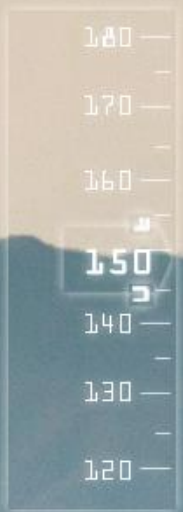




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Target Lock



A0F1  
VOR1

Kratos Defense & Security Solutions, Inc.  
| NASDAQ: KTOS |

INVESTMENT RESEARCH REPORT

*"Target Locked: Ready To Fire Management"*

RECOMMENDATION: *Strong Sell*

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Spruce Point believes it is time for significant change at Kratos (Nasdaq: KTOS). Based on our research suggesting abysmal financial and compliance failures leading to a recent criminal conviction of a senior Kratos Director, we are calling for the resignation of its CEO Eric Demarco and CFO Deanna Lund.



## Spruce Point Capital Is An Industry Recognized Research Activist Investment Firm Founded In 2009

- Founded by Ben Axler, a former investment banker with 17 years experience on Wall Street
- Ranked the #1 Short-Seller in the world by [Sumzero](#) after a comprehensive study of 12,000 analyst recommendations dating back to 2008 (March 2015)
- Ranked the #13 Most Influential FinTweeter on Twitter according to [Sentieo analysis](#) (Dec 2016)

## CEO Departures Post Recent Spruce Point Research Activism

Report Date	Company / Ticker	Enterprise Value At Report Date (\$ billions)	CEO Departure / Date
<a href="#">7/13/17</a>	Gentex / GNTX	\$4.7	Fred Bauer / <a href="#">Jan 2018</a>
<a href="#">4/13/16</a>	Sabre Corp / SABR	\$11.2	Tom Klein / <a href="#">June 2016</a>
<a href="#">12/17/15</a>	Intertain / IT.TO	\$1.5	John FitzGerald / <a href="#">Feb 2016</a>
<a href="#">8/19/15</a>	Caesarstone / CSTE	\$1.7	Yos Shiran / <a href="#">May 2016</a>
<a href="#">2/10/15</a>	Greif / GEF	\$3.2	David Fischer / <a href="#">Oct 2015</a>
<a href="#">11/13/14</a>	AMETEK / AME	\$14.0	Frank Hermance / <a href="#">May 2016</a>
<a href="#">1/15/14</a>	LKQ Corp / LKQ	\$11.8	Robert Wagman / <a href="#">March 2017</a>
<a href="#">3/5/13</a>	Boulder Brands / BDBD	\$1.0	Stephen Hughes / <a href="#">June 2015</a>
<a href="#">6/14/12</a>	Bazaarvoice / BV	\$1.2	Bret Hurt / <a href="#">Nov 2012</a>

# *Kratos Is Just Another Overhyped Robotics / Drone Company. Spruce Point Has Excelled Shorting These Types of Companies*

		
<b>Report Date(s)</b>	<a href="#">June 27</a> / <a href="#">Aug 18</a> / <a href="#">Sept 13</a>	<a href="#">Nov 8, 2017</a>
<b>Criticism</b>	Stagnant robotic and technology company with limited product innovation. Will come under severe product/price competition from new entrants. IRBT's distributor acquisitions are defensive and continue to reflect its poor capital allocation. The share price surge in early 2017 would not be sustainable. iRobot is heavily promoted to retail investors who would suffer 20%-60% long-term downside risk	Stagnant UAV / drone company with limited product innovation, poor capital allocation, terrible governance and insider alignment with shareholders. AVAV's extreme share price appreciation in 2017 would lead to disappointment along with its move into the consumer drone space. Heavily promoted by analysts and investor blogs as a "play" on drones, despite not being a leader in its industry. We estimate 30%-50% long-term downside risk
<b>Successful Outcome</b>	New competition (SharkNinja and others) stormed the market with lower price vacuum robotics, thereby pressuring iRobot's margins. Its <a href="#">share price crashed 20%</a> in Feb 2018 as its outlook missed lofty analyst expectations	AVAV's <a href="#">share price plunged nearly 18%</a> as its Q3 earnings result all but assured it would miss full year targets. Its backlog shrunk QoQ and the CEO dodged answering specific questions about the progress of its new consumer drone business



## *Executive Summary*

# *Spruce Point Believes Kratos (Nasdaq: KTOS) Is A “Strong Sell” With 40% - 70% Downside Risk*

After a reckless and failed acquisition spree from 2008-2012, Kratos teetered on credit default before divesting a key division to deleverage, and pivoting focus to hype its unmanned systems (aka drones) business. With its share price rising, and a wave of equity offerings, Kratos has made a remarkable come back. However, after a close forensic analysis, we question the legitimacy of Kratos' success and its ability to hit its aspirational goals of \$800m of revenues at 10% EBITDA margins. Given the propensity of Kratos to over-promise and under-deliver, we do not believe it warrants its premium valuation. We see 40%-70% downside risk

**Terrible Business Through Multiple Reinventions Now Hying Drones:** Originally a dotcom darling named Wireless Facilities that IPO'ed in 1999 with hopes of being the leading provider of outsourced services for wireless networks, the Company collapsed and later took a large accounting restatement when material weaknesses were revealed. Under new management, a name change to Kratos in 2007, and a divestment of businesses, the Company started focusing its efforts on products and solutions related to Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance (“C5ISR”). After failing to execute on these opportunities, Kratos is now promoting its billion dollar opportunities in unmanned systems (drones) in the hopes of finally turning the corner to sustain profits and free cash flow, both of which have been forever illusive for shareholders

**Significant Value Destruction Through Wasted Mergers and Acquisitions:** From 2008–2012, Kratos acquired ten businesses for nearly \$1bn. These deals contributed an estimated \$801m and \$129m of sales and EBITDA (16.1% margin). Yet, recent results suggest \$239m and \$69m of sales and EBITDA losses, net of divestitures, and margins are a pathetic 7.2%. Kratos looks like an abysmal failure run by management adept at value destruction. Share dilution is +24% p.a. since the current management team took control, while cumulative free cash flow is -\$25m. Leverage skyrocketed to >10x EBITDA, forcing it to initiate a strategic review process in 2015, which resulted in the divestment of its Electronics Products Division, allowing it to avert default. Kratos is now selling its Public Safety business at a depressed valuation of 0.5x and 6.5x 2018E sales and EBITDA (despite claiming it will generate free cash flow this year) and impaired more goodwill. Brace for additional disappointment.

**Warning About Management History Associated With Past Scandal:** Kratos is led by Eric DeMarco (CEO) and Deanna Lund (CFO) since 2003-2004. These executives joined from Titan Corp, where DeMarco was COO and Lund was Titan's Controller. Titan was a tainted defense contractor that in 2005 paid the largest fine in history (at the time) to settle criminal and civil charges that it violated the Foreign Corrupt Practices Act. Lockheed Martin aborted a takeover of Titan Corp after conducting its due diligence on this matter. According to shareholder lawsuit documents, Titan engaged in a scheme to inflate revenues and book fictitious receivables. Titan used “middlemen” and “private consulting companies” with ties to foreign government officials to secure business. The litigation says confidential witnesses claim DeMarco knew about the corruption and DeMarco was responsible for transferring funds to Benin, the African country involved. DeMarco was also allegedly the source of the “percentage of completion accounting techniques learned from the ‘Andersen school of accounting’ that allowed Titan to either overstate or prematurely state revenues at the company.” We note that Kratos CFO Deanna Lund omits from her current biography that she worked at Arthur Andersen, the defunct auditor that collapsed after the Enron scandal. Management has placed another former financial partner from its Titan Corp days on the Audit Committee as an “independent” member, so we worry that adequate oversight is absent. Management owns virtually no stock and appears more focused on milking its cash compensation by reaping a large % of EBITDA

## *Spruce Point Believes Kratos (Nasdaq: KTOS) Is A “Strong Sell” For The Following Reasons:*

**Kratos Doesn't Behave Ethically And Has A History of Association With Bad Activities:** Engaging middlemen and private consulting companies to gain illicit business appears to be a notable tactic that has followed CEO DeMarco from Titan Corp to Kratos. Coincidence or not? Spruce Point uncovered an undisclosed corruption case late last year of a senior Kratos Director pleading guilty to conspiring with others (including an Army Colonel), and using a shell company OzTEK Research LLC to fraudulently obtain \$20m worth of contracts over a decade from the US Army in Georgia. Ethical problems and government sanctions appear more the norm, rather than one-off lapses of judgement at Kratos; we have identified a disturbing pattern of problems associated with Kratos' businesses over the years which investors need to strongly evaluate

**The Bull Case On Kratos' Drone Business Appears More Promotion Than Reality:** With a newly adopted compensation clawback for financial misstatement in place by November 2015, Kratos ramped its promotion of its drone opportunity, while along the way conducting three dilutive equity raises. We believe its drone segment is an amalgamation of two legacy acquired businesses that are subscale and represent a meager 1% of unmanned system market share and DoD government spending. Many of its hyped programs are experimental and high risk in nature, with no guarantee of commercial success, and not currently making money. Kratos has already stopped commenting on certain programs, including Gremlins and UTAP-22. Its most hyped program (LCASD) requires Kratos to front 82% of the capital. Kratos would like investors to believe the deal allows it to protect its IP, but in our view, it shows the Air Force's desire to push the risk (and cost) to Kratos, while providing it a cheap abandonment option. We estimate Kratos has spent a meager \$63m on capex and R&D for its drone ambitions since 2013. The only two pure play drone companies, AeroVironment and Parrot SA, have spent \$255m and \$365m, respectively, during the same period. Although each company operates in a different market segment for drones, Kratos touts its drones to be *“high performance jet aircraft made of special composite materials”*; this heightens our concerns that Kratos is materially underspending to become a credible unmanned systems player

**Beware History of Failure To Meet Expectations, Cash Flow Struggles More Evident:** Bulls are buying into Kratos story that it can reach \$800m of revenues (pre PSS divestiture) at 10% EBITDA margin, while generating positive free cash flow. Our analysis of its ability to hit its financial targets (especially free cash flow) suggests investors should brace for disappointment. In addition to recent executive turnover in key positions (chief accountant, drone president, and CIO), Kratos quietly started disclosing a large loss accrual on contracts, rising 500% between 2015 and 2016. Its business mix has deteriorated (declining backlog and highest % of fixed-price, high risk contracts in its history). Its historical backlog definition is very aggressive, so take it with a grain of salt. However, most alarming in Q3'17 Kratos materially increased its cash burn estimate, cut drone capex in Q4'17, has DSOs rising to multi-year highs, and unexpectedly sold its PSS segment at a depressed value to raise cash

**Analysts See +29% Upside, A Terrible Risk/Reward Considering We See 40%-70% Downside:** Kratos has among the highest valuation in the aerospace and defense sector (20x and 70x 2018E EBITDA and P/E), despite having weak margins, poor management that cannot prevent activities that run afoul of laws, suspect accounting that doesn't depreciate corporate segment assets, and a history of failure. Its valuation is at a multiyear high, based on the hope that this time is different. Analysts are bullish, and some arbitrarily pencil in a few dollars per share for *“future potential drone opportunities.”* Many long-term fundamental Kratos holders have ditched the stock, leaving rules-based indices to buy. Valuing Kratos at a discount to peers on EBITDA, free cash flow, and book value we estimate 40%-70% downside (\$3.15-\$6.30/sh)

## Kratos CEO DeMarco

Litigation brought against CEO DeMarco while an executive at Titan Corp suggested that confidential witnesses knew he played an active role in fraud and was the source of “the Andersen school of accounting” – a reference to the disgraced auditing firm, Arthur Andersen, where Kratos’ current CFO Lund worked (though she omits it from her biography). The shareholder litigation case was settled for \$61.5m and Titan paid \$28.5m in FCPA fines.

27            221. That DeMarco had actual knowledge of the fraud is also demonstrated by a number of  
28 confidential witnesses. DeMarco would have had to have been aware of the problematic activities

- 73 -

04-CV-0676-LAB(NLS)

Case 3:04-cv-00676-LAB-NLS Document 17 Filed 09/17/2004 Page 79 of 87

1 going on in Benin because of DeMarco’s need to routinely transfer funds to pay for the \$7.5-\$8  
2 million in unaccountable Benin expenditures. Head kept writing checks to Amadou and DeMarco  
3 kept wiring more and more money. Indeed, DeMarco structured all of Titan’s business ventures,  
4 received the Benin P&L, traveled to Africa frequently, and was the source of the percentage of  
5 completion accounting techniques learned from “the Andersen school of accounting” that allowed  
6 Titan to either overstate or prematurely state revenues at the Company.

