KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
April 30, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended March 30, 2014

¨ 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)

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 ý No o

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 ý No o

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 o	Accelerated filer ý

Non-accelerated filer o
(Do not check if a smaller reporting company)

Smaller reporting company o

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

As of April 25, 2014, 57,430,572 shares of the registrant's common stock were outstanding.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED MARCH 30, 2014

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions, except par value and number of shares)
(Unaudited)

	December 29, 2013	March 30, 2014
Assets		
Current assets:		
Cash and cash equivalents	$55.7	$53.6
Restricted cash	5.0	5.0
Accounts receivable, net	265.8	248.0
Inventoried costs	74.6	81.1
Prepaid expenses	10.4	10.8
Other current assets	18.8	14.8
Total current assets	430.3	413.3
Property, plant and equipment, net	84.8	84.0
Goodwill	596.4	596.4
Intangible assets, net	69.9	64.3
Other assets	35.2	38.4
Total assets	$1,216.6	$1,196.4
Liabilities and Stockholders’ Equity		
Current liabilities:		
Accounts payable	$61.9	$48.2
Accrued expenses	46.2	41.1
Accrued compensation	44.9	38.7
Accrued interest	5.2	20.8
Billings in excess of costs and earnings on uncompleted contracts	52.5	54.5
Deferred income tax liability	28.4	28.4
Other current liabilities	11.9	12.4
Total current liabilities	251.0	244.1
Long-term debt principal, net of current portion	628.8	628.5
Long-term debt premium	14.5	13.5
Other long-term liabilities	26.5	26.2
Total liabilities	920.8	912.3
Commitments and contingencies		
Stockholders’ equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 29, 2013 and March 30, 2014	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 57,056,892 and 57,420,366 shares issued and outstanding at December 29, 2013 and March 30, 2014, respectively	—	—
Additional paid-in capital	856.0	859.5
Accumulated other comprehensive loss	(0.8)	(0.9)
Accumulated deficit	(559.4)	(574.5)
Total stockholders' equity	295.8	284.1
Total liabilities and stockholders’ equity	$1,216.6	$1,196.4

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(in millions, except per share amounts)
(Unaudited)

	Three Months Ended	
	March 31, 2013	March 30, 2014
Service revenues	$115.5	$100.6
Product sales	137.3	99.5
Total revenues	252.8	200.1
Cost of service revenues	88.2	74.1
Cost of product sales	98.9	73.4
Total costs	187.1	147.5
Gross profit	65.7	52.6
Selling, general and administrative expenses	49.2	43.4
Merger and acquisition expenses	0.1	—
Research and development expenses	4.9	5.2
Unused office space and other restructuring	—	0.7
Operating income from continuing operations	11.5	3.3
Other income (expense):		
Interest expense, net	(16.2)	(16.1)
Other income (expense), net	(0.7)	0.2
Total other expense, net	(16.9)	(15.9)
Loss from continuing operations before income taxes	(5.4)	(12.6)
Provision for income taxes from continuing operations	2.8	2.3
Loss from continuing operations	(8.2)	(14.9)
Loss from discontinued operations	(2.1)	(0.1)
Net loss	$(10.3)	$(15.0)
Basic and diluted loss per common share:		
Net loss from continuing operations	$(0.14)	$(0.26)
Net loss from discontinued operations	(0.04)	0.00
Net loss per common share	$(0.18)	$(0.26)
Basic and diluted weighted average shares outstanding	56.6	57.4
Comprehensive Loss		
Net loss from above	$(10.3)	$(15.0)
Change in cumulative translation adjustment	0.1	(0.1)
Comprehensive loss	$(10.2)	$(15.1)

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions)
(Unaudited)

