

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

Form S-4

April 10, 2008

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As filed with the Securities and Exchange Commission on April 9, 2008

Registration No.

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form S-4**

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

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**KRATOS DEFENSE & SECURITY  
SOLUTIONS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**4899**  
(Primary Standard Industrial  
Classification Code Number)

**13-3818604**  
(I.R.S. Employer  
Identification Number)

**4810 Eastgate Mall  
San Diego, CA 92121  
(858) 812-7300**

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

**Eric DeMarco  
President and Chief Executive Officer  
4810 Eastgate Mall  
San Diego, CA 92121  
(858) 812-7300**

(Name, address, including zip code, and telephone number, including area code, of agent for service)

---

**Copies to:  
WITH A COPY TO**

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**Approximate date of commencement of proposed sale of the securities to the public:  
As soon as practicable after this registration statement becomes effective and all other conditions to the proposed merger described  
herein have been satisfied or waived.**

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If the securities being registered on this Form are being offered in connection with the formation of a holding company and there is compliance with General Instruction G, check the following box.

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

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Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price Per Share	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee
Common Stock, par value \$0.001 per share	32,500,000(1)	N/A	\$69,550,000(2)	\$2,733.32

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(1) The number of shares of common stock of the registrant being registered is based upon (x) an estimate of the maximum number of shares of common stock, no par value, of SYS, a California corporation ("SYS") presently outstanding or issuable or expected to be issued multiplied by (y) the exchange ratio of 1.2582 shares of common stock, par value \$0.001 per share, of the registrant, for each such share of common stock of SYS.

(2) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(f) under the Securities Act of 1933, as amended. The proposed maximum aggregate offering price for the common stock is the product of (x) \$2.14, the average of the high and low sales prices of SYS common stock, as quoted on the American Stock Exchange, on April 7, 2008, and (y) 32,500,000, the estimated maximum number of shares of SYS common stock that may be exchanged for the shares of common stock of the registrant being registered.

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**The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further Amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.**

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**The information in this joint proxy statement/prospectus is not complete and may be changed. We may not sell the securities offered by this joint proxy statement/prospectus until the registration statement filed with the Securities and Exchange Commission is effective. This joint proxy statement/prospectus does not constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction where an offer, solicitation or sale is not permitted.**

**PRELIMINARY SUBJECT TO COMPLETION DATED APRIL 9, 2008**

### **PROPOSED MERGER YOUR VOTE IS VERY IMPORTANT**

Each of the boards of directors of Kratos Defense & Security Solutions, Inc., a Delaware corporation ("**Kratos**") and SYS, a California corporation ("**SYS**"), has approved a strategic merger, combining Kratos and SYS. We believe that the proposed merger will allow Kratos and SYS to be better positioned to compete in the rapidly evolving defense and security solutions industry.

Kratos and SYS have entered into an Agreement and Plan of Merger and Reorganization pursuant to which SYS will merge with a newly formed, wholly-owned subsidiary of Kratos, with SYS surviving the merger as a wholly-owned subsidiary of Kratos.

In the proposed merger, SYS shareholders will receive 1.2582 shares of Kratos common stock for each share of SYS common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing. The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger. Upon completion of the merger, SYS's former shareholders will own approximately 24% of the then outstanding shares of Kratos common stock, based on the number of shares of Kratos and SYS common stock expected to be outstanding on the closing of the merger. The value of the merger consideration to be received in exchange for each share of SYS common stock will fluctuate with the market price of Kratos common stock.

Based on the closing sale price for Kratos common stock on February 20, 2008, the last trading day before public announcement of the merger, the 1.2582 exchange ratio represented approximately \$2.65 in value for each share of SYS common stock. Based on the closing sale price for Kratos common stock on \_\_\_\_\_, 2008, the latest practicable date before the printing of this joint proxy statement/prospectus, which we refer to as this Proxy Statement, the 1.2582 exchange ratio represented approximately \$ \_\_\_\_\_ in value for each share of SYS common stock.

Kratos common stock is listed on The Nasdaq Global Select Market under the symbol "KTOS." SYS common stock is listed on the American Stock Exchange under the symbol "SYS." We urge you to obtain current market quotations for the shares of Kratos and SYS.

**Your vote is very important.** The merger cannot be completed unless Kratos stockholders approve the issuance of Kratos common stock and SYS shareholders adopt and approve the merger agreement. Each of Kratos and SYS is holding a meeting of its stockholders to vote on the proposals necessary to complete the merger, and in the case of Kratos, to approve certain other matters described in this Proxy Statement. Information about these meetings, the merger and the other business to be considered by stockholders is contained in this Proxy Statement. We urge you to read this Proxy Statement carefully. **You should also carefully consider the risk factors beginning on page 24.**

**Whether or not you plan to attend your respective company's meeting of stockholders, please submit your proxy as soon as possible to make sure that your shares are represented at that meeting.**

**The Kratos board of directors unanimously recommends that Kratos stockholders vote FOR the proposal to approve the issuance of Kratos common stock, which is necessary to effect the merger.**

**The SYS board of directors unanimously recommends that SYS shareholders vote FOR the proposal to adopt and approve the merger agreement.**

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Eric M. DeMarco

*Chief Executive Officer and President*

Kratos Defense & Security Solutions, Inc.

Clifton L. Cooke, Jr.

*President and Chief Executive Officer*

SYS

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the securities to be issued in connection with the merger or determined if this Proxy Statement is accurate or complete. Any representation to the contrary is a criminal offense.**

This Proxy Statement is dated \_\_\_\_\_, 2008, and is first being mailed to stockholders of Kratos and SYS on or about \_\_\_\_\_, 2008.

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NOTICE OF ANNUAL MEETING OF STOCKHOLDERS TO BE HELD ON \_\_\_\_\_, 2008

To the Stockholders of Kratos Defense & Security Solutions, Inc.:

An annual meeting of stockholders of Kratos Defense & Security Solutions, Inc. will be held at \_\_\_\_\_, on \_\_\_\_\_, 2008 at \_\_\_\_\_ a.m., local time, for the following purposes:

1. To elect five directors for one-year terms or until their successors are elected and duly qualified.
2. To ratify the selection of Grant Thornton LLP as Kratos' independent auditors for the fiscal year ending December 28, 2008.
3. To approve an amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the plan by 1,500,000 shares.
4. To approve an amendment to the Kratos 2005 Equity Incentive Plan to increase the aggregate number of shares that may be issued under the plan by 3,000,000 shares.
5. To approve the issuance of Kratos common stock, par value \$0.001 per share, pursuant to the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS, as the same may be amended from time to time (the "*Share Issuance*").
6. To approve any motion to adjourn or postpone the annual meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the annual meeting to approve the first five proposals listed above.
7. To transact such other business as may properly come before the annual meeting or any adjournment or postponement thereof.

The accompanying Proxy Statement further describes the matters to be considered at the meeting. A copy of the Agreement and Plan of Merger referenced above has been included as *Annex A* to the Proxy Statement.

The Kratos board of directors has set \_\_\_\_\_, 2008 as the record date for the annual meeting. Only holders of record of Kratos common stock at the close of business on \_\_\_\_\_, 2008 will be entitled to notice of and to vote at the annual meeting and any adjournments or postponements thereof. Any stockholder entitled to attend and vote at the meeting is entitled to appoint a proxy to attend and vote on such stockholder's behalf. Such proxy need not be a holder of Kratos common stock. **To ensure your representation at the annual meeting, please complete and return the enclosed proxy card or submit your proxy by telephone or through the Internet.** Please vote promptly whether or not you expect to attend the annual meeting. Submitting a proxy now will not prevent you from being able to vote at the annual meeting by attending in person and casting a vote.

**The Kratos board of directors unanimously recommends that you vote FOR the proposal to elect five directors for one-year terms or until their successors are elected and duly qualified; FOR the proposal to ratify the selection of Grant Thornton LLP as Kratos' independent auditors for the fiscal year ending December 28, 2008; FOR the proposal to approve an amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the plan by 1,500,000 shares; FOR the proposal to approve an amendment to the Kratos 2005 Equity Incentive Plan to increase aggregate number of shares that may be issued under the plan by 3,000,000 shares; FOR the proposal to approve the Share Issuance; and FOR the proposal to approve any motion to adjourn or postpone the annual meeting to a later date or dates if necessary to solicit additional proxies.**

By Order of the Kratos Board of Directors,

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Eric M. DeMarco  
*President and Chief Executive Officer*  
San Diego, CA  
, 2008

**PLEASE VOTE YOUR SHARES PROMPTLY. YOU CAN FIND INSTRUCTIONS FOR VOTING ON THE ENCLOSED PROXY CARD. IF YOU HAVE QUESTIONS ABOUT THE PROPOSALS OR ABOUT VOTING YOUR SHARES, PLEASE CALL KRATOS' PROXY SOLICITOR GEORGESON, INC. AT (800) 561-4162 (TOLL FREE).**

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NOTICE OF SPECIAL MEETING OF SHAREHOLDERS TO BE HELD ON \_\_\_\_\_, 2008

To the Shareholders of SYS:

A special meeting of shareholders of SYS will be held at 5050 Murphy Canyon Road, Suite 200, San Diego, CA 92123, on \_\_\_\_\_, 2008 at 11:00 a.m., local time, for the following purposes:

1. To adopt and approve the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS, as the same may be amended from time to time.
2. To approve any motion to adjourn or postpone the special meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the special meeting to approve the proposal to adopt the merger agreement.
3. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

The accompanying Proxy Statement further describes the matters to be considered at the special meeting. A copy of the Agreement and Plan of Merger referenced above has been included as *Annex A* to this Proxy Statement.

The SYS board of directors has set \_\_\_\_\_, 2008 as the record date for the special meeting. Only holders of record of shares of SYS common stock at the close of business on \_\_\_\_\_, 2008 will be entitled to notice of and to vote at the special meeting and any adjournments or postponements thereof. **To ensure your representation at the special meeting, please complete and return the enclosed proxy card or submit your proxy by telephone or through the Internet.** Please vote promptly whether or not you expect to attend the special meeting. Submitting a proxy now will not prevent you from being able to vote at the special meeting by attending in person and casting a vote.

**The board of directors of SYS recommends that you vote FOR the proposal to adopt and approve the merger agreement and FOR the proposal to approve any motion to adjourn or postpone the special meeting to a later date or dates if necessary to solicit additional proxies.**

By Order of the SYS Board of Directors,

Clifton L. Cooke, Jr.  
*President and Chief Executive Officer*  
\_\_\_\_\_, 2008

**PLEASE VOTE YOUR SHARES PROMPTLY. YOU CAN FIND INSTRUCTIONS FOR VOTING ON THE ENCLOSED PROXY CARD. IF YOU HAVE QUESTIONS ABOUT THE PROPOSALS OR ABOUT VOTING YOUR SHARES, PLEASE CALL MICHAEL W. FINK AT 858-244-7393 (TOLL FREE) OR VIA EMAIL AT [MFINK@SYSTECHNOLOGIES.COM](mailto:MFINK@SYSTECHNOLOGIES.COM).**

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Annex A	Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS
Annex B	Kratos Voting Agreement
Annex C	SYS Voting Agreement
Annex D	Opinion of Wachovia Capital Markets, LLC
Annex E	Opinion of Imperial Capital, LLC
Annex F	Chapter 13 of the California Corporations Code: "Dissenters' Rights"

**VOTING ELECTRONICALLY OR BY TELEPHONE**

Kratos stockholders of record on the close of business on \_\_\_\_\_, 2008, the record date for the Kratos annual meeting, may submit their proxies by telephone or Internet by following the instructions on their proxy card or voting form. If you have any questions regarding whether you are eligible to submit your proxy by telephone or by Internet, please contact Kratos' Proxy Solicitor, Georgeson, Inc. by telephone at (800) 561-4162 (toll free).

SYS shareholders of record on the close of business on \_\_\_\_\_, 2008, the record date for the SYS special meeting, may submit their proxies by telephone or Internet by following the instructions on their proxy card or voting form. If you have any questions regarding whether you are eligible to submit your proxy by telephone or by Internet, please contact Michael W. Fink by telephone at 858-244-7393 or via email at *mfink@systechnologies.com*.

**QUESTIONS AND ANSWERS ABOUT THE MEETINGS**

The following questions and answers briefly address some commonly asked questions about the Kratos and SYS meetings. They may not include all the information that is important to holders of stock of Kratos and SYS. We urge stockholders to read carefully this entire Proxy Statement, including the annexes and the other documents referred to herein.

**Q:**  
**Why am I receiving these materials?**

**A:**  
We are sending you these materials to help you decide how to vote your shares of Kratos or SYS common stock with respect to their proposed merger. Additionally, if you are a Kratos stockholder, we are sending these materials to you to help you decide how to vote your shares of Kratos common stock with respect to the other proposals at the Kratos annual meeting.

The merger cannot be completed unless Kratos stockholders approve the issuance of Kratos common stock and SYS shareholders adopt and approve the merger agreement. Each of Kratos and SYS is holding its meeting of holders of stock to vote on the proposals necessary to complete the merger. Information about these meetings, the merger and the other business to be considered by holders of stock is contained in this Proxy Statement.

We are delivering this document to you as both a joint proxy statement of Kratos and SYS and a prospectus of Kratos. It is a joint proxy statement because each of our boards of directors is soliciting proxies from its stockholders. It is a prospectus because Kratos will exchange shares of its common stock for shares of SYS in the merger.

**Q:**  
**What will stockholders receive in the merger?**

**A:**  
In the proposed merger, holders of SYS common stock will receive 1.2582 shares of Kratos common stock for each share of SYS common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing.

The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger.

**Q:**  
**When do Kratos and SYS expect to complete the merger?**

**A:**  
Kratos and SYS expect to complete the merger after all conditions to the merger in the merger agreement are satisfied or waived, including after stockholder approvals are received at the meetings of Kratos and SYS and all required regulatory approvals are received. Kratos and SYS currently expect to complete the merger during the first half of 2008. However, it is possible that factors outside of either company's control could require Kratos and SYS to complete the merger at a later time or not to complete it at all.

**Q:**  
**How do the boards of directors of Kratos and SYS recommend that I vote?**

**A:**  
The Kratos board of directors unanimously recommends that holders of Kratos common stock vote FOR the proposal to approve the issuance of Kratos common stock in the merger.

The SYS board of directors unanimously recommends that SYS shareholders vote FOR the proposal to adopt the merger agreement.

**Q:**  
**What do I need to do now?**

**A:**  
After carefully reading and considering the information contained in this Proxy Statement, please vote your shares as soon as possible so that your shares will be represented at your respective company's meeting. Please follow the instructions set forth on the proxy card or on the voting instruction form provided by the record holder if your shares are held in the name of your broker or other nominee.



**Q:**  
**How do I vote?**

**A:**  
You may vote before your company's meeting in one of the following ways:

use the toll-free number shown on your proxy card;

visit the website shown on your proxy card to vote via the Internet; or

complete, sign, date and return the enclosed proxy card in the enclosed postage-paid envelope.

You may also cast your vote in person at your company's meeting.

If your shares are held in "street name" through a broker, bank or other nominee, that institution will send you separate instructions describing the procedure for voting your shares. "Street name" stockholders who wish to vote at the meeting will need to obtain a proxy form from the institution that holds their shares.

**Q:**  
**When and where are the Kratos and SYS meetings of stockholders?**

**A:**  
The annual meeting of Kratos stockholders will be held at 4810 Eastgate Mall, San Diego, CA, on \_\_\_\_\_, 2008 at \_\_\_\_\_, a.m., local time. Subject to space availability, all stockholders as of the record date, or their duly appointed proxies, may attend the meeting. Since seating is limited, admission to the meeting will be on a first-come, first-served basis. Registration and seating will begin at \_\_\_\_\_ a.m., local time.

The special meeting of SYS shareholders will be held at 5050 Murphy Canyon Road, Suite 200, San Diego, CA 92123, on \_\_\_\_\_, 2008 at 11:00 a.m., local time. Subject to space availability, all stockholders as of the record date, or their duly appointed proxies, may attend the meeting. Since seating is limited, admission to the meeting will be on a first-come, first-served basis. Registration and seating will begin at \_\_\_\_\_ a.m., local time.

**Q:**  
**If my shares are held in "street name" by a broker or other nominee, will my broker or nominee vote my shares for me?**

**A:**  
Your broker or other nominee does not have authority to vote on most of the proposals described in this Proxy Statement including the proposals related to the proposed merger. Your broker or other nominee will vote your shares held by it in "street name" with respect to these matters ONLY if you provide instructions to it on how to vote. You should follow the directions your broker or other nominee provides.

**Q:**  
**What constitutes a quorum?**

Stockholders who hold a majority in voting power of the Kratos common stock issued and outstanding as of the close of business on the record date and who are entitled to vote must be present or represented by proxy in order to constitute a quorum to conduct business at the Kratos annual meeting.

Stockholders who hold a majority in voting power of the SYS common stock issued and outstanding as of the close of business on the record date and who are entitled to vote must be present or represented by proxy in order to constitute a quorum to conduct business at the SYS special meeting.

**Q:**  
**What vote is required to approve each proposal?**

**A:**  
For Kratos Stockholders:



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The affirmative vote of a majority of the outstanding shares of Kratos common stock entitled to vote at the meeting is required to approve all of the Kratos proposals, including the proposal to

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approve the issuance of Kratos common stock in the merger, which is referred to in this Proxy Statement as the Share Issuance.

For SYS Shareholders:

The affirmative vote of a majority of the outstanding shares of SYS common stock entitled to vote is required to approve the merger agreement, which is referred to in this Proxy Statement as the Merger Proposal.

**Q: What if I do not vote on the matters relating to the merger?**

A: If you are a Kratos stockholder and you fail to vote or fail to instruct your broker or other nominee how to vote on the Share Issuance, it will have the same effect as a vote against the Share Issuance. Similarly, if you respond with an "abstain" vote, your proxy will have the same effect as a vote against this proposal. If you submit a proxy but do not indicate how you want to vote on the Share Issuance, your proxy will be counted as a vote in favor of the Share Issuance in accordance with the recommendation of the Kratos Board.

If you are an SYS shareholder and you fail to vote or fail to instruct your broker or other nominee how to vote on the Merger Proposal, it will have the same effect as a vote against the Merger Proposal. If you respond with an "abstain" vote on the Merger Proposal, your proxy will have the same effect as a vote against the Merger Proposal. If you respond but do not indicate how you want to vote on the Merger Proposal, your proxy will be counted as a vote in favor of the Merger Proposal.

**Q: What if I hold shares in both Kratos and SYS?**

A: If you are a stockholder of both Kratos and SYS, you will receive two separate packages of proxy materials. A vote as a Kratos stockholder approving the issuance of Kratos common stock will not constitute a vote as an SYS shareholder for the Merger Proposal, or vice versa. Therefore, please sign, date and return all proxy cards that you receive, whether from Kratos or SYS, or vote as both a Kratos and SYS shareholder by telephone or via the Internet.

**Q: May I change my vote after I have delivered my proxy or voting instruction card?**

A: Yes. You may change your vote at any time before your proxy is voted at the applicable meeting. You may do this in one of four ways:

by sending a notice of revocation to the corporate secretary of Kratos or SYS, as applicable;

by sending a completed proxy card bearing a later date than your original proxy card;

by logging onto the Internet website specified on your proxy card in the same manner you would to submit your proxy electronically or by calling the telephone number specified on your proxy card, in each case if you are eligible to do so and following the instructions on the proxy card; or

by attending the applicable meeting and voting in person. Your attendance alone will not revoke any proxy.

If you choose any of the first three methods, you must take the described action no later than the beginning of the applicable meeting.

If your shares are held in an account at a broker or other nominee, you should contact your broker or other nominee to change your vote.

**Q: What are the material United States federal income tax consequences of the merger?**

A: Kratos and SYS intend for the merger to qualify as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended, which we refer to as the Code, for United States federal income tax purposes. Accordingly, a holder of SYS common stock generally will not recognize any gain or loss for U.S. federal income tax purposes upon the exchange of the holder's shares of SYS common stock for shares of Kratos common stock pursuant to the merger, except that an SYS shareholder will recognize a gain or loss with respect to any cash received in lieu of a fractional share of Kratos common stock.

**Q: Do I have appraisal rights?**

A: The holders of Kratos common stock will not be entitled to exercise any appraisal rights in connection with the merger. Pursuant to Section 1300 of the California Corporations Code, the holders of SYS common stock are entitled to appraisal rights if they do not vote in favor of the merger and otherwise comply with the requirements of Chapter 13 of the California General Corporation Law.

