

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

Form 10-K

March 11, 2016

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark
One)

✓ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED
DECEMBER 27, 2015

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES AND EXCHANGE ACT OF 1934

Commission file number 001-34460

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

(Exact name of Registrant as specified in its charter)

Delaware

13-3818604

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification No.)

4820 Eastgate Mall, Suite 200

San Diego, CA 92121

(858) 812-7300

(Address, including zip code, and telephone number, including
area code, of Registrant's principal executive offices)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT

Title of Each Class

Name of each exchange on which registered

Common Stock, par value \$0.001

The NASDAQ Global Select Market

Right to purchase Shares of Series C Preferred
Stock

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements

incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates as of June 28, 2015, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$302.5 million, based on the closing sale price for shares of the registrant's common stock as reported by the NASDAQ Global Select Market on such date. This disclosure excludes shares of common stock held by executive officers, directors and stockholders whose individual ownership exceeds 10% of the common stock outstanding on June 28, 2015 because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for any other purpose.

As of March 4, 2016, 59,583,344 shares of the registrant's common stock were outstanding.

Table of Contents

Documents Incorporated by Reference

Items 10, 11, 12, 13 and 14 of Part III of this annual report on Form 10-K incorporate information by reference from the registrant's definitive proxy statement filed pursuant to Regulation 14A in connection with the registrant's 2016 Annual Meeting of Stockholders or an amendment to this annual report on Form 10-K to be filed with the Securities and Exchange Commission within 120 days after the close of the fiscal year covered by this annual report on Form 10-K.

Table of Contents

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
 FORM 10-K
 FOR THE FISCAL YEAR ENDED DECEMBER 27, 2015

TABLE OF CONTENTS

	Page
<u>PART I</u>	
<u>Item 1. Business</u>	<u>3</u>
<u>Item 1A. Risk Factors</u>	<u>10</u>
<u>Item 1B. Unresolved Staff Comments</u>	<u>27</u>
<u>Item 2. Properties</u>	<u>27</u>
<u>Item 3. Legal Proceedings</u>	<u>28</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>28</u>
<u>PART II</u>	
<u>Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>28</u>
<u>Item 6. Selected Financial Data</u>	<u>31</u>
<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>32</u>
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>51</u>
<u>Item 8. Financial Statements and Supplementary Data</u>	<u>52</u>
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>52</u>
<u>Item 9A. Controls and Procedures</u>	<u>52</u>
<u>Item 9B. Other Information</u>	<u>53</u>
<u>PART III</u>	
<u>Item 10. Directors, Executive Officers and Corporate Governance</u>	<u>53</u>
<u>Item 11. Executive Compensation</u>	<u>53</u>
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>53</u>
<u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u>	<u>53</u>
<u>Item 14. Principal Accounting Fees and Services</u>	<u>53</u>
<u>PART IV</u>	
<u>Item 15. Exhibits, Financial Statement Schedules</u>	<u>53</u>

Table of Contents

All references to “us,” “we,” “our,” the “Company” and “Kratos” refer to Kratos Defense & Security Solutions, Inc., a Delaware Corporation, and its subsidiaries.

FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K (this “Annual Report”) contains “forward-looking statements” relating to our future financial performance, the market for our services and our expansion plans and opportunities. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” or “continue,” the negative of such terms or other comparable terminology. These forward-looking statements reflect our current beliefs, expectations and projections, are based on assumptions, and are subject to known and unknown risks and uncertainties that could cause our actual results or achievements to differ materially from any future results or achievements expressed in or implied by our forward-looking statements. Many of these factors are beyond our ability to control or predict. As a result, you should not place undue reliance on forward-looking statements. The most important risk and uncertainties that could cause our actual results or achievements to differ materially from the results or achievements expressed in or implied by our forward-looking statements, include, but are not limited to those specifically addressed in Item 1A “Risk Factors” in this Annual Report, as well as those discussed elsewhere in this Annual Report. These forward-looking statements reflect our views and assumptions only as of the date such forward-looking statements are made. Except as required by law, we assume no responsibility for updating any forward-looking statements, whether as a result of new information, future events or otherwise.