	Three Months Ended	
	March 31, 2013	March 30, 2014
Operating activities:		
Net loss	$(10.3)	$(15.0)
Less: Loss from discontinued operations	(2.1)	(0.1)
Loss from continuing operations	(8.2)	(14.9)
Adjustments to reconcile loss from continuing operations to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	14.2	9.6
Stock-based compensation	1.9	1.8
Amortization of deferred financing costs	1.3	1.3
Amortization of premium on Senior Secured Notes	(1.0)	(1.0)
Provision for doubtful accounts	0.1	0.1
Changes in unused office space accrual	—	0.2
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	(9.8)	17.8
Inventoried costs	6.3	(6.7)
Prepaid expenses and other assets	—	2.2
Accounts payable	(12.0)	(13.7)
Accrued compensation	(4.3)	(6.3)
Accrued expenses	(4.7)	(5.2)
Accrued interest payable	15.3	15.6
Billings in excess of costs and earnings on uncompleted contracts	4.9	(0.1)
Income tax receivable and payable	2.9	1.8
Other liabilities	(1.8)	(0.8)
Net cash provided by operating activities from continuing operations	5.1	1.7
Investing activities:		
Cash paid for acquisitions, net of cash acquired	1.2	(1.6)
Decrease in restricted cash	0.2	—
Capital expenditures	(3.3)	(3.1)
Net cash used in investing activities from continuing operations	(1.9)	(4.7)
Financing activities:		
Repayment of debt	(0.3)	(0.2)
Other	(0.2)	1.6
Net cash provided by (used in) financing activities from continuing operations	(0.5)	1.4
Net cash flows of continuing operations	2.7	(1.6)
Net operating cash flows of discontinued operations	0.2	(0.5)
Effect of exchange rate changes on cash and cash equivalents	(0.3)	—
Net increase (decrease) in cash and cash equivalents	2.6	(2.1)
Cash and cash equivalents at beginning of period	49.0	55.7
Cash and cash equivalents at end of period	$51.6	$53.6

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

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

(a) Basis of Presentation

The information as of March 30, 2014 and for the three months ended March 31, 2013 and March 30, 2014 is unaudited. The condensed consolidated balance sheet as of December 29, 2013 was derived from the Company’s audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company’s financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the United States (“GAAP”). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company’s audited annual consolidated financial statements for the fiscal year ended December 29, 2013, included in the Company’s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on March 12, 2014 (the “Form 10-K”). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(b) Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries for which all inter-company transactions have been eliminated in consolidation.

(c) Fiscal Year

The Company has a 52/53 week fiscal year ending on the last Sunday of the calendar year, with interim fiscal periods ending on the last Sunday of each calendar quarter. The three months ended March 31, 2013 and March 30, 2014 consisted of a 13-week period. There are 52 calendar weeks in the fiscal years ending on December 29, 2013 and December 28, 2014.

(d) Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include revenue recognition, allowance for doubtful accounts, warranties, inventory valuation, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset and uncertain tax positions, contingencies and litigation, contingent acquisition consideration, stock-based compensation, losses on unused office space, and business combination purchase price allocations. In the future, the Company may realize actual results that differ from the current reported estimates. If the estimates that the Company has used change in the future, such changes could have a material impact on the Company's consolidated financial position, results of operations and cash flows.

In accounting for our long-term contracts for production of products and services provided to the U.S. Government and provided to our PSS segment customers under fixed price contracts, we utilize both cost-to-cost and units delivered measures under the percentage-of-completion method of accounting in accordance with the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 605, Revenue Recognition.

Due to the size and nature of many of our contracts accounted for under the percentage-of-completion method of accounting, the estimation of total revenues and costs at completion is complicated and subject to many variables. For example, estimates are made regarding the length of time to complete a contract since costs also include expected increases in wages, prices for materials and allocated fixed costs. Similarly, assumptions are made regarding the future impact of our efficiency

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initiatives and cost reduction efforts. Incentives, awards or penalties related to performance on contracts are considered in estimating revenue and profit rates and are recorded when there is sufficient information to assess anticipated performance. Suppliers' assertions are also assessed and considered in estimating costs and profit rates. The Company closely monitors the consistent application of its critical accounting policies and compliance with contract accounting. Business operations personnel conduct periodic contract status and performance reviews. Also, regular and recurring evaluations of contract cost, scheduling and technical matters are performed by management personnel who are independent from the business operations personnel performing work under the contract. When adjustments in estimated contract revenues or costs are required, any significant changes from prior estimates are included in earnings in the current period ("the cumulative catch-up method").

(e) Accounting Standards Updates

There have been no changes in the Company's significant accounting policies for the three months ended March 30, 2014 as compared to the significant accounting policies described in the Form 10-K.