[Source:](#) Titan Inc Securities Litigation and [Settlement](#) for \$61.5m

[Source:](#) Titan Pays \$28.5m to settle Foreign Bribery



# Kratos: A Collection of Tainted Assets

“You Get What You Pay For” - A sum of the parts analysis for Kratos doesn't look pretty

Undocumented Accounting Concerns

“Corporate Activities” Assets The Fastest Growing Category Not Being Depreciated –We Estimate GAAP Earnings Overstated By ~\$2m, Material For A Cash Burning Business

**Kratos Defense & Security Solutions (KTOS)**

Charges of Fraud and Regulatory Issues

Including a recent indictment of a Senior Kratos Director for a \$20m scheme (undisclosed June '17)

**Kratos Three Largest Acquisitions All Tainted**

Herley Industries

- Chairman indicted on allegations of misrepresenting costs, and creating fake bids to the gov't
- Auditor revokes opinion
- Herley pays \$9.5m in fines + pleads guilty
- Herley fails to sell itself at auction
- Kratos acquires Herley for \$270m in 2011

Integral Systems

- CEO convicted of sex offense
- Failed strategic sale in 2006
- Defense Audit Agency found accounting weaknesses
- SEC sanctions company for employing Gary Prince, a formerly convicted executive
- Kratos acquires in 2011 for \$241m

Composite Engineering

- A core component of Kratos' drone ambitions, based near Sacramento, CA
- Jan 2015: Settles with US Dept. of Justice on allegations of inflating costs
- Spent nothing on R&D at time of its acquisition
- Growth plummeted post-acquisition
- One of the founders has left
- Kratos acquires in 2012 for \$164m

As part of the Herley acquisition, acquired Micro Systems, based in Ft. Walton Beach, FL. In 2009, a competitor brought legal action claiming that through former employees it obtained trade secrets to unfairly compete

These are the two core businesses central to Kratos' highly promoted Drone aspirations, which generates negative operating profit

# KTOS's Capital Structure and Valuation

Kratos is trading at peak valuation on the inflated belief that “this time is different” and that its aspirations in the heavily promoted unmanned systems (aka: Drones) will drive nearly \$800m of revenues and near record 10% EBITDA margins. (1) We believe investors should brace for disappointment, a cold hard fact of management’s repeated ability to over-promise and under-deliver.

\$ in mm, except per share figures

		<b>Street Valuation (CY)</b>	<b>2017E</b>	<b>2018E</b>	<b>2019E</b>
Stock Price	\$10.50	EV / Sales	2.0x	1.8x	1.7x
Diluted Shares Outstanding	103.5	EV / EBITDA	25.0x	19.8x	18.3x
<b>Market Capitalization</b>	<b>\$1,086.8</b>	EV / FCF	NM	76.7x	NA
Credit Facility due 2019	\$0.0	Price / Adj EPS	87.5x	70.0x	32.2x
6.5% Notes due 2025	\$300.0	Price / Book	2.1x	--	--
Israeli Term Loan	\$1.0	<b>Growth and Margins</b>	<b>2017E</b>	<b>2018E</b>	<b>2019E</b>
<b>Total Debt Outstanding</b>	<b>\$301.0</b>	Sales Growth	9.8%	8.6%	11.0%
Less: Cash and Equivalents	\$199.6	EBITDA Margin	8.0%	9.3%	9.1%
<b>Enterprise Value</b>	<b>\$1,188.2</b>	EPS Growth	271.4%	25.0%	117.3%
		<b>Spruce Pt. Adjusted</b>	<b>2017E</b>	<b>2018E</b>	<b>2019E</b>
		Price / Adj EPS (2)	110.6x	80.7x	34.3x

Source: Company filings. Pro forma for \$300m bond issue

Figures adjusted for sale of PSS segment and reflect incremental cash proceeds of \$70m

1) Pre-sale of PSS segment

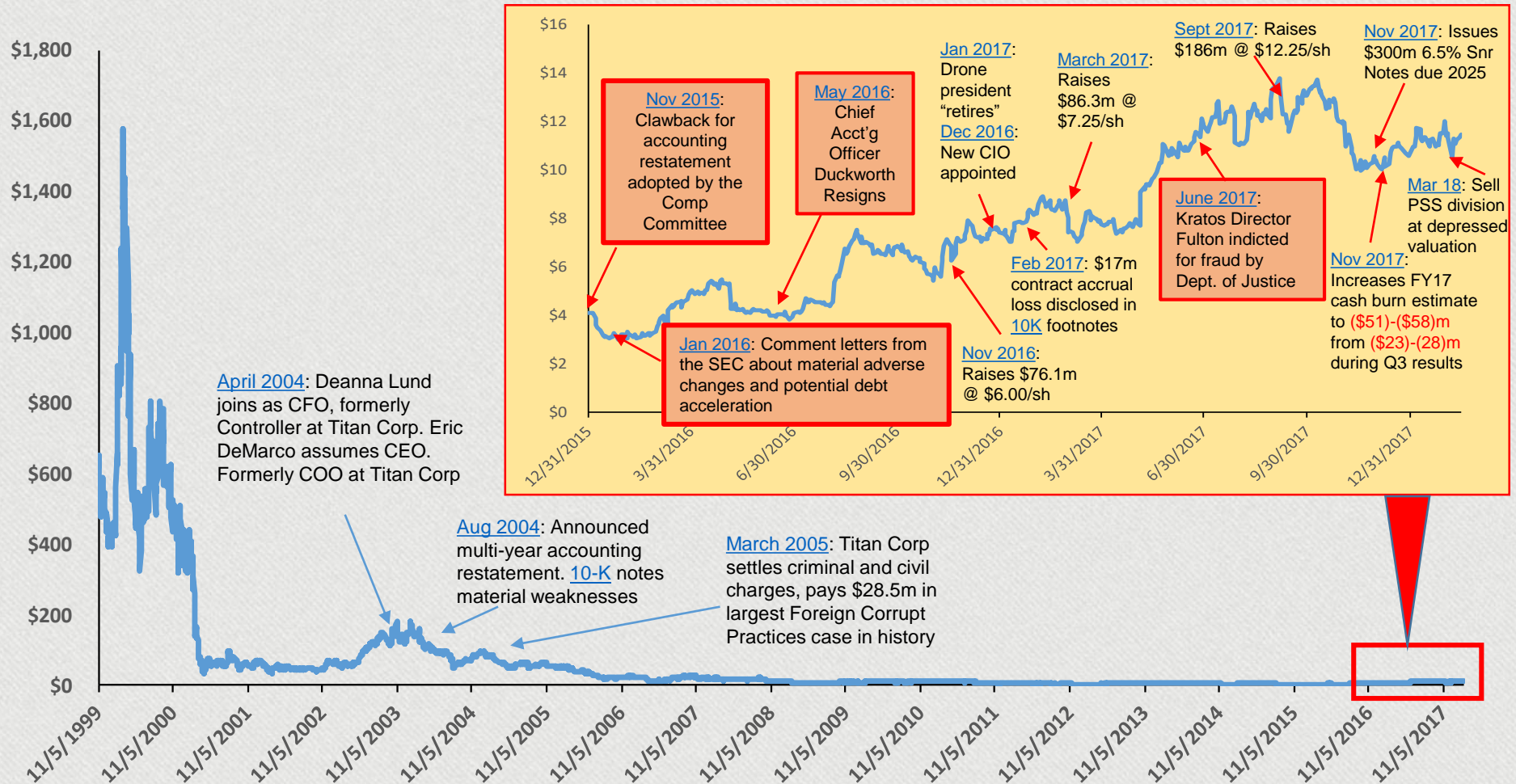
2) Kratos does not depreciate its \$127m of “corporate activities” segment asset. We model 2.5% annual depreciation expense



## *Evidence of Financial Struggles*

# Kratos: A Long-Term Loser

Long-term Kratos investors have been burned, but a repositioning of the Company as a play on unmanned aerial systems (aka Drones) has sparked a nearly 4x increase in its share price from 2015 – near all time lows. Investors should be very concerned that a clawback for financial misstatement was adopted right before its stock price increased, allowing the Company to raise nearly \$350m of equity. During this period, its Chief Accounting Officer resigned, a Director was indicted in a \$20m fraud by the Dept. of Justice and the Company made its first disclosure of a large contract loss accrual.



# Kratos: A Business Model In Constant Transition

## Kratos Prior to 2007: Dotcom Hype As Wireless Facilities (WFI)

Prior to 2007 we were an independent provider of outsourced engineering and network deployment services, security systems engineering and integration services and other technical services for the wireless communications industry, the U.S. government and enterprise customers. In 2006 and 2007, we undertook a transformation strategy whereby we divested our commercial wireless-related businesses and chose to pursue business with the federal government, primarily the U.S. Department of Defense, through strategic acquisitions. **On September 12, 2007, we changed our name from Wireless Facilities, Inc. (WFI) to Kratos Defense & Security Solutions, Inc. (Kratos).** Our new name reflects our revised focus as a defense contractor and security systems integrator for the federal government, for state and local agencies, and certain commercial customers.

## Kratos 2007 to 2015: \$1 billion of Acquisitions To Become a C5ISR Play

We are a specialized technology focused security business providing mission critical products, solutions and services for domestic and international customers, with our principal customers being agencies of the U.S. Government. Our core capabilities are sophisticated engineering, manufacturing, technology development, system integration, and test and evaluation offerings for national security platforms and programs. **Our principal products and solutions are related to Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance (“C5ISR”).** We offer our customers products, solutions, services and expertise to support their mission critical needs by leveraging our skills across our core offering areas in C5ISR.

## Kratos Today: Unmanned Systems (aka. Drone) Hype

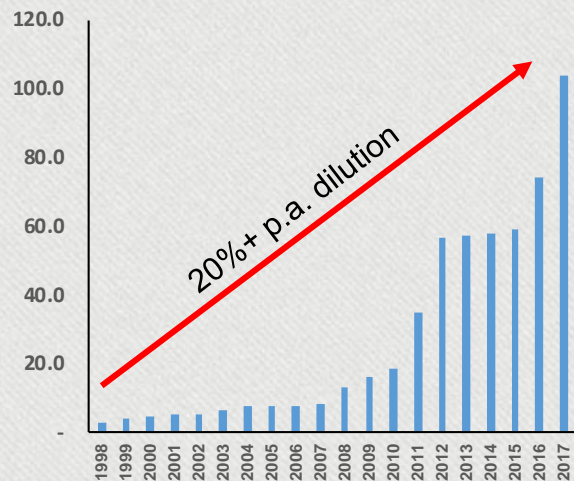
Kratos is a government contractor at the forefront of the DoD's Third Offset Strategy and Rapid Innovation Initiatives. Kratos is a leading technology, intellectual property, proprietary product and system company focused on the U.S. and its allies' national security. Kratos is a recognized industry leader in the rapid development, demonstration and fielding of high technology systems and products at an affordable cost. **Kratos' primary focus areas are unmanned systems,** satellite communications, microwave electronics, cyber security/warfare, training systems, missile defense and combat systems. We believe that our technology, intellectual property, proprietary products and designed-in positions on our customers' programs, platforms and systems, providing us with sole and single source positions with our offerings is a competitive advantage and high barrier to entry into our markets. Our work force is primarily technically oriented and highly skilled with a significant number of employees holding national security clearances. Our entire organization is focused on executing our strategy of becoming the leading technology and intellectual property based company in our industry

# Evidence of a Challenged Business Model

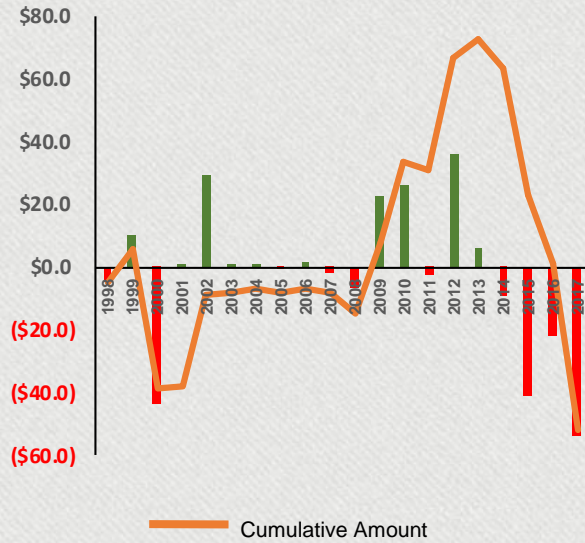
This historical context for those new to the “evolving” Kratos story is abysmal.

The Company has diluted shareholders at a rate of 20%+ p.a. and has generated negative cumulative free cash flow throughout its public history. This has resulted in just \$0.53 cents of “Adjusted” EBITDA per share to existing holders.

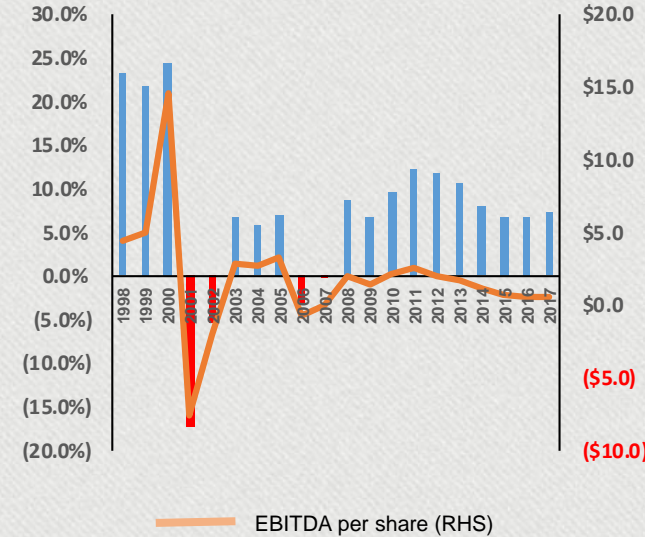
## Share Dilution



## Negative Cumulative Free Cash Flow



## Adj EBITDA Margin and Per Share



Source: KTOS financials, adjusted for 10:1 [reverse split](#) in June 2009

# Kratos Appeared To Be Teetering on Financial Destruction Prior To Its Recent “Success”

Before Kratos’ magic stock rally began in 2016, and it divested its Electronics Products Division to Ultra Electronics in June 2015, the Board hired an investment bank to assist in a formal review of Kratos’ strategic alternatives. (1) The Company’s financial condition was deteriorating significantly with Net Debt / EBITDA > 10x and EBITDA interest coverage hovering around 1x. Kratos’ financial condition even caught the attention of the SEC, which started issuing comment letters about its line of credit and conditions of default in the event of a material adverse change. (2)