PART I.

Item 1. Business.

Overview

Kratos is a mid-tier government contractor at the forefront of the U.S. Department of Defense’s (the “DoD”) Third Offset Strategy. Kratos is a leading technology, intellectual property and proprietary product and solution company focused on the U.S. and its allies’ national security. Kratos’ primary focus areas are unmanned systems, satellite communications, microwave electronics, cyber security/warfare, missile defense and combat systems. We believe that our technology, intellectual property, proprietary products and designed in positions on our customers’ platforms and systems 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 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.

Industry Update

Faced with significant budget pressures, in recent years the U.S. Government has implemented reductions in government spending, including reductions in appropriations for the DoD and other federal agencies, pursuant to the Budget Control Act of 2011 (“BCA”), as amended by the American Taxpayer Relief Act of 2012 and the Bipartisan Budget Act of 2013. Pursuant to the terms of the BCA, a sequestration went into effect in March 2013 resulting in a 7.8% reduction to the DoD budget for fiscal year (the period running from October 1st to September 30th, a “FY”) 2013 to \$495.5 billion, excluding funding for military personnel. The DoD budget was approximately \$496.0 billion in FY 2014 and remains at a similar level in FY 2015. The DoD base budget excludes funding for overseas contingency operations, such as those in Afghanistan, Iraq and Syria, which are appropriated separately and are not currently subject to the BCA.

On November 2, 2015, President Obama signed the Bipartisan Budget Act of 2015, formalizing the terms of a two-year budget agreement which raises the U.S. debt ceiling and lifts the sequestration spending caps by \$80.0

billion. Under the budget agreement, the total federal spending increase over the BCA topline funding caps will be \$50.0 billion in FY 2016 and \$30.0 billion in FY 2017, with the amounts divided equally between defense and domestic priorities. The overall discretionary budget will be \$1.067 trillion in FY 2016 and \$1.07 trillion in FY 2017. The FY 2016 discretionary defense budget will be \$548.1 billion, a \$25.0 billion increase over the BCA topline funding caps.

Under the Bipartisan Budget Act of 2015, the Obama Administration will receive \$33.0 billion of the \$38.0 billion national defense spending increase it sought in FY 2016. In summary the budget agreement:

- extends the BCA out to 2025;
- suspends the U.S. debt limit/ceiling until March 2017;

Table of Contents

increased spending caps for FY 2016 and FY 2017 by \$80.0 billion, including \$50.0 billion in FY 2016 and \$30.0 billion in FY 2017, split evenly between defense and domestic priorities; and includes a FY 2016 DoD base budget of \$548.0 billion; and includes a FY 2016 overseas contingency operation budget of \$59.0 billion.

Current Reporting Segments

The Company operates in three reportable segments. The Kratos Government Solutions (“KGS”) reportable segment is comprised of an aggregation of KGS operating segments, including our microwave electronic products, satellite communications, modular systems and rocket support operating segments. The Unmanned Systems (“US”) reportable segment consists of our unmanned aerial system and unmanned ground and seaborne system businesses. The Public Safety & Security (“PSS”) reportable segment provides independent integrated solutions for advanced homeland security, public safety, critical infrastructure, and security and surveillance systems for government and commercial applications. We organize our business segments based primarily on the nature of the products, solutions and services offered. Transactions between segments are negotiated and accounted for under terms and conditions similar to other government and commercial contracts, and these intercompany transactions are eliminated in consolidation. For additional information regarding our reportable segments, see Note 13 of the Notes to Consolidated Financial Statements. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Discontinued Operations