(f) Fair Value of Financial Instruments

The carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 29, 2013 and March 30, 2014 are presented in Note 8. The carrying value of all other financial instruments, including cash equivalents, accounts receivable, accounts payable, accrued expenses, billings in excess of cost and earnings on uncompleted contracts, income taxes payable and short-term debt, approximated their estimated fair values at December 29, 2013 and March 30, 2014 due to the short-term nature of these instruments.

Note 2. Goodwill and Intangible Assets

(a) Goodwill

The carrying amounts of goodwill as of December 29, 2013 and March 30, 2014 by reportable segment are as follows (in millions):

	Public Safety & Security	Kratos Government Solutions	Total
Gross value	$53.9	$789.9	$843.8
Less accumulated impairment	18.3	229.1	247.4
Net	$35.6	$560.8	$596.4

(b) Purchased Intangible Assets

The following table sets forth information for finite-lived and indefinite-lived intangible assets (in millions):

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	As of December 29, 2013			As of March 30, 2014		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	$97.7	$ (53.7)	$44.0	$97.7	$ (58.0)	$39.7
Contracts and backlog	80.0	(78.7)	1.3	80.0	(79.0)	1.0
Developed technology and technical know-how	22.1	(8.6)	13.5	22.1	(9.1)	13.0
Trade names	6.1	(3.1)	3.0	6.1	(3.6)	2.5
Favorable operating lease	1.8	(0.6)	1.2	1.8	(0.6)	1.2
Total finite-lived intangible assets	207.7	(144.7)	63.0	207.7	(150.3)	57.4
Acquired indefinite-lived intangible assets:						
Trade names	6.9	—	6.9	6.9	—	6.9
Total indefinite-lived intangible assets	6.9	—	6.9	6.9	—	6.9
Total intangible assets	$214.6	$ (144.7)	$69.9	$214.6	$ (150.3)	$64.3

Consolidated amortization expense related to intangible assets subject to amortization was $9.3 million and $5.6 million for the three months ended March 31, 2013 and March 30, 2014, respectively.

Note 3. Inventoried Costs

Inventoried costs are stated at the lower of cost or market. Cost is determined using the average cost or first-in, first-out method and is applied consistently within an operating entity. Inventoried costs primarily relate to work in process under fixed-price contracts using costs as the basis of the percentage-of-completion calculation under the units of delivery method of revenue recognition. These costs represent accumulated contract costs less the portion of such costs allocated to delivered items. Accumulated contract costs include direct production costs, factory overhead and production tooling costs. Pursuant to contract provisions of U.S. Government contracts, such customers may have title to, or a security interest in, inventories related to such contracts as a result of advances, performance-based payments or progress payments. The Company reflects those advances and payments as an offset against the related inventory balances.

The Company regularly reviews inventory quantities on hand, future purchase commitments with its suppliers, and the estimated utility of its inventory. If the Company’s review indicates a reduction in utility below carrying value, it reduces its inventory to a new cost basis.

Inventoried costs consisted of the following components (in millions):

	December 29, 2013	March 30, 2014
Raw materials	$44.5	$45.8
Work in process	24.3	29.5
Finished goods	4.6	4.4
Supplies and other	1.9	2.1
Subtotal inventoried costs	75.3	81.8
Less: Customer advances and progress payments	(0.7)	(0.7)
Total inventoried costs	$74.6	$81.1

Note 4. Stockholders’ Equity

A summary of the changes in stockholders' equity is provided below (in millions):

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	For the Three Months Ended	
	March 31, 2013	March 30, 2014
Stockholders' equity at beginning of period	$324.1	$295.8
Comprehensive loss:		
Net loss	(10.3)	(15.0)
Foreign currency translation	0.1	(0.1)
Total comprehensive loss	(10.2)	(15.1)
Exercise of stock options and warrants	—	(0.1)
Stock-based compensation	1.9	1.8
Employee stock purchase plan and restricted stock units settled in cash	—	1.8
Restricted stock units traded for taxes	(0.2)	(0.1)
Stockholders' equity at end of period	$315.6	$284.1

The components of accumulated other comprehensive loss are as follows (in millions):

	March 31, 2013	March 30, 2014
Cumulative translation adjustment	$(0.2)	$(0.4)
Post retirement benefit reserve adjustment net of tax expense	(0.5)	(0.5)
Total accumulated other comprehensive loss	$(0.7)	$(0.9)

There were no reclassifications from other comprehensive income to net loss for the three months ended March 31, 2013 or March 30, 2014.