\$ in mm	2010	2011	2012	2013	2014	June 2015
Cash and Equiv.	\$10.8	\$67.9	\$48.4	\$54.2	\$33.5	\$22.2
Short-Term Debt	\$0.6	\$1.6	\$1.5	\$1.3	\$1.1	--
Long-Term Debt	\$226.1	\$607.7	\$610.8	\$613.9	\$655.4	\$663.0
Equity	\$169.9	\$312.6	\$324.1	\$295.8	\$224.3	\$198.7
Interest Expense, Net	\$22.3	\$51.1	\$66.1	\$63.7	\$54.3	\$50.3
Reported EBITDA	\$39.7	\$93.0	\$115.4	\$100.3	\$60.7	\$36.9
<b>Credit Metrics</b>						
Total Debt / Debt and Equity	57%	66%	65%	68%	75%	77%
Net Debt / EBITDA	5.4x	5.8x	4.9x	5.6x	10.3x	12.1x
EBITDA / Interest Expense, Net	1.8x	1.8x	1.7x	1.6x	1.1x	1.1x
Credit Rating	B+/B3	B+/B3	B/B3	B/B3	B-/Caa1	B-/Caa2

Source: Kratos Financial results

1) 2014 [10-K](#), p.23

2) [SEC Comment Letter](#) re: FY 2014 10-K filed March 13, 2015

# Kratos Management Has Destroyed Tremendous Value

It's easy to see how Kratos has destroyed significant value. Since 2008, Kratos spent nearly \$1bn on acquisitions that have contributed an estimated \$801m and \$129m of revenues and EBITDA, respectively. Yet, recent results suggest over \$237m and \$69m of sales and EBITDA losses, net of divestitures. (1) It is time for management to resign from its failed business strategy

## Kratos Key Acquisitions and Divestitures

\$ in millions

Date	Target	Business Segment	Deal Value	Est. Sales	Est. EBITDA	Margin	EV/ Sales	EV/EBITDA
<a href="#">12/24/2008</a>	Digital Fusion	Gov't Solutions	\$37.0	\$40.0	\$4.0	10.0%	0.9x	9.3x
<a href="#">5/19/2010</a>	Gichner Holdings	Gov't Solutions	\$133.0	\$147.1	\$17.7	12.1%	0.9x	7.5x
<a href="#">8/9/2010</a>	DEI Services	Gov't Solutions	\$14.0	\$17.5	\$1.5	8.6%	0.8x	9.3x
<a href="#">12/7/2010</a>	Southside Container	Gov't Solutions	\$13.7	\$9.0	\$2.5	27.8%	1.5x	5.5x
<a href="#">12/15/2010</a>	Henry Bros Electric	Public Safety	\$56.6	\$65.0	\$8.1	12.4%	0.9x	7.0x
<a href="#">11/15/2011</a>	SecureInfo (2)	Gov't Solutions	\$20.3	\$20.3	\$2.5	12.3%	1.0x	8.1x
<a href="#">7/27/2011</a>	Integral Systems	Gov't Solutions	\$241.1	\$175.0	\$35.0	20.0%	1.4x	6.9x
<a href="#">3/25/2011</a>	Herley Industries	Gov't Solutions	\$270.7	\$193.3	\$37.1	19.2%	1.4x	7.3x
<a href="#">12/30/2011</a>	Critical Infrastructure	Public Safety	\$18.8	\$40.0	\$4.5	11.3%	0.5x	4.2x
<a href="#">7/2/2012</a>	Composite Engineering	Gov't Solutions	\$164.2	\$94.0	\$16.0	17.0%	1.7x	10.3x
<b>Total Kratos Acquisitions:</b>			<b>\$969.4</b>	<b>\$801.2</b>	<b>\$128.9</b>	<b>16.1%</b>	<b>1.2x</b>	<b>7.5x</b>
<b>Divestiture: (1)</b> <a href="#">6/1/15</a>	US/UK Electronics to Ultra Electronics	Gov't Solutions	\$265.0	\$109.0	\$22.0	20.1%	2.3x	10.7x

## Kratos Estimated Financial Performance Bridge Shows Massive Financial Destruction

Financials	2008A (A)	+ Acquisitions (B)	Less: Divestures (C)	=Pro Forma (D)	FY 2017 (E)	Deterioration (D-E)
Sales	\$297.3	\$801.2	(\$109.0)	\$989.5	\$751.9	(\$237.6)
EBITDA	\$16.8	\$128.9	(\$22.0)	\$123.7	\$54.4	(\$69.3)

(1) Divested revenues of \$109m and \$22m of EBITDA sourced from [10-K](#) F-28 and Ultra [press release](#), respectively. Excludes recent PSS sale.

(2) Revenue estimated based on 1x sales multiple



A quick investigative look into Integral Systems and Herley Industries – Kratos' two largest acquisitions – reveals significant question marks about the financial, accounting, and managerial integrity of the assets acquired.

## Integral Systems

- Oct 2006: Provides update that a strategic alternatives process has not resulted in a sale ([Source](#))
- From 2006 to 2009, Integral churns through five CEOs:
  - Steven Chamberlain ([sentenced for sex offense](#))
  - Peter Gaffney ([Source](#))
  - Alan Baldwin ([Source](#))
  - John Higginbotham ([Source](#))
  - Paul Casner ([Source](#))
- July 2009: SEC issues cease and desist order to Integral arising out of its failure to disclose that Gary A. Prince, an Integral Executive, had previously been convicted of conspiracy to commit securities fraud ([Source](#))
- Jan 2010: Discloses that as of January 27, 2010, the Defense Contract Audit Agency found its accounting system to be inadequate and identified certain significant deficiencies in its accounting systems, controls, policies and procedures ([Source](#))
- July 2011: Kratos acquires Integral for \$241m ([Source](#))

## Herley Industries

- June 2006: Herley and its Chairman Lee Blatt were indicted for fraud ([Source](#))
  - Alleged overcharging the U.S. military by misrepresenting manufacturing costs, creating fake bids to justify price
  - Profited up to 300% on \$3.9M of sales of electronic components
- August 2006: Auditor issues letter saying it could no longer rely on representations of management, and withdrew its audit opinion ([Source](#))
- May 2008: Herley paid \$9.5m in fines and plead guilty ([Source](#))
- April 2009: Herley fails to sell itself at auction ([Source](#))
- March 2011: Kratos acquires Herley for \$270m ([Source](#))

# Negative Operating Leverage

Kratos has been touting for years that its investment in corporate infrastructure will provide leverage to expand margins. In fact, the exact opposite has happened. EBITDA margins have contracted 470 bps with cash SG&A margin up 320 bps. **Recall** that Kratos acquired 10 companies with an average EBITDA margin of 16.1% - what happened?

**From Kratos in 2013:** *“Capitalize on Corporate Infrastructure Investments. In recent periods, we have made significant investments in our senior management and corporate infrastructure in anticipation of future revenue growth. These investments included hiring senior executives with significant experience in the national security industry, strengthening our internal controls over financial reporting and accounting staff in support of public company reporting requirements, and expanding our backlog and bid and proposal pipeline. We will be allocating additional resources in our pursuit of new and larger contract opportunities, leveraging our increased scale and robust past performance qualifications. We believe our management experience and corporate infrastructure are more typical of a company with a much larger revenue base than ours. **We therefore anticipate that, to the extent our revenue grows, we will be able to leverage this infrastructure base and increase our operating margins.**”* Source: 2013 [10-K](#), p. 9

\$ in mm	2013	2014	2015	2016	2017
Total Revenues	\$844.1	\$763.0	\$657.1	\$668.7	\$751.9
% growth	-0.6%	-9.6%	-13.9%	1.8%	12.4%
Reported EBITDA	\$100.3	\$60.7	\$44.6	\$45.0	\$54.4
% margin	11.9%	8.0%	6.8%	6.7%	7.2%
Selling, General, Administrative Exp. (SG&A)	\$172.8	\$153.6	\$150.7	\$146.3	\$160.6
% margin	20.5%	20.1%	22.9%	21.9%	21.4%
Less: Non-Cash Stock Comp Expense	(\$7.2)	(\$3.6)	(\$6.1)	(\$5.1)	(\$7.8)
Less: Amortization in SG&A	(\$32.8)	(\$19.1)	(\$13.0)	(\$10.5)	(\$10.4)
Pro Forma Cash SG&A Exp.	\$132.8	\$130.9	\$131.6	\$130.7	\$142.4
% margin	15.7%	17.2%	20.0%	19.5%	18.9%
Total Employees	3,800	3,600	2,900	2,900	2,900
Cash SG&A per Employee	\$34,947	\$36,361	\$45,379	\$45,069	\$49,103

470 bps EBITDA margin contraction. On the surface, SG&A margin is only +90 bps from 2013-2017 using Kratos reported figures

On a pro forma cash adjusted basis, SG&A margin is +320 bps

Cash SG&A per employee +8.8% p.a.

# Backlog and Revenue Mix Deterioration; New Disclosure On Loss Accruals

The quality of Kratos business has declined in recent years. We observe it just reported its highest quarter of fixed-price contract revenue. These contracts carry the highest risk of reduced profit and financial loss. Meanwhile, backlog continues to decline while the book to bill ratio hit a low of 0.8x in 2017.

**Warning: Kratos just started disclosing accruals for contract losses deep in its financial footnotes, and it rose 500% YoY:** “On a portion of the fixed price-completion contracts, revenue is recognized in accordance with Topic 605 using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. Estimates of costs to complete include material, direct labor, overhead, and allowable indirect expenses for government contracts. These cost estimates are reviewed and, if necessary, revised on a contract-by-contract basis. If, as a result of this review, management determines that a loss on a contract is probable, then the full amount of estimated loss is charged to operations in the period. **As of December 25, 2016 and December 27, 2015, accrued expenses included the accrual for losses on contracts of \$17.7 million and \$3.5 million, respectively.**” [10-K](#), F-8

\$ in mm		2012	2013	2014	2015	2016	Q1 2017	Q2 2017	Q3 2017	2017
<b>Contract Type</b>	Fixed Price Contracts	65%	80%	83%	80%	83%	86%	85%	88%	<b>88%</b>
	Cost Plus Fee	24%	14%	12%	14%	12%	9%	11%	6%	8%
	Time and Materials	11%	6%	5%	6%	5%	5%	4%	6%	4%
<b>Backlog</b>	Funded	\$674.0	\$541.0	\$662.0	\$528.7	\$626.1	\$616.2	\$543.8	\$586.2	\$531.1
	Unfunded	\$626.0	\$559.0	\$438.0	\$385.1	\$273.6	\$262.1	\$222.7	\$212.7	\$199.3
	Total Backlog % YoY growth	\$1,300.0 +18%	\$1,100.0 -15%	\$1,100.0 0%	\$913.8 -17%	\$899.7 -2%	\$878.3 -3%	\$766.5 -12%	\$798.9 -11%	<b>\$730.4 -19%</b>
<b>Contractual Purchase Orders</b>		\$276.7	\$219.1	\$109.9	\$95.8	\$139.7	--	--	--	<b>\$138.2</b>
<b>Book To Bill</b>		1.1x	1.1x	1.4x	0.8x	1.0x	0.9x	0.4x	1.2x	<b>0.8x</b>
<b>Loss Accrual</b>		--	--	--	\$3.5	<b>\$17.7</b>	--	--	--	<b>\$10.3</b>

# Aggressive Backlog Presentation

Kratos has historically used a very aggressive definition of backlog to sell investors on its investment merits. Its 10-K proclaims one of its “*Competitive Strengths*” is its “*Significant cash flow visibility driven by stable backlog*”; yet, a close look at how it used to define Total Backlog, specifically the Unfunded Backlog portion, shows that it includes both the value of unexercised options and revenue estimates for types of ID/IQ contracts. While this presentation is not unprecedented, it is certainly the most aggressive definition. No surprise, KTOS will be restating backlog sharply lower to comply with AUS 2014-09 adoption.

Company	Include Unexercised Options	Include IDIQ Contracts	Backlog Description
<a href="#">Kratos</a>	✓	✓	Unfunded backlog reflects our estimate of future revenue under awarded government contracts and task orders for which either funding has not yet been appropriated or the expenditure has not yet been authorized. Our total backlog does not include estimates of revenue from government wide acquisition contracts (“GWACs”) or General Services Administration (“GSA”) schedules beyond awarded or funded task orders, <b>but our unfunded backlog does include estimates of revenue beyond awarded or funded task orders for other types of indefinite delivery or indefinite quantity contracts</b> based on our experience under such contracts and similar contracts. <b>Unfunded backlog also includes priced options, which consist of the aggregate contract revenues expected to be earned as a result of a customer exercising an option period that has been specifically defined in the original contract award.</b>
<a href="#">AeroVironment</a>	✓	✓	We define unfunded backlog as the total remaining potential order amounts under cost reimbursable and fixed price contracts with multiple one-year options, and indefinite delivery, indefinite quantity, or IDIQ contracts.
<a href="#">Mantech</a>	✓	✓	We define backlog as our estimate of the remaining future revenues from existing signed contracts, assuming the exercise of all options relating to such contracts and including executed task orders issued under Indefinite Quantity/Indefinite Delivery (ID/IQ) contracts. We also include an estimate of revenues for solutions that we believe we will be asked to provide in the future under the terms of ID/IQ contracts for which there are established patterns of revenues.
<a href="#">CACI</a>	✓	✗	We calculate our unfunded backlog based on the aggregate contract revenue we have the potential to realize. On unfunded contract work, including amounts based on the assumed exercise of options under such contract
<a href="#">SAIC</a>	✓	✗	Negotiated unfunded backlog represents estimated amounts of revenue to be earned in the future from negotiated contracts for which funding has not been appropriated or otherwise authorized and from unexercised priced contract options. Negotiated unfunded backlog does not include any estimate of future potential task orders expected to be awarded under IDIQ, GSA schedules or other master agreement contract vehicles
<a href="#">Cubic</a>	✗	✗	The difference between total backlog and funded backlog represents options under multiyear CGD Services contracts. Funding for these contracts comes from annual operating budgets of the U.S. government and the options are normally exercised annually. Funded backlog includes unfilled firm orders for our products and services for which funding has been both authorized and appropriated by the customer (Congress, in the case of U.S. government agencies). Options for the purchase of additional systems or equipment are not included in backlog until exercised. In addition to the amounts identified above, we have been selected as a participant in or, in some cases, the sole contractor for several substantial indefinite delivery/indefinite quantity (ID/IQ) contracts. ID/IQ contracts are not included in backlog until an order is received
<a href="#">Lockheed Martin</a>	✗	✗	Our backlog includes both funded (firm orders for our products and services for which funding has been both authorized and appropriated by the customer) and unfunded (firm orders for which funding has not been appropriated) amounts. We do not include unexercised options or potential orders under indefinite-delivery, indefinite-quantity agreements in our backlog.
<a href="#">Northrup Grumman</a>	✗	✗	Total backlog includes both funded backlog (firm orders for which funding is authorized and appropriated) and unfunded backlog. Unexercised contract options and indefinite delivery indefinite quantity (IDIQ) contracts are not included in backlog until the time the option or IDIQ task order is exercised or awarded. For multi-year service contracts with non-U.S. Government customers having no stated contract values, backlog includes only the amounts committed by the customer.

