11,232	\$ 885	\$ 257	\$ -	\$ -	\$ 85,544
Income (loss) before taxes(1)	40,399	(635)	4,499	(3,423)	2,177	(12,917)	(15,941)	14,159
Depreciation/ amortization expense	155	15	68	52	-	924	2,105	3,319

(1) Interest income, interest expense and foreign exchange gain/(loss) are reported in Corporate and not allocated to the principal operating segments. Only expenses directly related to an operating segment are charged to the appropriate operating segment. All other expenses for marketing and administrative support activities that cannot be specifically identified with a principal operating segment are allocated to Corporate.

(2) The North American defense and commercial segment and the International defense and commercial segment differ in definition from the defense market segment described in the Company's management discussion and analysis ("MD&A"). The defense market segment in the MD&A refers to the worldwide defense market. The North American defense and commercial segment and the International defense and commercial are operating segments as defined by Statement No. 131 and are subsets of the worldwide defense market discussed in the MD&A.

Foreign revenue is based on the country in which the legal subsidiary is domiciled. Foreign revenue and long-lived assets represent less than 10% of the Company's total long-lived assets for the fiscal years ended June 30, 2000, 1999, and 1998 respectively.

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

Year Ended June 30,	2000	1999	1998
Customer D	12%	12%	10%
Customer E	14%	16%	-
Customer B	19%	22%	20%
Customer A	12%	-	10%

L. Sale of division

On January 18, 2000, the Company completed the sale of the SSBU to IBM. Payments are structured with an initial payment of \$4,500,000 (excluding \$1,000,000 to be held in escrow and payable on a contingent basis), followed by 12 quarterly contingent payments of \$1,500,000 plus interest. The quarterly payments are contingent upon IBM's continued use of the technology. If IBM defaults, Mercury has the right to recover the assets, including the patent and other intellectual property. The contingency payments of \$1,500,000 are recognized when collected. The Company has recorded a \$4,820,000 gain on the sale of this division which includes cash received of \$6,100,000 less legal and advisory costs of \$581,000, costs reimbursable to IBM of \$499,000, and the net book value of equipment and inventories sold of \$200,000.

M. Equity loss in joint venture:

In September, 1999, the Company formed AgileVision as a joint venture with Sarnoff Corporation, the developer of color television and a pioneer in the creation of digital television ("DTV"). AgileVision provides broadcasters and cable providers equipment to optimize their DTV investment and develop new broadband media commerce revenue streams, including master control systems that permit broadcasters to perform multiple functions on a single platform that previously would have required the engineering and integration of numerous discrete products and systems. The Company's contribution to AgileVision was \$3,500,000 in cash. During the year ended June 30, 2000, the Company recognized \$3,721,000 in expenses related to the operation of AgileVision. The Company has funded the losses of Agilevision to date and as of June 30, 2000, intends to continue to fund this venture. No expenses were recognized during the year ended June 30, 1999.

Summarized Income Statement results for AgileVision during the year ended June 30, 2000 are as follows:

Expenses	<u>\$(3,721)</u>
Loss from continuing operations	<u>(3,721)</u>
Net loss	<u>\$(3,721)</u>

Summarized Statement of Financial Position of AgileVision during the year 2000:

Current assets	<u>\$ 1,009</u>
Non-current assets	<u>12</u>
Total assets	<u>\$ 1,021</u>
Current liabilities	\$ 2,744
Shareholders' equity	<u>(1,723)</u>
Total liabilities and equity	<u>\$ 1,021</u>

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and
Stockholders of Mercury Computer Systems, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in stockholders' equity, and of cash flows present fairly, in all material respects, the financial position of Mercury Computer Systems, Inc. and its subsidiaries at June 30, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2000 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.



Boston, Massachusetts
August 17, 2000

SUPPLEMENTARY INFORMATION (UNAUDITED)

The following sets forth certain unaudited consolidated quarterly statements of operations data for each of the Company's last eight quarters. In management's opinion, this quarterly information reflects all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation for the periods presented. Such quarterly results are not necessarily indicative of future results of operations and should be read in conjunction with the audited consolidated financial statements of the Company and the notes thereto included elsewhere herein.