Common stock issued by the Company for the three months ended March 31, 2013 and March 30, 2014 was as follows (in millions):

	For the Three Months Ended	
	March 31, 2013	March 30, 2014
Shares outstanding at beginning of the period	56.6	57.1
Stock issued for employee stock purchase plan, stock options and restricted stock units exercised	0.1	0.4
Shares outstanding at end of the period	56.7	57.4

Note 5. Net Income (Loss) Per Common Share

The Company calculates net income (loss) per share in accordance with FASB ASC Topic 260, Earnings per Share ("Topic 260"). Under Topic 260, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period. Diluted net income (loss) per common share reflects the effects of potentially dilutive securities.

Shares from stock options and awards of 5.5 million and 1.2 million as of March 31, 2013 and March 30, 2014, respectively, were excluded from the calculation of diluted loss per share because their inclusion would have been anti-dilutive.

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Note 6. Income Taxes

A reconciliation of the total income tax provision to the tax benefit computed by applying the statutory federal income tax rate of 35% to loss from continuing operations before income tax provision for the three months ended March 31, 2013 and March 30, 2014 is as follows (in millions):

	For the Three Months Ended	
	March 31, 2013	March 30, 2014
Income tax benefit at federal statutory rate	$(1.8)	$(4.4)
State and foreign taxes, net of federal tax benefit and valuation allowance	0.9	0.6
Nondeductible expenses and other	0.5	0.6
Impact of indefinite lived deferred tax liabilities	1.9	1.7
Increase in reserves for uncertain tax positions	0.1	—
Increase in federal valuation allowance	1.2	3.8
Total income tax provision	$2.8	$2.3

In assessing the Company's ability to realize deferred tax assets, management considers, on a periodic basis, whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. As such, management has determined that it is appropriate to maintain a full valuation allowance against the Company's U.S. federal, combined state and certain foreign deferred tax assets, with the exception of an amount equal to its deferred tax liabilities, which can be expected to reverse over a definite life.

Federal and state income tax laws impose restrictions on the utilization of net operating loss (“NOL”) and tax credit carryforwards in the event that an “ownership change” occurs for tax purposes, as defined by Section 382 of the Internal Revenue Code of 1986, as amended (“Section 382”). In general, an ownership change occurs when shareholders owning 5% or more of a “loss corporation” (a corporation entitled to use NOL or other loss carryovers) have increased their ownership of stock in such corporation by more than 50 percentage points during any 3-year period. The annual base Section 382 limitation is calculated by multiplying the loss corporation's value at the time of the ownership change by the greater of the long-term tax-exempt rate determined by the Internal Revenue Service in the month of the ownership change or the two preceding months. This base limitation is subject to adjustments, including an increase for built-in gains recognized in the five-year period after the ownership change.

In March 2010, an “ownership change” occurred that will limit the utilization of NOL carryforwards. In July 2011, another “ownership change” occurred. The March 2010 ownership change limitation is more restrictive. In prior years, the company acquired corporations with NOL carryforwards at the date of acquisition ("Acquired NOLs"). The Acquired NOLs are subject to separate limitations that may further restrict the use of Acquired NOLs. As a result, the Company's federal annual utilization of NOL carryforwards will be limited to at least $27 million a year for the five years succeeding the March 2010 ownership change and at least $11.6 million for each year thereafter subject to separate limitations for Acquired NOLs. If the entire limitation amount is not utilized in a year, the excess can be carried forward and utilized in future years.

For the three months ended March 30, 2014, there was no impact of such limitations on the income tax provision since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also cause in an “ownership change.” If and when any other “ownership change” occurs, utilization of the NOL or other tax attributes may be further limited.

As discussed elsewhere, deferred tax assets relating to the NOL and credit carryforwards are offset by a full valuation allowance. In addition, utilization of state tax loss carryforwards is dependent upon sufficient taxable income apportioned to the states.