Are regulatory infractions just a cost of doing business at Kratos, or emblematic of a rogue corporate culture designed to inflate financial results at all costs for the benefit of insider enrichment?

## Here's What Kratos Says

### Ethics & Compliance



Kratos is committed to maintaining its reputation as a company with the highest standards of business conduct. The Company requires its employees, agents, contractors and suppliers to behave in an ethical manner and to comply with applicable federal, state and local laws and regulations. In support of this goal, Kratos has appointed a Chief Compliance Officer to oversee the Company's Ethics and Compliance program, which includes:

- Codes of conduct for employees, contractors and vendors
- State-of-the-art, interactive compliance training
- Periodic signed disclosures and certifications of key personnel
- Monitoring of fraud hotline, with investigation and resolution of inquiries
- Annual audit, reporting and updates

Source: [Kratos website](#)

## Here's What The Evidence Suggests

Date	Kratos Regulatory Sanctions
<a href="#">May 2007</a>	<b>The Securities and Exchange Commission</b> today announced that it obtained an emergency asset freeze against the former stock options administrator of San Diego-based Wireless Facilities, Inc. (WFI – now Kratos), who was charged with defrauding the company and its shareholders by causing the unauthorized issuance and transfer of over 700,000 shares of WFI stock and stock options to himself and his wife.
<a href="#">July 2009</a>	<b>Indictment Charges Civilian Navy Employees and Contractors with Fraud and Bribery (FBI, San Diego)</b> The indictment also charges Jackie Godwin, a former manager at Kratos Defense Security Solutions, Inc. (Kratos), a large San Diego-based defense prime contractor, who hired the subcontractors as directed by Gary Alexander according to the scheme.
<a href="#">June 2012</a>	<b>Dept. of Labor Office of Federal Contract Compliance:</b> Compensation data provided by Kratos for employees as of June 1, 2012, revealed that Kratos provided lower compensation to the minority, female employee when compared to the similarly situated non-minority, male employee
<a href="#">Jan 2015</a>	<b>Sacramento Defense Contractor Agrees To Pay \$2 Million To Settle Allegations Of Inflating Costs (Dept. of Justice, Eastern California)</b> Composite Engineering Inc., a Sacramento-based subsidiary of Kratos Defense & Security Solutions that manufactures remote-controlled subscale aircraft for the U.S. military, has agreed to pay the United States \$2 million to resolve allegations that it violated the False Claims Act by submitting inflated costs in connection with a 2007 contract, United States Attorney Benjamin Wagner announced today.
<a href="#">June 2017</a>	<b>Army Colonel and Others Indicted In \$20 Million Bribery and Fraud Scheme Arising Out Of Fort Gordon, Georgia</b> Dwayne Fulton, 58, an employee of Kratos was indicted for his alleged role to solicit and bribe an army official in exchange for rigging the award of \$20m in US Army contracts to a minority owned business. According to a <a href="#">press release</a> , Fulton was a Director of Kratos-MRD Adv Telecom Group in Augusta

# Has Kratos Booked Illicit Revenues And Will It Restate Its Financials?

Kratos recently included a risk factor warning that minority-owned and other small businesses sponsored by the SBA could disadvantage the Company. Isn't it peculiar that a Kratos Director Dwayne Fulton recently pled guilty to scheme involving procuring contracts under the guise of a minority owned small business? How much illicit revenues has Kratos booked; will it restate its financials?

## New Problem Identified By Kratos

**A preference for minority-owned, small and small disadvantaged businesses could impact our ability to be a prime contractor on certain governmental procurements.**

*As a result of the Small Business Administration ("SBA") set-aside program, the federal government may decide to restrict certain procurements only to bidders that qualify as minority-owned, small, or small disadvantaged businesses. As a result, we would not be eligible to perform as a prime contractor on those programs and in general would be restricted to no more than 49% of the work as a subcontractor on those programs. An increase in the amount of procurements under the SBA set-aside program may impact our ability to bid on new procurements as a prime contractor or restrict our ability to recompile on incumbent work that is placed in the set-aside program.*

Source: Kratos 2014 [10-K](#)

## Solution: Commit Fraud on America?

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Roper and other public officials, including cash and no-show jobs, in exchange for official acts, including the award of U.S. Army contracts;

It was further part of the conspiracy that CDL, Defendant **Dwayne Oswald Fulton** and other coconspirators, aided and abetted by each other, would provide false and fraudulent documents and information to the U.S. Army, the United States Small Business Administration ("SBA"), government contractors and others for the purpose of fraudulently obtaining and maintaining millions of dollars in U.S. Army and private company contracts;

It was further part of the conspiracy that CDL, Defendant **Dwayne Oswald Fulton** and other coconspirators, aided and abetted by each other, would fraudulently arrange for and use employees of other government contracting companies to perform the work awarded to CREC Group;

It was further part of the conspiracy that CDL, Defendant **Dwayne Oswald Fulton**, **Anthony Tyrone Roper** and other coconspirators, aided and abetted by each other, would send and cause to be sent by interstate wires, false information and money, for the purpose of facilitating their bribery and fraud schemes;

It was further part of the conspiracy that some of the coconspirators, aided and abetted by each other, would prepare and provide false and fictitious documents in an effort to conceal and hide their bribery and fraud schemes, and to obstruct an investigation into their unlawful activities;

It was further part of the conspiracy that some of the coconspirators, aided and abetted by each other, would make false, fraudulent, and fictitious statements and

Source: Plea Agreement, USA vs. Fulton, Nov 9, 2017



## *Kratos Latest Hype: Unmanned Aerial Drones*

# Kratos Unmanned Systems (Drone) Business Hyped Despite Abysmal Results

There is ample evidence to suggest that Kratos' Unmanned System ("US" or "UAV") segment is a mediocre combination of acquired businesses. We remind investors that segment revenues are still below 2013 levels, and operating profits (still negative).

**Kratos Unmanned Systems segment:** consists of its unmanned aerial system and unmanned ground and seaborne system businesses. Kratos [lists properties](#) in this segment in San Diego, Sacramento California, and Ft. Walton Beach, Florida

**Growth by Acquisitions, Business Failure Evident:** We believe the majority of the US segment reflect the acquisition of Composite Engineering Inc ("CEI" [acquired 2012](#)) and the legacy [Micro Systems Inc](#) (acquired from Herley Industries in 2011. Note: [Herley acquired Micro Systems in 2005](#)). It was reported that CEI had \$94m of sales in 2011 and Micro Systems had \$14m in 2004. Thus, baseline combined revenues should be ~\$108m. When the segment was formed in 2012, total revenues reported were \$92.3m (-14.% lower)

**Red Flags:** 1) CEI was touted as generating 25% organic growth in 2011 at acquisition, yet by the time Kratos reclassified its segments in [Q4'14](#) to show US segment performance, organic growth plummeted, 2) At least one CEI founder [Amy Fournier](#) has left the firm 3) According to Kratos [pro forma filings](#), CEI spent nothing on research and development costs in 2011, which appears at odds with CEI being touted as an "industry leading" drone manufacturer, 4) Recent [reviews](#) suggest CEI's problems are indicative of a small company in over its head (a) "They have even been known to sell technology that has not been invented yet" (b) "Sometimes programs are underbid and understaffed" (c) "We often find ourselves out of depth (agreeing to contracts with not enough time or money to execute, planning, etc.)." 4) CEI settled with the Dept. of Justice ([2015](#)) on fraud allegations that it submitted inflated costs in connection with a contract

## Kratos US Segment Results

\$ in mm	2012	2013	2014	2015	2016	2017
Sales	\$92.3	\$121.6	\$81.5	\$66.3	\$75.8	\$121.7
% growth	--	31.7%	-33.0%	-18.7%	14.3%	60.6%
Operating Income (1)	\$3.5	(\$17.2)	(\$9.8)	(\$16.2)	(\$27.7)	(\$3.0)
% margin	3.8%	-14.1%	-12.0%	-24.4%	-36.5%	-2.5%
Segment Assets (2)	N/A	\$178.1	\$166.1	\$162.0	\$172.1	\$201.9
Operating Inc. / Avg Assets	N/A	N/A	-5.7%	-9.9%	-16.1%	-1.6%

1) Included in the 2016 operating losses for the US reportable segment is an \$18.7 million loss accrual recorded on the Air Force Research Laboratory ("AFRL") Low-Cost Attributable Strike UAS Demonstration ("LCASD") cost share contract awarded in July 2016. Included in the 2013, 2014, and 2015 operating losses for the US Segment are increased costs of \$7.6 million, \$3.1 million, and \$5.7 million respectively, primarily related to certain retrofits necessary to address product design changes as well as due to a contract conversion adjustment on certain of our aerial platforms

2) 2014 assets revised down from \$173.2m to \$166.1m without explanation



Our research suggests that Kratos is a tiny player in the field of unmanned systems, with approximately 1% share of industry revenues and contract awards as a percentage of the DoD budget for drone procurement, research, development and construction. Investors are paying an all-time high premium valuation to bet on Kratos, a perennial loser, that has been challenged to execute on many of its growth opportunities in nearly 20 years

## Unmanned Systems Competitors

\$ in billions	Revenues	Market Share
General Atomics	\$4.0	44%
Northrop Grumman	\$2.0	22%
Textron	\$0.9	10%
Boeing	\$0.6	7%
AeroVironment	\$0.2	3%
<b>Kratos</b>	<b>\$0.1</b>	<b>1%</b>
Others	\$1.1	13%
<b>Total</b>	<b>\$9.0</b>	<b>100%</b>

Source: Spruce Point and Wall St. Research

## Estimated Kratos Drone Awards As A % of DoD Budget

\$ in mm	CEI (A)	Micro Systems (B)	US Drone Spending (C)	KTOS Share (A+B)/(C)
<b>2013</b>	\$45.3	\$7.9	\$5,629.2	0.9%
<b>2014</b>	\$10.3	\$12.6	\$4,551.2	0.5%
<b>2015</b>	\$28.1	\$10.4	\$5,091.8	0.8%
<b>2016</b>	\$24.2	\$9.7	\$6,693.2	0.5%
<b>2017</b>	\$64.2	\$18.8	\$5,746.1	1.4%
<b>Total</b>	<b>\$172.1</b>	<b>\$59.4</b>	<b>\$27,711.5</b>	<b>0.8%</b>

Sources: Budget data from Bard University's [report](#) "Drones in the FY18 Defense Budget"  
 CEI drone awards and Micro Systems information from [USASpending.gov](#)

# Hyping Drone Contracts

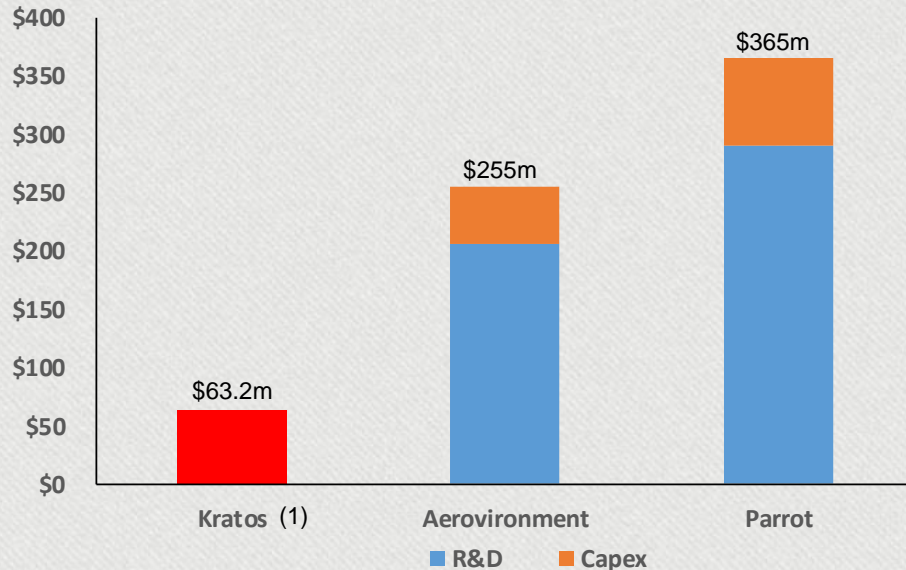
An acceleration of Kratos press releases hyping drone related contracts, with few details, should be a red flag, particularly in the context of Kratos rapid issuance of stock in [November 2016](#), [March 2017](#) and [September 2017](#)