On August 21, 2015, the Company completed the sale of the U.S. and U.K. operations of its Electronic Products Division to Ultra Electronics Holdings plc (“Ultra”), a public limited company formed under the laws of England and Wales and traded on the London Stock Exchange, and Ultra Electronics Defense Inc. (the “Buyer”), a Delaware corporation ultimately owned by Ultra (the “Transaction”). Pursuant to the terms of that certain Stock Purchase Agreement dated May 31, 2015, by and among the Company, Ultra and the Buyer (the “Purchase Agreement”), the Company sold to the Buyer all of the issued and outstanding capital stock of its wholly owned subsidiary Herley Industries, Inc. (“Herley”) and certain of Herley’s subsidiaries, including Herley-CTI, Inc., EW Simulation Technology, Ltd. and Stapor Research, Inc. (collectively, the “Herley Entities”), for \$260.0 million in cash plus \$5.0 million for taxes incurred as part of the Transaction, less a \$2.0 million escrow to satisfy any purchase price adjustments, and an estimated working capital adjustment of \$8.3 million. The Purchase Agreement also contains certain non-compete and indemnification provisions. Under the Purchase Agreement, the Company entered into an agreement to indemnify the Buyer for any pre-acquisition tax liabilities. As a result of this arrangement, the Company recorded amounts that have historically been classified as unrecognized tax benefits into other long term liabilities. The Company also agreed to indemnify Ultra for pre-existing environmental conditions for a period of five years from the closing date and with a maximum indemnification payment of \$34.0 million. The Company does not believe payments will be required under the indemnification provision, and the assessment of the fair value is immaterial. Under the terms of the Purchase Agreement, a joint 338(h)(10) election has been made for income tax purposes, providing a “step up” in tax basis to Ultra. The Company incurred approximately \$11.5 million in transaction-related costs. The gain on sale of \$80.8 million is subject to changes in the indemnification obligations. In accordance with ASC 360-10-45-9, Property, Plant, and Equipment (Topic 360) and ASC 205-20-45-3 Presentation of Financial Statements (Topic 205), the Herley Entities were reported in discontinued operations in the accompanying Consolidated Financial Statements for all periods presented. For additional information regarding discontinued operations, see Note 8 of the Notes to Consolidated Financial Statements.

Immediately prior to the closing of the Transaction, the outstanding shares of the capital stock of (i) General Microwave Corporation, a New York corporation, and its direct and indirect wholly owned subsidiaries General Microwave Israel Corporation, a Delaware corporation, General Microwave Israel (1987) Ltd., an Israeli company,

and Herley GMI Eyal Ltd., an Israeli company, (ii) MSI Acquisition Corp., a Delaware corporation and its wholly owned subsidiary Micro Systems, Inc., a Florida corporation, and (iii) Herley-RSS, Inc., a Delaware corporation, were distributed as a dividend by Herley to the Company and will continue their current operations as wholly owned subsidiaries of the Company.

In November 2015, the Company and Ultra settled the working capital adjustment at \$8.1 million, and the net cash position at closing, resulting in a net payment to the Company of \$2.7 million. This represents the payment from escrow to the Company of \$2.0 million, as well as the payment from Ultra of \$0.7 million, reflecting the difference in the estimated working capital and actual working capital and the net cash position at the close of the Transaction. In December 2015, the Company submitted to Ultra for reimbursement the maximum \$5.0 million for taxes incurred as part of the Transaction, which was reimbursed in January 2016.

Following the sale of the Herley Entities, the Company, on August 21, 2015, paid down the \$41.0 million outstanding on the Company's \$110.0 million Credit and Security Agreement, dated May 14, 2014 (the "Credit Agreement"), by and among

Table of Contents

the Company, the lenders from time to time party thereto, SunTrust Bank, as Agent (the “Agent”), PNC Bank, National Association, as Joint Lead Arranger and Documentation Agent, and SunTrust Robinson Humphrey, Inc., as Joint Lead Arranger and Sole Book Runner, and on September 22, 2015, repurchased \$175.0 million of the \$625.0 million of 7.00% Senior Secured Notes due in 2019 at par, in accordance with the Indenture, dated May 14, 2014 (the “Indenture”), among the Company, all of the Company’s 100% owned domestic subsidiaries (the “Subsidiary Guarantors”) and Wilmington Trust, National Association, as Trustee and Collateral Agent.

Competitive Strengths

Kratos’ primary competitive strengths are our intellectual property, proprietary products, customer relationships and the designed in position of our technology and products into our customers’ platforms and systems.