The Company is subject to taxation in the U.S., various state tax jurisdictions and various foreign tax jurisdictions. The Company's tax years for 2000 and later are subject to examination by the U.S. and state tax authorities due to the existence

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of the NOL carryforwards. Generally, the Company's tax years for 2002 and later are subject to examination by various foreign tax authorities.
As of December 29, 2013, the Company had $15.8 million of unrecognized tax benefits that, if recognized, would affect the effective income tax rate, subject to possible offset by an increase in the deferred tax asset valuation allowance. During the three months ended March 30, 2014, unrecognized tax benefits were increased by $2.7 million relating to various current year and prior positions. This increase in unrecognized tax benefits was offset in full by an increase in the deferred tax asset valuation allowance.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. There was no material expense or benefit recorded for the three months ended March 31, 2013 and March 30, 2014. The Company believes that no material amount of the liabilities for uncertain tax positions will expire within twelve months of March 30, 2014.

Note 7. Discontinued Operations

In June 2012, consistent with its plans to complete an assessment and evaluation of the non-core businesses acquired in the Integral acquisition, the Company committed to a plan to sell certain lines of business associated with antennas, satellite-cased products and fly-away terminals. These operations were previously reported in the KGS segment, and in accordance with ASC Topic 205, Presentation of Financial Statements ("Topic 205"), these businesses have been classified as held for sale and reported in discontinued operations in the accompanying condensed consolidated financial statements.

In the second quarter of 2012, the Company recorded a $1.5 million impairment charge associated with the portion of goodwill that was allocated to the discontinued businesses based on management's estimate of the fair value of the business. The Company sold its domestic operations to two buyers for approximately $0.8 million in cash consideration and the assumption of certain liabilities. The Company received $0.3 million in cash in 2012 from the first buyer and $0.5 million in cash in April 2013 from the second buyer. The Company recorded a $1.2 million impairment charge in the first quarter of 2013 related to its revised estimate of the fair value of these operations.

The following table presents the results of discontinued operations (in millions):

	For the Three Months Ended	
	March 31, 2013	March 30, 2014
Revenue	$3.6	$—
Net income (loss) before taxes	(2.1)	(0.1)
Net income (loss) after taxes	$(2.1)	$(0.1)

The following is a summary of the assets and liabilities of discontinued operations, which are in other current liabilities and other long-term liabilities in the accompanying condensed consolidated balance sheets as of December 29, 2013 and March 30, 2014 (in millions):

	December 29, 2013	March 30, 2014
Accounts payable and accrued expenses	$1.1	$1.1
Other current liabilities	1.4	1.4
Current liabilities of discontinued operations	$2.5	$2.5
Other long-term liabilities	$0.2	$—

Note 8. Debt

(a) Issuance of 10% Senior Secured Notes due 2017

On May 19, 2010, the Company entered into an indenture with the guarantors set forth therein and Wilmington Trust FSB, as trustee and collateral agent (as amended or supplemented the “Indenture”), to issue the Notes which are due June 1,

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2017. As of March 30, 2014, the Company has issued Notes in the aggregate principal amount of $625.0 million under the Indenture. These Notes have been used to fund acquisitions and for general corporate purposes. The holders of the Notes have a first priority lien on substantially all of the Company's assets and the assets of the guarantors, except with respect to accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property), on which the holders of the Notes have a second priority lien to the $110.0 million credit facility described below.

The Company pays interest on the Notes semi-annually, in arrears, on June 1 and December 1 of each year. The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy, insolvency, material judgments and changes in control. As of March 30, 2014, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

On or after June 1, 2014, the Company may redeem some or all of the Notes at 105% of the aggregate principal amount of such Notes through June 1, 2015, 102.5% of the aggregate principal amount of such Notes through June 1, 2016 and 100% of the aggregate principal amount of such Notes thereafter, plus accrued and unpaid interest to the date of redemption. In addition, the Company may, at its option, redeem some or all of the Notes at any time prior to June 1, 2014 by paying a “make whole” premium, plus accrued and unpaid interest, if any, to the date of redemption. The Company may also purchase outstanding Notes traded on the open market at any time.

(b) Other Indebtedness

$110.0 Million Credit Facility

The Company has a credit and security agreement ("the Credit Revolver") with a consortium of banks entered into as of May 2010. The Credit Revolver is a five-year senior secured revolving credit facility in the amount of $110.0 million and is secured by a lien on substantially all of the Company's assets and the assets of the guarantors thereunder, subject to certain exceptions and permitted liens. The Credit Revolver has a first priority lien on accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property). On all other assets, the Credit Revolver has a second priority lien junior to the lien securing the Notes.