Date	Contract Value	Description	Tenor	Bids	Type
<a href="#">3/1/18</a>	\$24.3	modification to a previously awarded firm-fixed-price, cost-plus-fixed-fee contract to exercise an option for the low rate initial production of the Subsonic Aerial Target BQM-177A and technical data	2yr		Firm Fixed / Cost plus
<a href="#">2/20/18</a>	\$81.0	Related to unmanned drone systems and associated command, control, and communications. "Maximum potential" value of \$81m from an undisclosed gov't agency	5yr	--	IDIQ
<a href="#">1/8/18</a>	\$23.0	Production award for a new high performance, jet powered unmanned aerial drone system which has been under development	1yr	--	--
<a href="#">1/3/18</a>	\$3.2	Unmanned aerial drone and other system product orders	--	--	--
<a href="#">1/2/18</a>	\$93.0	Procure adv. subscale aerial drone systems, an unmanned target aircraft with launchers and ground equipment and spares	4yr	1 Received	Firm Fixed
<a href="#">12/18/17</a>	\$27.0	N/A	--	--	IDIQ
<a href="#">12/14/17</a>	\$3.3	N/A	--	--	--
<a href="#">10/31/17</a>	\$14.5	Eight high performance, jet powered unmanned aerial drone systems	--	--	--
<a href="#">9/28/17</a>	\$6.2	Orders for specialized products in support of certain National Security Related Programs	--	--	--
<a href="#">9/26/17</a>	\$9.7	For the production and delivery of multiple high performance unmanned aerial drone system aircraft and related mission support, technical, development and other services	--	--	--
<a href="#">8/31/17</a>	\$2.2	High performance jet powered unmanned aerial drone aircraft and related services.	1yr	--	--
<a href="#">6/6/17</a>	N/A	Six High Performance Unmanned Aerial Drone System Aircraft	--	--	--
<a href="#">3/15/17</a>	\$1.6	New, in development, High Performance Jet Powered Unmanned Aerial Drone System	--	--	--
<a href="#">3/13/17</a>	\$22.3	Received Lot 13 production option exercise, valued at \$22.3 million, on the previously awarded Air Force Subscale Aerial Target (AFSAT) Lots 11-13 production contract. CEi will provide an additional quantity of 25 AFSAT production target aircraft	--	--	--
<a href="#">3/9/17</a>	\$5.6	High Performance Unmanned Aerial Target Drone Systems	--	--	--
<a href="#">11/30/16</a>	N/A	Multiple high performance jet powered unmanned aerial drone target systems	--	--	--
<a href="#">11/16/16</a>	\$18	CEi will provide this international new customer with full operational capability for the BQM-167i high performance unmanned aerial target drone system for two separate sites	--	--	--
<a href="#">10/17/16</a>	\$12.6	DIUx (experimental) for Sensor Integration into UTAP-22 Unmanned Combat Aerial System	--	--	--
<a href="#">8/30/16</a>	\$14	UAS and C5ISR Program related product and system orders	--	--	--
<a href="#">7/11/16</a>	\$40.8	Low-Cost Attributable Strike Unmanned Aerial System (UAS) Demonstration (LCASD). Kratos will receive \$7.3 million in Government funding, and invest up to \$33.5 million over the approximate 30 month period of performance	30 months	7 competitors	Single Award Cost Share
<a href="#">5/4/16</a>	\$3.8	DARPA award for Phase I Gremlins	--	--	--
<a href="#">2/23/16</a>	\$18.7	(CEi), has received a \$18,674,455 million award for the Lot 12 option on the previously awarded Air Force Subscale Aerial Target (AFSAT) Lots 11-13 production contract. CEi will provide an additional quantity of 21 AFSAT production target aircraft plus the associated warranty	--	--	--

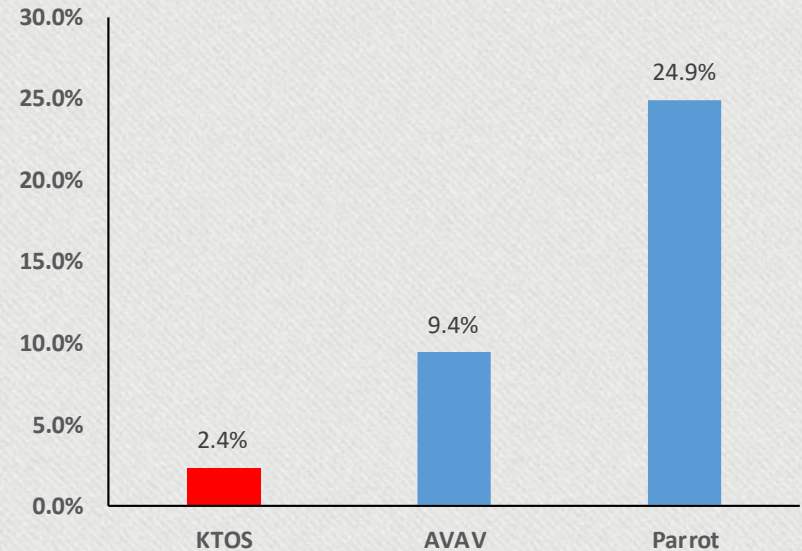
# Hyped Drone Opportunity: Signs of Significant Capital Underinvestment

There are limited pure-play drone companies except for AeroVironment and Parrot S.A. However, according to public filings, each has spent \$255 and \$355m, respectively, of combined capex and research and development costs since 2013. During the same period, Kratos has spent approximately \$63m. We believe much of the costs have circumvented the income statement and been accounted for as capex spending.

**Cumulative Capex and R&D Since 2013 Among UAV / Drone Companies**



**LTM R&D as % of Sales Among UAV / Drone Companies**



1) Includes Total Capex and R&D related to unmanned aerial systems. KTOS doesn't disclose Capex or R&D spending by segment, but the Company has made the following statements suggesting total investment of \$63m since 2013

a. Q3'16 CEO: "Kratos has made in the unmanned aerial systems area since 2013, which aggregate to over \$50 million in internal research and development, contract design development and capital expenditures"

b. FY 2017 10-K "The 2017 capital expenditures included approximately \$13.2 million related to investments we are making in our US segment to build Company-owned tactical aircraft and related equipment related to the LCASD and UTAP-22 or Mako platforms"

# Kratos Portfolio of Speculative Projects

Kratos management is quick to talk big revenue figures as market opportunities for projects that are speculative in nature, with a low probability of receiving permanent funding. Management quickly issued equity in [November 2016](#) after leading investors to believe there were billions of dollars worth of revenue opportunities in Q3 2016. Major primes compete against Kratos too.

Program	Potential Market Opportunity Hyped By Kratos Management on Conference Call (1)	Agency	Cost Per Unit / Lot Size	Spruce Point Assessment of Commercialization Chance
Low-Cost Attributable Strike Unmanned Aerial System Demonstration (LCASD)	"Several hundreds of millions of dollars"	AFRL: Air Force Research Lab	\$2-\$3m / 100	Kratos is having to fund \$33m of this project, with the government contributing just \$7m. Kratos claims the structure allows it to maintain the IP. In our view, it was more likely structured to push a majority of the costs (and risk) to Kratos, giving AFRL an easy abandonment option <b>ASSESSMENT: LOW</b>
UTAP-22 / MAKO	"tens of millions up to the hundreds of millions of dollars"	DIUx: Defense Innovation Unit Experimental	\$1-\$3m / 20	DIUx is a fairly new organization launched in 2015 focused on accelerating commercial technologies to the US Military. On the <a href="#">Q1 2016 conference call</a> , the CEO stopped providing information on UTAP-22 "Due to competitive considerations which are increasing, I will not be providing additional information related to Kratos' UTAP-22 at this time. However, we are making no significant additional investment in the Tornado aircraft at this time." <b>ASSESSMENT: LOW</b>
Subsonic Aerial Target System (SSAT)	"We believe that the potential market opportunity for this platform to be an excess of \$1 billion."	Navy	N/A	Just the next gen of drones replacing inventory. Program continuation dependent on annual funding. <b>Slippage of timing evident:</b> "should be coming online in 2016 ramping in 2017 and 2018" (Dec 2015, BofA Conf) and then "We currently expect the full rate production phase of the SSAT program to begin in the first of 2019" (Q3 Results, <a href="#">July 2017</a> ) <b>ASSESSMENT: MEDIUM</b>
Gremlins	"high several hundreds of millions of dollars up into billions of dollars"	DARPA: Defense Advanced Research Projects Agency	\$700k / 1,000	DARPA <a href="#">describes</a> its projects as "high risk, high payoff"; programs are finite in nature and many fail. Either way, Kratos is only a subcontractor on this project, and as noted on the next slide, the CEO is also providing no further information on the project <b>ASSESSMENT: LOW</b>

1) Q3 2016 [Earnings Call](#)

Kratos has a history of touting great opportunities with large “potential” markets. This time around, it has been promoting the Gremlin opportunity, which is still experimental in nature. Kratos is just the subcontractor on the program to Dynetics, which is competing with General Atomics, ranked the 33<sup>rd</sup> largest federal contractor (1,2).  
Who do you think wins?

## CEO Hying The Gremlin Opportunity:

CEO Demarco [Q3'16](#): “A second new UAV contract that Kratos received is the Defense Advanced Research Project Agency or DARPA Gremlins program, a prime Phase I contract award of \$3.9 million, which we are currently performing on and we just submitted our Gremlins Phase II proposal last week. Phase I is currently scheduled to lead to a systems requirement review in the next few months, at which time DARPA plans to down select the two teams issuing contracts of approximately \$20 million each for Phase II preliminary system design. In mid-2018, DARPA is expected to hold the preliminary design review and one team will be selected for Phase III, an estimated \$40 million contract concluding with flight test in 2020. The government has indicated that the price point for the Gremlin aircraft will be approximately \$700,000 each for order quantity lots of 1,000 once in production which could be expected approximately three years from now. **At these estimated production levels, we believe the potential market opportunity for Gremlin type aircraft is in the high several hundreds of millions of dollars up into billions of dollars**”

CEO Demarco [Q4'16](#): “However, as you know, we believe that a key reason Kratos was selected as one of the four Gremlin prime Phase 1 contract awardees was due to Kratos' industry leading position in designing, demonstrating, producing and fielding low cost high performance jet UAVs in a short timeframe. And today, **I'm truly more confident than ever that Kratos will be producing a UAV for the Gremlin's program.**”

## Only To Go Silent On It Later:

Sheila Kahyaoglu on [Q2'17 Call](#) : “And then last question, just on Gremlins, where are we there? Is it just in -- just the past days right now with the 12 months or any update on that would be appropriate I guess.”

CEO Eric DeMarco: “It is very competitive, **I am sorry, I did not talk about it in the script and I am not talking about it anymore.** It's focus time. So, I apologize.”

- 1) General Atomics – [DARPA contracts the company for Phase 2 of the Gremlins Program](#) – March 2017
- 2) [GSA Top 100 Contractors](#), 2016 (note: Kratos did not make the top 100 list)



## *Serious Management and Governance Concerns*

# Background on Management

Kratos' CEO and CFO have questionable pasts while formerly at Titan Corporation. Furthermore, audit committee member Jane Judd also served at Titan as VP/Controller. We question how "independent" her judgement may be given her historical acquaintance with management (1)

KTOS Executive	Biography According To Company	What It Fails To Mention
Eric DeMarco / CEO	Prior to Kratos, Mr. DeMarco was the President and Chief Operating Officer of the Titan Corporation, which was later acquired by L-3 (Source: <a href="#">Kratos Website</a> )	<ol style="list-style-type: none"> <li>1. Lockheed Martin backed out of acquiring Titan Corp after a criminal and civil investigation emerged regarding Titan's overseas business dealings (<a href="#">Source</a>)</li> <li>2. SEC issued a Wells Notice to Titan an SEC investigation commenced (<a href="#">Source</a>)</li> <li>3. Titan paid a \$28.5m fine to settle criminal and civil charges that it bribed the president of Benin (<a href="#">Source</a>)</li> <li>4. Shareholder litigation charges Titan with a scheme to inflate revenues and book fictitious receivables. Titan's use of "middlemen" and "private consulting companies" with ties to government officials to secure business (<a href="#">Source</a>)</li> <li>5. The litigation says confidential witnesses claim DeMarco knew about the fraud and DeMarco was responsible for transferring funds to Benin. He was allegedly the source of the "percentage of completion accounting techniques learned from the 'Andersen school of accounting' that allowed Titan to either overstate or prematurely state revenues at the company"</li> </ol>
Deanna Lund / CFO	Deanna Lund has served as Chief Financial Officer for Kratos since April 2004. Prior to joining Kratos, Ms. Lund most recently served as Vice President and Corporate Controller for the Titan Corporation. Ms. Lund is a graduate of San Diego State University, where she received her Bachelor of Science degree in Accounting, magna cum laude, and is a certified public accountant. (Source: <a href="#">Kratos Website</a> )	<ol style="list-style-type: none"> <li>1. Mrs Lund was also named in the shareholder litigation at Titan Corp</li> <li>2. Her biography omits that she worked at Arthur Andersen LLP, the accounting firm notorious for having audited Enron and its creative accounting that favored booking cashless profits (<i>see reference above to the Andersen school of accounting</i>)</li> </ol>

1) Kratos Board member Jane Judd sits on the audit committee. She is described as "independent" according to the [proxy statement](#). However, we note that Ms. Judd was Vice President and Corporate Controller of The Titan Corporation from April 1986 to May 1996.

## Kratos CEO DeMarco

Litigation brought against CEO DeMarco while an executive at Titan Corp suggested that confidential witnesses knew he played an active role in fraud and was the source of “the Andersen school of accounting” – a reference to the disgraced Arthur Andersen firm where Kratos’ current CFO Lund worked (though she omits it from her biography). The shareholder litigation case was settled for \$61.5m and Titan paid \$28.5m in FCPA fines.