**Q: Should I send in my stock certificates now?**

A: No. Please do not send your stock certificates with your proxy card.

If you are a holder of SYS common stock, you will receive written instructions from the exchange agent after the merger is completed on how to exchange your stock certificates for Kratos common stock. Kratos stockholders will not be exchanging their stock certificates in connection with the merger. Accordingly, Kratos stockholders holding stock certificates should keep their stock certificates both now and after the merger is completed.

**Q: What if I hold SYS and Kratos stock options or other stock-based awards?**

A: Kratos stock options and other equity-based awards, including restricted stock units, will remain outstanding and will not be affected by the merger.

All outstanding SYS stock options will become fully vested prior to the closing. The stock options may be exercised for SYS shares ("cashless exercise" being permissible) at or prior to closing in accordance with the terms of the stock option plans which shares would then be exchanged for Kratos shares in accordance with the exchange ratio. Any such stock option exercises may be subject to withholding taxes as a result. No outstanding SYS stock options will be assumed by or converted into options of Kratos.

**Q: Who should I contact if I have any questions about the merger, the proxy materials or voting power?**

A: If you have any questions about the merger or if you need assistance in submitting your proxy or voting your shares or need additional copies of the Proxy Statement or the enclosed proxy card, you should contact the company in which you hold shares.

If you are a Kratos stockholder, you should contact Georgenson, Inc., the proxy solicitation agent for Kratos at (800) 561-4162 (toll-free). If you are an SYS shareholder, you should contact Michael W. Fink at 858-244-7393 or via email at mfink@systechnologies.com for SYS. If your shares are held in a stock brokerage account or by a bank or other nominee, you should call your broker or other nominee for additional information.

## SUMMARY

*This summary highlights selected information contained in this joint proxy statement/prospectus, referred to as this Proxy Statement, and does not contain all the information that may be important to you. Kratos and SYS urge you to read carefully this Proxy Statement in its entirety, including the annexes. Unless stated otherwise, all references in this Proxy Statement to Kratos refer to Kratos Defense & Security Solutions, Inc., a Delaware corporation, all references to SYS refer to SYS, a California corporation, all references to Merger Sub refer to White Shadow, Inc., a California corporation, and all references to the merger agreement refer to the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos, White Shadow, Inc., and SYS, a copy of which is attached as Annex A to this Proxy Statement.*

### The Merger

Each of the boards of directors of Kratos and SYS has approved a strategic merger of Kratos and SYS. Kratos and SYS have entered into an Agreement and Plan of Merger and Reorganization pursuant to which SYS will merge with a newly formed, wholly-owned subsidiary of Kratos, with SYS surviving the merger as a wholly-owned subsidiary of Kratos. In the proposed merger, SYS shareholders will receive 1.2582 shares of Kratos common stock for each share of SYS common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing. The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger.

### The Parties

#### Kratos

**Kratos Defense & Security Solutions, Inc.**  
**4810 Eastgate Mall**  
**San Diego, CA 92121**  
**(858) 812-7300**

Kratos is an innovative provider of mission critical engineering, IT services and warfighter solutions. Kratos performs work primarily for the U.S. government and government agencies, but also performs work for state and local agencies and commercial customers. As a result of its market focus, Kratos is organized into two primary operating segments: the Kratos Government Solutions, or KGS, segment; and the Public Safety and Security, or PSS, segment. The principle services of Kratos include, but are not limited to, Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance, or C5ISR; weapon systems life cycle support and extension; military range operations and technical services; missile, rocket and weapons systems test and evaluation; mission launch services; public safety; security and surveillance systems; advanced network engineering and IT services; and critical infrastructure design and integration services. Kratos offers its customers a range of solutions and technical expertise to support their mission-critical needs by leveraging skills across Kratos' core service areas.

Kratos derives a substantial portion of its revenue from contracts performed for federal government agencies. Kratos believes its diversified and stable client base, strong client relationships, broad array of contracts, considerable employee base possessing government security clearances, extensive list of past performance qualifications, and significant management and operational capabilities provides a sizable advantage and positions the company for continued growth. Founded in 1994, Kratos is headquartered in San Diego and has offices in California, Washington D.C. and several other locations in the U.S.

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For more information regarding Kratos, visit [www.kratosdefense.com](http://www.kratosdefense.com). The information on the Kratos' website is not a part of this prospectus.

### **SYS**

#### **SYS**

**5050 Murphy Canyon Road, Suite 200  
San Diego, CA 92123  
(858) 244-7393**

SYS and its subsidiaries provide information connectivity solutions that capture, analyze and present real-time information to customers in the Department of Defense, Department of Homeland Security, other government agencies and commercial companies. Using interoperable communications software, sensors, digital video broadcast and surveillance technologies, wireless networks, network management, decision-support tools and Net-Centric technologies, SYS's technical experts enhance complex decision-making. Founded in 1966, SYS is headquartered in San Diego and has principal offices in California and Virginia.

SYS delivers its solutions through two reportable segments, the Defense Solutions Group and the Public Safety, Security and Industrial Systems Group. The Defense Solutions Group focuses on engineering, technical and management services to Federal Government agencies. The Public Safety, Security and Industrial Systems Group focuses on providing "right-time" situation status and mission execution support solutions to government and commercial customers. Historically, SYS has generated revenues by providing information technology, systems integration and program and financial management services under long term contracts for the Department of Defense and in particular the U.S. Navy. More recently, SYS has expanded and leveraged its technical engineering services with complementary products and has broadened its customer base to include commercial enterprises and other governmental agencies beyond the Department of Defense.

These expanded products and services capabilities, together with SYS's longstanding expertise in situational awareness and systems engineering, have enabled SYS to develop a set of information technology solutions to complement SYS's services offerings for the Information Technology services and Public Safety and Security markets. SYS's customers in these markets such as federal, state and local governments, public safety first-responders, large corporations, schools and universities, all share a common need for decision support products and services that enhance or enable connecting real-time data to decision makers.

SYS also provides solution lifecycle support with program, financial, test and logistical services, including classroom and online training.

For additional information regarding SYS, visit [www.systechnologies.com](http://www.systechnologies.com). The information on SYS's website is not a part of this prospectus.

### **Merger Sub**

White Shadow, Inc., or Merger Sub, a wholly-owned subsidiary of Kratos, is a California corporation formed on February 19, 2008 for the sole purpose of effecting the merger. Upon completion of the merger, Merger Sub will merge with and into SYS, and SYS will become a wholly-owned subsidiary of Kratos.

Merger Sub has not conducted any activities other than those incidental to its formation and the matters contemplated by the merger agreement, including the preparation of applicable regulatory filings in connection with the merger.

## **The Merger Agreement**

A copy of the merger agreement is attached as *Annex A* to this Proxy Statement. Kratos and SYS encourage you to read the entire merger agreement carefully because it is the principal document governing the merger. For more information on the merger agreement, see "The Merger Agreement" beginning on page 79.

## **What SYS shareholders Will Receive in the Merger**

At the effective time of the merger, each outstanding share of SYS common stock will be converted into the right to receive 1.2582 shares of Kratos common stock in the merger, which number we refer to as the exchange ratio. Holders of SYS common stock will not receive any fractional Kratos shares in the merger. Instead, the total number of shares that each holder of SYS common stock will receive in the merger will be rounded down to the nearest whole number, and Kratos will pay cash for any resulting fractional share that an SYS shareholder otherwise would be entitled to receive. The amount of cash payable for a fractional share of Kratos common stock will be determined by multiplying the fraction by the average closing price for Kratos common stock on The Nasdaq Global Select Stock Market during the three days prior to the date the merger becomes effective.

*Example: If you currently own 25 shares of SYS common stock, absent the treatment of fractional shares described above, you would be entitled to receive 31.455 (25 × 1.2582) shares of Kratos common stock. Since fractional shares will not be issued, you will be entitled to 31 shares of Kratos common stock and a check for the market value of 0.455 shares of Kratos common stock based on the average closing price during the three days prior to date the merger becomes effective.*

The merger agreement provides for adjustments to the exchange ratio to reflect the effect of any stock split, stock dividend, reverse stock split, reclassification, recapitalization or other similar transaction with respect to Kratos common stock or SYS common stock that occurs prior to the effective date of the merger.

For a more complete description of the merger consideration, see "The Merger Agreement Consideration to be Received in the Merger" beginning on page 80.

## **Treatment of SYS Subordinated Convertible Notes and Warrants**

SYS has \$3,125,000 of convertible notes payable outstanding, which we refer to as the Notes, which are unsecured, subordinate to its bank debt, bear interest at 10% per annum payable quarterly, are due February 14, 2009 and are convertible at any time into shares of common stock at a conversion rate of \$3.60 per share. These notes are being assumed by Kratos subject to those same terms and conditions.

If the Notes are not converted prior to the merger, following the merger the Notes will not be convertible into SYS common stock. Instead, they will be convertible into the merger consideration as if they had been converted into SYS common stock immediately prior to the merger.

SYS has 508,401 warrants outstanding, which will be, following the merger, exercisable for merger consideration.

Following the merger, the holders of these warrants shall have the right to receive, upon exercise of the warrants, the same amount and kind of securities, cash or property, as they would have been entitled to receive upon the occurrence of the merger if they had been, immediately prior to the merger, the holders of the number of warrant shares then issuable upon exercise in full of these warrants.

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For a more complete discussion of the treatment of SYS Subordinated Convertible Notes and Warrants, see "The Merger Subordinated Convertible Notes" and "The Merger Warrants," each beginning on page 68.

### **Treatment of Stock Options and Other Stock-Based Awards**

All outstanding SYS stock options will become fully vested and exercisable into SYS shares at or prior to closing in accordance with the terms of their respective stock option plans and may be subject to withholding taxes as a result. No SYS stock options will be assumed by or converted into options of Kratos.

Effective February 20, 2008, the execution date of the merger agreement, SYS terminated the then current stock purchase period for its Employee Stock Purchase Plan, and Kratos is not assuming this plan.

For a more complete discussion of the treatment of SYS options and other stock-based awards, see "The Merger Agreement Treatment of SYS Options" beginning on page 80.

### **Directors and Executive Management Following the Merger**

The directors and executive management of Kratos will remain unchanged at the effective time of the merger.

At the effective time of the merger, the directors and officers of Merger Sub will become the directors and officers of SYS until each is replaced by his or her successor.

For a more complete discussion of the directors and management of Kratos, see "The Merger Composition of Kratos Board of Directors" beginning on page 66.

### **Recommendations of the Kratos Board of Directors**

After careful consideration, the Kratos board of directors unanimously recommends that holders of Kratos common stock vote **FOR** the issuance of Kratos common stock in connection with the merger.

For a more complete description of the Kratos reasons for the merger and the recommendations of the Kratos board of directors, see "The Merger The Kratos Board of Directors Recommendations and Reasons for the Merger" beginning on page 49.

### **Recommendation of the SYS Board of Directors**

After careful consideration, the SYS board of directors unanimously recommends that holders of SYS common stock vote **FOR** the Merger Proposal.

For a more complete description of SYS's reasons for the merger and the recommendation of the SYS board of directors, see "The Merger The SYS Board of Directors' Recommendation and Reasons for the Merger" beginning on page 51.

## Opinions of Financial Advisors

### *Kratos Financial Advisor*

Wachovia Capital Markets, LLC, which we refer to as Wachovia, delivered an opinion to Kratos' board of directors that, subject to and based upon the assumptions made, procedures followed, matters considered and limitations on its review undertaken, as of February 20, 2008, the exchange ratio in the merger agreement was fair from a financial point of view to Kratos. The full text of Wachovia's written opinion, dated February 20, 2008, is attached as *Annex D* to this Proxy Statement. Holders of shares of Kratos common stock are urged to read the opinion carefully and in its entirety. Wachovia's opinion does not and shall not constitute a recommendation to any holders of shares of Kratos common stock as to how they should vote in connection with the Merger. This summary of Wachovia's opinion contained in this Proxy Statement is qualified in its entirety by reference to the full text of the opinion.

For a more complete description of Wachovia's opinion, see "The Merger Opinion of Financial Advisor to the Kratos Board of Directors" beginning on page 53. See also *Annex D* to this Proxy Statement.

### *SYS Financial Advisor*

Imperial Capital, LLC, which is referred to as Imperial Capital, has rendered its opinion to the SYS board of directors to the effect that, as of February 19, 2008, and based upon and subject to the factors, assumptions, qualifications and limitations set forth therein, the exchange ratio of 1.2582 shares of Kratos common stock to be received for each share of SYS common stock pursuant to the merger agreement was fair from a financial point of view to the holders of such shares of SYS common stock.

The full text of the written opinion of Imperial Capital, dated February 19, 2008, is attached as *Annex E* to this Proxy Statement and sets forth assumptions made, general procedures followed, factors considered and limitations and qualifications on the review undertaken by Imperial in connection with its opinion. Imperial Capital provided its opinion for the information and assistance of the SYS board of directors in connection with its consideration of the merger. The Imperial Capital opinion is not a recommendation as to how any holder of shares of SYS common stock should vote with respect to the merger.

For a more complete description of the Imperial Capital opinion and engagement letter, see "The Merger Opinion of Financial Advisor to the SYS Board of Directors" beginning on page 59. See also *Annex E* to this Proxy Statement.

## Interests of SYS Directors and Executive Officers in the Merger

When you consider the unanimous recommendation of SYS's board of directors that SYS shareholders approve the merger agreement, the plan of merger and the merger, you should be aware that some SYS officers and directors may have interests in the transaction that may be different from, or in addition, to their interests as shareholders of SYS.

For a further discussion of interests of directors and executive officers in the merger, see "The Merger Interests of SYS Directors and Executive Officers in the Merger" beginning on page 66.

## Material United States Federal Income Tax Consequences of the Merger

Kratos and SYS intend for the merger to qualify as a reorganization within the meaning of Section 368(a) of the Code for U.S. federal income tax purposes. Accordingly, SYS shareholders generally will not recognize gain or loss for U.S. federal income tax purposes upon the receipt of Kratos common stock in the merger, except that an SYS shareholder will recognize gain or loss with respect to any cash received in lieu of a fractional share of Kratos common stock. It is a condition to



completion of the merger that Kratos and SYS each receive a legal opinion from their respective counsel that the merger will constitute a reorganization within the meaning of Section 368 of the Code. In the event that such counsel does not render this opinion, this condition shall be deemed to be satisfied if the other party's counsel delivers the opinion to both Kratos and SYS.

Tax matters are very complicated and the tax consequences of the merger to you, if you are an SYS shareholder, will depend upon the facts of your situation. In addition, you may be subject to state, local or foreign tax laws that are not addressed in this Proxy Statement. You are urged to consult with your own tax advisors for a full understanding of the tax consequences of the merger to you.

For a more complete description of the material U.S. federal income tax consequences of the merger, see "Material United States Federal Income Tax Consequences" beginning on page 76.

### **Accounting Treatment of the Merger**

The merger will be accounted for as an acquisition by Kratos of SYS under the purchase method of accounting according to U.S. generally accepted accounting principles.

### **Dissenters' Rights and Appraisal Rights**

Under applicable law:

Kratos stockholders have no dissenters' or appraisal rights with respect to the merger under Section 262 of Delaware General Corporate Law; and

SYS shareholders are entitled to dissenters' rights under the California General Corporation Law in connection with the merger if the specific conditions set forth in the section entitled "The Merger Dissenters' Rights and Appraisal Rights," which begins on page 71, are met.

### **Conditions to Completion of the Merger**

Kratos and SYS expect to complete the merger after all the conditions to the merger in the merger agreement are satisfied or waived, including after the receipt of stockholder approvals at the annual meeting of Kratos and at the special meetings of SYS. Kratos and SYS currently expect to complete the merger during the first half of 2008. However, it is possible that factors outside of either company's control could cause the merger to be completed at a later time or not at all.

Each party's obligation to complete the merger is subject to the satisfaction or waiver of various conditions, including the following:

the receipt of the required stockholder approvals;

the effectiveness of the registration statement of which this Proxy Statement is a part, and the registration statement not being subject to any stop order or threatened stop order;

the absence of any injunctions or legal prohibitions preventing the consummation of the merger;

the receipt of opinions of counsel relating to the U.S. federal income tax treatment of the merger;

the accuracy of the other party's representations and warranties in the merger agreement, including the other party's representation that no material adverse effect has occurred;

the other party's compliance in all material respects with its obligations under the merger agreement; and

the receipt of authorization from The Nasdaq Global Select Stock Market for listing of Kratos common stock to be issued in connection with the merger.

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Neither Kratos nor SYS is aware of the need to obtain any other material regulatory approvals in order to complete the merger.

The merger agreement provides that certain of these conditions may be waived, in whole or in part, by Kratos or SYS, to the extent legally allowed. Neither Kratos nor SYS currently expects to waive any material condition to the completion of the merger. If either Kratos or SYS determines to waive any condition to the merger that would result in a material and adverse change in the terms of the merger to Kratos or SYS shareholders (including any change in the tax consequences of the transaction to SYS shareholders), proxies would be resolicited from the Kratos or SYS shareholders, as applicable.

For a more complete discussion of the conditions to the merger, see "The Merger Agreement Conditions to Completion of the Merger" beginning on page 84.

### **Timing of the Merger**

The merger is expected to be completed during the first half of 2008, subject to the receipt of necessary regulatory approvals and the satisfaction or waiver of other closing conditions. For a discussion of the timing of the merger, see "The Merger Agreement Closing and Effective Time of the Merger" beginning on page 79.

### **No Solicitation of Other Offers**

In the merger agreement, SYS has agreed that it will not directly or indirectly:

solicit, initiate, or knowingly or intentionally encourage or facilitate, any inquiries, offers or proposals that constitute, or could reasonably be expected to lead to, any alternative acquisition proposal; or

enter into, continue or otherwise participate in any discussions or negotiations regarding, furnish to any person any non-public information with respect to, assist or participate in any effort or attempt by any person with respect to, or otherwise knowingly or intentionally cooperate in any way with, any alternative acquisition.

The merger agreement does not, however, prohibit SYS from considering a bona fide acquisition proposal from a third party if certain specified conditions are met.

For a discussion of the prohibition on solicitation of acquisition proposals from third parties, see "The Merger Agreement No Solicitation; Changes in Recommendations" beginning on page 85.

### **Termination**

Generally, the merger agreement may be terminated and the merger may be abandoned at any time prior to the completion of the merger (including after stockholder approval):

by mutual written consent of Kratos and SYS;

by either Kratos or SYS, if

the merger is not consummated on or before August 20, 2008; except that such right is not available to any party whose failure to comply with the merger agreement has been a principal cause of, or resulted in, the merger not being consummated by such date and provided that this date (referred to herein as the "outside date") may be extended to February 20, 2009 by either Kratos or SYS;

a governmental entity issues an order, decree or ruling or takes any other nonappealable final action permanently restraining, enjoining or otherwise prohibiting the merger;

the required Kratos or SYS shareholder vote has not been obtained at the applicable stockholder meeting or any adjournment or postponement thereof (except that this right is not available to any party who is in material breach of or has materially failed to fulfill its obligations under the merger agreement);

the SYS board of directors changes its recommendation that its shareholders vote in favor of the merger proposal, or if SYS enters into an acquisition agreement relating to an alternative transaction; or

the other party breaches any of its agreements or representations in the merger agreement in such a way as would cause one or more of the conditions to closing not to be satisfied, and such breach is either incurable or is not cured after 30 days' written notice;

by Kratos, if:

SYS willfully and materially breaches its covenants with respect to non-solicitation of an alternative acquisition proposal or its obligations to hold its shareholders meeting and mail this Proxy Statement to its shareholders; or

SYS's board of directors determines to accept an alternative acquisition proposal for a change of control transaction, in which case SYS would be required to pay the applicable termination fee (as described below); or

by SYS to accept a proposal from a third party to acquire SYS that SYS's board of directors determines to be superior to the terms of Kratos' proposed acquisition of SYS, if SYS's board of directors changes or withdraws its recommendation of the merger in response to such superior proposal and pays the applicable termination fee (as described below).

#### **Termination Fees and Expenses**

Pursuant to the merger agreement, SYS is required to pay a termination fee of \$2,394,000 dollars to Kratos in the event the merger agreement is terminated:

By Kratos, if

the SYS board of directors has failed to reconfirm its recommendation of approval of the SYS voting proposal after Kratos requests such reconfirmation pursuant to the terms of the merger agreement;

the SYS board of directors or any committee of the SYS board of directors has approved or recommended to the SYS shareholders an alternative acquisition transaction;

SYS enters into an alternative acquisition transaction; or

SYS has willfully breached its obligations under the merger agreement pertaining to non-solicitation of alternative acquisition proposals and the SYS shareholder meeting to approve the SYS Voting Agreement.

