

Kratos Defense & Security Solutions

NASDAQ: KTOS

Analyst: Michael Post

Sector: Aerospace / Defense

BUY

Price Target: \$7.53

Key Statistics as of 4/20/2016

Market Price:	\$5.39
Industry:	Defense & Security
Market Cap:	\$301 M
52-Week Range:	\$7.12 – 2.80
Beta:	.62

Thesis Points:

1. KTOS is equipped with a strong backlog and series of new contracts which will provide higher profit margin sales in 2016.
2. Government support and ceased budget cuts will help the industry and KTOS especially.
3. KTOS may beat analyst's estimates for the year because management only gave "Kratos' Base Case 2016" conservative forward guidance.

Company Description:

Kratos Defense & Security Solutions, Inc. was founded in 1994 and is headquartered in California. The company operates out of 3 segments and provides mission critical products, solutions, and services primarily for the Government and commercial customers. The Kratos Government Solutions segment offers microwave electronic products, satellite communications, training solutions, modular systems, and defense and rocket support services. The Unmanned Systems segment provides unmanned aerial, ground, seaborne, command control, and communications systems. The Public Safety & Security segment offers integrated solutions for homeland security, public safety, critical infrastructure, and security surveillance systems.



Industry Review- KTOS

The North American defense industry is highly complex and manipulated by decisions of the U.S. Department of Defense. The Department of Defense (DoD) has recently requested that defense companies undergo a strategic shift to reinvent war-fighting capabilities with a focus on affordability. From that moment forward, future success for defense companies is dependent on their ability to embrace an affordable culture, adopt commercial capabilities, and strategically focus on growing defense segments while simultaneously exiting unprofitable ones.

Kratos Defense & Security Solutions (KTOS) is successfully restructuring its business model to make these essential changes. Kratos made the decision to make satellite communications, microwave electronics, and unmanned systems the primary focus for the future of the company. KTOS' unmanned systems segment is quickly growing and experiencing increasing government and private contractual interests. Management recognized the growing demand and acted by investing a greater effort on improving the products associated with this segment. With great success, KTOS created a newer model unmanned combat aerial system known as the UTAP-22. Kratos' UTAP-22 has been field tested, is low-cost, capable of reaching speeds of Mach .96, has manned fighter-like performance, and is ready for commercial sale in 2016.

Since 2011, the budget control act has put an increasing amount of pressure on many small and mid-cap defense companies like Kratos. Over the past several years, Kratos has seen its government services business contract go from approximately \$300 million in revenue at its peak to less than \$100 million today. This services business decrease is primarily responsible for Kratos' declining revenues over the past several years. However, in December of 2015, Congress released the 2016 and 2017 Omnibus Spending Bill and the President signed the Federal 2016 Budget. The Spending Bill and 2016 Defense Budget both provide the defense industry some relief from the Budget Control Act spending limitations. More importantly, the budget request specifically included Unmanned Systems, Satellite Communications, and Electronic Warfare and Missile Defense, which are all strategic focus areas for Kratos.

Thesis Point 1 – Backlog + Contracts

Kratos ended quarter 4 of 2015 with an impressive \$914 million in backlog orders, contributed by organic growth of 41.8% in the microwave products business, 16% in the

modular systems business, 9.6% in the satellite communications business, 4% in the defense and rocket support business, and 16.6% in the public safety business. The increased backlog enables Kratos to return manufacturing to full capacity and eliminate an approximate 1 million dollars of unabsorbed manufacturing overhead costs as stated in the 2015 10K. The increased production of unmanned systems alone is expected to contribute an additional \$100 million per year of revenue once at max capacity. Additionally, redesigned products in most of these business segments have lower associated cost, in order to satisfy the affordable request made by the U.S. Department of Defense. Fortunately, Kratos was able to achieve this mandatory strategic shift and it helped Kratos project improving operating margins in 2016 from 2015. Furthermore, by complying with the requested strategy of the U.S. Department of Defense, Kratos was rewarded with a number of new contracts for 2016.