Highly Specialized Experience. Kratos and our work force have years of experience working on and with the U.S. and its allies’ national security platforms and systems.

We believe that Kratos is one of the industry leaders in our core business areas including, unmanned systems, satellite communications, microwave products, missile systems and radars, missile defense, directed energy weapons, cyber security and warfare, and training systems.

Kratos’ work force of approximately 2,900 employees have specialized national security related experience with the majority performing their duties at customer locations, secure manufacturing facilities or critical infrastructure sites. Specialized national security focus aligned with mission-critical national security priorities. Continued concerns related to the threats posed by certain foreign nations and terrorists have caused the U.S. Government to identify national security as an area of functional and spending priority. Budget pressures, particularly related to DoD spending, have placed a premium on developing and fielding low-cost, high-technology solutions to assist in national security missions. Our primary capabilities and areas of focus, listed below, are strongly aligned with the objectives of the U.S. Government:

- Unmanned systems
- Satellite communications and radio frequency detection
- Electronic warfare, attack, missile, and radar systems
- Intelligence, surveillance and reconnaissance
- Ballistic missile defense
- Command, control and combat systems
- Cybersecurity and information assurance
- Specialized training systems

Diverse base of key contracts with low concentration. Many of our contracts are single-award and or sole source in nature, where Kratos is the only awardee by the customer. In many cases, our ability to obtain single award, sole source contracts is due to our intellectual property, proprietary products, past performance qualifications and relative experience. We have a highly diverse base of contracts with no contract representing more than 5% of 2015 revenue. Our fixed-price contracts, the vast majority of which are production contracts, represent approximately 80% of our 2015 revenue. Our cost-plus-fee contracts and time and materials contracts represent approximately 14% and 6%, respectively, of our 2015 revenue. We believe our diverse base of key contracts and low reliance on any one contract provides us with a stable, balanced revenue stream.

In-depth understanding of customer missions. We have a reputation for successfully providing mission-critical products, solutions and services to our customers. Our long-term relationships with the U.S. Air Force, U.S. Army, U.S. Navy and other national security related customers and agencies enable us to develop an in-depth understanding of their missions and technical requirements. In addition, the majority of our employees are located at our customer locations, at secure manufacturing facilities or at critical infrastructure locations, all of which provides Kratos with valuable strategic insight into our customers’ ongoing missions and future program requirements. This understanding of our customers’ missions, requirements and needs, in conjunction with the strategic location of our employees, enables us to offer technical solutions tailored to our customers’ specific requirements and evolving mission objectives. In addition, once we are on-site with a customer, we have historically been successful in winning new and recomplete

business.

Significant cash flow visibility driven by stable backlog. As of December 27, 2015, our total backlog (see Backlog below) was approximately \$0.9 billion, of which approximately \$528.7 million was funded backlog. The majority of our sales are from orders issued under long-term contracts, typically three to five years in duration. Our contract backlog provides visibility into stable future revenue and cash flow over a diverse set of contracts.

5

Table of Contents

Highly skilled employees and an experienced management team. We deliver our services through a skilled and primarily technically oriented workforce of approximately 2,900 employees. Our senior managers have significant experience with U.S. Government agencies, the U.S. military and U.S. Government contractors. Many of our employees hold national security clearances. Members of our management team have experience growing businesses both organically and through acquisitions. We believe that the cumulative experience and differentiated expertise of our personnel in our core focus areas, coupled with our sizable employee base, allow us to qualify for and bid on larger projects in a prime contracting role.

Our Strategy

Our strategy is to continue to grow our business as a proprietary product and intellectual property focused national security company, focused on Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance (“C5ISR”), providing highly differentiated technology, products, solutions and services in our core areas of focus. We execute our strategy by delivering comprehensive, leading technology products, high-end engineering services, technical solutions, product manufacturing, and engineering solutions to U.S. Government agencies. To achieve our objective, we intend to primarily focus on internal growth by selectively investing in strategic growth areas, curtailing such investments when deemed appropriate, and eliminating unnecessary or duplicative costs where possible.