By SYS, if its board of directors or any committee thereof has made a recommendation to accept an alternative transaction proposal and SYS enters into an alternative acquisition agreement which was the subject of such adverse recommendation change.

Whether or not the merger is completed, all costs and expenses incurred in connection with the merger agreement and the transactions contemplated by the merger agreement will be paid by the party incurring those costs or expenses, except that Kratos and SYS will share equally the expenses incurred in connection with the printing and mailing of this Proxy Statement.



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This termination fee could discourage other companies from seeking to acquire or merge with either SYS or Kratos. See "The Merger Agreement Termination," " Termination Fees and Expenses" and " Effect of Termination," beginning on pages 86, 87 and 88, respectively.

### **Comparison of the rights of Kratos and SYS shareholders**

The rights of SYS shareholders as Kratos stockholders after the merger will be governed by Kratos' certificate of incorporation and bylaws, each as amended, and the laws of the State of Delaware. Those rights differ from the rights of SYS shareholders under SYS's articles of incorporation and bylaws and the laws of the State of California.

### **Matters to be Considered at the Meetings**

#### ***Kratos***

Kratos stockholders will be asked to vote on the following six proposals:

1. To elect five directors for one-year terms or until their successors are elected and duly qualified.
2. To ratify the selection of Grant Thornton LLP as the independent auditors of Kratos for the fiscal year ending December 28, 2008.
3. To approve an amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the Plan by 1,500,000 shares.
4. To approve an amendment to the Kratos 2005 Equity Incentive Plan to increase the aggregate number of shares that may be issued under the Plan by 3,000,000 shares.
5. To approve the issuance of Kratos common stock, par value \$0.001 per share, pursuant to the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS, as the same may be amended from time to time.
6. To approve any motion to adjourn or postpone the annual meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the annual meeting to approve the first five proposals listed above.
7. To transact such other business as may properly come before the annual meeting or any adjournment or postponement thereof.

The Kratos board of directors unanimously recommends that Kratos stockholders vote FOR all of the proposals set forth above, as more fully described under "Kratos Annual Meeting" beginning on page 142.

#### ***SYS***

SYS shareholders will be asked to vote on the following two proposals:

1. To adopt and approve the Agreement and Plan of Merger and Reorganization.
2. To approve any motion to adjourn or postpone the special meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the special meeting to approve the proposal to adopt the merger agreement.
3. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

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The SYS board of directors unanimously recommends that SYS shareholders vote FOR all of the proposals set forth above, as more fully described under "SYS Special Meeting" beginning on page 193.

### **Voting by Kratos and SYS Directors and Executive Officers**

On \_\_\_\_\_, 2008, the record date set by the Kratos board of directors, directors and executive officers of Kratos and their affiliates owned and were entitled to vote \_\_\_\_\_ shares of Kratos common stock, or approximately \_\_\_\_\_%, of the total voting power of the shares of Kratos common stock outstanding on that date.

On \_\_\_\_\_, 2008, the record date set by the SYS board of directors, directors and executive officers of SYS and their affiliates owned and were entitled to vote \_\_\_\_\_ shares of SYS common stock, or approximately \_\_\_\_\_% of the shares of SYS common stock outstanding on that date. Stockholders of SYS holding approximately 9.1% of the shares of SYS common stock outstanding on that date have executed voting agreements agreeing to vote in favor of the merger.

## SELECTED HISTORICAL FINANCIAL DATA OF KRATOS

The tables below present summary selected consolidated historical financial data of KRATOS (in millions except for per share data) prepared in accordance with accounting principles generally accepted in the United States of America. This information should be read in conjunction with "INFORMATION RELATING TO KRATOS KRATOS MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS," "INFORMATION RELATING TO KRATOS BUSINESS" and Kratos' consolidated financial statements and related notes, included elsewhere in this proxy statement/prospectus.

	Year Ended December 31, (in millions)				
	2003	2004	2005	2006	2007
<b>CONSOLIDATED STATEMENT OF OPERATIONS DATA:</b>					
Revenues	\$ 43.4	\$ 116.9	\$ 152.3	\$ 153.1	\$ 193.6
Operating costs and expenses:					
Costs of revenues	22.2	87.9	115.7	124.2	162.0
Selling, general and administrative expenses	18.0	28.9	35.5	38.5	39.5
Stock option investigation and related fees					14.0
Estimated cost for settlement of securities litigation					4.9
Loss (recovery) of unauthorized issuance of stock options	5.7				(3.4)
Contingent acquisition consideration and restatement fees		13.9	(2.1)	0.1	
Impairment and restructuring fees	0.1			21.8	1.2
<b>Total operating costs and expenses</b>	<b>46.0</b>	<b>130.7</b>	<b>149.1</b>	<b>184.6</b>	<b>218.2</b>
Operating income (loss) from continuing operations	(2.6)	(13.8)	3.2	(31.5)	(24.6)
Other (income) expense:					
Interest income (expense), net	0.9	0.2	0.1	(0.7)	(1.2)
Impairment of investments in unconsolidated subsidiaries		(2.9)			(1.8)
Other income and (expense), net	(0.1)	(0.1)	0.2	(0.2)	0.7
<b>Total other (income) expense</b>	<b>0.8</b>	<b>(2.8)</b>	<b>0.3</b>	<b>(0.9)</b>	<b>(2.3)</b>
Income (loss) from continuing operations before income taxes	(1.8)	(16.6)	3.5	(32.4)	(26.9)
Provision (benefit) for income taxes from continuing operations	(1.0)	(8.4)	(0.1)	13.8	1.3
Income (loss) from continuing operations	(0.8)	(8.2)	3.6	(46.2)	(28.2)
Income (loss) from discontinued operations	2.7	23.2	(2.0)	(11.7)	(12.6)
Net income (loss)	1.9	15.0	1.6	(57.9)	(40.8)
Preference dividend requirements					
Net income (loss) applicable to common stock	\$ 1.9	\$ 15.0	\$ 1.6	\$ (57.9)	\$ (40.8)
Basic earnings (loss) per common share:					
Continuing operations	\$ (0.01)	\$ (0.12)	\$ 0.05	\$ (0.63)	\$ (0.38)
Discontinued operations	0.04	0.34	(0.03)	(0.16)	(0.17)
Net income (loss)	\$ 0.03	\$ 0.22	\$ 0.02	\$ (0.79)	\$ (0.55)
Diluted earnings (loss) per common share:					



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Year Ended December 31, (in millions)

Continuing operations	\$ (0.01)	\$ (0.12)	\$ 0.05	\$ (0.63)	\$ (0.38)
Discontinued operations	0.04	0.34	(0.03)	(0.16)	(0.17)
Net income (loss)	\$ 0.03	\$ 0.22	\$ 0.02	\$ (0.79)	\$ (0.55)
Weighted average common shares outstanding:					
Basic	68.4	67.7	74.0	73.5	74.0
Diluted	68.4	67.7	75.0	73.5	74.0

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December 31, (in millions)

	2003	2004	2005	2006	2007
<b>CONSOLIDATED BALANCE SHEET DATA:</b>					
Cash and cash equivalents	\$ 75.8	\$ 58.0	\$ 7.7	\$ 5.4	\$ 8.6
Working capital	132.5	98.6	67.4	(3.8)	23.4
Goodwill	5.5	57.1	94.4	129.9	194.5
Other intangible assets	1.9	6.4	7.4	13.4	19.9
Total assets	279.3	330.7	342.0	337.7	335.3
Long-term debt					74.0
Preferred stock					
Stockholders' equity	\$ 191.9	\$ 219.6	\$ 229.7	\$ 187.1	\$ 167.2

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## SELECTED HISTORICAL FINANCIAL DATA OF SYS

The tables below present summary selected consolidated historical financial data of SYS (*in millions except for per share data*) prepared in accordance with accounting principles generally accepted in the United States of America. This information should be read in conjunction with "INFORMATION RELATING TO SYS SYS MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS," "INFORMATION RELATING TO SYS BUSINESS" and SYS's consolidated financial statements and related notes, included elsewhere in this proxy statement/prospectus.

The statement of income data for the six months ended December 28, 2007 and December 29, 2006, and the balance sheet data as of December 28, 2007 are unaudited but include, in the opinion of management of SYS, all adjustments including normal recurring adjustments, necessary for a fair presentation of such information. Results for the six months ended December 28, 2007 and December 29, 2006 are not necessarily indicative of the results that may be expected for any other interim periods or for the fiscal year as a whole.

	Year Ended June 30,					Six Months Ended	
	2003	2004	2005	2006	2007	December 29, 2006	December 28, 2007
	(In millions)					(Unaudited)	
<b>CONSOLIDATED STATEMENT OF OPERATIONS DATA:</b>							
Revenues	\$ 24.8	\$ 34.9	\$ 45.8	\$ 55.9	\$ 75.8	\$ 35.5	\$ 38.6
Operating costs and expenses:							
Costs of revenues	20.6	28.8	37.4	44.6	58.0	27.2	28.4
Selling, general and administrative expenses	3.5	4.1	4.9	8.5	15.5	6.7	6.8
Research, engineering and development expenses			0.7	3.6	4.0	2.0	2.2
Legal settlement	1.0						
Impairment charges				1.3			
Total operating costs and expenses	25.1	32.9	43.0	58.0	77.5	35.9	37.4
Income (loss) from operations	(0.3)	2.0	2.8	(2.1)	(1.7)	(0.4)	1.2
Other (income) expense:							
Other income		(0.1)	(0.1)	(0.2)	(0.1)	(0.1)	(0.1)
Interest expense	0.2	0.3	0.5	0.5	0.8	0.4	0.2
Total other income	0.2	0.2	0.4	0.3	0.7	0.3	0.1
Income (loss) from continuing operations before income taxes	(0.5)	1.8	2.4	(2.4)	(2.4)	(0.7)	1.1
Income tax (benefit) provision	(0.2)	0.8	1.0	(0.7)	(0.7)	(0.3)	0.5
Income (loss) from continuing operations	(0.3)	1.0	1.4	(1.7)	(1.7)	(0.4)	0.6
Loss from discontinued operations, net of taxes	(0.5)						
Net income (loss)	(0.8)	1.0	1.4	(1.7)	(1.7)	(0.4)	0.6
Net income (loss) applicable to common stock	\$ (0.8)	\$ 1.0	\$ 1.4	(1.7)	(1.7)	(0.4)	\$ 0.6
Basic earnings (loss) per common share:							
Continuing operations	\$ (0.06)	\$ 0.15	\$ 0.16	\$ (0.14)	\$ (0.10)	\$ (0.03)	\$ 0.03
Discontinued operations	(0.09)						

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	Six Months Ended							
Net income (loss)	\$ (0.15)	\$ 0.15	\$ 0.16	\$ (0.14)	\$ (0.10)	<del>(0.03)</del>	<del>0.03</del>	
Diluted earnings (loss) per common share:								
Continuing operations	\$ (0.06)	\$ 0.13	\$ 0.15	\$ (0.14)	\$ (0.10)	(0.03)	\$ 0.03	
Discontinued operations	(0.09)							
Net income (loss)	\$ (0.15)	\$ 0.13	\$ 0.15	\$ (0.14)	\$ (0.10)	(0.03)	\$ 0.03	
Weighted average common shares outstanding:								
Basic	5.2	6.7	8.7	12.7	17.6	16.5	19.4	
Diluted	5.2	8.5	11.2	12.7	17.6	16.5	19.5	

	June 30,					December 28,					
	2003	2004	2005	2006	2007	2007					
						(Unaudited)					
<b>CONSOLIDATED BALANCE SHEET DATA:</b>											
Cash and cash equivalents	\$	\$	2.2	\$	3.5	\$	2.1	\$	2.8	\$	2.2
Working capital		3.2	5.2	8.1	7.3	8.2	10.7				
Goodwill			5.5	7.3	18.6	23.5	23.1				
Other intangible assets			0.6	1.2	3.4	6.1	5.6				
Total assets		7.7	17.7	24.8	42.2	52.4	53.4				
Long-term debt		1.2	3.6	2.4	3.9	3.6	3.6				
Preference stock		0.1									
Stockholders' equity		3.1	8.3	15.4	27.5	35.1	36.7				

**SUMMARY UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL DATA**

The following summary unaudited pro forma condensed combined financial information is designed to show how the merger of Kratos and SYS might have affected historical financial statements if the merger had been completed at an earlier time and was prepared based on the historical financial results reported by Kratos, including Haverstick, and SYS. The following should be read in connection with "Unaudited Pro Forma Condensed Combined Financial Statements" beginning on page 197 and the Kratos, SYS and Haverstick audited consolidated financial statements beginning on pages FI-1, FII-1 and FIII-1, respectively.

The pro forma condensed combined financial data is presented for illustrative purposes only and is not necessarily indicative of the financial condition or results of operations of future periods or the financial condition or results of operations that actually would have been realized had the entities been a single company during these periods.

	<b>Year Ended December 31, 2007</b>	
	<b>(In millions, except per share amounts)</b>	
<b>Statements of Operations Data:</b>		
Revenues	\$	366.8
Operating loss		(20.6)
Net loss from continuing operations		(34.0)
Loss per common share:		
Basic	\$	(0.33)
Diluted	\$	(0.33)
Weighted average common shares outstanding:		
Basic		104.6
Diluted		104.6
<b>Balance Sheet Data:</b>		
Cash and cash equivalents	\$	3.4
Property and equipment, net		8.9
Goodwill		235.9
Intangible assets, net		27.6
Total assets		401.0
Long-term debt, net of current portion		77.2
Accumulated deficit		(245.5)
Total stockholders' equity		218.3

**COMPARATIVE PER SHARE DATA (UNAUDITED)**

The following table shows per share data regarding losses from continuing operations, book value and cash dividends for Kratos, including Haverstick, and SYS on a historical, pro forma combined basis. The pro forma book value per share information was computed as if the merger had been completed on December 31, 2007. The pro forma losses from continuing operations information was computed as if the merger had been completed on January 1, 2007. The SYS pro forma equivalent information was calculated by multiplying the corresponding pro forma combined data by the exchange ratio of 1.2582. This information shows how each share of SYS common stock would have participated in the combined companies' losses from continuing operations and book value per share if the merger had been completed on the relevant dates. These amounts do not necessarily reflect future per share amounts of earnings (losses) from continuing operations and book value per share of Kratos.

The following unaudited comparative per share data is derived from the historical consolidated financial statements of each of Kratos and SYS. The information below should be read in conjunction with the audited consolidated financial statements and accompanying notes of Kratos, SYS and Haverstick, which are included in this Proxy Statement. We urge you also to read "Unaudited Pro Forma Condensed Combined Financial Statements" beginning on page 197.

	<b>As of and for the year ended December 31, 2007</b>
<b>Kratos Historical</b>	
Basic loss per share	\$ (0.38)
Diluted loss per share	\$ (0.38)
Book value per common share	\$ 2.26
Cash dividends per share	\$
<b>SYS Historical</b>	
Basic loss per share	\$ (0.04)
Diluted loss per share	\$ (0.04)
Book value per common share	\$ 1.89
Cash dividends per share	\$
<b>Unaudited Pro Forma Combined</b>	
Basic loss per share	\$ (0.33)
Diluted loss per share	\$ (0.33)
Book value per common share	\$ 2.09
Cash dividends per share	\$
<b>Unaudited Pro Forma Combined SYS Equivalents(1)</b>	
Basic loss per share	\$ (0.41)
Diluted loss per share	\$ (0.41)
Book value per common share	\$ 2.64
Cash dividends per share	\$

(1) SYS pro forma equivalent amounts are calculated by multiplying pro forma per share amounts by the exchange ratio of 1.2582.

**MARKET PRICES AND DIVIDENDS AND OTHER DISTRIBUTIONS*****Kratos***

Since November 4, 1999, the Common Stock of Kratos has been traded on the Nasdaq Global Stock Exchange under the symbols "WFII" and "KTOS." The ranges of high and low quotations during the two most recent fiscal years of Kratos are as follows:

	<u>High</u>	<u>Low</u>
<b>Fiscal Year 2008</b>		
First Quarter	\$ 2.35	\$ 1.50
<b>Fiscal Year 2007</b>		
First Quarter	\$ 2.94	\$ 1.20
Second Quarter	\$ 1.80	\$ 1.01
Third Quarter	\$ 2.85	\$ 1.70
Fourth Quarter	\$ 3.09	\$ 1.80
<b>Fiscal Year 2006</b>		
First Quarter	\$ 5.56	\$ 3.73
Second Quarter	\$ 4.53	\$ 2.75
Third Quarter	\$ 2.94	\$ 1.85
Fourth Quarter	\$ 2.98	\$ 1.98

This summary is based on prices quoted by the Nasdaq Global Stock Exchange.

As of April 8, 2008, there were approximately 214 holders of record of the Common Stock of Kratos.

No cash dividends have been paid on Kratos Common Stock during the two most recent fiscal years of Kratos, and Kratos does not intend to pay cash dividends on its Common Stock in the immediate future.

***SYS***

Since January 3, 2005, the Common Stock of SYS has been traded on the American Stock Exchange under the symbol "SYS." Prior to that date, SYS Common Stock was traded in the



over-the-counter market. The ranges of high and low quotations during SYS's two most recent fiscal years are as follows:

	<u>High</u>	<u>Low</u>
<b>Fiscal Year 2008</b>		
First Quarter	\$ 2.52	\$ 1.90
Second Quarter	\$ 2.45	\$ 1.60
Third Quarter	\$ 2.47	\$ 1.30
<b>Fiscal Year 2007</b>		
First Quarter	\$ 2.90	\$ 2.10
Second Quarter	\$ 3.14	\$ 2.11
Third Quarter	\$ 2.80	\$ 1.97
Fourth Quarter	\$ 2.34	\$ 1.73
<b>Fiscal Year 2006</b>		
First Quarter	\$ 4.33	\$ 2.61
Second Quarter	\$ 5.98	\$ 3.34
Third Quarter	\$ 4.25	\$ 3.35
Fourth Quarter	\$ 3.95	\$ 2.70

This summary is based on prices quoted by the American Stock Exchange.

As of April 7, 2008, there were approximately 712 holders of record of SYS's Common Stock.

No cash dividends have been paid on SYS Common Stock during the two most recent fiscal years of SYS, and SYS does not intend to pay cash dividends on its Common Stock in the immediate future.

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#### REFERENCES TO ADDITIONAL INFORMATION

This Proxy Statement incorporates important business and financial information about Kratos from documents filed with the Securities and Exchange Commission that have not been included in or delivered with this document. This information is available at the internet website that the Securities and Exchange Commission maintains at <http://www.sec.gov>, as well as from other sources.

You may also request copies of these documents from Kratos, without charge, upon written or oral request to:

Kratos Defense & Security Solutions, Inc.  
4810 Eastgate Mall  
San Diego, California 92121  
Attn: Investor Relations  
(858) 812-7300

**In order to receive timely delivery of the documents, you must make your request no later than \_\_\_\_\_, 2008.**

For more information, see the section entitled "Where You Can Find More Information."

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

We make forward-looking statements in this Proxy Statement. These forward-looking statements relate to outlooks or expectations for earnings, revenues, expenses, asset quality or other future financial or business performance, strategies or expectations, or the impact of legal, regulatory or supervisory matters on business, results of operations or financial condition. Specifically, forward looking statements may include:

statements relating to the benefits of the merger, including anticipated synergies and cost savings estimated to result from the merger;

statements relating to future business prospects, revenue, income and financial condition; and

statements preceded by, followed by or that include the words "estimate," "plan," "project," "forecast," "intend," "expect," "anticipate," "believe," "seek," "target" or similar expressions.

These statements reflect management judgments based on currently available information and involve a number of risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

Future performance cannot be ensured. Actual results may differ materially from those in the forward-looking statements. Some factors that could cause actual results to differ include:

the ability to obtain governmental approvals of the merger on the proposed terms and time schedule, and without the imposition of significant terms, conditions, obligations or restrictions;

the risk that the businesses will not be integrated successfully;

expected cost savings from the merger may not be fully realized within the expected time frames or at all;

revenues following the merger may be lower than expected;

the effects of vigorous competition in the markets in which Kratos and SYS operate;

the possibility of one or more of the markets in which Kratos and SYS compete being impacted by changes in political or other factors such as monetary policy, legal and regulatory changes or other external factors over which they have no control;

the ability of Kratos to obtain debt financing on terms favorable to it or at all, whether to complete any required refinancing of outstanding debt or otherwise;

changes in general economic and market conditions; and

other risks referenced from time to time in filings with the SEC and those factors listed in this Proxy Statement under "Risk Factors" beginning on page 24.