27            221.    That DeMarco had actual knowledge of the fraud is also demonstrated by a number of  
28 confidential witnesses. DeMarco would have had to have been aware of the problematic activities

- 73 -

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1 going on in Benin because of DeMarco’s need to routinely transfer funds to pay for the \$7.5-\$8  
2 million in unaccountable Benin expenditures. Head kept writing checks to Amadou and DeMarco  
3 kept wiring more and more money. Indeed, DeMarco structured all of Titan’s business ventures,  
4 received the Benin P&L, traveled to Africa frequently, and was the source of the percentage of  
5 completion accounting techniques learned from “the Andersen school of accounting” that allowed  
6 Titan to either overstate or prematurely state revenues at the Company.

[Source:](#) Titan Inc Securities Litigation and [Settlement](#) for \$61.5m

[Source:](#) Titan Pays \$28.5m to settle Foreign Bribery



# Key Executive Departures

Kratos is on its fourth Chief Accounting Officer / Corporate Controller in a decade, and third since 2013! Even worse, its newly appointed Chief Information Officer Rich Gary appointed in Jan 2016 abruptly left and was replaced by Kevin Walden in December 2016.

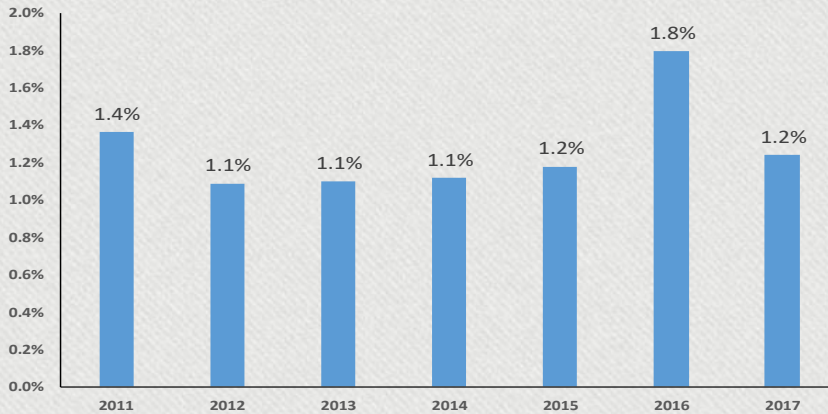
In addition, the president of its hyped unmanned aerial systems business suddenly “retired” in early 2017

Date	Executive
<a href="#">Jan 2017</a>	Jerry Beaman retires. Mr. Beaman joined Kratos in 2013 as President of its Unmanned Combat Aerial Systems (UCAS) Division and Senior Vice President of Strategic Programs, focused primarily on building Kratos’ UCAS business. In 2014, Mr. Beaman was named President of KUSD, expanding his responsibility to all Kratos unmanned aerial, ground, seaborne drone and combat system related programs and initiatives.
<a href="#">Dec 2016</a>	Kratos Appoints Kevin Walden as Chief Information Officer
<a href="#">May 2016</a>	<b><u>Richard Duckworth, Vice President, Corporate Controller and Principal Accounting Officer of Kratos Defense &amp; Security Solutions, Inc. (the "Company"), left the Company effective May 12, 2016.</u></b>
<a href="#">Jan 2016</a>	Kratos Appoints Rich Gary as Chief Information Officer
<a href="#">Sept 2015</a>	Deborah S. Butera, Senior Vice President, General Counsel/Registered In-House Counsel, Chief Compliance Officer and Secretary of the Company, left Kratos Defense & Security Solutions, Inc. effective September 24, 2015.
<a href="#">July 2013</a>	<b><u>Laura L. Siegal resigned from her position as Vice President, Corporate Controller and Principal Accounting Officer of Kratos Defense &amp; Security Solutions, Inc. (the "Company") to pursue an opportunity outside of the Company.</u></b>
<a href="#">Dec 2005</a>	<b><u>Carol Clay resigned as Controller and Principal Accounting Officer of Wireless Facilities, Inc. (the “Company”) for personal reasons. Ms. Clay’s resignation is effective January 6, 2006.</u></b>

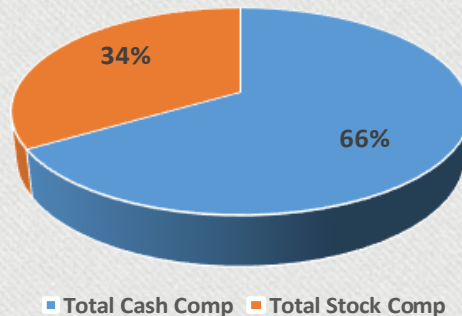
# Limited Insider Ownership By Kratos Management

Management has virtually nothing at risk and limited alignment with shareholders.

## Insider Beneficial Ownership By Kratos Management Executives Non-Existent



## Total Executive Pay Heavily Cash Oriented



## Management Cash Bonuses Driven By Subjective Criteria

**The Compensation Committee and/or the Chief Executive Officer also retain the right to exclude extraordinary charges or other special circumstances in determining whether the objectives were met during any particular fiscal year and may decide to grant 100% of the targeted cash bonus award, even if the financial targets do not fall within the specified range,** based upon an evaluation of business conditions, industry trends, and additional accomplishments achieved. Based on a 40/60 allocation of non-financial and strategic achievements versus financial achievements for corporate executive officers, **the Compensation Committee made the decision to grant 100% of the non-financial achievements** (or 40% of the targeted cash bonus award) and 66.7% of the financial achievements (or 40% of the targeted cash bonus award), for an aggregate 80% of the total targeted cash bonus award.

## Willingness To Pay Management Large Bonuses For Questionable Value Creation For Shareholders

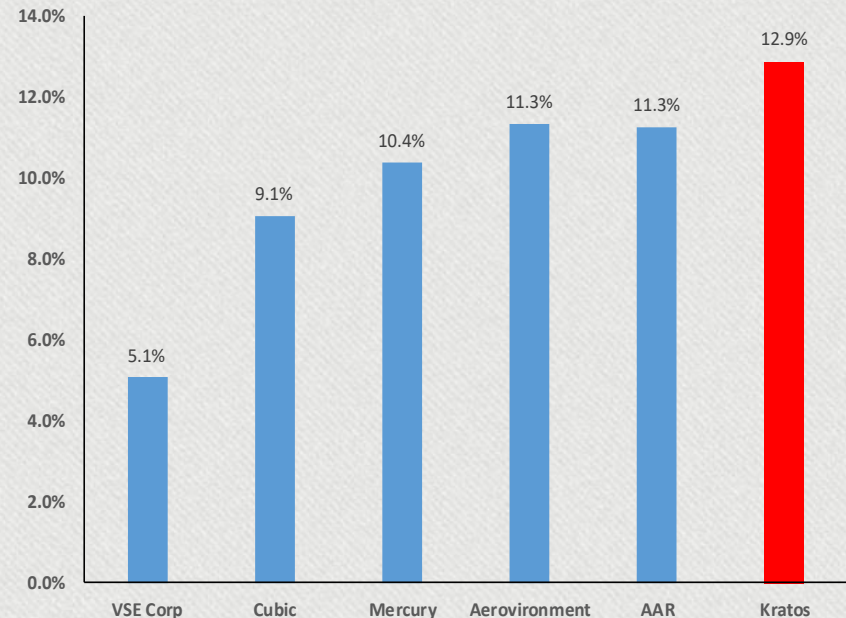
- In 2011, Kratos acquired Herley Industries for ~\$270m ([Source](#))
- In 2015, Ultra electronics acquired the Electronics Products Division (Herley business) from Kratos for ~\$265m ([Source](#))
  - Included Herley-CTI, EW Simulation Technology and Stapor Research, Inc
- Kratos' President Richard Poirer received a \$4m bonus for the divestiture of these businesses (Source: [Proxy](#))

Management compensation is a significant percentage of EBITDA and has been immune to Kratos' struggles and poor performance. Among small cap aerospace and defense contracting peers, Kratos' management is excessively paid relative to EBITDA

## Kratos Executive Comp Trends as a % of EBITDA

\$ in mm	2014	2015	2016
Kratos EBITDA	\$60.7	\$44.6	\$45.0
Total Insider Compensation	\$5.6	\$5.6	\$5.8
<b>Comp as % of EBITDA</b>	<b>9.3%</b>	<b>12.6%</b> ↑	<b>12.9%</b> ↑
EBITDA including EPD (1)	\$82.7	\$66.6	--
Compensation to Ricard Poirier (EPD President)	\$0.9	\$5.0	--
Total Adjusted Insider Compensation	\$6.6	\$10.6	--
<b>Adjusted Comp as % of EBITDA</b>	<b>8.0%</b>	<b>15.9%</b> ↑	--

## Total Executive Comp as a % of EBITDA vs. Peers



1) Assumes \$22m of EBITDA from the divested Electronics Products Division (EPD)

Source: Company proxy and financial statements



## *Serious Financial Management and Accounting Concerns*





Management has shown limited ability to forecast its business accurately in the past few years. This gives us little confidence in trusting their longer term outlook. We note that management has proven terrible at forecasting its free cash flow, with the biggest misses from initial guidance.

\$ in mmm	2013	2014	2015 (1)	2016
<b>Revenues</b>	<b>\$950 - \$1,000</b>	<b>\$920 - \$980</b>	<b>\$670 - \$690</b>	<b>"approximately the same as 2015"</b>
1 <sup>st</sup> Revision	\$960 - \$990	\$920 - \$960	\$640 - \$660	\$659 (+\$10m)
2 <sup>nd</sup> Revision	\$955 - \$975	\$870 - \$890	--	\$665.0 (+\$4m)
Actual Sales	\$844.1	\$763.0	\$657.1	\$668.7
Guidance Miss Relative To Original Guidance	<b>-15.6%</b>	<b>-14.2%</b>	<b>-4.7%</b>	<b>+1.6%</b>
<b>EBITDA</b>	<b>\$115 - \$125</b>	<b>\$92-\$106</b>	<b>\$50 - \$55</b>	<b>"approximately the same as 2015"</b>
1 <sup>st</sup> Revision	\$110 - \$120	\$93 - \$106	\$40 - \$45	\$42 (+1.5m)
2 <sup>nd</sup> Revision	\$102 - \$106	\$93 - \$100	--	--
3 <sup>rd</sup> Revision		\$79 - \$82	--	--
Actual EBITDA	\$100.3	\$82.2	\$44.6	\$45.0
Guidance Miss Relative To Original Guidance	<b>-19.7%</b>	<b>-22.4%</b>	<b>-18.9%</b>	<b>+0.9%</b>
<b>Free Cash Flow</b>	<b>\$50</b>	<b>\$25 - \$40</b>	<b>NA</b>	<b>"Greater than or better than 2015"</b>
1 <sup>st</sup> Revision	\$40 - \$50	--	--	--
2 <sup>nd</sup> Revision	\$5 - \$15	--	--	--
Actual Cash Flow	\$8.6	<b>(\$9.1)</b>	<b>(\$41.0)</b>	<b>(\$21.6)</b>
Guidance Miss Relative To Original Guidance	<b>-82.8%</b>	<b>-122%</b>	--	<b>+50%</b>

1) Starting from the point of the divestiture of the US and UK operations in June 2015

# Inability To Generate Free Cash Flow, Now Selling Assets At Depressed Values

Kratos raised 2017 revenue guidance twice, but could not increase its EBITDA forecast. In Q3'17 management significantly increased its cash flow burn guidance. The explanation was related to certain milestones in the unmanned systems and public safety business of \$26-\$28m expected to occur in Q1 and Q2 2018. Kratos touted its Q4 and full year results “exceeded” estimates, but digging beneath the surface everything is not rosy. We find that Kratos dramatically curtailed Unmanned System capital spending and unexpectedly sold its PSS division for \$70m at a depressed valuation (0.5x and 6.5x '18E Sales and EBITDA, respectively) to raise cash, but still says it will generate free cash flow of \$12-\$19m in 2018. Something doesn't add up!