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
2000				
Revenues	\$37,863	\$35,405	\$32,351	\$35,325
Cost of revenues	10,037	9,333	9,388	10,388
Gross profit	27,826	26,072	22,963	24,937
Operating expenses:				
Selling, general and administrative	9,105	10,144	10,060	10,166
Research and development	5,537	6,851	7,445	9,029
Total operating expenses	14,642	16,995	17,505	19,195
Income from operations	13,184	9,077	5,458	5,742
Interest income	322	574	751	783
Interest expense	(18)	(106)	(282)	(325)
Equity loss in joint venture	(515)	(926)	(1,136)	(1,144)
Gain on sale of division, net			3,220	1,600
Other income (expense), net	(16)	93	53	(44)
Income before taxes	12,957	8,712	8,064	6,612
Provision for income taxes	4,665	2,876	1,974	1,934
Net income	\$ 8,292	\$ 5,836	\$ 6,090	\$ 4,678
Net income per common share:				
Basic	\$ 0.40	\$ 0.28	\$ 0.29	\$ 0.22
Diluted	\$ 0.37	\$ 0.26	\$ 0.26	\$ 0.20
1999				
Revenues	\$24,062	\$25,598	\$27,225	\$29,686
Cost of revenues	8,460	8,606	8,229	8,942
Gross profit	15,602	16,992	18,996	20,744
Operating expenses:				
Selling, general and administrative	7,358	8,304	8,668	8,672
Research and development	4,707	4,669	5,373	5,960
Total operating expenses	12,065	12,973	14,041	14,632
Income from operations	3,537	4,019	4,955	6,112
Interest income, net	369	326	313	277
Other income (expense), net	45	261	(24)	(97)
Income before taxes	3,951	4,606	5,244	6,292
Provision for income taxes	1,422	1,572	1,835	1,802
Net income	\$ 2,529	\$ 3,034	\$ 3,409	\$ 4,490
Net income per common share:				
Basic	\$ 0.13	\$ 0.15	\$ 0.17	\$ 0.22
Diluted	\$ 0.12	\$ 0.14	\$ 0.16	\$ 0.21

DIRECTORS AND MANAGEMENT

Board of Directors

GORDON B. BATY
Partner of Zero Stage Capital
Director of several technology companies

ALBERT P. BELLE ISLE
Independent investor in
technology-based companies

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President and Chief Executive Officer,
MDT Advisers, Inc.
Director of several private and public companies

SHERMAN N. MULLIN
Retired President,
Lockheed Advanced Development Company

MELVIN SALLEN
Consultant, Komon International
Director of several technology companies

Clerk and General Counsel

ANTHONY J. MEDAGLIA, JR.
Hutchins, Wheeler & Dittmar,
A Professional Corporation
101 Federal Street
Boston, MA 02110

President and Chief Executive Officer

JAMES R. BERTELLI

Senior Vice Presidents

G. MEAD WYMAN
Chief Financial Officer and Treasurer

STEVEN M. CHASEN
Operations

Vice Presidents

DAVID L. BERTELLI
Organization Development

EDMUND L. BURKE
Advanced Development

DOUGLAS F. FLOOD
Corporate Development

ROBERT C. FRISCH
Chief Engineer

BARRY S. ISENSTEIN
General Manager Wireless Communications Group

MARK R. LAFOREST
Product Development

VINCENT A. MANCUSO
General Manager Government Electronics Group

STEPHEN C. PATTERSON
Product Planning

ROBERT W. PERRY
Manufacturing

ALFRED L. SIMENSEN
International Operations

DIDIER M.C. THIBAUD
General Manager Medical Business Group

Senior Management

RICHARD A. JAENICKE
Product Marketing

CRAIG LUND
Chief Technology Officer

GERALD P. NADEAU
Chief Information Officer

GARY E. OLIN
Corporate Communications/Investor Relations

YOGESH B. PARIKH
Chief Quality Officer

CORPORATE INFORMATION

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Chelmsford, MA	Vienna, VA

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Germany	Norway
Israel	Sweden
Italy	Taiwan/Republic of China
Korea	Turkey

Auditors

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Boston, MA 02109

Stockholder Information

The Company's Form 10-K as filed with the Securities and Exchange Commission, and other published information is available, free of charge on request by writing or phoning:

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Equiserve, Limited Partnership
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Boston, MA 02266-8040
tel. 781-575-3120
<http://www.EquiServe.com>

Annual Meeting

The annual meeting of stockholders will be held at 10:00 a.m. on Thursday, November 16 at:
Museum of Science
Science Park, O'Brien Highway
Boston, MA.

Common Stock

Mercury Computer Systems' common stock is traded on NASDAQ National Market System under the symbol MRCY.

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