You are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Proxy Statement, or in the case of any other document, as of the date of that document. Except as required by law, neither Kratos nor SYS undertakes any obligation to publicly update or release any revisions to these forward-looking statements to reflect any events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Additional factors that could cause actual results to differ materially from those expressed in the forward-looking statements are discussed in this Prospectus, including the section of this Prospectus entitled "Risk Factors."

## RISK FACTORS

*In addition to the other information contained in this Proxy Statement, you should carefully consider the following risk factors in deciding how to vote on the merger. In addition, you should read and consider the risks associated with each of the businesses of Kratos and SYS because these risks will also relate to Kratos following completion of the merger.*

**The failure to successfully integrate SYS's business and operations in the expected time frame may adversely affect the combined company's future results.**

Kratos believes that the merger with SYS will result in certain benefits including cost synergies and operational efficiencies. To realize the anticipated benefits, Kratos will be required to devote significant management attention and resources to integrating the two companies. The merger involves the integration of two companies that have previously operated independently with principal offices in two distinct locations. Due to legal restrictions, at present Kratos and SYS are able to conduct only limited planning regarding the integration of the two companies. The actual integration may result in additional and unforeseen expenses or delays. If Kratos is not able to successfully integrate SYS' business and operations, or if there are delays in combining the businesses, the anticipated benefits of the merger may not be realized fully or at all or may take longer to realize than expected. Failure to realize the full benefits of the merger could adversely affect Kratos' business, financial results, financial condition and stock price following the merger.

**Because the market price of Kratos common stock will fluctuate, SYS shareholders cannot be sure of the market value of the Kratos common stock that they will receive.**

When we complete the merger, each share of SYS common stock will be converted into the right to receive 1.2582 shares of Kratos common stock. The exchange ratio is fixed and will not be adjusted for changes in the market price of either Kratos common stock or SYS common stock. The merger agreement does not provide for any price-based termination right for either party. Accordingly, the market value of the shares of Kratos common stock that Kratos issues and SYS shareholders will be entitled to receive when the parties complete the merger will depend on the market value of shares of Kratos common stock at the time that the parties complete the merger and could vary significantly from the market value on the date of this Proxy Statement or the date of the Kratos annual meeting and the SYS special meeting. The market value of Kratos common stock will continue to fluctuate after the completion of the merger. For example, during the third and the fourth calendar quarters of 2007, the sales price of Kratos common stock ranged from a low of \$1.70 to a high of \$3.09, all as reported on The Nasdaq Global Select Stock Market. See "Market Prices and Dividends and Other Distributions" on page 21.

These variations could result from changes in the business, operations or prospects of Kratos or SYS prior to or following the merger, market assessments as to whether and when the merger will be consummated, regulatory considerations, general market and economic conditions and other factors both within and beyond the control of Kratos or SYS.

**The issuance of shares of Kratos common stock to SYS shareholders in the merger will substantially dilute the interest in Kratos held by Kratos stockholders prior to the merger.**

If the merger is completed, Kratos will issue up to approximately 25.3 million shares of Kratos common stock in the merger. Based on the number of shares of Kratos and SYS common stock outstanding on the Kratos and SYS record dates, SYS shareholders before the merger will own, in the aggregate, approximately 24% of the shares of Kratos common stock outstanding immediately after the merger on a fully diluted basis. The issuance of shares of Kratos common stock to SYS shareholders in

the merger will cause a significant reduction in the relative percentage interest of current Kratos stockholders in the earnings, voting rights, liquidation value and book and market value of Kratos.

**Uncertainty about the merger and diversion of management could harm Kratos and SYS, whether or not the merger is completed.**

In response to the announcement of the merger, existing or prospective customers of Kratos or SYS may delay or defer their procurement or other decisions concerning Kratos or SYS, or they may seek to change their existing business relationship. In addition, as a result of the merger, current and prospective employees could experience uncertainty about their future with Kratos or SYS, and either organization could lose key employees as a result. In addition to retention, these uncertainties may also impair each company's ability to recruit or motivate key personnel. Completion of the merger will also require a significant amount of time and attention from management. The diversion of management attention away from ongoing operations could adversely affect ongoing operations and business relationships.

**Failure to complete the merger could adversely affect Kratos' and SYS's stock prices and their future business and financial results.**

Completion of the merger is conditioned upon, among other things, the receipt of approval of the Kratos and SYS stockholders. There is no assurance that the parties will receive the necessary approvals or satisfy the other conditions to the completion of the merger. Failure to complete the proposed merger would prevent Kratos and SYS from realizing the anticipated benefits of the merger. Each company will also remain liable for significant transaction costs, including legal, accounting and financial advisory fees. In addition, the market price of each company's common stock may reflect various market assumptions as to whether the merger will occur. Consequently, the failure to complete the merger could result in a significant change in the market price of the common stock of Kratos and SYS.

**The combined company will incur significant transaction and merger-related costs in connection with the merger.**

Kratos and SYS expect to incur significant costs associated with completing the merger and combining the operations of the two companies. The exact magnitude of these costs is not yet known. In addition, there may be unanticipated costs associated with the integration. Although Kratos and SYS expect that the elimination of duplicative costs and other efficiencies may offset incremental transaction and merger-related costs over time, these benefits may not be achieved in the near term or at all.

**Because SYS's executive officers have interests in seeing the merger completed that are different than those of SYS's other shareholders, these persons may have conflicts of interest in recommending that SYS shareholders vote to adopt and approve the merger agreement.**

Certain of SYS's directors and executive officers have interests in the merger that are different from, or are in addition to, the interests of SYS shareholders generally. This difference of interests stems from the equity and equity-linked securities held by such persons, the change of control severance arrangements covering SYS's executive officers under which such officers are entitled to severance payments and other benefits if their employment is terminated following the merger, and the Kratos obligation under the merger agreement to indemnify SYS's directors and officers following the merger. These and other material interests of the directors and executive officers of SYS in the merger that are different than those of the other SYS shareholders are described under "The Merger Interests of SYS Directors and Executive Officers" beginning on page 66.

**The merger agreement contains provisions that could discourage a potential alternative acquirer that might be willing to pay more to acquire SYS.**

The merger agreement contains "no shop" provisions that restrict SYS's ability to solicit or facilitate proposals regarding a merger or similar transaction with another party. Further, there are only limited exceptions to SYS's agreement that its board of directors will not withdraw or adversely qualify its recommendation regarding the merger agreement. SYS's board of directors is permitted to terminate the merger agreement in response to an unsolicited third party proposal to acquire SYS, which SYS's board of directors determines to be more favorable than the merger with Kratos. However, if SYS or Kratos terminates the merger agreement because SYS has received an acquisition proposal that is deemed more favorable by its board of directors, Kratos will be entitled to collect a \$2,394,000 termination fee from SYS. We describe these provisions under "The Merger Agreement Termination" beginning on page 86 and " Termination Fees and Expenses" beginning on page 87.

These provisions could discourage a potential third party acquirer from considering or proposing an alternative acquisition, even if it were prepared to pay consideration with a higher value than that proposed to be paid in the merger, or might result in a potential third party acquirer proposing to pay a lower per share price than it might otherwise have proposed to pay because of the added expense of the termination fee.

**Resales of shares of Kratos common stock following the merger and additional obligations to issue shares of Kratos common stock by Kratos may cause the market price of Kratos common stock to decrease.**

As of December 31, 2007, Kratos had 78,998,922 shares of common stock outstanding and approximately 8,327,306 shares of common stock subject to outstanding options and other rights to purchase or acquire its shares. Kratos currently expects that it will issue approximately 25.3 million shares of common stock in connection with the merger. The issuance of these new shares of Kratos common stock and the sale of additional shares of Kratos common stock that may become eligible for sale in the public market from time to time upon exercise of options and other equity-linked securities could have the effect of depressing the market price for shares of Kratos common stock.

**Future results of the combined company may differ materially from the unaudited pro forma financial statements presented in this Proxy Statement.**

The future results of Kratos may be materially different from those shown in the unaudited pro forma financial statements presented in this Proxy Statement that show only a combination of the historical results of Kratos and SYS. Kratos expects to incur significant costs associated with completing the merger and combining the operations of the two companies, and the exact magnitude of these costs is not yet known. Furthermore, these costs may decrease the capital that Kratos could use for income-earning investments in the future.

**The trading price of shares of Kratos common stock after the merger may be affected by factors different from those affecting the price of shares of Kratos common stock or shares of SYS common stock before the merger.**

When the merger is completed, holders of SYS common stock will become holders of Kratos common stock. The results of operations of Kratos, as well as the trading price of Kratos common stock, after the merger may be affected by factors different from those currently affecting Kratos' or SYS's results of operations and the trading price of Kratos common stock or SYS common stock.

**Kratos' business could be adversely affected by changes in the contracting or fiscal policies of the federal government and governmental entities.**

Kratos derives a significant portion of Kratos' revenue from contracts with the U.S. Federal Government and government agencies and subcontracts under Federal Government prime contracts, and the success of Kratos' business and growth of Kratos' business will continue to depend on Kratos' successful procurement of government contracts either directly or through prime contractors. Accordingly, changes in government contracting policies or government budgetary constraints could directly affect Kratos' financial performance. Among the factors that could adversely affect Kratos' business are:

changes in fiscal policies or decreases in available government funding, including budgetary constraints affecting federal government spending generally, or specific departments or agencies in particular;

the adoption of new laws or regulations or changes to existing laws or regulations;

changes in political or social attitudes with respect to security and defense issues;

changes in federal government programs or requirements, including the increased use of small business providers;

changes in or delays related to government restrictions on the export of defense articles and services;

potential delays or changes in the government appropriations process; and

delays in the payment of our invoices by government payment offices.

These and other factors could cause governments and government agencies, or prime contractors that use Kratos as a subcontractor, to reduce their purchases under existing contracts, to exercise their rights to terminate contracts at-will or to abstain from exercising options to renew contracts, any of which could have an adverse effect on Kratos' business, financial condition and results of operations. Many of Kratos' government customers are subject to stringent budgetary constraints. The award of additional contracts from government agencies could be adversely affected by spending reductions or budget cutbacks at these agencies.

**Kratos derives a substantial amount of revenues from the sale of its solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in Kratos' revenues and earnings.**

Government contracts frequently include provisions that are not standard in private commercial transactions, and are subject to laws and regulations that give the Federal Government rights and remedies not typically found in commercial contracts, including provisions permitting the federal government to:

terminate Kratos' existing contracts;

reduce potential future income from Kratos' existing contracts;

modify some of the terms and conditions in Kratos' existing contracts;

suspend or permanently prohibit Kratos from doing business with the federal government or with any specific government agency;

impose fines and penalties;

subject Kratos to criminal prosecution;



suspend work under existing multiple year contracts and related task orders if the necessary funds are not appropriated by Congress;

decline to exercise an option to extend an existing multiple year contract; and

claim rights in technologies and systems invented, developed or produced by Kratos.

In addition, government contracts are frequently awarded only after formal competitive bidding processes, which have been and may continue to be protracted and typically impose provisions that permit cancellation in the event that necessary funds are unavailable to the public agency. Competitive procurements impose substantial costs and managerial time and effort in order to prepare bids and proposals for contracts that may not be awarded to Kratos. In many cases, unsuccessful bidders for government agency contracts are provided the opportunity to formally protest certain contract awards through various agency, administrative and judicial channels. The protest process may substantially delay a successful bidder's contract performance, result in cancellation of the contract award entirely and distract management. Kratos may not be awarded contracts for which Kratos bids, and substantial delays or cancellation of purchases may follow Kratos' successful bids as a result of such protests.

Certain of Kratos' government contracts also contain "organizational conflict of interest" clauses that could limit Kratos' ability to compete for certain related follow-on contracts. For example, when Kratos works on the design of a particular solution, Kratos may be precluded from competing for the contract to install that solution. While Kratos actively monitors Kratos' contracts to avoid these conflicts, Kratos cannot guarantee that Kratos will be able to avoid all organizational conflict of interest issues.

**A significant number of Kratos' customers are government agencies which are subject to unique political and budgetary constraints and have special contracting requirements that may affect Kratos' ability to obtain other new government customers.**

A significant number of Kratos' customers are government agencies, principally DoD agencies. These agencies often do not set their own budgets and therefore have little control over the amount of money they can spend. In addition, these agencies experience political pressure that may dictate the manner in which they spend money. Due to political and budgetary processes and other scheduling delays that frequently occur in the contract or bidding process, some government agency orders may be canceled or substantially delayed, and the receipt of revenues or payments may be substantially delayed.

**Kratos faces intense competition from many competitors that have greater resources than Kratos does, which could result in price reductions, reduced profitability or loss of market share.**

Kratos operates in highly competitive markets and generally encounters intense competition to win contracts from many other firms, including mid-tier federal contractors with specialized capabilities and large defense and IT services providers. Competition in Kratos' markets may increase as a result of a number of factors, such as the entrance of new or larger competitors, including those formed through alliances or consolidation. These competitors may have greater financial, technical, marketing and public relations resources, larger client bases and greater brand or name recognition than Kratos does. These competitors could, among other things:

divert sales from Kratos by winning very large-scale government contracts, a risk that is enhanced by the recent trend in government procurement practices to bundle services into larger contracts;

force Kratos to charge lower prices; or

adversely affect Kratos' relationships with current clients, including Kratos' ability to continue to win competitively awarded engagements in which Kratos is the incumbent.

If Kratos loses business to Kratos' competitors or is forced to lower Kratos' prices, Kratos' revenue and Kratos' operating profits could decline. In addition, Kratos may face competition from Kratos' subcontractors who, from time-to-time, seek to obtain prime contractor status on contracts for which they currently serve as a subcontractor to Kratos. If one or more of our current subcontractors are awarded prime contractor status on such contracts in the future, it could divert sales from Kratos or could force Kratos to charge lower prices, which could cause Kratos' margins to suffer.

**Recent acquisitions and potential future acquisitions could prove difficult to integrate, disrupt Kratos' business, dilute stockholder value and strain Kratos' resources.**

Kratos has completed several acquisitions of complementary businesses in recent years, including Kratos' October 2006 acquisition of Madison Research Technology Corporation and December 2007 acquisition of Haverstick Consulting, Inc. Kratos currently expects the merger with SYS to close by the end of the second quarter of 2008 upon receipt of the required stockholder approvals. However, the merger may not close as expected, and the anticipated synergies from the acquisition may not be fully realized or may take longer to realize than expected. The success of the merger with SYS will depend in part on the success in integrating the operations, technologies and personnel of SYS. The failure to successfully integrate the operations of the two companies or otherwise to realize any of the anticipated benefits of the acquisition could seriously harm Kratos' results of operations.

Kratos continually evaluates opportunities to acquire new businesses as part of Krato's ongoing strategy, and Kratos may in the future acquire additional companies that Kratos believes could compliment or expand Kratos' business or increase Kratos' customer base. Kratos may not be able to identify suitable acquisition candidates at prices that Kratos considers appropriate. If Kratos does identify an appropriate acquisition candidate, Kratos may not be able to successfully negotiate the terms of the acquisition or finance the acquisition on terms that are satisfactory to Kratos. Negotiations of potential acquisitions and the integration of acquired business operations could disrupt Kratos' business by diverting management attention from day-to-day operations. Acquisitions of businesses or other material operations may require additional debt or equity financing, resulting in additional leverage or dilution of ownership. Kratos may encounter increased competition for acquisitions, which may increase the price of Kratos' acquisitions. Acquisitions involve numerous risks, including:

difficulties in integrating operations, technologies, accounting and personnel;

difficulties in supporting and transitioning customers of acquired companies;

difficulties or delays in transitioning federal government contracts pursuant to federal acquisition regulations;

diversion of financial and management resources from existing operations;

potential loss of key employees;

federal acquisition regulations may require us to enter into government novation agreements, a potentially time-consuming process; and

inability to generate sufficient revenue to offset acquisition costs.

Acquired companies may have liabilities or adverse operating issues that Kratos fails to discover through due diligence prior to the acquisition. In particular, to the extent that prior owners of any acquired businesses or properties failed to comply with or otherwise violated applicable laws or regulations, or failed to fulfill their contractual obligations to the federal government or other clients, Kratos, as the successor owner, may be financially responsible for these violations and failures and may suffer reputational harm or otherwise be adversely affected. Acquisitions also frequently result in the recording of goodwill and other intangible assets which are subject to potential impairments in the future that could harm our financial results. In addition, if Kratos finances acquisitions by issuing

convertible debt or equity securities, Kratos' existing stockholders may be diluted, which could affect the market price of Kratos' stock. As a result, if Kratos fails to properly evaluate acquisitions or investments, Kratos may not achieve the anticipated benefits of any such acquisitions, and Kratos may incur costs in excess of what Kratos anticipates.

**Kratos agreed to indemnify acquirers of Kratos' divested operations against specified losses in connection with the sale of these operations, and any demands for indemnification may result in expenses Kratos does not anticipate and distract the attention of Kratos' management from Kratos' continuing businesses.**

Kratos agreed to indemnify acquirers of Kratos' divested operations against specified losses in connection with their sale and generally retain responsibility for various legal liabilities that accrued prior to closing. Kratos also made representations and warranties to these acquirers about the condition of the divested businesses. If any acquirer makes an indemnification claim because it has suffered a loss or a third party has commenced an action against the divested business, Kratos may incur substantial expenses resolving such claims or defending against the third party action, which would harm Kratos' operating results. In addition, Kratos' ability to defend itself may be impaired because Kratos' former employees are now employees of the acquirer or other companies, and Kratos' management may have to devote a substantial amount of time to resolving the claim. In addition, these indemnity claims may divert management attention from responsibilities related to the daily ongoing concerns of the business. In addition, Kratos may be required to expend substantial resources trying to determine which party has responsibility for the claim, even if Kratos is ultimately found to be not responsible.

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

As a result of an SBA set-aside program, the Federal Government may decide to restrict certain procurements to bidders that qualify as minority-owned, small or small disadvantaged businesses. As a result, Kratos would not be eligible to perform as a prime contractor on those programs and would be restricted to a maximum of 49% of the work as a subcontractor on those programs. An increase in the amount of procurements under the SBA set-aside program may impact Kratos' ability to bid on new procurements or restrict Kratos' ability to recomplete on incumbent work that is placed in the set-aside program.

**Kratos' financial results may vary significantly from quarter to quarter.**

Kratos expects Kratos' revenue and operating results to vary from quarter to quarter. Reductions in revenue in a particular quarter could lead to lower profitability in that quarter because a relatively large amount of our expenses are fixed in the short-term. Kratos may incur significant operating expenses during the start-up and early stages of large contracts and may not be able to recognize corresponding revenue in that same quarter. Kratos may also incur additional expenses when contracts expire, are terminated or are not renewed.

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In addition, payments due to Kratos from federal government agencies may be delayed due to billing cycles or as a result of failures of government budgets to gain congressional and administration approval in a timely manner. The Federal Government's fiscal year ends September 30. If a federal budget for the next federal fiscal year has not been approved by that date in each year, Kratos' clients may have to suspend engagements that Kratos is working on until a budget has been approved. Any such suspensions may reduce Kratos' revenue in the fourth quarter of that year or the first quarter of the subsequent year. The federal government's fiscal year end can also trigger increased purchase requests from clients for equipment and materials. Any increased purchase requests Kratos receives as a result of the federal government's fiscal year end would serve to increase Kratos' third or fourth quarter revenue, but will generally decrease profit margins for that quarter, as these activities generally are not as profitable as Kratos' typical offerings.

Additional factors that may cause Kratos' financial results to fluctuate from quarter to quarter include those addressed elsewhere in these Risk Factors and the following, among others:

the terms of customer contracts that affect the timing of revenue recognition;

variability in demand for Kratos' services and solutions;

commencement, completion or termination of contracts during any particular quarter;

timing of award or performance incentive fee notices;

timing of significant bid and proposal costs;

variable purchasing patterns under the GSA Schedule 70 Contracts, government wide acquisition contracts, which we refer to as GWACs, blanket purchase agreements and other indefinite delivery/indefinite quantity contracts;

restrictions on and delays related to the export of defense articles and services;

costs related to ongoing government inquiries;

strategic decisions by Kratos or Kratos' competitors, such as acquisitions, divestitures, spin-offs and joint ventures;

strategic investments or changes in business strategy;

changes in the extent to which we use subcontractors;

seasonal fluctuations in Kratos' staff utilization rates;

changes in Kratos' effective tax rate including changes in Kratos' judgment as to the necessity of the valuation allowance recorded against Kratos' deferred tax assets; and

the length of sales cycles.