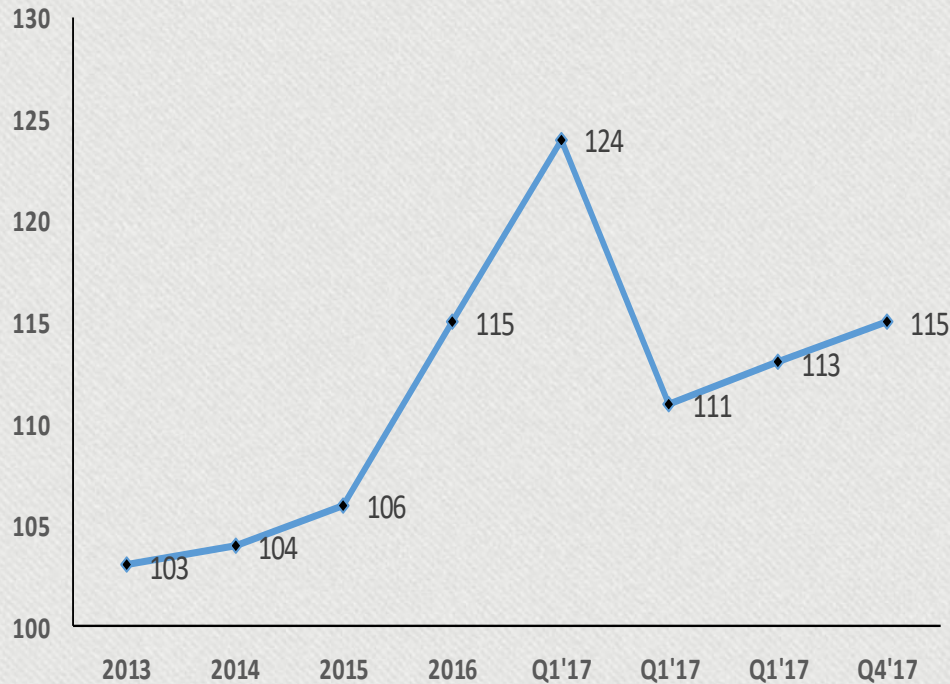
Date:	<u>Q3'16</u>	<u>Q4'16</u>	<u>Q1'17</u>	<u>Q2'17</u>	<u>Q3'17</u>	2017A	<u>Pro Forma 2018</u>
Revenues	\$700 - \$720	\$700 - \$720	\$700 - \$720	\$720 - \$740 	\$735 - \$745 	\$751.9	\$640 - \$650 (2)
EBITDA	\$52 - \$54	\$52 - \$54	\$52 - \$54	\$52 - \$54	\$52 - \$54	\$54.4	\$55 - \$59 (2) 
Total Capex	--	\$28 - \$33	\$28 - \$33	\$28 - \$33	\$26 - \$30	\$28.1 (3)	\$23 - \$26
Unmanned System Capex	--	\$18 - \$23	\$18 - \$23	\$18 - \$23	\$18 - \$23 (1)	\$13.2 	\$14 - \$17
Free Cash Flow (Usage)	--	(\$26) to (\$31)	(\$23) to (\$28)	(\$23) to (\$28)	(\$51) to (\$58)	(\$53.5)	\$12 - \$19

- 1) Management said \$17 - \$22m on the [Q3'17 conference call](#), but the [10-Q](#) kept the guidance unchanged
- 2) Per [management guidance](#), adjusted for PSS divestiture which was forecast for 2018 to produce \$140-\$150m of sales and \$9 - \$12m of EBITDA. **We note that Kratos' EBITDA guidance for 2018 was a disappointment vs. expectations of \$58 to \$61m**
- 3) Includes \$1.6m of capex included in accounts payable and accrued expenses noted at the bottom of the cash flow statement

# Warning From Rising Days Sales Outstanding (DSOs)

Elevated DSOs signal cash flow collection issues. The problem is also suggested by an accounts payable specialist posting on the company review website Glassdoor. Kratos is now expanding discussion about DSO in its 10-K.

**Kratos DSO**



**Jan 19, 2017 from Accounts Payable Specialist:** "They [Kratos] could never pay their bills during the time I was there. Terms were net 90 for every vendor expect ones like SDG&E, etc. It was stressful because of this, causing non stop credit holds, non stop emails from vendors wanting payment, statements to review that had months of bills entered but not paid. I couldn't wait to leave. The office supply area was completely bare and empty. It was hard to order supplies. Many temps would buy their own supplies and bring them in. Supplies such as inboxes, file folders, etc, that should have ben provided by the company" **Source:** [Glassdoor Review](#)

**Kratos New Discussion in 2017 Annual Report:** DSO rising "primarily as a result of certain contractual billing milestones that have not yet been attained, such as equipment shipments and deliveries on certain products, and for certain flight requirements that must be fulfilled on certain aerial target programs, or final billings which are not due until completion on certain of our large critical infrastructure deployment projects and large training systems deliveries, and therefore we are unable to contractually bill for amounts outstanding related to those milestones at this time." **Source:** [10-K](#), p. 45

Source: KTOS SEC filings and conference calls

# Questionable Accounting Could Enable Segment Margin Misstatement

Spruce Point has concerns about Kratos' accounting methods. For example, the Company reports assets, but not Capex, by business segment. However, when allocating depreciation and amortization it conveniently fails to attribute any portion to corporate activities, its fastest growing segment. Management cannot be ignorant on this issue, as the CEO and CFO came from Titan Corp, where they disclosed Capex and corporate depreciation and amortization (1). How can any investor have confidence in Kratos' segment margins, when costs are clearly not being allocated correctly.

	December 31, 2017	December 25, 2016	December 27, 2015
<b>3yr CAGR</b>			
-0.1%			
+11.6%			
0.0%			
+83.4%			
<b>Assets:</b>			
Kratos Government Solutions	\$ 597.9	\$ 609.8	\$ 606.8
Unmanned Systems	201.9	172.1	162.0
Public Safety & Security	97.4	92.0	96.8
Corporate activities	126.8	74.7	37.7
<b>Total assets</b>	<b>\$ 1,024.0</b>	<b>\$ 948.6</b>	<b>\$ 903.3</b>
<b>Depreciation and amortization:</b>			
Kratos Government Solutions	\$ 14.3	\$ 14.9	\$ 18.2
Public Safety & Security	0.4	0.5	0.6
Unmanned Systems	7.8	7.4	6.7
<b>Total depreciation and amortization</b>	<b>\$ 22.5</b>	<b>\$ 22.8</b>	<b>\$ 25.5</b>

Why are "Corporate Activity" assets up 236% in 3yrs, the fastest growing segment without any depreciation?

?

1) Source: Titan 2002 10-K, Note 6



# Questionable Charges, Aggressive EBITDA Presentation

Spruce Point has evaluated thousands of financial statements over the years, but we have never seen an income statement charge called “unused office space” which Kratos repeatedly discloses. It would like investors to ignore these repeated charges and give it the benefit towards its EBITDA presentation. We are not buying what Kratos is selling

## Income Statement Charge

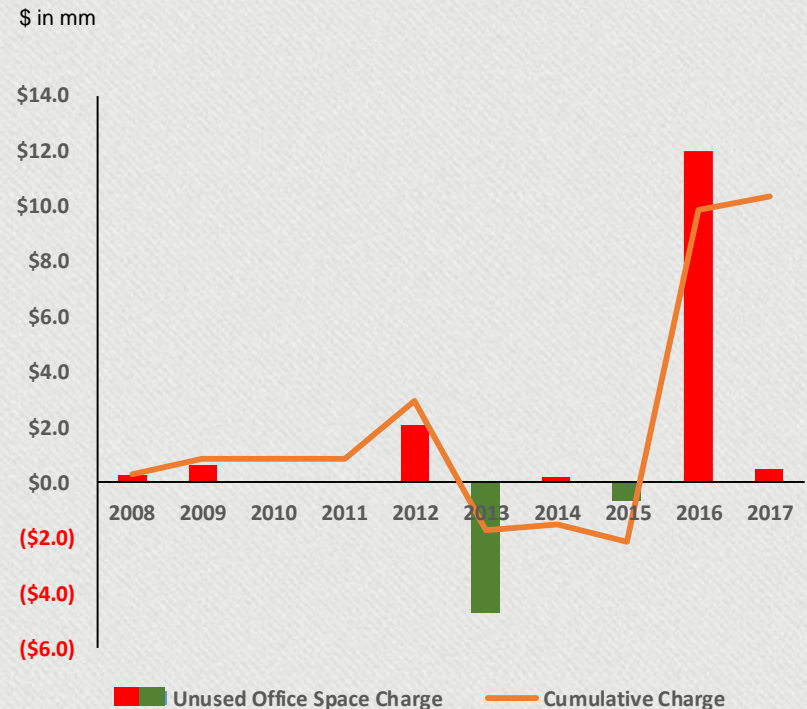
	Three Months Ended		Twelve Months Ended	
	December	December	December	December
	25, 2016	27, 2015	25, 2016	27, 2015
Selling, general and administrative expenses				
Unused office space, restructuring expenses, and other	33.4	34.6	132.6	134.8
Research and development expenses	1.5	(1.9)	12.0	(0.6)
Depreciation	3.8	4.5	13.9	16.2
Amortization of intangible assets	0.7	0.6	3.2	2.9
Operating income (loss) from continuing operations	2.6	2.9	10.5	13.0
	4.6	1.5	(18.6)	(4.5)

## Kratos Adds Back To EBITDA

	Three Months Ended		Twelve Months Ended	
	December	December	December	December
	25, 2016	27, 2015	25, 2016	27, 2015
Acquisition and transaction related items	\$ -	\$ 0.4	\$ -	\$ 2.2
Excess capacity and restructuring costs	2.1	1.0	13.4	6.6
Litigation related items	-	-	1.9	0.1
Reserve on customer receivable due to liquidation proceedings	-	-	-	0.7
Investment in unmanned combat systems	-	2.2	20.0	3.4
Costs related to pending customer change orders	-	-	-	0.3
	\$ 2.1	\$ 3.6	\$ 35.3	\$ 13.3

Source: Kratos [2016 results](#)

## Annual and Cumulative Charges Labeled With Unused Office Space By Kratos



Source: Kratos Financials

Note: Negative charges to the income statement have been recorded as benefits to operating income by Kratos



*Valuation and 40%-70%  
Downside Price Target*

# Terrible Risk/Reward Owning KTOS: Analysts See 29% Upside

Kratos is covered by a roster of smaller brokers.  
Not surprisingly, the majority are “Buy” on the stock.  
We expect a substantial re-rating lower in the share price once investors critically analyze its financials.

Analyst	Recent Action	Recommendation	Price Target
B. Riley		Buy	\$16.00
Noble Capital		Buy	\$15.00
Canaccord		Buy	\$15.00
Seaport	Down from \$15.00	Buy	\$14.00
Drexel Hamilton		Buy	\$14.00
JP Morgan	Initiation Dec 2017	Neutral	\$13.00
Jefferies	Price Cut from \$13.00	Hold	\$12.50
SunTrust		Hold	\$12.00
Goldman Sachs	Down from \$11.50	Neutral	\$10.75
<b>Average Price Target % Implied Upside (1)</b>			<b>\$13.58 +29%</b>

Smartest Guy  
In The Room

1) Upside based on \$10.50 share price

# This Time Is Different Right?

Sell-side analysts have amnesia when it comes to Kratos and its ability to hit its financial targets. As we've noted previously, the Company's inability to consistently hit targets should give analysts skepticism not to take management's targets at face value. Furthermore, Kratos should not receive among the highest multiple in the industry.

## Spruce Point Criticism

**Figure 2: KTOS stock price target calculation**

Kratos Price Target Calculation (\$M)		
2019E Adj. EBITDA	Higher 2018E Multiple on 2019E EBITDA?	\$85
Multiple on 2018E EBITDA		17x
Ent. Value		\$1,448
Net debt (Dec. 31, 2018 proforma est.)		\$133
Equity value		\$1,315
<b>Base business stock price value</b>		<b>\$13</b>
<b>UCAS FCF valuation</b>		
Equity value		\$201
\$325M revs, 15% margin by 2025		
15% discount rate, 3% TV		
<b>Value of future UCAS opportunity</b>		<b>\$2</b>
<b>KTOS stock price target calculation</b>		<b>\$15</b>

Source: Company Reports, FactSet, Canaccord Genuity estimates

Analyst blindly pencils in KTOS's ambitious 60% increase in EBITDA, though we have demonstrated its repeatedly failures to hit targets






So you award Kratos one of the highest multiples in the defense sector for below average industry margins, and highest risk revenue profile?

Pie-in-the-sky math for everything you cannot value to engineer a higher price target to say "Buy"

# Index Funds and ETFs Driving KTOS Share Price, Not Fundamental Institutions

Spruce Point is concerned that long-time fundamental growth owners have either given up or rotated out of Kratos, and have not returned despite the renewed optimism for Unmanned Systems. Instead, we find the disturbing reality that Kratos' share price has been driven by rules-based index and ETF buying

Kratos  
Shareholder  
Base  
Today

Asset Manager	Share Ownership / % of Total	General Ownership Trend Past 2yrs	Orientation
<a href="#">Oak Mgmt</a>	12.9M / 12.5%		Venture Capital
<a href="#">Blackrock</a>	9.5M / 9.2%		Index/Quant/ETF
<a href="#">State Street</a>	8.2M / 7.9%		Index/Quant/ETF
<a href="#">Capital World</a>	8.2M / 7.9%		Fundamental
<a href="#">Dimensional</a>	3.5M / 3.5%		Quant

Kratos  
Shareholder  
Base  
5 years  
Ago  
In 2012

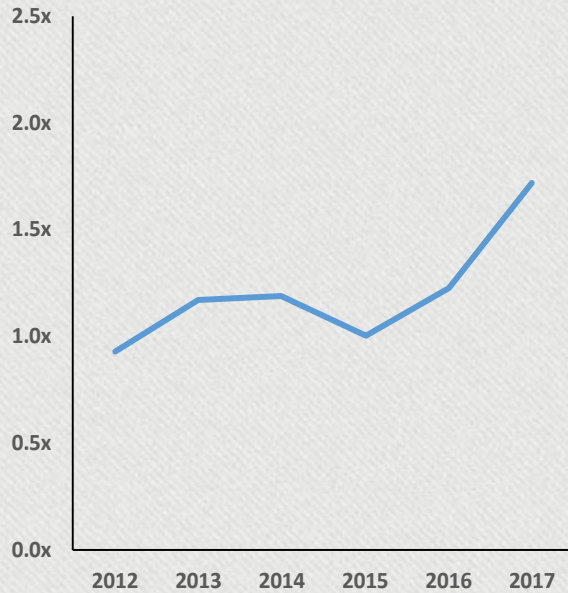
Asset Manager	Share Ownership / % of Total	Orientation
Wellington	2.8M / 8.9%	Fundamental
T. Rowe Price	2.5M / 7.8%	Fundamental
Paradigm Capital	2.4M / 7.6%	Fundamental
Blackrock	1.9M / 6.0%	Index/Quant/ETF
State of Wisconsin Investment Board	1.7M / 5.3%	Fundamental

Source: Kratos 2012 [Proxy Statement](#)

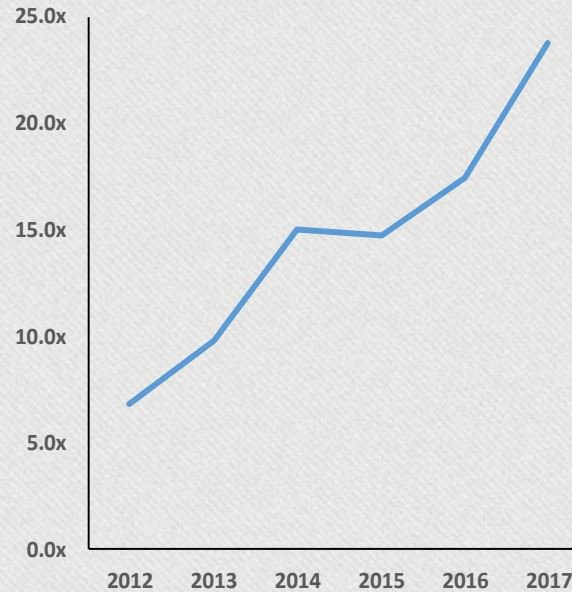
# Irrational Valuation Expansion

Current investors are paying a significant premium to the Company's historical valuation. Spruce Point finds it difficult to justify Kratos' valuation expansion in light of its history of disappointment, unproven drone opportunities, questionable business practices, shrinking backlog, and rising cash burn.