Internal Growth

We are focused on generating internal growth by capitalizing on our intellectual property, proprietary products, current contract base and customer relationships and by making targeted discretionary investments in strategic growth areas including unmanned tactical systems, satellite communications and microwave electronic products, which have the highest potential for growth and in which we will retain the intellectual property rights.

Expand Technology Product, Solution and Service Offerings Provided to Existing customers. We are focused on expanding the technology, products, solutions and services we provide to our current customers by leveraging our strong relationships, technical capabilities and past performance record and by offering a wider range of comprehensive technology rich products and solutions. In regard to areas of specialization, our product and service offerings include manufacturing of specialized defense electronics products, integrated technology solutions for satellite communications and specialized unmanned aerial aircraft, targets, Unmanned Aerial Systems (“UAS”) and Unmanned Ground Systems (“UGS”). We believe our understanding of customer missions, processes, needs and requirements, and our ability to deliver low cost, technology leading products and solutions, position us well for success in the current constrained budget environment.

Capitalize on Current Contract Base. We are pursuing new program and contract opportunities and awards as we build the business with our expanding technology base, contract portfolio, and product, solution and service offerings. We are also aggressively pursuing several new national security programs, including air and missile defense radar, F-35 aircraft, Three-Dimensional Expeditionary Long-Range Radar, directed energy systems, hypersonic systems, electromagnetic rail gun systems, next generation ballistic missile targets, denied environment systems, UAS, UGS, tactical unmanned aircraft systems, small satellite command and control systems, and robotics. We also are aggressively pursuing task orders under existing contract vehicles to maximize our revenue and strengthen our customer relationships. We have developed several internal tools that facilitate our ability to track, prioritize and win task orders under these vehicles. Combining these tools with our technical expertise, our strong past performance record and our knowledge of our customers’ needs should position us to win additional task orders.

Expand Customer and Contract Base. We are also focused on expanding our customer base into areas with significant growth opportunities by leveraging our technology, intellectual property, proprietary products, capabilities, industry reputation, long-term customer relationships and diverse contract base. We anticipate that this expansion will enable us both to pursue additional higher value work and to further diversify our revenue base across additional U.S. Government, international and commercial customers.

Improve Operating Margins. We believe that we have opportunities to increase our operating margins and improve profitability by capitalizing on our corporate infrastructure investments and internally developed tools, improving efficiencies and reducing costs, and concentrating our efforts on increasing the percentage of revenues generated from high value-added contracts.

Investment in Strategic Growth Areas. Over the past several years, we have made significant investments in strategic growth areas including the unmanned tactical aircraft systems area. Specifically, we have increased internally funded research and development, capital expenditures and infrastructure investments including bid and proposal and new business capture and pursuit expenses. We have made these investments with the intention of retaining the intellectual property rights and design packages for unmanned platforms and systems, and to secure a sole source position in these strategic growth areas. Once we have either secured these sole source positions or in the event our solution is not selected, we will curtail our investments in these areas, which we expect will improve our margins and cash flows at that time, and if our products enter production.

Table of Contents

Capitalize on Corporate Infrastructure Investments. In recent periods, we have made significant investments in our senior management and corporate infrastructure for cyber security threats to our Company, increased and changing regulations we are subject to, and the changing national security environment. These investments also 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, larger and highly technical contract opportunities. We believe our management experience and corporate infrastructure can support a company with a much larger revenue base than ours. Accordingly, we believe that, to the extent our revenue grows, we will be able to leverage this infrastructure base and increase our operating margins.

Customers

A representative list of our customers in our KGS and US segments during 2015 included the U.S. Air Force, U.S. Army, U.S. Navy, U.S. Marines, Missile Defense Agency, the Department of Homeland Security, the National Aeronautics and Space Administration, Foreign Military Sales (“FMS”), the U.S. Southern Command, U.S. intelligence community and certain classified customers. In 2015, representative customers in the PSS segment included Metropolitan Transportation Authority of New York, Prince George’s County Public Schools, Children’s Hospital of Philadelphia, Alamo Colleges, University of New Hampshire, City of Galveston, Texas Orthopedic Hospital, Port Authority of New York & New Jersey, Prudential, New York University, Fidelity, Scripps Clinic, PNC Bank, Halliburton, AT&T, Chevron, Mellon Bank, Calpine Power Plants, Capital Health, DuPont Fabros, BP America, University of Houston, Meridian Health and Memorial Hermann Hospital System.