Significant fluctuations in Kratos' operating results for a particular quarter could cause Kratos to fall out of compliance with the financial covenants contained in Kratos' credit facility, which if not waived by the lender, could restrict Kratos' access to capital and cause Kratos to take extreme measures to pay down Kratos' debt under the credit facility. In addition, fluctuations in Kratos' financial results could cause Kratos' stock price to decline.

**If Kratos fails to establish and maintain important relationships with government entities and agencies and other government contractors, Kratos' ability to bid successfully for new business may be adversely affected.**

To develop new business opportunities, Kratos primarily relies on establishing and maintaining relationships with various government entities and agencies. Kratos may be unable to successfully

maintain our relationships with government entities and agencies, and any failure to do so could materially adversely affect Kratos' ability to compete successfully for new business. In addition, Kratos often acts as a subcontractor or in "teaming" arrangements in which Kratos and other contractors bid together on particular contracts or programs for the federal government or government agencies. As a subcontractor or team member, Kratos often lacks control over fulfillment of a contract, and poor performance on the contract could tarnish Kratos' reputation, even when Kratos performs as required. Kratos expects to continue to depend on relationships with other contractors for a portion of Kratos' revenue in the foreseeable future. Moreover, Kratos' revenue and operating results could be materially adversely affected if any prime contractor or teammate chooses to offer a client services of the type that Kratos provides or if any prime contractor or teammate teams with other companies to independently provide those services.

**Kratos derives a significant portion of Kratos' revenues from a limited number of customers.**

Kratos has derived, and believes that it will continue to derive, a significant portion of Kratos' revenues from a limited number of customers. To the extent that any significant customer uses less of Kratos' services or terminates its relationship with Kratos, our revenues could decline significantly. As a result, the loss of any significant client could seriously harm our business. For the fiscal year ended December 31, 2007, two customers comprised approximately 60% and 44% of Kratos' federal business revenues and total revenues, respectively, and Kratos' five largest customers accounted for approximately 84% and 62% of Kratos' total federal business revenues and total revenues, respectively. None of Kratos' customers are obligated to purchase additional services from Kratos. As a result, the volume of work that Kratos performs for a specific customer is likely to vary from period to period, and a significant client in one period may not use Kratos' services in a subsequent period.

**Kratos' margins and operating results may suffer if Kratos experience unfavorable changes in the proportion of cost-plus-fee or fixed-price contracts in Kratos' total contract mix.**

Although fixed-price contracts entail a greater risk of a reduced profit or financial loss on a contract compared to other types of contracts Kratos enters into, fixed-price contracts typically provide higher profit opportunities because Kratos may be able to benefit from cost savings. In contrast, cost-plus-fee contracts are subject to statutory limits on profit margins, and generally are the least profitable of Kratos' contract types. Kratos' federal government customers typically determine what type of contract Kratos enters into. Cost-plus-fee and fixed-price contracts in Kratos' federal business accounted for approximately 51.1% and 23.3%, respectively, of Kratos' federal business revenues for the fiscal year ended December 31, 2007. To the extent that Kratos enters into more cost-plus-fee or less fixed-price contracts in proportion to Kratos' total contract mix in the future, Kratos' margins and operating results may suffer.

**The Federal Government may revise its procurement or other practices in a manner adverse to Kratos.**

The Federal Government may revise its procurement practices or adopt new contracting rules and regulations, such as cost accounting standards. It could also adopt new contracting methods relating to GSA contracts, MACs or other government-wide contracts, or adopt new standards for contract awards intended to achieve certain social or other policy objectives, such as establishing new set-aside programs for small or minority-owned businesses. In addition, the Federal Government may face restrictions from new legislation or regulations, as well as pressure from government employees and their unions, on the nature and amount of services the Federal Government may obtain from private contractors. These changes could impair Kratos' ability to obtain new contracts or contracts under which Kratos currently performs when those contracts are put up for recompetition bids. Any new contracting methods could be costly or administratively difficult for Kratos to implement, and, as a result, could harm Kratos' operating results.

**Kratos' cash flow and profitability could be reduced if expenditures are incurred prior to the final receipt of a contract.**

Kratos provides various professional services and sometimes procure equipment and materials on behalf of our federal government customers under various contractual arrangements. From time to time, in order to ensure that Kratos satisfies Kratos' customers' delivery requirements and schedules, Kratos may elect to initiate procurement in advance of receiving final authorization from the government customer or a prime contractor. If Kratos' government or prime contractor customers' requirements should change or if the government or the prime contractor should direct the anticipated procurement to a contractor other than Kratos or if the equipment or materials become obsolete or require modification before Kratos is under contract for the procurement, Kratos' investment in the equipment or materials might be at risk if Kratos cannot efficiently resell them. This could reduce anticipated earnings or result in a loss, negatively affecting Kratos' cash flow and profitability.

**Loss of Kratos' GSA contracts or GWACs would impair Kratos' ability to attract new business.**

Kratos is a prime contractor under several GSA contracts and GWAC schedule contracts. Kratos believes that Kratos' ability to provide services under these contracts will continue to be important to our business because of the multiple opportunities for new engagements each contract provides. If Kratos were to lose Kratos' position as prime contractor on one or more of these contracts, Kratos could lose substantial revenues and our operating results could suffer. GSA contracts and other GWACs typically have a one or two-year initial term with multiple options exercisable at the government client's discretion to extend the contract for one or more years. Kratos cannot be assured that Kratos' government clients will continue to exercise the options remaining on Kratos' current contracts, nor can Kratos be assured that Kratos' future clients will exercise options on any contracts Kratos may receive in the future.

**Failure to properly manage projects may result in additional costs or claims.**

Kratos' engagements often involve large scale, highly complex projects. The quality of Kratos' performance on such projects depends in large part upon our ability to manage the relationship with Kratos' customers, and to effectively manage the project and deploy appropriate resources, including third-party contractors, and Kratos' own personnel, in a timely manner. Any defects or errors or failure to meet clients' expectations could result in claims for substantial damages against us. Kratos' contracts generally limit Kratos' liability for damages that arise from negligent acts, error, mistakes or omissions in rendering services to Kratos' clients. However, Kratos cannot be sure that these contractual provisions will protect Kratos from liability for damages in the event Kratos is sued. In addition, in certain instances, Kratos guarantees customers that Kratos will complete a project by a scheduled date. If the project experiences a performance problem, Kratos may not be able to recover the additional costs Kratos will incur, which could exceed revenues realized from a project. Finally, if Kratos underestimates the resources or time Kratos needs to complete a project with capped or fixed fees, Kratos' operating results could be seriously harmed.

**The loss of any member of Kratos' senior management could impair Kratos' relationships with federal government clients and disrupt the management of Kratos' business.**

Kratos believes that the success of Kratos' business and Kratos' ability to operate profitably depends on the continued contributions of the members of Kratos' senior management. Kratos relies on Kratos' senior management to generate business and execute programs successfully. In addition, the relationships and reputation that many members of Kratos' senior management team have established and maintain with federal government personnel contribute to Kratos' ability to maintain strong client relationships and to identify new business opportunities. Kratos does not have any employment agreements providing for a specific term of employment with any member of Kratos' senior

management. The loss of any member of Kratos' senior management could impair Kratos' ability to identify and secure new contracts, to maintain good client relations and to otherwise manage Kratos' business.

**If Kratos fail to attract and retain skilled employees or employees with the necessary security clearances, Kratos might not be able to perform under Kratos' contracts or win new business.**

The growth of Kratos' business and revenue depends in large part upon Kratos' ability to attract and retain sufficient numbers of highly qualified individuals who have advanced information technology and/or engineering skills. These employees are in great demand and are likely to remain a limited resource in the foreseeable future. Certain federal government contracts require Kratos, and some of Kratos' employees, to maintain security clearances. Obtaining and maintaining security clearances for employees involves a lengthy process, and it is difficult to identify, recruit and retain employees who already hold security clearances. In addition, some of Kratos' contracts contain provisions requiring Kratos to staff an engagement with personnel that the client considers key to Kratos' successful performance under the contract. In the event Kratos is unable to provide these key personnel or acceptable substitutions, the client may terminate the contract and Kratos may lose revenue.

If Kratos is unable to recruit and retain a sufficient number of qualified employees, Kratos' ability to maintain and grow our business could be limited. In a tight labor market, our direct labor costs could increase or Kratos may be required to engage large numbers of subcontractor personnel, which could cause our profit margins to suffer. Conversely, if Kratos maintains or increases Kratos' staffing levels in anticipation of one or more projects and the projects are delayed, reduced or terminated, Kratos may underutilize the additional personnel, which would increase Kratos' general and administrative expenses, reduce Kratos' earnings and possibly harm Kratos' results of operations.

**If Kratos' subcontractors fail to perform their contractual obligations, Kratos' performance and reputation as a prime contractor and Kratos' ability to obtain future business could suffer.**

As a prime contractor, Kratos often relies upon other companies to perform work Kratos is obligated to perform for Kratos' clients as subcontractors. As Kratos secures more work under our GWAC vehicles, Kratos expects to require an increasing level of support from subcontractors that provide complementary and supplementary services to Kratos' offerings. Depending on labor market conditions, Kratos may not be able to identify, hire and retain sufficient numbers of qualified employees to perform the task orders Kratos expects to win. In such cases, Kratos will need to rely on subcontracts with unrelated companies. Moreover, even in favorable labor market conditions, Kratos anticipates entering into more subcontracts in the future as Kratos expand Kratos' work under Kratos' GWACs. Kratos is responsible for the work performed by Kratos' subcontractors, even though in some cases Kratos has limited involvement in that work.

If one or more of Kratos' subcontractors fail to satisfactorily perform the agreed-upon services on a timely basis or violate federal government contracting policies, laws or regulations, Kratos' ability to perform Kratos' obligations as a prime contractor or meet Kratos' clients' expectations may be compromised. In extreme cases, performance or other deficiencies on the part of our subcontractors could result in a client terminating Kratos' contract for default. A termination for default could expose Kratos to liability, including liability for the agency's costs of reprocurement, could damage Kratos' reputation and could hurt Kratos' ability to compete for future contracts.

**Kratos' failure to comply with complex procurement laws and regulations could cause Kratos to lose business and subject Kratos to a variety of penalties.**

Kratos must comply with laws and regulations relating to the formation, administration and performance of federal government contracts, which affect how Kratos does business with Kratos'



clients and may impose added costs on Kratos. In addition, the federal government, including the Defense Contract Audit Agency, which we refer to as the DCAA, audits and reviews Kratos' performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. The DCAA reviews a contractor's internal control systems and policies, including the contractor's purchasing, property, estimating, compensation and management information systems, and the contractor's compliance with such policies. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. Adverse findings in a DCAA audit could materially affect Kratos' competitive position and result in a substantial adjustment to Kratos' revenue and profit.

**Accuracy of indirect billing rates is critical.**

Kratos' provisional indirect billing rates are approved at least annually by the Defense Contract Management Agency, which we refer to as the DCMA after being reviewed by the DCAA. These rates can differ from Kratos' actual indirect rates. Kratos budgets to have our actual indirect rates as close as possible to Kratos' government approved indirect rates at fiscal year end. Throughout the year, management assesses how these rates compare to forecasted rates for the year. If a variance is expected to exceed the amount to be billed, provisions for such variance are recognized at that time.

For interim reporting purposes, Kratos applies overhead and selling, general and administrative expenses as a percentage of direct contract costs based on annual budgeted indirect expense rates. To the extent actual expenses for an interim period are greater than the budgeted rates, the variance is deferred if management believes it is probable that the variance will be absorbed by planned contract activity. This probability assessment includes projecting whether future indirect costs will be sufficiently less than the annual budgeted rates or can be absorbed by seeking increased billing rates applied on cost-plus-fee contracts. At the end of each interim reporting period, management assesses the recoverability of any amount deferred to determine if any portion should be charged to expense. In assessing the recoverability of variances deferred, management takes into consideration estimates of the amount of direct labor and other direct costs to be incurred in future interim periods, the feasibility of modifications for provisional billing rates, and the likelihood that an approved increase in provisional billing rates can be passed along to a customer. If assumptions about the probability of recovering deferred variances change, deferred amounts could be expensed and such expenses could have a material adverse effect on the results of operations.

**The commercial business arena in which Kratos operates has relatively low barriers to entry and increased competition could result in margin erosion, which would make profitability even more difficult to sustain.**

Other than the technical skills required in our commercial business, the barriers to entry in this area are relatively low. Kratos does not have any intellectual property rights in this segment of Kratos' business to protect Kratos' methods and business start-up costs do not pose a significant barrier to entry. The success of Kratos' commercial business is dependent on Kratos' employees, customer relations and the successful performance of Kratos' services. If we face increased competition as a result of new entrants in Kratos' markets, Kratos could experience reduced operating margins and loss of market share and brand recognition.

**If Kratos experiences systems or service failure, Kratos' reputation could be harmed and Kratos' clients could assert claims against Kratos for damages or refunds.**

Kratos creates, implements and maintains IT solutions that are often critical to Kratos' clients' operations. We have experienced, and may in the future experience, some systems and service failures,

schedule or delivery delays and other problems in connection with Kratos' work. If Kratos experiences these problems, Kratos may:

lose revenue due to adverse client reaction;

be required to provide additional services to a client at no charge;

receive negative publicity, which could damage Kratos' reputation and adversely affect Kratos' ability to attract or retain clients; and

suffer claims for substantial damages.

In addition to any costs resulting from product or service warranties, contract performance or required corrective action, these failures may result in increased costs or loss of revenue if clients postpone subsequently scheduled work or cancel, or fail to renew, contracts.

While many of Kratos' contracts limit our liability for consequential damages that may arise from negligence in rendering services to Kratos' clients, Kratos cannot assure you that these contractual provisions will be legally sufficient to protect Kratos if Kratos is sued. In addition, our errors and omissions and product liability insurance coverage may not be adequate, may not continue to be available on reasonable terms or in sufficient amounts to cover one or more large claims, or the insurer may disclaim coverage as to some types of future claims. The successful assertion of any large claim against Kratos could seriously harm our business. Even if not successful, these claims could result in significant legal and other costs, may be a distraction to Kratos' management and may harm Kratos' reputation.

**Security breaches in sensitive federal government systems could result in the loss of clients and negative publicity.**

Many of the systems Kratos develops, installs and maintains involve managing and protecting information involved in intelligence, national security and other sensitive or classified federal government functions. A security breach in one of these systems could cause serious harm to Kratos' business, damage Kratos' reputation and prevent Kratos from being eligible for further work on sensitive or classified systems for federal government clients. Kratos could incur losses from such a security breach that could exceed the policy limits under Kratos' errors and omissions and product liability insurance. Damage to Kratos' reputation or limitations on Kratos' eligibility for additional work resulting from a security breach in one of the systems Kratos develops, installs and maintains could materially reduce Kratos' revenue.

**Kratos' employees may engage in misconduct or other improper activities, which could cause Kratos to lose contracts.**

Kratos is exposed to the risk that employee fraud or other misconduct could occur. Misconduct by employees could include intentional failures to comply with federal government procurement regulations, engaging in unauthorized activities or falsifying time records. Employee misconduct could also involve the improper use of Kratos' clients' sensitive or classified information, which could result in regulatory sanctions against Kratos and serious harm to Kratos' reputation and could result in a loss of contracts and a reduction in revenues. It is not always possible to deter employee misconduct, and the precautions Kratos takes to prevent and detect this activity may not be effective in controlling unknown or unmanaged risks or losses, which could cause Kratos to lose contracts or cause a reduction in revenues.

**Kratos' business is dependent upon Kratos' ability to keep pace with the latest technological changes.**

The market for Kratos' services is characterized by rapid change and technological improvements. Failure to respond in a timely and cost effective way to these technological developments would result in serious harm to Kratos' business and operating results. Kratos has derived, and Kratos expects to continue to derive, a substantial portion of Kratos' revenues from providing innovative engineering services and technical solutions that are based upon today's leading technologies and that are capable of adapting to future technologies. As a result, Kratos' success will depend, in part, on Kratos' ability to develop and market service offerings that respond in a timely manner to the technological advances of Kratos' customers, evolving industry standards and changing client preferences.

**If Kratos is unable to manage its growth, Kratos' business could be adversely affected.**

Sustaining Kratos' growth has placed significant demands on Kratos' management, as well as on Kratos' administrative, operational and financial resources. For Kratos to continue to manage its growth, Kratos must continue to improve its operational, financial and management information systems and expand, motivate and manage its workforce. If Kratos is unable to manage Kratos' growth while maintaining its quality of service and profit margins, or if new systems that Kratos implements to assist in managing Kratos' growth do not produce the expected benefits, Kratos' business, prospects, financial condition or operating results could be adversely affected.

**Kratos may be harmed by intellectual property infringement claims and Kratos' failure to protect Kratos' intellectual property could enable competitors to market products and services with similar features.**

Kratos may become subject to claims from Kratos' employees or third parties who assert that software and other forms of intellectual property that Kratos uses in delivering services and solutions to its clients infringe upon intellectual property rights of such employees or third parties. Kratos' employees develop some of the software and other forms of intellectual property that Kratos uses to provide its services and solutions to its clients, but Kratos also licenses technology from other vendors. If Kratos' employees, vendors, or other third parties assert claims that Krato or its clients are infringing on their intellectual property rights, Kratos could incur substantial costs to defend those claims. If any of these infringement claims are ultimately successful, Kratos could be required to cease selling or using products or services that incorporate the challenged software or technology, obtain a license or additional licenses from Kratos' employees, vendors, or other third parties, or redesign our products and services that rely on the challenged software or technology.

Kratos attempts to protect its trade secrets by entering into confidentiality and intellectual property assignment agreements with third parties, its employees and consultants. However, these agreements can be breached and, if they are, there may not be an adequate remedy available to Kratos. In addition, others may independently discover Kratos' trade secrets and proprietary information and in such cases Kratos could not assert any trade secret rights against such party. Enforcing a claim that a party illegally obtained and is using Kratos' trade secret is difficult, expensive and time consuming, and the outcome is unpredictable. If Kratos is unable to protect its intellectual property, its competitors could market services or products similar to its services and products, which could reduce demand for Kratos' offerings. Any litigation to enforce Kratos' intellectual property rights, protect its trade secrets or determine the validity and scope of the proprietary rights of others could result in substantial costs and diversion of resources, with no assurance of success. See "Legal Proceedings" on page 94 for additional information.

**The matters relating to Kratos' internal review of its stock option granting practices and the restatement of its financial statements have exposed Kratos to civil litigation claims, regulatory proceedings and government proceedings which could have a material adverse effect on Kratos.**

In the summer of 2006, Kratos' current executive management team, which has been in place since 2004, initiated an investigation of Kratos' past stock option granting practices, which we refer to as the Equity Award Review, in reaction to media reports regarding stock option granting practices of public companies. The Equity Award Review was conducted with oversight from the Board and assistance from Kratos' outside counsel. In February 2007, the Board appointed a Special Committee of the Board to review the adequacy of the Equity Award Review and the recommendations of management regarding historical option granting practices, and to make recommendations and findings regarding those practices and individual conduct. The Special Committee was not charged with making, and did not make, any evaluation of the accounting determinations or tax adjustments. The Special Committee was comprised of a non-employee director who had not served on the Compensation Committee before 2005.

The Equity Award Review encompassed all grants of options to purchase shares of Kratos' common stock and other equity awards made since two months prior to our IPO in November 1999 through December 2006. Kratos also reviewed all option grants that were entered into its stock option database, which is known as Equity Edge, after its IPO with a grant date before November 1999, as well as other substantial grants issued prior to its IPO, consisting of more than 14,000 grants. Kratos further reviewed all option grants with a grant date that preceded an employee's date of hire. As part of the review, interviews of 18 current and former officers, directors, employees and attorneys were conducted, and more than 40 million pages of electronic and hard copy documents were searched for relevant information. The Special Committee also conducted its own separate review of the option granting practices during the tenure of current executive management team through additional interviews and document collection and review with the assistance of its own separate counsel and FTI Consulting.