Contracts and Achievements in the 4th quarter of 2015

- 1) Kratos completed a test flight with the Navy for its new unmanned system called UTAP-22. The test included multiple strategic missions involving 2 or more unmanned aircrafts cooperating together to complete tasks of different difficulties. For competitive reason, further details of the test flights were not able to be disclosed, however management stated they were encouraged by the interest that the product received from both private and congressional entities. Unfortunately, management was not willing to disclose any specific potential customer activity for competitive reasons at this time. Investors were told to wait till later in 2016 for finalized contracts available for publication.
- 2) Kratos completed private testing of its newest unmanned aerial target drone system called BQM-177A. BQM-177A is designed to deliver longer range, lower cruising altitudes, and greater maneuverability. The test results were reviewed by the Navy and the product is scheduled for low rate production by the end of 2016. The purpose of this product is to eventually replace the old existing BQM-74E and BQM-34S Firebee Targets that customers are currently using.
- 3) Kratos was awarded a \$44 million contract for weapons systems sustainment. The contract assumes a period of approximately two years, and the \$44 million potential value of the contract has increased over the previously received award. Kratos has performed this work since 2005, and has unique qualifications and capabilities related to the weapon systems covered by this contract.
- 4) Kratos received a \$9.1 million contract award for Oriole

Rocket Systems from the U.S. Naval Surface Warfare Center, Port Hueneme Division. Under this contract award, Kratos will deliver Oriole solid propellant rocket motors and related rocket system hardware to support ongoing experimental and test support missions.

5) Kratos received a \$3.8 million task order from U.S. Army Targets Management Office (TMO) to provide High Speed Aerial Target Plus unmanned aerial targets under its TMO Aerial Target Support prime contract.

Thesis Point 2 – Government Support

As mentioned before, the budget control act of 2011 significantly impacted Kratos' government service business segment for the past several years. The decline in sales impacted operations and caused higher operating costs associated with lower revenues. However, in December of 2015, Congress released the 2016 and 2017 Omnibus Spending Bill and the President signed the Federal 2016 Budget. The Bill provided relief of further budget cuts for the defense industry and highlighted increased spending in three of Kratos' focus segments; Unmanned Systems, Satellite Communications, and Electronic Warfare and Missile Defense. Now that the defense budget hit its trough in 2014/2015, management has a better viewpoint on the macro environment and foresees continued growth in these segments as the Department of Defense begins increasing spending over the next few years. This factor is a key driver that once plagued Kratos to lose value for five consecutive years but will now foster growth for years to come.

Thesis Point 3- Beating Expectations

Kratos' management has set the bar very low for 2016 by what they are calling the "Kratos' Base Case". This guidance was highlighted in the q4 earnings call and projects revenue and adjusted EBITDA to be approximately the same as 2015 with similar quarterly trajectories as well. The base case also includes guidance of improved cash flows from 2015 to 2016 but without detailed specifications.

Interestingly, Kratos' management later shared that the "Kratos' Base Case" did not include any considerations for the very large and strategic tactical unmanned systems opportunity that Kratos is pursuing, and it does not include any revenue related to Kratos' new product, the UTAP-22 initiative. Additionally, the base case excluded all cost reductions from reorganizations that may or may not be pursued by management in 2016 depending on strategic opportunities.

The conservative 2016 Kratos' Base Case, which excludes a few valuable key driving factors, positions Kratos to beat analysts' expectations in the coming quarters of 2016. The value derived from the UTAP 22 could not be estimated by management and therefore was not included in their forward projections to investors. This decision underestimates the expected incoming revenue growth from the unmanned systems segment, and also ignores the low cost and higher profit component associated with the UTAP-22.

The Base Case, can be considered conservative because of all the great achievements KTOS accomplished by the end of 2015. Mr. DeMarco (CFO) stated, "As we begin 2016 we believe that major areas of our Company are well positioned for growth, including Unmanned Systems, Satellite Communications, Missile Defense and Microwave Electronics, driven by specific program opportunities Kratos is involved in and under contract on, and an improving overall U.S. DoD budgetary environment". He continued by detailing a number of new satellite communication products entering the market, several new large contract awards for microwave products designed on several new platforms, and a few new large opportunities in Kratos' Unmanned Systems area. These comments lead me to believe Kratos will return to organic growth in 2016, and will outperform the base case guidance provided by management at the end of 2015.