Enterprise Value / Revenues



Enterprise Value / Adj EBITDA



Price / Book Value



Source: KTOS Financial Statements

# KTOS Trading At An Unjustified Premium To Its Peers

KTOS is trying to position itself as a play on drones to justify its valuation relative to a limited universe of pure-play stocks such as AeroVironment, which Spruce Point [previously profiled](#) as a repeated loser. Wall Street is fixated on Kratos' earnings "potential" of >100% growth in the next few years and give KTOS a commanding 20x and 70x EBITDA and P/E ratio. Be warned: this growth is off a low EPS base, on highly adjusted figures, and will surely disappoint given Kratos demonstrated ability to poorly execute.

\$ in millions except per share figures

Segment	Name (Ticker)	Stock Price 3/15/2018	% of 52-wk High	Ent. Value	'18E-'19E		P/E		Enterprise Value				Price/ Book	Net Debt/ 18E EBITDA	Dividend Yield
					Sales Growth	EPS Growth	2018E	2019E	EBITDA		Sales				
Tier 1	Lockheed Martin (LMT)	\$333.23	92%	\$106,037	4.7%	15.6%	21.5x	18.6x	13.3x	12.4x	2.1x	2.0x	NM	1.4x	2.4%
Tier 1	General Dynamics (GD)	\$222.60	67%	\$67,090	6.8%	10.2%	19.9x	18.0x	14.1x	12.8x	2.0x	1.9x	5.8x	0.2x	1.5%
Tier 1	Northrop Grumman (NOC)	\$340.82	95%	\$63,383	7.7%	12.5%	22.1x	19.6x	15.4x	13.8x	2.3x	2.2x	8.4x	1.0x	1.2%
Tier 1	L-3 Technologies (LLL)	\$203.75	93%	\$18,589	4.9%	12.6%	21.3x	18.9x	13.8x	12.7x	1.9x	1.8x	3.1x	2.0x	1.5%
Tier 1	Orbital ATK (OA)	\$131.67	98%	\$8,888	5.5%	13.2%	19.3x	17.0x	11.5x	10.9x	1.8x	1.7x	3.7x	1.7x	1.0%
Tier 1	SAIC (SAIC)	\$77.38	86%	\$4,215	2.7%	11.9%	21.5x	19.2x	14.0x	12.8x	1.0x	0.9x	10.3x	3.0x	1.7%
Tier 2	Flir Systems (FLIR)	\$50.41	95%	\$6,969	5.1%	9.0%	24.0x	22.0x	15.5x	14.3x	4.0x	3.8x	3.7x	0.0x	1.2%
Tier 2	CACI Int'l (CACI)	\$154.15	97%	\$4,886	3.5%	14.3%	19.6x	17.2x	12.3x	11.7x	1.1x	1.0x	1.9x	2.8x	0.4%
Tier 2	ManTech (MANT)	\$53.90	87%	\$1,369	7.7%	11.5%	27.0x	24.2x	8.6x	8.0x	0.7x	0.7x	1.6x	-0.1x	1.6%
Tier 2	AAR Corp (AIR)	\$43.58	96%	\$1,649	9.6%	22.9%	18.5x	15.0x	10.1x	8.2x	0.8x	0.7x	1.6x	1.0x	0.7%
Tier 2	VSE Corp (VSEC)	\$54.15	60%	\$777	NA	NA	15.0x	NA	9.7x	NA	1.0x	NA	2.0x	2.4x	0.5%
Drone	AeroVironment (AVAV)	\$48.58	82%	\$891	17.2%	20.0%	59.5x	49.6x	28.2x	21.0x	2.8x	2.4x	2.9x	-8.3x	0.0%
Drone	Parrot SA (EPA: PARRO)	\$9.19	59%	\$106	17.0%	NM	NM	NM	NM	11.4x	0.6x	0.5x	0.8x	NM	0.0%
	<b>Max</b>				17.2%	22.9%	59.5x	49.6x	28.2x	21.0x	4.0x	3.8x	10.3x	3.0x	2.4%
	<b>Average</b>				7.7%	14.0%	24.1x	21.8x	13.9x	12.5x	1.7x	1.6x	3.8x	0.6x	1.0%
	<b>Min</b>				2.7%	9.0%	15.0x	15.0x	8.6x	8.0x	0.6x	0.5x	0.8x	-8.3x	0.0%
	<b>Kratos Defense (KTOS)</b>	<b>\$10.50</b>	<b>75%</b>	<b>\$1,188</b>	<b>11.0%</b>	<b>117.3%</b>	<b>70.0x</b>	<b>32.2x</b>	<b>19.8x</b>	<b>18.3x</b>	<b>1.8x</b>	<b>1.7x</b>	<b>2.1x</b>	<b>1.7x</b>	<b>0.0%</b>
	<b>Adjusted for corporate depreciation (1)</b>				<b>11.0%</b>	<b>135.2%</b>	<b>80.7x</b>	<b>34.3x</b>	<b>19.8x</b>	<b>18.3x</b>	<b>1.8x</b>	<b>1.7x</b>	<b>2.1x</b>	<b>1.7x</b>	<b>0.0%</b>

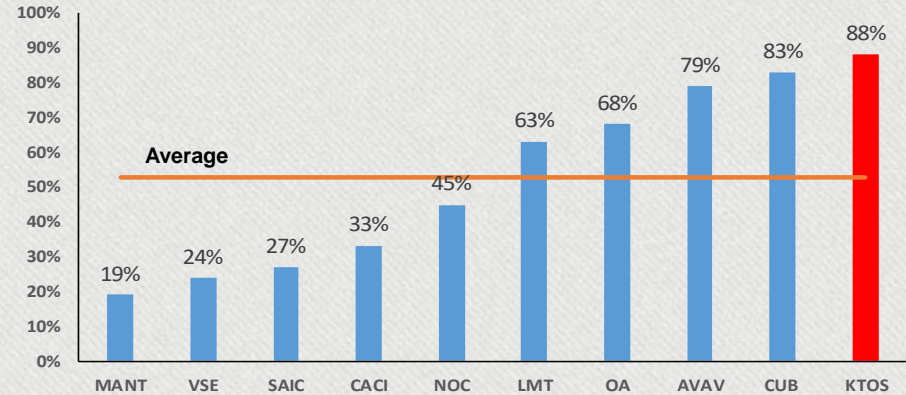
Source: Company filings, Wall St estimates.

1) Assumes 2.5% annual depreciation on \$127m of corporate segment assets

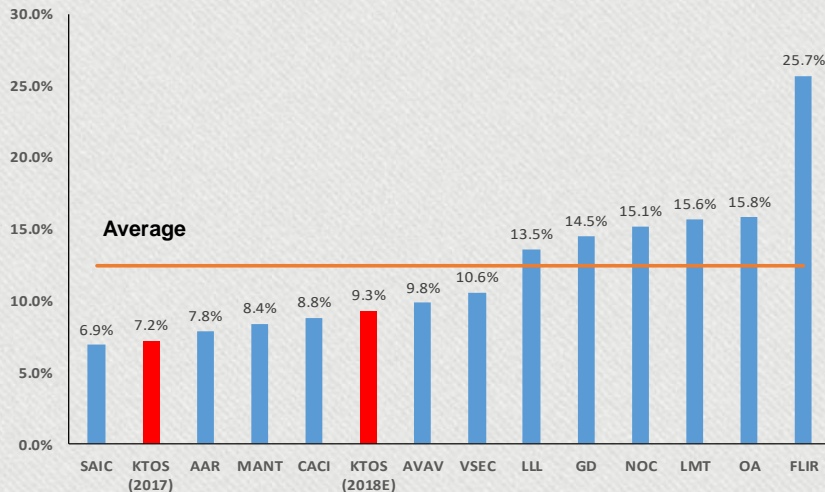
# Kratos = Worst of Breed, Not Deserving A Premium Industry Valuation

- Kratos' premium valuation of earnings and EBITDA does not reconcile with its below average financial performance and mix of revenue quality
- The Company has the highest % of revenues from fixed-price contracts, which are the riskiest contracts that expose Kratos to cost overruns.
- Not surprisingly, the Company has often failed to generate cash flow and has below industry margins – reflective of its inability to execute
- The Company and sell-side analysts have bought into Kratos' dream that it can expand EBITDA margins to 10%, but this remains entirely a "show me" story

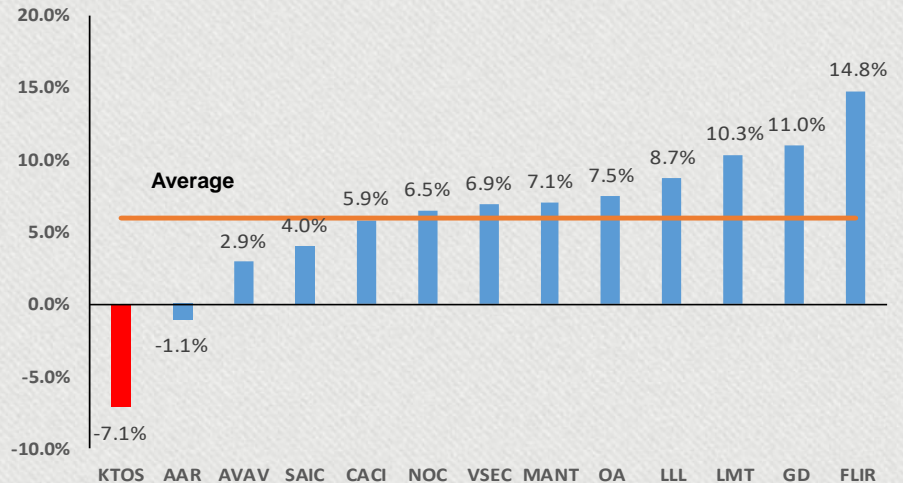
## Revenues % From Fixed-Price Contracts



## 2018E EBITDA Margin



## LTM Free Cash Flow Margin



Source: Company financials.

Note: Excludes Parrot S.A. as a result of it being an extreme negative outlier

Free Cash Flow defined as Operating Cash Flow – Gross Capital Expenditures



There is no way to justify Kratos' inflated valuation.

\$ in millions, except per share amounts

Valuation	Low Price	High Price	Note
<b>EBITDA Multiple</b> <b>2018E EBITDA</b> <b>Enterprise Value</b> <b>Plus: Cash</b> <b>Less: Debt</b> <b>Dil. Shares</b> <b>Price Target</b> <b>% Downside</b>	10.0x <u>\$58.0</u> \$580.0 \$199.6 (\$301.0) <u>103.3</u> \$4.60/sh -56%	12.0x <u>\$61.0</u> \$732.0 \$199.6 (\$301.0) <u>103.3</u> \$6.10/sh -42%	Kratos' current 2018E EBITDA multiple of 20x is ridiculously higher than its peers at 12x. We don't trust management's EBITDA figure to begin with given our documented evidence of accounting concerns (including not depreciating \$126m of corporate assets). We apply a discounted multiple of 10x – 12x EBITDA to reflect its below average margin profile, low revenue quality, and poor management
<b>Price / Book Multiple</b> <b>Stated Book Value</b> <b>Price Target</b> <b>% Downside</b>	1.0x <u>\$4.94</u> \$4.94/sh -53%	1.5x <u>\$4.94</u> \$7.40/sh -29%	Kratos' assets have historically traded between 0.7x to 1.4x. We could argue that Kratos should trade below book value because it continues to burn cash. Even giving Kratos the benefit of the doubt it can stop the cash bleed, and generate cash this year, we apply a 1.0x – 1.5x range
<b>Multiple of Free Cash Flow</b> <b>KTOS Estimated Free Cash Flow</b> <b>Enterprise Value</b> <b>Plus: Cash</b> <b>Less: Debt</b> <b>Dil. Shares</b> <b>Price Target</b> <b>% Downside</b>	20.0x <u>\$12.0</u> \$240.0 \$199.6 (\$301.0) <u>103.3</u> \$1.35/sh -87%	25.0x <u>\$19.0</u> \$475.0 \$199.6 (\$301.0) <u>103.3</u> \$3.60/sh -66%	Kratos has offered 2018 free cash flow guidance of \$12 to \$19m. Giving it the benefit of the doubt for hitting this target, and applying a generous 20-25x multiple (commensurate with <u>peers that generate consistent free cash flow</u> , [Kratos does not]), we estimate almost 70% – 90% downside

Downside based on \$10.50/share. Includes the impact of the PSS segment divestiture which we assume sold for 1x book value

Note: Analysis does not factor in federal tax loss carryforwards of \$390.7 million and various state tax loss carryforwards of \$348.7 million. The federal tax loss carryforwards will begin to expire in 2020 and state tax loss carryforwards will begin to expire in 2018 in certain states