The Equity Award Review established the absence of contemporaneous evidence supporting a substantial number of the previously-recorded option grants, substantially all of which were made in the period from 1998 through late 2003. During this period of time, in some instances, documents, data and interviews suggest that option grants were prepared or finalized days or, in some cases, weeks or months after the option grant date recorded in Kratos' books. The affected grants include options issued to certain newly-hired employees but dated prior to their employment start dates and options issued to non-employees, including advisors to the Board erroneously designated as employees. The Special Committee also concluded that certain former employees and former officers participated in making improper option grants, including the selection of grant dates with the benefit of hindsight and in the deferral of the recording of otherwise approved option grants.

In light of the Equity Award Review, the Audit Committee of Kratos' Board concluded that Kratos' prior financial statements for periods from 1998 through Kratos' filing of interim financial statements for the period ended September 30, 2006, could no longer be relied upon and must be restated. Kratos' management determined that, from fiscal year 1998 through fiscal year 2005, Kratos had unrecorded non-cash equity-based compensation charges associated with its equity incentive plans. These charges are material to Kratos' financial statements for the years ended December 31, 1998 through 2005, the periods to which such charges would have related. Previously filed annual reports on Form 10-K and quarterly reports on Form 10-Q affected by the restatements have not been and will not be amended and should not be relied upon. Kratos' Annual Report on Form 10-K filed on September 11, 2007 superseded and replaced in their entirety all of Kratos' previously issued financial statements and related reports filed with the Securities and Exchange Commission.

Kratos' past stock option granting practices and the restatement of its prior financial statements have exposed and may continue to expose Kratos to greater risks associated with litigation, regulatory proceedings and government inquiries and enforcement actions. As described in "Legal Proceedings" on page 94, several derivative complaints have been filed in state and federal courts against Kratos' current directors, some of its former directors and some of its current and former executive officers pertaining to allegations relating to stock option grants. The SEC also initiated an informal inquiry into Kratos' historical stock option granting practices and Kratos received a subpoena from the United States Attorney's Office for the Southern District of California for the production of documents relating to its historical stock option granting practices, which could result in civil and/or criminal actions seeking, among other things, injunctions against Kratos and the payment of significant fines and penalties by Kratos. On April 1, 2008, the SEC notified Kratos that it had completed its informal investigation and that it did not intend to recommend any enforcement action by the SEC against the company. Kratos is cooperating with the United States Attorney's Office for the Southern District of California, and expects to continue to do so.

The period of time necessary to resolve the U.S. Attorney's inquiry is uncertain, and Kratos cannot predict the outcome or whether Kratos will face additional government inquiries, investigations or other actions related to its historical stock option grant practices. Subject to certain limitations, Kratos is obligated to indemnify its current and former directors, officers and employees in connection with the investigation of its historical stock option practices, the pending DOJ and recently concluded SEC inquiries and any future government inquiries, investigations or actions. These inquiries could require Kratos to expend significant management time and incur significant legal and other expenses, and could result in civil and criminal actions seeking, among other things, injunctions against Kratos and the payment of significant fines and penalties by Kratos, which could have a material adverse effect on its financial condition, business, results of operations and cash flow.

If a Federal Government investigation uncovers improper or illegal activities, including any potential improper or illegal activities related to Kratos' stock option review or related matters, Kratos may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with federal government agencies. In addition, Kratos could suffer serious harm to its reputation and competitive position if allegations of impropriety were made against it, whether or not true. If Kratos' reputation or relationship with Federal Government agencies were impaired, or if the Federal Government otherwise ceased doing business with Kratos or significantly decreased the amount of business it does with Kratos, Kratos' revenue and operating profit would decline.

**If Kratos fails to maintain an effective system of internal controls, Kratos may not be able to accurately report Kratos' financial results or prevent fraud.**

Effective internal controls are necessary for Kratos to provide reliable financial reports. If Kratos cannot provide reliable financial reports, Kratos' operating results could be misstated, Kratos' reputation may be harmed and the trading price of Kratos' stock could be negatively affected. Kratos' management has concluded that there are no material weaknesses in Kratos' internal controls over financial reporting as of December 31, 2007. However, there can be no assurance that Kratos' controls over financial processes and reporting will be effective in the future or that additional material weaknesses or significant deficiencies in Kratos' internal controls will not be discovered in the future. Any failure to remediate any future material weaknesses or implement required new or improved controls, or difficulties encountered in their implementation, could harm Kratos' operating results, cause Kratos to fail to meet Kratos' reporting obligations or result in material misstatements in Kratos' financial statements or other public disclosures. Inferior internal controls could also cause investors to lose confidence in Kratos' reported financial information, which could have a negative effect on the trading price of Kratos' stock. In addition, from time to time we acquire businesses which could have

limited infrastructure and systems of internal controls. Performing assessments of internal controls, implementing necessary changes, and maintaining an effective internal controls process is costly and requires considerable management attention, particularly in the case of newly acquired entities.

**Kratos may need additional capital in the future to fund the growth of Kratos' business, and financing may not be available.**

Kratos currently anticipates that Kratos' available capital resources, including Kratos' credit facility and operating cash flows, will be sufficient to meet Kratos' expected working capital and capital expenditure requirements for at least the next 12 months. However, such resources may not be sufficient to fund the long-term growth of Kratos' business or the expenses associated with the ongoing litigation, litigation settlements and government inquiries. In particular, Kratos may experience a negative operating cash flow due to billing milestones and project timelines in certain of Kratos' contracts.

Kratos may raise additional funds through public or private debt or equity financings if such financings become available on favorable terms or Kratos may expand Kratos' credit facility to fund future acquisitions and for general corporate purposes. However, due to the current challenges in the lending markets, Kratos can provide no assurance that the lender would agree to extend additional or continuing credit under that facility. Kratos could fall out of compliance with financial and other covenants contained in Kratos' credit facility which, if not waived, would restrict Kratos' access to capital and could require Kratos to pay down Kratos' existing debt under the credit facility. Any new financing or offerings would likely dilute Kratos' stockholders' equity ownership. In addition, additional financing may not be available on terms favorable to Kratos, or at all. If adequate funds are not available or are not available on acceptable terms, Kratos may not be able to take advantage of unanticipated opportunities, develop new products or otherwise respond to competitive pressures. In any such case, Kratos' business, operating results or financial condition could be materially adversely affected.

**Kratos' ability to make payments on Kratos' debt will be contingent on Kratos' future operating performance, which will depend on a number of factors that are outside of Kratos' control.**

Kratos' debt service obligations are estimated to be approximately \$11 million to \$13 million in 2008, including approximately \$2.6 million of principal repayments. This debt service may have an adverse impact on Kratos' earnings and cash flow, which could in turn negatively impact Kratos' stock price.

Kratos' ability to make principal and interest payments on Kratos' debt is contingent on Kratos' future operating performance, which will depend on a number of factors, many of which are outside of Kratos' control. The degree to which Kratos is leveraged could have other important negative consequences, including the following:

Kratos must dedicate a substantial portion of Kratos' cash flows from operations to the payment of Kratos' indebtedness, reducing the funds available for future working capital requirements, capital expenditures, acquisitions or other general corporate requirements;

a significant portion of Kratos' borrowings are, and will continue to be, at variable rates of interest, which may result in higher interest expense in the event of increases in interest rates;

Kratos may be more vulnerable to a downturn in the industries in which Kratos operates or a downturn in the economy in general;

Kratos may be limited in Kratos' flexibility to plan for, or react to, changes in Kratos' businesses and the industries in which Kratos operates;

Kratos may be placed at a competitive disadvantage compared to Kratos' competitors that have less debt;

Kratos may determine it to be necessary to dispose of certain assets or one or more of Kratos' businesses to reduce Kratos' debt; and

Kratos' ability to borrow additional funds in excess of Kratos' current financing may be limited.

Kratos may not generate sufficient cash flow from operations and future borrowings may not be available in amounts sufficient to enable Kratos to pay Kratos' indebtedness or to fund Kratos' other liquidity needs. Moreover, Kratos may need to refinance all or a portion of Kratos' indebtedness on or before maturity. In such a case, Kratos cannot make assurances that Kratos will be able to refinance any of Kratos' indebtedness on commercially reasonable terms or at all. If Kratos are unable to make scheduled debt payments or comply with the other provisions of Kratos' debt instruments, Kratos' various lenders may be permitted under certain circumstances to accelerate the maturity of the indebtedness owed to them and exercise other remedies provided for in those instruments and under applicable law.

**Kratos is subject to restrictive debt covenants pursuant to Kratos' indebtedness. These covenants may restrict Kratos' ability to finance Kratos' business and, if Kratos does not comply with the covenants or otherwise default under them, Kratos may not have the funds necessary to pay all amounts that could become due and the lenders could foreclose on substantially all of Kratos' assets.**

Kratos' indebtedness contains covenants that, among other things, significantly restricts and, in some cases, effectively eliminates Kratos' ability and the ability of Kratos' subsidiaries to:

incur additional debt;

create or incur liens;

secure performance bonds by letters of credit, thereby limiting the amount of work Kratos may bid on or perform;

pay dividends or make other equity distributions to Kratos' stockholders;

make investments;

sell assets;

issue or become liable on a guarantee;

create or acquire new subsidiaries;

effect a merger or consolidation of, or sell all or substantially all of our assets; and

raise capital via equity securities.

In addition, Kratos must comply with certain financial covenants. In the event Kratos fails to meet any of such covenants and is unable to cure such breach or otherwise renegotiate such covenants, Kratos' lenders would have significant rights to deny future access to liquidity and/or seize control of substantially all of Kratos' assets. The material financial covenants with which Kratos must comply include a maximum first lien leverage ratio, a maximum total leverage ratio, a minimum liquidity ratio, a minimum fixed charge coverage ratio, and a minimum consolidated EBITDA.

The covenants contained in Kratos' indebtedness and any credit agreement governing future debt may significantly restrict Kratos' future operations. Furthermore, upon the occurrence of any event of default, Kratos' lenders could elect to declare all amounts outstanding under such agreements, together with accrued interest, to be immediately due and payable. If those lenders were to accelerate the payment of those amounts, Kratos' assets may not be sufficient to repay those amounts in full.



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Kratos is also subject to interest rate risk due to Kratos' indebtedness at variable interest rates, based on a base rate or LIBOR plus an applicable margin. Shifts in interest rates could have a material adverse effect on Kratos.

### **Kratos may be required to prepay Kratos' indebtedness prior to its stated maturity, which may limit Kratos' ability to pursue business opportunities.**

Pursuant to the terms of certain of Kratos' indebtedness, in certain instances Kratos is required to prepay outstanding indebtedness prior to its stated maturity date. Specifically, certain non-recurring cash inflows such as proceeds from asset sales, insurance recoveries, and equity offerings may have to be used to pay down indebtedness and may not be reborrowed. These prepayment provisions may limit Kratos' ability to utilize this cash flow to pursue business opportunities.

### **Kratos' stock price may be volatile, which may result in lawsuits against Kratos and Kratos' officers and directors.**

The stock market in general and the stock prices of government services companies in particular, have experienced volatility that has often been unrelated to or disproportionate to the operating performance of those companies. The market price of Kratos' common stock has fluctuated in the past and is likely to fluctuate in the future. Factors which could have a significant impact on the market price of Kratos' common stock include, but are not limited to, the following:

- quarterly variations in operating results;
- announcements of new services by Kratos or Kratos' competitors;
- the gain or loss of significant customers;
- changes in analysts' earnings estimates;
- rumors or dissemination of false information;
- pricing pressures;
- short selling of Kratos' common stock;
- impact of litigation and ongoing government inquiries;
- general conditions in the market;
- political and/or military events associated with current worldwide conflicts; and
- events affecting other companies that investors deem comparable to Kratos.

Companies that have experienced volatility in the market price of their stock have frequently been the object of securities class action litigation. Kratos and certain of Kratos' current and former officers and directors have been named defendants in class action and derivative lawsuits. These matters and any other securities class action litigation and derivative lawsuits in which Kratos may be involved could result in substantial costs to Kratos and a diversion of Kratos' management's attention and resources, which could materially harm Kratos' financial condition and results of operations.

### **Kratos' charter documents and Delaware law may deter potential acquirers and may depress Kratos' stock price.**

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Certain provisions of Kratos' charter documents and Delaware law, as well as certain agreements Kratos has with Kratos' executives, could make it substantially more difficult for a third party to acquire control of Kratos. These provisions include:

authorizing the board of directors to issue preferred stock;

prohibiting cumulative voting in the election of directors;

prohibiting stockholder action by written consent;

establishing advance notice requirements for nominations for election to Kratos' board of directors or for proposing matters that can be acted on by stockholders at meetings of Kratos' stockholders;

Section 203 of the Delaware General Corporation Law, which prohibits Kratos from engaging in a business combination with an interested stockholder unless specific conditions are met; and

a number of Kratos' executives have agreements with Kratos that entitle them to payments in certain circumstances following a change in control.

Kratos has a stockholder rights plan which may discourage certain types of transactions involving an actual or potential change in control and may limit our stockholders' ability to approve transactions that they deem to be in their best interests. As a result, these provisions may depress Kratos' stock price.

**Kratos may incur goodwill impairment charges in Kratos' reporting entities which could harm Kratos' profitability.**

A significant portion of Kratos' net assets come from goodwill and other intangible assets. In accordance with Statement of Financial Accounting Standards, or SFAS, No. 142, "Goodwill and Other Intangible Assets," Kratos periodically reviews the carrying values of Kratos' goodwill to determine whether such carrying values exceed the fair market value. Our acquired companies are subject to annual review for goodwill impairment. If impairment testing indicates that the carrying value of a reporting unit exceeds its fair value, the goodwill of the reporting unit is deemed impaired. Accordingly, an impairment charge would be recognized for that reporting unit in the period identified, which could reduce Kratos' profitability.

## THE MERGER

*The following is a discussion of the merger and the material terms of the merger agreement between Kratos and SYS. You are urged to read carefully the merger agreement in its entirety, a copy of which is attached as Annex A to this Proxy Statement and incorporated by reference herein.*

### Background of the Merger

SYS has regularly reviewed and assessed trends and conditions impacting SYS, the information connectivity solutions business, the government services industry generally and the related impacts of all of these factors on SYS's stock price and market capitalization. Further, from time to time, the SYS board of directors, which we refer to as the SYS Board, and management has reviewed various strategic options potentially available to achieve SYS's desired business objectives, including internal growth through expanded services capabilities and product initiatives and growth through acquisitions of other businesses. More recently and, in particular during calendar 2007, as a direct result of increasing competition, changes within the government contract services industry affecting smaller service providers, overall consolidation within the industry and general market conditions limiting or inhibiting small cap funds from investing in small publicly traded companies and the ever increasing costs associated with being a publicly traded company, the SYS management and SYS Board began considering more fully the possibilities of various strategic alternatives including a business combination.

In this regard, over a period of time ranging from January 2007 through August 2007 Clifton L. Cooke, Jr., President and CEO of SYS, held various informal discussions with key decision makers at numerous companies in the government services sector as to their potential interest in acquiring SYS at some point in the future and with regard to the specific criteria that would drive their decision making process. These discussions helped Mr. Cooke shape the strategic direction of SYS, as these discussions provided valuable data points regarding the product and service capabilities as well as the types of government programs which were sought after by these companies as part of their merger and acquisition strategies. Most of these conversations were held with executives with whom Mr. Cooke had developed relationships over the course of his 30+ year career in the industry; and in addition to helping shape the strategic direction of SYS, these discussions also provided a means by which to measure SYS's progress toward building a business capable of creating value for its shareholders through such a strategic transaction.

Several of these discussions took place in or around the last quarter of SYS's 2007 fiscal year between April 1<sup>st</sup> and June 30<sup>th</sup>. Three companies expressed a willingness to engage in general discussions about potential business combinations but wanted to defer detailed discussions until SYS completed its fourth quarter and fiscal year 2007 and its budget cycle process for fiscal year 2008. Accordingly, SYS and these companies mutually agreed to defer further conversations until SYS could complete its audit for the fiscal year ended June 30, 2007 and so that SYS could complete its business planning for fiscal year 2008, at which time SYS could provide any such interested parties with updated pro forma financial information as a basis for more detailed discussions. Throughout this period, Mr. Cooke notified the SYS Board of such discussions at the regularly scheduled board meetings as part of his ongoing business and strategic update.

Since 2004, Kratos has undertaken a number of strategic acquisitions and since 2006, has also undertaken a number of divestitures and, as a result of successfully executing the plan to divest all of its previous Commercial Wireless Communications Infrastructure business, has successfully completed its initial transition to being substantially a "pure-play" Government services solution provider. Kratos' stated strategy is to grow the business, organically and through strategic acquisitions, into the premier mid-market Federal Government Security, IT, and Engineering Solutions provider. As a result the Kratos board of directors has reviewed numerous strategic opportunities (i) to reach new customers and acquire additional contract vehicles, (ii) to quickly follow changes in government priorities, (iii) to

position the company for changes in the coming years from Base Realignment and Closure, or BRAC, activities, (iv) to broaden and improve the company's services offerings, and (v) to ultimately grow Kratos' revenue and improve profit margins. In furtherance of these goals, and as a result of increased competition and consolidation in the defense and security solutions industry, Kratos regularly reviews possible strategic actions, including acquisitions and combinations, and has discussions from time to time with various parties regarding such possible actions. For example, and as part of pursuing this strategic agenda, on December, 31, 2007, Kratos completed its acquisition of the Haverstick business.

Subsequent to completing its fiscal year ended June 30, 2007 and in preparation for implementing its operating plan for the fiscal year ending June 30, 2008, SYS management and the SYS Board began to engage in a series of discussions regarding both the near-term and long-term strategy for SYS in light of its financial results, current industry trends and general stock market conditions. During this same approximate timeframe, Mr. Cooke and the CEO and President of Kratos, Eric DeMarco, met informally to discuss common industry issues and trends affecting both companies, business operations challenges and the continuing difficulties of growing their respective businesses while maintaining and expanding their shareholder bases. During these discussions, the concept of the two companies joining forces was broached, but nothing specific was concluded.

During its regularly scheduled board meeting in September 2007, SYS management and the SYS Board engaged in further discussions regarding the status of the industry, the capital markets and the continuing decrease of investment funds available to invest in micro cap stocks, the general strategy of SYS and various courses of action that would best serve the interests of its shareholders. The SYS Board discussed the formation of a strategic working group, which we refer to as the Committee, to formally assess strategic alternatives.

In the late summer and early fall of 2007, Mr. Cooke met with defense industry analysts and investment bankers and attended conferences with the goal of gaining current information on merger and acquisition trends in the government contracting arena. In addition to providing relevant and timely valuation metrics, these activities highlighted various market issues affecting mergers and acquisitions, including political uncertainty, the impact on valuations resulting from recent changes in the small business contract rules, the recent downturn in the credit markets and federal and defense budget spending impacts from the ongoing war effort.

At the SYS Board meeting on October 26, 2007, Mr. Cooke briefed the SYS Board on this conference and presented a strategic working group charter together with a proposed plan of action and a timetable. After discussing the proposed charter, the SYS Board resolved to form the Committee to further explore the various alternatives outlined in the charter in order to determine which path would best maximize shareholder value given the circumstance described above. The Committee was tasked to complete its detailed review and analysis and to report back to the SYS Board with a recommendation at the next regularly scheduled meeting on December 7, 2007. These alternatives included conducting assessments of internal growth opportunities, further SYS acquisitions, divestitures of existing products and/or business lines and an outright sale of SYS. SYS management was further authorized to extend the engagement letter with its financial advisory services firm, USBX Advisory Services LLC, which we refer to as USBX, to assist management in this undertaking. Mr. Cooke also advised the SYS Board that he had been having some general business discussions with Mr. DeMarco; and, given the nature of the activities being undertaken by management and the Committee, on October 26, 2007, Kratos and SYS signed a mutual nondisclosure agreement in connection with such discussions.

During the first two weeks of November 2007, Messrs. Cooke and DeMarco met to further assess the prospects of a potential merger between the two companies. Initial discussions included the potential synergies between the two companies that existed between customers, capabilities and programs as well as potential cost savings that might be expected. Additionally, preliminary discussions were held regarding business valuation expectations, forms of potential consideration, impacts on their

employees and customers and preliminary estimated timetables to complete such a transaction if approved by their respective boards of directors.

Subsequent to its conference call on November 13, 2007, concerning its first quarter results and based on the direction of the SYS Board, management, together with its financial advisor, commenced and conducted a rigorous and detailed analysis of SYS's business prospects in advance of a Committee meeting held on November 29, 2007, the results of which would be presented to the SYS Board on December 7, 2007.