Borrowings under the Credit Revolver are subject to mandatory prepayment upon the occurrence of certain events, including the issuance of certain securities, the incurrence of certain debt and the sale or other disposition of certain assets. The Credit Revolver includes customary affirmative and negative covenants and events of default, as well as a financial covenant relating to a minimum fixed charge coverage ratio of 1.25. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy and insolvency, material judgments and changes in control.

The amounts of borrowings that may be made under the Credit Revolver are based on a borrowing base and are comprised of specified percentages of eligible receivables, eligible unbilled receivables and eligible inventory. If the amount of borrowings outstanding under the Credit Revolver exceeds the borrowing base then in effect, the Company is required to repay such borrowings in an amount sufficient to eliminate such excess. The Credit Revolver includes $50.0 million of availability for letters of credit and $10.0 million of availability for swing line loans.

The Company may borrow funds under the Credit Revolver at a rate based either on LIBOR or a base rate. Base rate borrowings bear interest at an applicable margin of 1.00% to 1.75% over the base rate (which will be the greater of the prime rate or 0.5% over the federal funds rate, with a floor of 1.0% over one month LIBOR). LIBOR rate borrowings will bear interest at an applicable margin of 3.00% to 3.75% over the LIBOR rate. The applicable margin for base rate borrowings and LIBOR borrowings will depend on the average monthly revolving credit availability. The Credit Revolver also has a commitment fee of 0.50% to 0.75%, depending on the average monthly revolving credit availability. As of March 30, 2014, there were no outstanding borrowings on the Credit Revolver and $9.2 million was outstanding on letters of credit, resulting in net borrowing base availability of $65.8 million. The Company was in compliance with the financial covenants as of March 30, 2014.

Debt Acquired in Acquisition

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The Company has a 10-year term loan with a bank in Israel entered into on September 16, 2008 in connection with the acquisition of one of its wholly owned subsidiaries. The balance as of March 30, 2014 was $4.5 million, and the loan is payable in quarterly installments of $0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, including the minimum net equity covenant, as of March 30, 2014.

Fair Value of Long-term Debt

Carrying amounts and the related estimated fair values of the Company’s long-term debt financial instruments not measured at fair value on a recurring basis at December 29, 2013 and March 30, 2014 are presented in the following table:

	As of December 29, 2013			As of March 30, 2014		
$ in millions	Principal	Carrying Amount	Fair Value	Principal	Carrying Amount	Fair Value
Total Long-term debt including current portion	$629.8	$644.3	$679.7	$629.5	$643.0	$667.8

The fair value of the Company’s long-term debt was based upon actual trading activity (Level 1, Observable inputs —quoted prices in active markets) and is the estimated amount the Company would have to pay to repurchase its debt, including any premium or discount attributable to the difference between the stated interest rate and market value of interest at the balance sheet date.

The net unamortized debt premium of $13.5 million as of March 30, 2014, which is the difference between the carrying amount of $643.0 million and the principal amount of $629.5 million represented in the previous table, is being amortized to interest expense over the terms of the related debt.

Note 9. Segment Information

The Company operates in two principal reportable business segments: Kratos Government Solutions ("KGS") and Public Safety & Security ("PSS"). The Company organizes its reportable business segments based on the nature of the services offered.

Revenues, depreciation and amortization, and operating income generated by the Company’s current reportable segments for the three month periods ended March 31, 2013 and March 30, 2014 are as follows (in millions):

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	Three Months Ended	
	March 31, 2013	March 30, 2014
Revenues:		
Kratos Government Solutions		
Service revenues	$64.9	$51.7
Product sales	137.3	99.5
Total Kratos Government Solutions	202.2	151.2
Public Safety & Security		
Service revenues	50.6	48.9
Product sales	—	—
Total Public Safety & Security	50.6	48.9
Total revenues	$252.8	$200.1
Depreciation & amortization:		
Kratos Government Solutions	$13.2	$9.1
Public Safety & Security	1.0	0.5
Total depreciation and amortization	$14.2	$9.6
Operating income:		
Kratos Government Solutions	$12.2	$4.1
Public Safety & Security	1.2	1.0
Unallocated corporate expense, net	(1.9)	(1.8)
Total operating income	$11.5	$3.3

Total operating income of the reportable business segments is reconciled to the corresponding consolidated amount. The reconciling item “Unallocated corporate expense, net” includes costs for certain stock-based compensation programs, the effects of items not considered part of management’s evaluation of segment operating performance, merger and acquisition expenses, corporate costs not allocated to the operating segments, and other miscellaneous corporate activities. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts.