Revenue from the U.S. Government (which includes FMS) includes revenue from contracts for which we are the prime contractor as well as those for which we are a subcontractor and the ultimate customer is the U.S. Government. Revenues from U.S. Government agency customers in aggregate accounted for approximately 62%, 57% and 61% of total revenues in 2013, 2014, and 2015, respectively.

Revenues from foreign customers were approximately \$76.5 million or 9%, \$89.0 million or 12%, and \$73.2 million or 11% of total revenue for the years ended December 29, 2013, December 28, 2014, and December 27, 2015, respectively.

Backlog

As of December 28, 2014 and December 27, 2015, our backlog was approximately \$1.0 billion and \$0.9 billion, respectively, of which \$585.8 million was funded in 2014 and \$528.7 million was funded in 2015. Backlog is our estimate of the amount of revenue we expect to realize over the remaining life of awarded contracts and task orders that we have in hand as of the measurement date. Our total backlog consists of funded and unfunded backlog. We define funded backlog as estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus our estimate of the future revenue we expect to realize from our commercial contracts that are under firm orders. Our funded backlog does not include the full potential value of our contracts because Congress often appropriates funds to be used by an agency for a particular program of a contract on a yearly or quarterly basis even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriation and the procuring agency allocates funding to the contract.

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, 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 based on our experience under such contracts and similar contracts. 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.

Contracts undertaken by us may extend beyond one year. Accordingly, portions are carried forward from one year to the next as part of backlog. Because many factors affect the scheduling of projects, no assurance can be given as to when revenue will be realized on projects included in our backlog. Although funded backlog represents only business that is considered to be firm, we cannot guarantee that cancellations or scope adjustments will not occur. The majority of funded backlog represents contracts with terms that would entitle us to all or a portion of our costs incurred and potential fees upon cancellation by the customer.

Table of Contents

Management believes that year-to-year comparisons of backlog are not necessarily indicative of future revenues. The actual timing of receipt of revenues, if any, on projects included in backlog could change because many factors affect the scheduling of projects. In addition, cancellation or adjustments to contracts may occur. Backlog is typically subject to large variations from quarter to quarter as existing contracts are renewed or new contracts are awarded.

Additionally, all U.S. Government contracts included in backlog, whether or not funded, may be terminated at the convenience of the U.S. Government.

Employees

As of December 27, 2015, we had a work force of approximately 2,900 full-time, part-time and on-call employees.

Competition

Our market is competitive and includes a number of companies in the U.S. defense and security integration industries. Many of the companies that we compete against have significantly greater financial, technical and marketing resources and generate greater revenues than we do. Competition in the KGS and US segments include tier one, large U.S. Government contractors such as Northrop Grumman, Lockheed Martin, General Dynamics, SAIC, Leidos, Engility, ITT Systems, CSRA, Raytheon, BAE Systems, L3, Orbital/ATK, Boeing, and CACI. While we view other government contractors as competitors, we also team with these companies in joint proposals or in the delivery of our products, solutions and services for customers. Tier two competitors include smaller government contractors such as AeroVironment, API Technologies, iRobot and AAR. Intense competition and long operating cycles are key characteristics of our business within the defense industry. It is also common in the defense industry for work on major programs to be shared among a number of companies. A company competing to be a prime contractor or subcontractor on an award may, upon final award of the contract to another competitor, become a subcontractor for the final prime contractor. It is not unusual to compete for a contract award with a peer company and simultaneously perform as a supplier to or be a customer of that same competitor on other contracts, or vice versa. The nature of major defense programs, conducted under binding contracts, allows companies that perform well to benefit from a level of program continuity not frequently found in other industries. Competition in the PSS segment includes Siemens Building Technology, Johnson Controls, and Convergent Technologies, among others.