Conclusion

Kratos has the necessary demand and proper business strategy to begin an upward trend as a growing company with a more affordable focus. Macroeconomic factors are positively boosting the potential for the defense industry and Kratos is focused on the correct war-fighting capabilities most recently requested by the United States Department of Defense. Kratos will experience organic growth in many of its business segments and has set expectations really low for 2016 in an effort to remain conservative. When evaluating the company, I factored a slightly higher revenue estimate of 1% growth for 2016, in an attempt to conservatively estimate the effects of UTAP-22 sales. Keeping everything else the same, I calculated an intrinsic value of \$6.13 and price target of \$7.53 which signifies the stock is currently undervalued and represent a roughly 40% return based on the current price of \$5.39. The catalyst that changed the future of this company was the

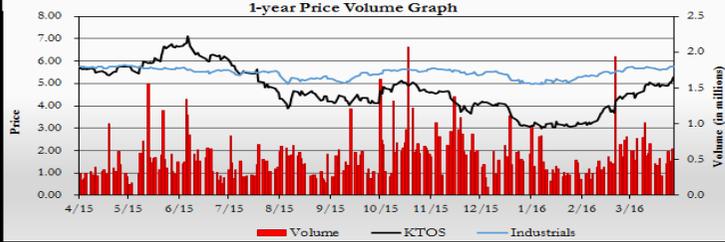
increased spending outlook by the Department of Defense (DoD). Budget cuts are no longer punishing this company and increased spending will only foster strong growth for years to come.

Analysis by P.C. Principal
4/20/2016

Current Price: \$5.39
Divident Yield: 0.0%

Intrinsic Value: \$6.14
Target Price: \$7.53

Target 1 year Return: 39.78%
Probability of Price Increase: 93%



Description	
Kratos Defense & Security Solutions, Inc. provides mission critical products, solutions, and services primarily for the Government and commercial customers.	
General Information	
Sector	Industrials
Industry	Aerospace and Defense
Last Guidance	November 3, 2015
Next earnings date	May 9, 2016
Estimated Country Risk Premium	6.21%
Effective Tax rate	38%
Effective Operating Tax rate	6%

Market Data	
Market Capitalization	\$321.16
Daily volume (mil)	0.39
Shares outstanding (mil)	59.58
Diluted shares outstanding (mil)	58.70
% shares held by institutions	48%
% shares held by investments Managers	39%
% shares held by hedge funds	6%
% shares held by insiders	3.33%
Short interest	12.97%
Days to cover short interest	15.58
52 week high	\$7.12
52-week low	\$2.80
Levered Beta	1.61
Volatility	46.31%

Past Earning Surprises		
Quarter ending	Revenue	EBITDA
12/28/2014	-18.50%	-38.90%
3/29/2015	-16.94%	-52.17%
6/28/2015	-15.08%	-91.01%
9/27/2015	-11.64%	-47.33%
12/27/2015	5.65%	-55.20%
Mean	-11.30%	-56.92%
Standard error	4.4%	9.0%

Management	
DeMarco, Eric	Chief Executive Officer, Pre
Lund, Deanna	Chief Financial Officer and
Carrai, Philip	President of Technology & Tr
Beaman, Gerald	President of Unmanned System
Adelman, Yonah	President of Microwave Elect
Duckworth, Richard	Principal Accounting Officer

Profitability	
ROIC	2.9%
NOPAT Margin	6%
Revenue/Invested Capital	0.51
ROE	0.9%
Adjusted net margin	2%
Revenue/Adjusted Book Value	0.53

Invested Funds	
Total Cash/Total Capital	2.6%
Estimated Operating Cash/Total Capital	2.6%
Non-cash working Capital/Total Capital	10.8%
Invested Capital/Total Capital	100.1%