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Note 10. Significant Customers

Revenue from the U.S. Government, which includes foreign military sales, includes revenue from contracts for which the Company is the prime contractor as well as those for which the Company is a subcontractor and the ultimate customer is the U.S. Government. The KGS segment has substantial revenue from the U.S. Government. Sales to the U.S. Government amounted to approximately $160.7 million and $116.3 million or 64% and 58% of total Kratos revenue for the three months ended March 31, 2013 and March 30, 2014.

Note 11. Commitments and Contingencies

(a) Legal Matters

In addition to commitments and obligations in the ordinary course of business, the Company is subject to various claims, pending and potential legal actions for damages, investigations relating to governmental laws and regulations and other matters arising out of the normal conduct of its business. The Company assesses contingencies to determine the degree of probability and range of possible loss for potential accrual in its condensed consolidated financial statements. An estimated loss contingency is accrued in the Company's consolidated financial statements if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Because litigation and legal matters are inherently unpredictable and unfavorable resolutions could occur, assessing litigation and legal matter contingencies is highly subjective and requires judgments about future events. When evaluating contingencies, the Company may be unable to provide a meaningful estimate due to a number of factors, including the procedural status of the matter in question, the presence of complex or novel legal theories, and/or the ongoing discovery and development of information important to the matters. In addition, damage amounts claimed in litigation against the Company may be unsupported, exaggerated or unrelated to possible outcomes, and as such are not meaningful indicators of the Company's potential liability. The Company regularly reviews contingencies to determine the adequacy of its accruals and related disclosures. The amount of ultimate loss may differ from these estimates. It is possible that cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies. Whether any losses finally determined in any claim, action, investigation or proceeding could reasonably have a material effect on the Company's business, financial condition, results of operations or cash flows will depend on a number of variables, including the timing and amount of such losses; the structure and type of any remedies; the monetary significance of any such losses, damages or remedies on the Company's condensed consolidated financial statements; and the unique facts and circumstances of the particular matter that may give rise to additional factors.

Regulatory Matters
U.S. Government Cost Claims. The Company's contracts with the Department of Defense are subject to audit by the Defense Contract Audit Agency (“DCAA”). As a result of these audits, from time to time, the Company is advised of claims concerning potential disallowed, overstated or disputed costs. For example, during the course of its current audits, the DCAA is closely examining and questioning certain of its established and disclosed practices that it had previously audited and accepted. In addition, based on a DCAA audit, the U.S. Department of Justice is currently investigating whether one of the Company's subsidiaries violated the federal False Claims Act by overstating its labor and material costs in a contract with the Department of Defense prior to the Company's acquisition of the subsidiary. Under the False Claims Act, the Department of Justice can seek civil penalties plus treble damages. The Company intends to defend itself in these matters and to work to resolve or settle any disputed contract costs. When appropriate, the Company records accruals to reflect its expected exposure to the matters raised by the U.S. Government. The Company reviews such accruals on a quarterly basis for sufficiency based on the most recent information available. Based on its assessment, the Company has accrued an amount in its financial statements for contingent liabilities associated with these matters that it considers to be immaterial to its overall financial position. The matter that is currently being investigated was identified during the acquisition process and was taken into consideration in the

purchase price allocation of this subsidiary. Contract disputes with the U.S. Government, however, are inherently unpredictable, and unfavorable resolutions could occur. As a result, assessing contingencies is highly subjective and requires judgment about future events. The amount of ultimate loss may exceed the Company's current accruals, and it is possible that its cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies.

Other Litigation Matters. The Company is subject to normal and routine litigation arising from the ordinary course and conduct of business and, at times, as a result of acquisitions and dispositions. Such disputes include, for example, commercial, employment, intellectual property, environmental and securities matters. The aggregate amounts accrued related to these matters are not material to the total liabilities of the Company. We intend to defend ourselves in any such matters and do not currently believe that the outcome of any such matters will have a material adverse impact on our financial condition, results of operations or cash flows.