We believe that the principal competitive factors in our ability to win new business include our intellectual property, proprietary products and technology. Also important is our past performance qualifications, customer relationships, domain and technology expertise, the ability to replace contract vehicles, the ability to deliver results within budget (time and cost), reputation, accountability, staffing flexibility, and project management expertise. Additionally, our ability to deliver cost effective products, solutions and services that meet our customers' requirements is a key differentiator. The current federal procurement environment is driven primarily by "low price, technically acceptable" contract award decisions. Accordingly, innovation and the ability for a contractor to quickly deliver a low cost, technically compliant solution or product are critical in the current competitive environment. In addition, competitor bid protests have become more prevalent in the current competitive environment, resulting in further delay of contract procurement activity.

In the U.S. defense, IT, and services markets, the U.S. Government has stressed competition and affordability in connection with its future procurement of products and services. This has led to fewer sole source awards, as well as more emphasis on cost competitiveness. In addition, the DoD has announced several initiatives to improve efficiency, refocus priorities, modify contract terms, and enhance DoD best practices including those used to procure goods and services from defense contractors. See the Industry Background section in Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Industry Update section in Item 1 "Business" contained within this Annual Report. These initiatives, when implemented, together with planned reductions in defense spending levels, are likely to result in fewer new opportunities for our industry as a whole with more demanding terms. A reduced opportunity set is likely to intensify competition within the industry as companies compete for a more limited set of new programs.

Research and Development

We believe that our future success depends upon our ability to continue to develop new products and services, and enhancements to and applications for our existing products and services. Our research and development expenses were

\$19.7 million, \$18.6 million and \$16.2 million in 2013, 2014, and 2015, respectively. We intend to continue our focus on research and development as a key strategy for growth, which will focus on investments in those fields that we believe will offer the greatest opportunity for growth and profitability. Our current primary internal research and development (“IR&D”) focus areas include unmanned systems, electronic warfare, satellite communications and signal monitoring.

8

Table of Contents

Intellectual Property

We believe that our continued success depends in large part on our proprietary technology, the intellectual skills of our employees and the ability of our employees to continue to innovate. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as confidentiality agreements, to establish and protect our proprietary rights.

As of December 27, 2015, we held a number of U.S. and foreign patents. We do not consider our business to be materially dependent upon any individual patent. We will continue to file and pursue patent applications when and where appropriate to attempt to protect our rights in our proprietary technologies. We also encourage our employees to continue to invent and develop new technologies so as to maintain our competitiveness in the marketplace.

We own or have rights to use certain trademarks, service marks and trade names that we use in conjunction with the operation of our business. Certain of our trademarks have also been registered in selected foreign countries.

Government Regulation

We are subject to various government regulations, including various U.S. Government regulations as a contractor and subcontractor to the agencies of the U.S. Government. Among the most significant U.S. Government regulations affecting our business are:

- the Federal Acquisition Regulations and supplemental agency regulations, which comprehensively regulate the formation, administration, and performance under government contracts;
- the Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations;
- the Cost Accounting Standards, which impose accounting requirements that govern our right to reimbursement under cost-based government contracts;
- the Foreign Corrupt Practices Act, which prohibits U.S. companies from providing anything of value to a foreign official to help obtain, retain or direct business, or obtain any unfair advantages;
- the False Claims Act and the False Statements Act, which, respectively, impose penalties for payments made on the basis of false facts provided to the government and impose penalties on the basis of false statements, even if they do not result in a payment; and
- laws, regulations and executive orders restricting the use and dissemination of information classified for national security purposes and the exportation of certain products and technical data.

We also need special security clearances to continue working on and advancing certain of our projects with the U.S. Government. Classified programs generally will require that we comply with various Executive Orders, federal laws and regulations and customer security requirements that may include restrictions on how we develop, store, protect and share information, and may require our employees to obtain government clearances.