Between November 14, 2007 and November 29, 2007, Messrs. Cooke and DeMarco continued these discussions and established an objective to develop a preliminary valuation based on information shared to date, and transaction structure that Mr. Cooke could incorporate into the work the Committee was performing as a frame of reference for its strategic discussions to be held on November 29, 2007.

These discussions led to a "preliminary" enterprise value for SYS on the low end of a range of \$50 million to \$55 million, subject to the treatment of outstanding debt and other equity related instruments, with the purchase price to be paid in registered shares of Kratos stock. This enterprise value represented a premium to the then market capitalization of SYS. The low end of the range was predicated on the most recent last twelve months SYS financial results and market based EBITDA multiples applied to those results. This enterprise value also reflected the concern that certain of the SYS small business contracts might be at risk to the acquirer due to recent changes in the rules governing the treatment of small business contracts after an acquisition.

On November 27, 2007, management from the two companies met and reviewed a presentation provided by Edward Lake, Executive Vice President and CFO of SYS, that provided a general business overview, recent actual financial results, estimated financial results for the fiscal year ended June 30, 2008, and a pro forma analysis of what the SYS financial results would look like absent certain non-recurring costs, such as the costs of being a publicly traded company, among other EBITDA adjustments customary in such circumstances. During this same timeframe, management from Kratos briefed the management of SYS with a similar presentation and financial analysis.

In the SYS Committee meeting held on November 29, 2007, SYS management and its financial advisor presented a comprehensive analysis to the Committee that included, among other things: (i) the current status of the business, (ii) current public company challenges, (iii) valuation metrics and issues, (iv) SYS financial projections under a variety of scenarios, (v) strategic alternatives including staying the course, selling the business, taking the company private and continuing to pursue acquisitions as an acquirer, and (vi) key drivers that management considered relevant to this decision process. During these discussions, management provided the Committee with a synopsis of the discussions that had been held to date with Kratos, including preliminary valuation estimates and information regarding another government IT services company that SYS management considered as a potential acquisition candidate for SYS.

As a result of this meeting, SYS management was tasked with: (i) preparing a final concise summary of its findings and recommendations to be delivered in advance of and for full discussion at the SYS Board meeting scheduled for December 7, 2007, (ii) continuing its discussions with Kratos management, (iii) together with its financial advisor, continuing to build on other discussions that had taken place from time to time with other potential interested acquirers, and (iv) developing and pursuing a focused target list of other potential acquirers that SYS management believed would represent viable candidates who were capable of making a decision and who could execute on that decision in a timely manner.

During the period from November 29, 2007 through December 7, 2007, SYS management and its financial advisor finalized a list of other potential acquirers based on prior discussions or indications of interest and that represented a fair sampling of companies in the government IT services industry that

could quickly review and assess a management presentation of SYS's capabilities and provide SYS management with an indication of interest and a general estimate of value for comparative purposes.

Also during this time, Messrs. Cooke and Demarco, together with Mr. Lake and the respective financial and legal advisors of SYS and Kratos, continued to review and refine the preliminary valuation analysis and worked to develop customary terms and conditions that might lead to a non-binding indication of interest which could be presented to the SYS Board on December 7, 2007.

Through this process, SYS was able to provide financial and other information that supported a higher valuation based on the pro forma analysis of what the SYS financial results would look like absent certain non-recurring costs, such as the costs of being a publicly traded company, among other EBITDA adjustments customary in such circumstances, its projections for the remainder of fiscal year 2008 and fiscal year 2009, potential key new contract wins during those periods and was further able to demonstrate that the risk of losing any of its small business contracts was minimal. As a result, the parties developed a "revised" preliminary enterprise valuation of \$60 million less the value of the outstanding subordinated debt of \$3.1 million for a post-debt equity value of \$56.9 million and such that, after the transaction and after the completion of the then pending Haverstick transaction by Kratos, the SYS shareholders would own approximately 24% of the issued and outstanding stock of Kratos post-closing.

On December 3, 2007 Kratos engaged Wachovia Capital Markets, LLC as its financial advisor with respect to a potential business combination of Kratos and SYS.

On December 4, 2007, Kratos delivered its preliminary proposal to SYS, expressing Kratos' interest in a potential stock-for-stock merger with SYS at an enterprise value for SYS of \$60 million subject to a fixed stock price assumption of Kratos' common stock of \$2.25 per share. With its letter of intent, Kratos included proposed exclusivity provisions and requested that SYS agree to exclusive negotiations with respect to its proposal.

On December 7, 2007 the SYS Board met with management to review the report and findings previously briefed to the Committee and the initial letter of intent from Kratos. As a result of these discussions, the SYS Board instructed management to continue working with Kratos management to negotiate a letter of intent that might be deemed acceptable to both parties, to continue discussions with the other potential acquirers, and to report those findings to the SYS Board. The SYS Board also authorized management to have SYS legal counsel conduct a thorough legal due diligence review of litigation in which Kratos was involved and which Kratos has recently resolved. A telephonic board meeting was scheduled for December 21, 2007 to reconvene and assess the outcome of the aforementioned activities.

From the period between December 7, 2007 and December 21, 2007, SYS management and its financial advisor continued to pursue the efforts recommended by the SYS Board as outlined below:

1. They conducted face to face and/or telephonic meetings with the short list of other potential acquirers. Each of these companies was provided with a significant amount of information relevant to determining a level of interest in acquiring SYS and were provided with current information as to the status of SYS' deliberations;
2. They directed legal counsel to conduct a thorough review of the outstanding litigation matters involving Kratos, which resulted in the preparation of a detailed analysis that was then reviewed with management and its financial advisor; and
3. They continued to hold meetings with Kratos to better understand the detailed aspects of Kratos' business and continued to work on terms and conditions that would lead to an acceptable non-binding letter of intent, including valuation, the treatment of outstanding

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SYS options and warrants, a break-up fee upon termination of the agreement and other items customary in a non-binding letter of intent.

On December 21, 2007 SYS received a revised letter of intent from Kratos.

Also on December 21, 2007 SYS management and the SYS board of directors met to review the results of management's efforts over the previous few weeks. Management reported that, based on the results of its meetings with other companies, that the other companies either were not interested in pursuing a transaction with SYS or, if they did want to pursue further discussions, that it was not likely that they would put forth an offer that would exceed the then current market capitalization for SYS which was considerably lower than the \$60 million enterprise value contemplated in the non-binding letter of intent with Kratos.

The SYS Board then reviewed and discussed the proposed terms in the non-binding letter of intent from Kratos and authorized management to continue refining certain terms and, if successful in achieving those refinements, to execute the non-binding letter of intent. The SYS Board further discussed and reviewed the terms of the engagement letter with the company's financial advisor, USBX, which had been assigned to Imperial Capital LLC, which we refer to as Imperial Capital, upon its acquisition of USBX and approved the fee structure for completing a transaction in accordance with the engagement letter.

On December, 24, 2007, Kratos executed and delivered a revised letter of intent to SYS which contained the changes deemed acceptable and necessary to the SYS Board which was then executed by Mr. Cooke on behalf of SYS. Pursuant to this letter of intent, SYS agreed to negotiate exclusively with Kratos until February 22, 2008.

During the period from December 28, 2007 through February 19, 2008, Kratos, SYS, Wachovia and Imperial Capital, financial advisors for Kratos and SYS, respectively, and DLA Piper and Luce, Forward, Hamilton & Scripps, which we refer to as Luce Forward, legal counsel for Kratos and SYS, respectively, engaged in a lengthy and detailed process of completing due diligence, drafting a definitive merger agreement and completing all the other matters necessary to determine if a final agreement could be reached, which included assessing the impacts of such a transaction on existing contract vehicles, customers, employees, facilities and shareholders.

On December 31, 2007, Kratos completed its acquisition of Haverstick Consulting, Inc.

On January 1, 2008, DLA Piper delivered to Luce Forward an initial draft of the merger agreement. From January 1, 2008 until the execution of the merger agreement, Kratos and SYS and their representatives exchanged drafts of the merger agreement and held extensive negotiations relating to its terms and conditions.

On January 7, 2008, the parties held an organizational meeting at which SYS provided a business presentation to a broader set of both Kratos and SYS management and their respective financial advisors.

From January 7, 2008 onward, management from both companies, together with their respective financial advisors and legal counsel, conducted due diligence via an analysis of items in an electronic data room, meetings and conference calls.

On January 31, 2008, the senior management teams of Kratos and SYS, as well as DLA Piper and Luce Forward met to negotiate the merger agreement.

On February 8, 2008, the senior management teams of Kratos and SYS, as well as Wachovia and Imperial Capital met to review SYS's projected financial statements and to discuss other due diligence items.



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On February 12, 2008, Kratos, SYS, Wachovia and Imperial Capital met to review Kratos' projected financials and to discuss other due diligence items.

On February 13, 2008, Kratos, SYS, DLA Piper and Luce Forward met to review outstanding items in, and schedules to, the merger agreement.

On February 19, 2008, the SYS Board met to review and discuss the terms and conditions of the definitive agreement, the fairness opinion of SYS's financial advisor, an update of the litigation status of Kratos as prepared by SYS's legal counsel and the proposed timetable for the transaction taking into consideration the required SEC filings and shareholder approval process. The full text of the Imperial Capital opinion, which sets forth, among other things, the procedures followed, assumptions made, matters considered and limitations on the scope of the review undertaken by Imperial Capital in rendering its opinion, is attached as *Annex E* to this Proxy Statement. The SYS Board discussed the various presentations and the terms of the transaction and approved the merger agreement and the share issuance. The SYS Board then approved moving forward with the transaction.

Also on February 19, 2008, the Kratos board of directors convened a special meeting to consider the proposed transaction with SYS. Representatives of Kratos' senior management, as well as representatives of Wachovia and DLA Piper were present at the meeting. The Kratos board of directors reviewed and discussed the terms and conditions of the definitive agreement, Wachovia's fairness opinion and the proposed timetable for the transaction taking into consideration the required SEC filings and stockholder approval process. Representatives of Wachovia reviewed Wachovia's financial analyses of the proposed exchange ratio and rendered the oral opinion of Wachovia, subsequently confirmed by delivery of its written opinion dated February 20, 2008, that as of such date and based upon and subject to the various considerations described in its written opinion, the exchange ratio provided for in the merger agreement was fair, from a financial point of view, to Kratos. The full text of the Wachovia opinion, which sets forth, among other things, the procedures followed, assumptions made, matters considered and limitations on the scope of the review undertaken by Wachovia in rendering its opinion, is attached as *Annex D* to this Proxy Statement. The Kratos board of directors discussed the various presentations and the terms of the transaction and approved the merger agreement and the share issuance.

On February 20, 2008, Kratos, SYS, DLA Piper and Luce Forward finalized the merger agreement and the schedules thereto. Kratos and SYS thereafter executed the merger agreement. Concurrently, certain of Kratos' directors, executive officers and significant stockholders executed the Kratos voting agreement, the form of which is included as *Annex B* to this Proxy Statement, and certain of SYS's directors and executive officers executed the SYS voting agreement, the form of which is included as *Annex C* to this Proxy Statement.

On February 21, 2008, Kratos and SYS each issued a press release announcing the transaction and the execution of the merger agreement.

### **The Kratos Board of Directors' Recommendations and Reasons for the Merger**

**The Kratos board of directors believes that the merger and the merger agreement, and related transactions, are advisable and in the best interests of Kratos and its stockholders. Accordingly, the Kratos board of directors has approved the merger and the merger agreement, and related transactions, and recommends that Kratos stockholders vote "FOR" " approval of the Share Issuance.**

In connection with the foregoing actions, the Kratos board of directors consulted with Kratos' management, as well as Kratos' financial advisor and outside legal counsel, and considered the short-term and long-term interests of Kratos and its stockholders. In reaching the foregoing determinations, the Kratos board of directors considered that the merger could enhance stockholder

value through, among other things, enabling Kratos, following the merger, to capitalize on the following strategic advantages and opportunities:

The government market is an attractive market to continue to expand into due to relative stability and steady cash flow generation;

The merger would allow Kratos to access new customers and obtain new/more contract vehicles;

The combined company, with greater scale, size, more past performance qualifications and a larger number of employees, especially those with security clearances, will be able to bid on larger/more contracts in the prime contract position/role;

The merger will improve the offerings of Kratos to its customers

Obtaining several hundred hard-to-find employees with skill sets that are very marketable, and in high demand;

Expand the reach of Kratos with SPAWAR one of Kratos' major customers;

Help Kratos achieve growth objectives and profitability targets.

The Kratos board of directors also considered a variety of other factors and risks concerning the merger, including the following:

The information concerning the respective historic businesses of Kratos and SYS, financial results and prospects, including the result of Kratos due diligence review of SYS;

The assessments of Kratos that SYS's business can effectively and efficiently be integrated;

The opinion of the financial advisor of Kratos, Wachovia, that, subject to and based on the assumptions made, procedures followed, matters considered and limitations on its review undertaken, as of February 20, 2008, the exchange ratio of 1.2582 shares of Kratos common stock for each share of SYS common stock was fair to Kratos from a financial point of view;

The exchange ratio and the fact that the exchange ratio is fixed and will not fluctuate based upon changes in the Kratos stock price between signing and closing, reflecting the strategic purpose of the merger and consistent with market practices for a merger of this type;

The expectation that SYS shareholders and option holders, immediately after completion of the merger, would hold approximately 24% of the outstanding shares of common stock of Kratos, on a fully diluted basis;

The risk that U.S. and foreign antitrust and competition authorities may not approve the merger or may impose terms and conditions on their approvals that, if accepted, would materially and adversely affect the projected financial results of the combined company;

The potential impact of the restrictions under the merger agreement on the ability of Kratos to take certain actions during the period prior to the closing of the merger, which may delay or prevent Kratos from undertaking business opportunities that may arise pending completion of the merger;

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The challenges and costs of combining the two businesses and the risks of completing the integration, which could harm the combined company's operating results and preclude the realization of anticipated synergies or benefits from the merger;

The potential for diversion of management and employee attention from other strategic priorities and for increased employee attrition both before and after the closing of the merger agreement, and the potential effect on the business and relations of Kratos with customers and suppliers;

The fees and expenses associated with completing the merger; and

The risk that anticipated cost savings will not be achieved.

The foregoing discussion of the factors considered by the Kratos board of directors is not intended to be exhaustive but summarizes the material factors and risks considered by Kratos' board of directors in making its recommendation. In view of the wide variety of factors considered in connection with its evaluation of the merger and the complexity of these matters, the Kratos board of directors did not find it useful to, and did not attempt to, quantify, rank or otherwise assign relative weights to these factors. In considering the factors described above, individual members of the Kratos board of directors may have given different weight to different factors.

In addition, the Kratos board of directors did not undertake to make any specific determination as to whether any particular factor, or any aspect of any particular factor, was favorable or unfavorable to its ultimate determination, but rather conducted an overall analysis of the factors described above, including discussions with the Kratos management team and the Kratos outside legal and financial advisors. Based on the totality of the information presented, the Kratos board of directors determined that Kratos should proceed with the merger and the merger agreement, and recommends that the Kratos stockholders approve the Share Issuance.

#### **The SYS Board of Directors' Recommendations and Reasons for the Merger**

**The SYS board of directors believes that the merger and the merger agreement are advisable and in the best interests of SYS and its shareholders. Accordingly, the SYS board of directors has unanimously approved the merger and the merger agreement and unanimously recommends that SYS shareholders vote "FOR" approval of the Merger Proposal. When SYS's shareholders consider the SYS board of directors' recommendation, SYS's shareholders should be aware that SYS's directors may have interests in the merger that may be different from, or in addition to, their interests. These interests are described in "Interests of SYS's Directors and Executive Officers in the Merger" beginning on page 9.**

At a special meeting of the SYS Board held on February 19, 2008, the SYS Board of directors voted unanimously to approve the merger agreement, the merger, and the other transactions contemplated by the merger agreement, to direct that the merger agreement and the merger be submitted to a vote of SYS's shareholders and to recommend that SYS's shareholders vote to adopt and approve the merger agreement and the merger. In the course of reaching its decision to enter into the merger agreement, SYS's Board consulted with its senior management, outside legal counsel and Imperial Capital, reviewed a significant amount of information and considered a number of factors, the most relevant of which include the following:

that by combining complementary operations, the combined company would have better opportunities for future growth;

the opportunity for SYS's shareholders to participate in a larger, more diversified organization and to benefit from the potential appreciation in the value of Kratos' common stock;

information concerning the business, earnings, operations, competitive position and prospects of SYS and Kratos both individually and on a combined basis;

the opportunity for SYS shareholders to receive a significant premium over the existing market price for shares of SYS's common stock prior to the announcement of the merger;

discussions with, SYS senior management and legal and financial advisor regarding certain business, financial, legal and accounting aspects of the merger, the results of the legal and financial due diligence and a review of the terms and conditions of the merger;

the opinion of Imperial Capital that, as of February 19, 2008, and subject to the assumptions and limitations set forth in the fairness opinion, the exchange ratio in the merger was fair, from a financial point of view, to the holders of SYS's common stock;



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the possibility, as alternatives to the merger, of seeking to acquire another company, seeking to engage in one or more joint ventures, seeking to raise additional capital, or seeking to engage in a business combination with an organization other than Kratos;

the likely impact of the merger on SYS's employees and customers;

the interests that certain executive officers and directors of SYS may have with respect to the merger, in addition to their interests as shareholders of SYS generally, as described in "THE MERGER CERTAIN ARRANGEMENTS BETWEEN SYS AND ITS EXECUTIVE OFFICERS, DIRECTORS AND AFFILIATES" starting on page 70;

the fact that the parties intend for the merger to qualify as a tax-free transaction for U.S. federal income tax purposes which would permit SYS's shareholders to receive Kratos common stock in a tax-free exchange; and

the history of contacts with other potential strategic partners and the judgment of SYS's Board and management that it was unlikely that any other party would be a more attractive strategic partner or make a proposal more favorable to SYS and its shareholders than Kratos.

SYS's Board also considered a number of potentially negative factors in its deliberations concerning the merger. The negative factors considered by the Board of SYS included:

the risk that the merger would not be completed in a timely manner or at all;

the possible negative effects of the public announcement of the merger on SYS's sales, relationships with customers, suppliers, and employees; and operating results;

the fact that SYS shareholders will not receive the full benefit of any future growth in the value of their equity that SYS may have achieved as an independent company, and the potential disadvantage to SYS shareholders in the event that Kratos does not perform as well in the future as SYS may have performed as an independent company;

the substantial management time, effort and expense that will be required to consummate the merger and integrate the operations of the two companies;

the possibility that certain provisions of the merger agreement, including, among others, the no solicitation and termination fee payment provisions of the merger agreement and the fact that certain officers of SYS executed shareholder voting agreements, would likely have the effect of discouraging other persons potentially interested in merging with or acquiring SYS from pursuing such an opportunity; and

the other risks and uncertainties discussed above under "RISK FACTORS" starting on page 24 of this proxy statement/prospectus including the various outstanding shareholder and stock option litigation matters involving Kratos and the potential future impacts of those matters on the merger consideration being issued to the SYS shareholders.

The foregoing discussion of the information and factors considered by the Board of SYS is not intended to be exhaustive. In view of the wide variety of the material factors considered in connection with the evaluation of the merger and the complexity of these matters, the Board of SYS did not find it practicable to, and did not, quantify or otherwise attempt to assign any relative weight to the various factors considered. In addition, the Board of SYS did not undertake to make any specific determination as to whether any particular factor, or any aspect of any particular factor, was favorable or unfavorable to the ultimate determination of the SYS Board, but rather the SYS Board conducted an overall analysis of the factors described above, including discussions with and questioning of SYS's senior management, and legal and financial adviser. In considering the factors described above, individual members of the board of directors of SYS Board may have given different weight to different factors.



**Opinion of Financial Advisor to the Kratos Board of Directors**

At the February 19, 2008 meeting of Kratos' board of directors, Wachovia indicated to Kratos' board of directors, that subject to and based on the assumptions made, procedures followed, matters considered and limitations on its review undertaken, that assuming that the merger agreement was substantially in the form provided at the meeting, Wachovia would, at the time of execution of the merger agreement, be able to provide its opinion that, as of the date of the merger agreement, the 1.2582 to 1 exchange ratio pursuant to the merger agreement was fair from a financial point of view to Kratos. Wachovia subsequently delivered a written opinion to Kratos' board of directors to the effect that, subject to and based on the assumptions made, procedures followed, matters considered and limitations on its review undertaken, as of February 20, 2008, the exchange ratio pursuant to the merger agreement was fair from a financial point of view to Kratos.