Capital Structure	
Total Debt/Common Equity (LTM)	2.35
Cost of Existing Debt	5.95%
Estimated Cost of new Borrowing	4.80%
CGFS Risk Rating	CC
Unlevered Beta (LTM)	0.62
WACC	6.59%

Peers	
Discommun Inc.	
Ciber, Inc.	
DigitalGlobe, Inc.	
HEICO Corporation	
Esterline Technologies Corp.	
Teledyne Technologies Inc.	
Sparton Corp.	
TransDigm Group Incorporated	

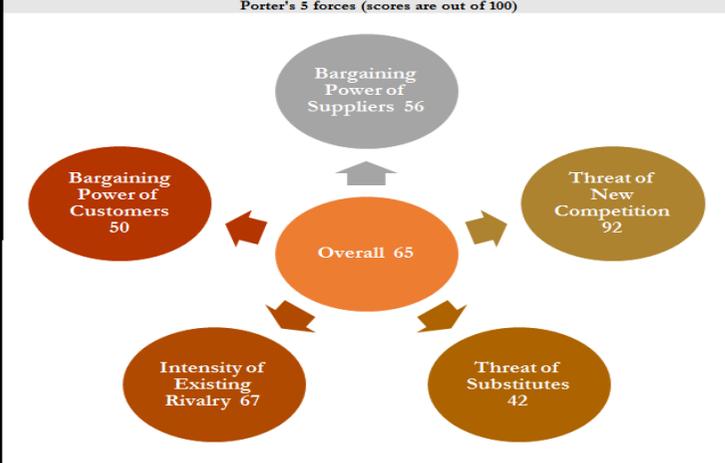
Total compensations growth	
6.82% per annum over 6y	
3.41% per annum over 6y	
6.38% per annum over 5y	
68.55% per annum over 2y	
N/M	
N/M	

KTOS (5 years historical average)	
6.59%	
6.30%	
1.05	
4.39%	
2.31%	
1.90	

KTOS (5 years historical average)	
3.9%	
3.3%	
10.3%	
99.5%	
KTOS (5 years historical average)	
2.59	
11.22%	
5.86%	
D	
0.63	
9.84%	



Sensitivity Attribution Analysis	
Revenue	32.1%
Operating Expenses	51.8%
Dividends	0.4%
NWC	1.2%
CAPEX	14.0%
Operating Cash	0.5%



Revenue growth	
Base Year	-13.9%
12/27/2016	1.0%
12/27/2017	7.0%
12/27/2018	6.0%
12/27/2019	5.0%
12/27/2020	4.0%
12/27/2021	3.0%
12/27/2022	3.0%
12/27/2023	3.0%
12/27/2024	3.0%
12/27/2025	3.0%
Continuing Period	2.1%

Invested Capital	
Base Year	\$461.16
12/27/2016	\$1,040.53
12/27/2017	\$1,324.27
12/27/2018	\$1,305.64
12/27/2019	\$1,299.45
12/27/2020	\$1,112.75
12/27/2021	\$1,131.12
12/27/2022	\$1,163.70
12/27/2023	\$1,188.62
12/27/2024	\$1,203.76
12/27/2025	\$1,222.25
Continuing Period	

Valuation	
NOPAT margin	
5.8%	0.44
4.8%	0.41
6.7%	0.58
7.3%	0.64
8.1%	0.72
8.8%	0.80
9.4%	0.86
10.0%	0.93
10.0%	0.95
10.1%	0.95
10.1%	0.96
10.1%	0.97

Net Claims	
Base Year	\$580.73
12/27/2016	\$551.46
12/27/2017	\$532.85
12/27/2018	\$498.57
12/27/2019	\$444.32
12/27/2020	\$384.57
12/27/2021	\$309.15
12/27/2022	\$224.80
12/27/2023	\$140.33
12/27/2024	\$50.33
12/27/2025	-\$42.43
Continuing Period	

Price per share	
\$6.05	
\$7.44	
\$8.73	
\$10.11	
\$11.59	
\$13.12	
\$14.69	
\$16.28	
\$17.89	
\$19.52	
\$21.17	