The nature of the work we do for the federal government may also limit the parties who may invest in or acquire us. Export laws may keep us from providing potential foreign acquirers with a review of the technical data they would be acquiring. In addition, there are special requirements for foreign parties who wish to buy or acquire control or influence over companies that control technology or produce goods in the security interests of the U.S. There may need to be a review under the Exon-Florio provisions of the Defense Production Act. Finally, the government may require a prospective foreign owner to establish intermediaries to actually run that part of the company that does classified work, and establishing a subsidiary and its separate operation may make such an acquisition less appealing to such potential acquirers.

In addition, the export from the U.S. of certain of our products may require the issuance of a license by the U.S. Department of Commerce under the Export Administration Act, as amended, and its implementing regulations as kept in force by the International Emergency Economic Powers Act of 1977, as amended. Some of our products may require the issuance of a license by the U.S. Department of State under the Arms Export Control Act and its implementing regulations, which licenses are generally harder to obtain and take longer to obtain than do Export Administration Act licenses.

Our business may require compliance with state or local laws designed to limit the uses of personal user information gathered online or require online services to establish privacy policies.

Table of Contents

Material Availability

We procure critical material and subsystems from both domestic and global supply partners. These supply sources may be single sources for certain components and the material provided may have extended lead times. To support our continuing customer needs, we have taken steps to mitigate sourcing risks. This includes working closely with our suppliers to ensure future material and subsystem availability to support our manufacturing plans. In some cases, we have elected to stock reserve material to ensure future availability.

Environmental

Our manufacturing operations are subject to many requirements under environmental laws. In the U.S., the U.S. Environmental Protection Agency and similar state agencies administer laws that restrict the emission of pollutants into the air, discharges of pollutants into bodies of water and disposal of pollutants in the ground. Violations of these laws can result in significant civil and criminal penalties and incarceration. The failure to obtain a permit for certain activities may be a violation of environmental law and subject the owner and operator to civil and criminal sanctions. Most environmental agencies also have the power to shut down an operation if it is operating in violation of environmental law. U.S. laws also typically allow citizens to bring private enforcement actions in some situations. Outside the U.S., the environmental laws and their enforcement vary and may be more burdensome. We have management programs and processes in place that are intended to minimize the potential for violations of these laws. Other environmental laws, primarily in the U.S., address the contamination of land and groundwater and require the clean-up of such contamination. These laws may apply not only to the owner or operator of an on-going business, but also to the owner of land contaminated by a prior owner or operator. In addition, if a parcel is contaminated by the release of a hazardous substance, such as through its historic use as a disposal site, any person or company that has contributed to that contamination, whether or not it has a legal interest in the land, may be subject to a requirement to clean up the parcel.

Available Information

We file reports with the Securities and Exchange Commission (“SEC”). We make available on our website under “Investor Relations/Financial Information/SEC Filings,” free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we electronically file such materials with or furnish them to the SEC. Our website address is www.kratosdefense.com. You may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, NE, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site that contains our reports, proxy and information statements, and other information at www.sec.gov.

References to our website and the SEC’s website in this report are provided as a convenience and do not constitute, and should not be viewed as, incorporation by reference of the information contained on, or available through, such websites. Such information should not be considered a part of this report, unless otherwise expressly incorporated by reference in this report.

Item 1A. Risk Factors.

You should carefully consider the following risk factors and all other information contained herein as well as the information included in this Annual Report and other reports and filings made with the SEC in evaluating our business and prospects. Risks and uncertainties, in addition to those we describe below, that are not presently known to us or that we currently believe are immaterial may also impair our business operations. If any of the following risks occur, our business and financial results could be harmed and the price of our common stock could decline. You should also refer to the other information contained in this Annual Report, including our Consolidated Financial Statements and the related Notes.

Risks Related to Our Business

The U.S. Government provides a significant portion of our revenue, and our business could be adversely affected by changes in the fiscal policies of the U.S. Government and governmental entities.

In fiscal 2013, 2014 and 2015, we generated 62%, 57% and 61%, respectively, of our total revenues from contracts with the U.S. Government (including all branches of the U.S. military and FMS), either as a prime contractor or a

subcontractor. We expect to continue to derive most of our revenues from work performed under U.S. Government contracts. See the Industry Update section in Item