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(b) Warranty

Certain of the Company’s products, product finishes, and services are covered by a warranty to be free from defects in material and workmanship for periods ranging from one to ten years. Optional extended warranty contracts can also be purchased with the revenue deferred and amortized over the extended warranty period. The Company accrues a warranty liability for estimated costs to provide products, parts or services to repair or replace products in satisfaction of warranty obligations. Warranty revenues related to extended warranty contracts are amortized to income, over the life of the contract, using the straight-line method. Costs under extended warranty contracts are expensed as incurred.

The Company’s estimate of costs to service its warranty obligations is based upon historical experience and expectations of future conditions. To the extent that the Company experiences any changes in warranty claim activity or costs associated with servicing those claims, its warranty liability is adjusted accordingly.

The changes in the Company's aggregate product warranty liabilities, which are included in other current liabilities and other long term-liabilities on the Company's condensed consolidated balance sheets, were as follows (in millions):

	Three Months Ended	
	March 31, 2013	March 30, 2014
Balance at beginning of the period	$4.9	$5.4
Costs accrued and revenues deferred	0.2	0.4
Settlements made (in cash or kind) and revenues recognized	—	(0.1)
Balance at end of period	5.1	5.7
Less: Current portion	(4.8)	(5.3)
Non-current accrued product warranty and deferred warranty revenue	$0.3	$0.4

Note 12. Condensed Consolidating Financial Statements

The Company has $625.0 million in outstanding Senior Secured Notes (see Note 8). The Notes are guaranteed by all of the Company's 100% owned domestic subsidiaries (the "Subsidiary Guarantors") and are collateralized by the assets of all of the Company's 100% owned subsidiaries. The Notes are fully and unconditionally guaranteed on a joint and several basis by each guarantor subsidiary and the Company. There are no contractual restrictions limiting cash transfers from guarantor subsidiaries by dividends, loans or advances to the Company. The Senior Secured Notes are not guaranteed by the Company's foreign subsidiaries (the “Non-Guarantor Subsidiaries”).

The following tables present condensed consolidating financial statements for the parent company, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries, respectively. The condensed consolidating financial information below follows the same accounting policies as described in the condensed consolidated financial statements, except for the use of the equity method of accounting to reflect ownership interests in wholly owned subsidiaries, which are eliminated upon consolidation.

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Condensed Consolidating Balance Sheet
December 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$42.7	$(3.0)	$ 16.0	$—	$55.7
Accounts receivable, net	—	238.6	27.2	—	265.8
Amounts due from affiliated companies	410.2	—	—	(410.2)	—
Inventoried costs	—	59.1	15.5	—	74.6
Other current assets	10.7	19.4	4.1	—	34.2
Total current assets	463.6	314.1	62.8	(410.2)	430.3
Property, plant and equipment, net	2.1	71.9	10.8	—	84.8
Goodwill	—	574.8	21.6	—	596.4
Intangible assets, net	—	68.5	1.4	—	69.9
Investment in subsidiaries	474.2	36.7	—	(510.9)	—
Amounts due from affiliated companies	—	24.0	—	(24.0)	—
Other assets	12.9	23.0	(0.7)	—	35.2
Total assets	$952.8	$1,113.0	$ 95.9	$(945.1)	$1,216.6
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$2.8	$54.1	$ 5.0	$—	$61.9
Accrued expenses	6.6	40.9	3.9	—	51.4
Accrued compensation	4.0	36.9	4.0	—	44.9
Billings in excess of costs and earnings on uncompleted contracts	—	45.4	7.1	—	52.5
Deferred income tax liability	—	28.4	—	—	28.4
Amounts due to affiliated companies	—	390.2	20.0	(410.2)	—
Other current liabilities	1.3	9.5	1.1	—	11.9
Total current liabilities	14.7	605.4	41.1	(410.2)	251.0
Long-term debt, net of current portion	639.5		3.8	—	643.3
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	2.8	21.4	2.3	—	26.5
Total liabilities	657.0	626.8	71.2	(434.2)	920.8
Total stockholders' equity	295.8	486.2	24.7	(510.9)	295.8
Total liabilities and stockholders' equity	$				