The full text of Wachovia's opinion, dated February 20, 2008, which sets forth, among other things, the assumptions made, procedures followed, matters considered and limitations on the review undertaken by Wachovia in connection with the opinion, is attached as *Annex D* to this Proxy Statement. Holders of shares of Kratos common stock are urged to read the opinion carefully and in its entirety. This summary is qualified in its entirety by reference to the full text of the opinion.

Wachovia's opinion only addressed the fairness of the exchange ratio offered to Kratos from a financial point of view and did not address any other term of the Merger or any other agreement, arrangement or understanding entered into in connection with the Merger or otherwise, and did not address the relative merits of the Merger compared with other business strategies that may have been considered by Kratos' management or its board of directors, nor did its opinion address the merits of the underlying decision by Kratos to enter into the merger agreement. Wachovia's opinion does not and shall not constitute a recommendation to any holders of shares of Kratos common stock as to how they should vote in connection with the Merger.

In arriving at its opinion, Wachovia, among other things:

Reviewed the merger agreement including the proposed financial terms of the merger set forth therein.

Reviewed Annual Reports to Stockholders and Annual Reports on Form 10-K for Kratos.

Reviewed certain interim reports to Stockholders and Quarterly Reports on Form 10-Q for Kratos.

Reviewed certain other business, financial, and other information, including certain confidential information, regarding Kratos and its prospects, including financial forecasts, which were furnished to Wachovia, and that Wachovia discussed with the management of Kratos and its agents or representatives.

Reviewed Annual Reports to Stockholders and Annual Reports on Form 10-K for SYS.

Reviewed certain interim reports to Stockholders and Quarterly Reports on Form 10-Q for SYS.

Reviewed certain business, financial, and other information, including certain confidential information, regarding SYS and its subsidiaries and their respective prospects, which were publicly available or furnished to Wachovia by, and that Wachovia has discussed with, the respective managements of SYS and Kratos, including financial forecasts for SYS furnished to Wachovia by SYS, and reviewed and discussed with Kratos estimates for SYS prepared by Kratos.

Compared certain business, financial, and other information regarding SYS and Kratos with publicly available business, financial and other information regarding certain publicly traded companies that Wachovia deemed relevant.



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Compared the proposed financial terms of the merger with the financial terms of certain other business combinations and transactions that Wachovia deemed relevant.

Reviewed a discounted cash flow model based upon the Kratos forecasts for Kratos and SYS, respectively, on a stand-alone basis.

Reviewed the potential pro forma impact of the merger on the Kratos financial statements on a Pro Forma and GAAP basis based upon Kratos' forecasts for Kratos and SYS.

Reviewed a contribution analysis based upon Kratos' forecasts for Kratos and SYS.

Reviewed the historic reported stock price and trading volumes of the Kratos common stock and SYS common stock.

Considered other information such as financial studies, analyses and investigations as well as financial, economic and market criteria that Wachovia deemed relevant.

In connection with its review, Wachovia relied upon and assumed for purposes of its opinion, the accuracy and completeness of the foregoing financial and other information, including all accounting, legal, regulatory and tax information Wachovia obtained and reviewed for the purpose of its opinion, and Wachovia did not assume any responsibility for any independent verification of such information nor has it undertaken an independent evaluation or appraisal of any of the assets or liabilities of SYS and its subsidiaries or Kratos and its subsidiaries or been furnished with any such evaluation or appraisal. Wachovia also assumed that the forecasts, including the forecasts for the combined company following the merger provided by Kratos management, estimates, judgments, and all assumptions expressed by management of Kratos, have been reasonably formulated and that they are the best currently available forecasts, estimates, judgments, and assumptions of Kratos as to the expected future financial performance of SYS or Kratos, as the case may be. Wachovia assumed no responsibility for and expressed no view as to any such forecasts, estimates, judgments, or the assumptions upon which they are based. In arriving at its opinion, Wachovia did not prepare or obtain any independent evaluations or appraisals of the assets or liabilities of SYS or Kratos, including any contingent liabilities.

In rendering its opinion, Wachovia assumed that the merger would be consummated on the terms described in the merger agreement, without waiver of any material terms or conditions, and that in the course of obtaining any necessary legal, regulatory or third-party consents or approvals, no restrictions or conditions will be imposed that will have an adverse effect on the merger, Kratos, SYS or other actions contemplated by the merger agreement. Wachovia's opinion was necessarily based on economic, market, financial and other conditions and the information made available to Wachovia as of the date thereof. Wachovia did not consider, nor did Wachovia express any opinion with respect to, the price at which Kratos common stock would trade following the announcement of the merger or the price at which such stock will trade following the consummation of the Merger. Further, Wachovia did not express any opinion as to the fairness or nature of the compensation to be received by either the Kratos or SYS directors, officers, employees or other insiders, or class of such persons, in connection with the Merger relative to the exchange ratio.

The following summaries of Wachovia's material financial analyses present some information in tabular format. In order to fully understand the financial analyses used by Wachovia, the tables must be read together with the text of each summary. The tables alone do not constitute a complete description of the financial analyses. Accordingly, the analyses listed in the tables and described below must be considered as a whole. Considering any portion of such analyses and the factors considered, without considering all analyses and factors, could create a misleading or incomplete view of the process underlying Wachovia's opinion.

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**Historical Trading Analysis:** Wachovia reviewed general trading information concerning SYS and Kratos, including the stock price, average stock price and volume over various periods and dates ending February 19, 2008 and the stock trading history of SYS common stock and Kratos common stock. The table below illustrates the range of stock prices over those periods:

	Share Price	
	SYS	Kratos
1-Day Prior	\$ 1.60	\$ 2.11
5-Day Average	1.59	2.10
20-Day Average	1.61	2.06
60-Day Average	1.85	2.09
1-Year Average	2.13	2.00
52-Week High	2.78	3.04
52-Week Low	1.35	1.07

**Historical Exchange Ratio Analysis:** Wachovia analyzed the ratios of the daily closing prices of SYS common stock to those of Kratos common stock over various periods and dates ending February 19, 2008. The table below illustrates the average of those exchange ratios for those periods or the exchange ratio for such dates and the premiums or discounts based on an implied exchange ratio of 1.2582 shares of Kratos common stock for each share of SYS common stock:

	Exchange Ratio	Implied Premium
1-Day Prior	0.7583x	65.9%
5-Day Average	0.7579x	66.0%
20-Day Average	0.7817x	61.0%
60-Day Average	0.8834x	42.4%
1-Year Average	1.1229x	12.1%
52-Week High	1.9907x	(36.8)%
52-Week Low	0.6622x	90.0%

**Comparable Companies Analysis:** Using publicly available information, Wachovia analyzed certain trading multiples of selected publicly traded Government Information Technology services companies that it believed were reasonably comparable to SYS and Kratos.

These companies included the following:

CACI International, Inc.

Dynamics Research Corp.

ManTech International Corp.

NCI, Inc.

SAIC, Inc.

SI International, Inc.

SRA International, Inc.

Stanley, Inc.



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For each of the comparable companies, Wachovia analyzed the following metrics:

Multiple of enterprise value, defined as the market value of equity plus net debt plus preferred stock plus minority interest, to last twelve months, or LTM, revenue and estimated revenue for calendar years ended 2008 and 2009; and

Multiple of enterprise value to LTM EBITDA and estimated EBITDA for the calendar years ended 2008 and 2009.

Estimates for the comparable companies were as reported by First Call and Kratos management for SYS and Kratos. This analysis produced multiples of selected valuation data which Wachovia compared to multiples for SYS based on the implied value of the merger consideration of 1.2582 Kratos shares and Kratos, in each case based on the closing price of shares of Kratos common stock on February 19, 2008. The following table presents, for the periods indicated the multiples implied by the ratio of the enterprise value to LTM revenue and EBITDA and calendar years ended 2008 and 2009 revenue and EBITDA estimates:

	Comparable Company Multiple					
	SYS	Kratos	Low	Mean	Median	High
LTM Enterprise Value / Revenue	0.7x	0.8x	0.4x	0.9x	0.9x	1.2x
CY08 Enterprise Value / Revenue	0.7x	0.7x	0.4x	0.8x	0.8x	1.0x
CY09 Enterprise Value / Revenue	0.6x	0.7x	0.7x	0.8x	0.8x	0.8x
LTM Enterprise Value / EBITDA	23.0x	12.6x	5.2x	10.3x	10.3x	13.6x
CY08 Enterprise Value / EBITDA	8.7x	11.2x	4.6x	8.7x	9.1x	10.5x
CY09 Enterprise Value / EBITDA	7.9x	10.8x	7.0x	8.1x	8.3x	9.0x

None of the companies utilized in the above analyses for comparative purposes is identical to SYS or Kratos. Accordingly, a complete analysis of the results of the foregoing calculations cannot be limited to a quantitative review of such results and involves complex considerations and judgments concerning the differences in the financial and operating characteristics of the comparable companies and other factors that could affect the public trading value of the comparable companies as well as the potential trading value of SYS or Kratos.

**Precedent Transactions Analysis:** Using publicly available information, Wachovia examined selected transactions announced since January 1, 2006 involving privately held and publicly traded Government Information Technology services companies it believed were reasonably comparable to SYS and Kratos.

For each of the selected precedent transactions, Wachovia analyzed the following metrics:

Multiple of enterprise value to LTM revenue and estimated next twelve months, or NTM, revenue; and

Multiple of enterprise value to LTM EBITDA and estimated NTM EBITDA.

Estimates for the selected precedent transactions were as available through First Call reports, SEC filings and press releases. This analysis produced multiples of selected valuation data which Wachovia then compared to multiples for SYS based on the implied value of the merger consideration of 1.2582 shares of Kratos stock and Kratos based on the closing price of shares of Kratos common stock on February 19, 2008. The following table presents, for the periods indicated, the multiples for the selected

precedent transactions implied by the ratio of the enterprise value to LTM revenue and EBITDA and NTM revenue and EBITDA estimates:

	Selected Transactions					
	SYS	Kratos	Low	Mean	Median	High
LTM Enterprise Value / Revenue	0.7x	0.8x	0.3x	1.2x	1.2x	3.1x
NTM Enterprise Value / Revenue	0.7x	0.7x	0.3x	1.3x	1.1x	2.7x
LTM Enterprise Value / EBITDA	23.0x	12.6x	6.2x	10.7x	10.8x	16.4x
NTM Enterprise Value / EBITDA	8.7x	11.2x	9.4x	11.3x	10.5x	15.6x

**Premiums Paid Analysis:** Wachovia reviewed transactions involving publicly traded companies in the U.S. technology and services industry ranging in value from \$25 million to \$500 million to determine the premium or discount paid by the acquiror relative to the closing market price of the target company's common shares for one-day prior, one-week prior and one-month prior. Using publicly available information, Wachovia calculated, among other things, the high, low, mean and median premiums paid in these selected transactions and compared the implied value of the merger consideration of 1.2582 shares of Kratos stock to the closing price of shares of SYS common stock on February 19, 2008, one-week prior and one-month prior. The following table sets forth information concerning the stock price premiums implied by the Merger and the stock price premiums (and discounts) in the selected transactions:

	Selected Transactions				
	SYS	Low	Mean	Median	High
One-Day Prior Premium	65.6%	(54.4)%	30.1%	24.5%	151.4%
One-Week Prior Premium	60.6%	(46.2)%	33.0%	27.1%	151.4%
One-Month Prior Premium	76.7%	(49.6)%	35.8%	28.2%	144.9%

**Discounted Cash Flow Analysis:** Wachovia estimated a range of values for Kratos common stock and SYS common stock based upon the discounted present value of the projected after-tax cash flows of Kratos and SYS described in the respective financial forecasts provided by Kratos, for the nine months ending December 31, 2008 through the year ending December 31, 2012, and of the terminal values of Kratos and SYS based upon multiples of EBITDA and perpetuity growth rates. This analysis was based upon certain assumptions described by, projections supplied by and discussions held with management of Kratos. In performing this analysis, Wachovia utilized discount rates for Kratos ranging from 11.0% to 13.0% and for SYS ranging from 13.0% to 15.0%. The discount rates were selected based on weighted average cost of capital calculations for each of Kratos and SYS, respectively. Wachovia utilized terminal multiples of EBITDA for Kratos and SYS ranging from 9.0 times to 11.0 times and perpetuity growth rates for Kratos and SYS ranging from 3.5% to 4.5%.

This analysis resulted in implied exchange ratios ranging from 0.6991x to 3.2768x.

Additionally, Wachovia analyzed implied exchange ratios assuming a constant Kratos stock price equal to the closing price of Kratos common stock on February 19, 2008. This analysis resulted in implied exchange ratios ranging from 0.6692x to 1.5326x.

**Contribution Analysis:** Wachovia analyzed the respective contributions of fiscal year 2007, estimated fiscal year 2008 and estimated fiscal year 2009 revenues, EBITDA, Pro Forma EBIT and Pro Forma net income of Kratos and SYS to the combined company, based on the projected financial results of Kratos and SYS prepared by Kratos and the implied exchange ratios resulting from this analysis. Pro Forma EBIT and net income excluded amortization of intangibles and non-recurring items. Wachovia's analysis resulted in a range of implied exchange ratios from 0.3345x to 2.5321x.

**Pro Forma Earnings Analysis:** Wachovia analyzed the potential effect of the proposed merger on the pro forma earnings per share, or EPS, of Kratos for the six months ending December 31, 2008 and fiscal year 2009, assuming that the merger closed on June 30, 2008. This analysis was based upon the respective financial forecasts for Kratos and SYS provided by Kratos. This analysis was done on a GAAP as well as a pro forma basis. Pro Forma forecasts excluded amortization of intangibles and non-recurring items for Kratos and SYS.

This analysis indicated that the proposed Merger would be accretive to Kratos' pro forma six months ending December 31, 2008 and fiscal year 2009 GAAP and Pro Forma EPS assuming no synergies as a result of the transaction.

The summary above does not purport to be a complete description of the analyses performed by Wachovia, but describes, in summary form, the material elements of the analyses underlying its opinion dated February 20, 2008. The preparation of a fairness opinion is a complex process and is not necessarily susceptible to a partial analysis or summary description. In arriving at its opinion, Wachovia considered the results of all of its analyses as a whole and did not attribute any particular weight to any analysis or factor considered by it. Wachovia believes that the summary provided and the analyses described above must be considered as a whole and that selecting portions of these analyses, without considering all of them, would create an incomplete view of the process underlying its analyses and opinion.

In performing its analyses, Wachovia made numerous assumptions with respect to industry performance, general business and economic conditions and other matters, many of which are beyond Kratos' and SYS's control. No company, transaction or business used in the analyses described above is identical to Kratos, SYS or the merger. Any estimates contained in Wachovia's analyses are not necessarily indicative of future results or actual values, which may be significantly more or less favorable than those suggested by these estimates. The analyses performed were prepared solely as a part of Wachovia's analysis of the fairness, from a financial point of view, to Kratos of the exchange ratio pursuant to the terms of the merger agreement and were conducted in connection with the delivery by Wachovia of its opinion dated February 20, 2008, to Kratos' board of directors. The exchange ratio was determined through negotiations between Kratos, SYS, members of their respective senior management teams and respective advisors, and was approved by Kratos' board of directors. Wachovia did not recommend any specific consideration to Kratos or that any given consideration constituted the only appropriate consideration for the merger.

Wachovia's opinion was one of the many factors taken into consideration by Kratos' board of directors in making its determination to approve the merger. Wachovia's analyses summarized above should not be viewed as determinative of the opinion of Kratos' board of directors with respect to Kratos' value or of whether Kratos' board of directors would have been willing to agree to a different form of consideration.

Wachovia Capital Markets, LLC is a nationally recognized investment banking and advisory firm and a subsidiary of Wachovia Corporation. Wachovia and its affiliates provide a full range of financial advisory, securities and lender services for which it receives customary fees. Wachovia Capital Markets, LLC and its affiliates, including Wachovia Corporation and its affiliates, may provide additional banking or other financial services, including, but not limited to, investment banking services to SYS or Kratos in the future for which Wachovia would also be paid fees and may receive other compensation. In the ordinary course of its business, Wachovia and its affiliates may actively trade or hold the securities (including derivative securities) of Kratos for its own account or for the account of its customers and, accordingly, may at any time hold a long or short position in such securities. Wachovia was previously engaged by Wireless Facilities, Inc. (Kratos' former name), and received a fee for advising Wireless Facilities in the divestiture of its U.S. Engineering Business to LCC International in May 2007 and its

Wireless Deployment Business to Platinum Equity in July 2007. In the ordinary course of business, Wachovia may provide in the future, equity or other research coverage of the securities of Kratos.

Pursuant to a letter agreement dated December 3, 2007, Kratos engaged Wachovia as its exclusive financial advisor with respect to a possible transaction involving SYS. Pursuant to the terms of the letter agreement, Kratos engaged Wachovia to deliver its opinion and has agreed to pay Wachovia a significant portion of its compensation as a transaction fee contingent upon consummation of the merger.

Kratos has also agreed to reimburse Wachovia for its expenses incurred in performing its services, including the fees and expenses of Wachovia's counsel, and to indemnify Wachovia and its affiliates, their respective directors, officers, agents and employees and each person, if any, controlling Wachovia or any of its affiliates against certain liabilities and expenses, including certain liabilities under federal securities laws, related to or arising out of Wachovia's engagement and any related transactions.

#### **Opinion of Financial Advisor to the SYS Board of Directors**

On February 19, 2008, at a meeting of SYS's Board held to evaluate the proposed merger, Imperial Capital delivered to SYS's Board an oral opinion, confirmed by delivery of a written opinion, dated February 19, 2008, to the effect that, as of that date and based on and subject to various assumptions, matters considered and limitations described in its opinion, the exchange ratio in the merger was fair, from a financial point of view, to the holders of SYS common stock.

The full text of Imperial Capital's opinion describes the documents reviewed, matters considered and limitations on the review undertaken by Imperial Capital. This opinion is attached as *Annex E* and is incorporated into this proxy statement by reference. **Imperial Capital's opinion is directed only to the fairness, from a financial point of view, of the exchange ratio in the merger to the holders of SYS common stock. The opinion does not address the merits of the underlying decision by SYS to engage in the transaction or the relative merits of any alternatives discussed by SYS's Board and does not constitute an opinion with respect to SYS's underlying business decision to effect the transaction, any legal, tax or accounting issues concerning the transaction, or any terms of the transaction (other than the exchange ratio). The opinion does not constitute a recommendation as to any action SYS or any shareholder of SYS should take in connection with the transaction or any aspect thereof. Holders of SYS common stock are encouraged to read this opinion carefully in its entirety. The summary of Imperial Capital's opinion described below is qualified in its entirety by reference to the full text of its opinion.**

In arriving at its opinion, Imperial Capital, among other things:

Analyzed certain publicly available information of SYS that it believed to be relevant to its analysis, including SYS's annual reports on Form 10-K for the fiscal years ending June 30, 2005, June 30, 2006, and June 30, 2007, and SYS's quarterly reports on Form 10-Q for the quarters ending September 30, 2007 and December 31, 2007;

Analyzed certain publicly available information about Kratos that Imperial believed to be relevant to its analysis, including the Kratos annual report on Form 10-K for the fiscal year ending December 31, 2006 and the Kratos quarterly reports on Form 10-Q for the quarters ending March 31, 2007, June 30, 2007, and September 30, 2007;

Reviewed the Kratos internal draft income statements for the quarter and year ending December 31, 2007;

Reviewed certain internal financial forecasts and budgets prepared and provided by the SYS and Kratos management including the Kratos pro forma model prepared by management;

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Met with and held discussions with certain members of the SYS and Kratos management to discuss the SYS and Kratos operations and future prospects;

Reviewed industry reports and publications;

Reviewed public information with respect to certain other public companies with business lines and financial profiles which Imperial deemed to be relevant;

Reviewed the implied financial multiples and premiums paid in merger and acquisition transactions which Imperial deemed to be relevant;

Reviewed current and historical market prices of SYS and Kratos common stock, as well as the trading volume and public float of such common stock;

Reviewed the letter of intent and term sheet sent to SYS by Kratos dated December 21, 2007;

Reviewed the draft definitive agreement, including material schedules and exhibits, dated February 18, 2008 which is referred to in this section as the Merger Agreement; and

Conducted such other financial studies, analyses and investigations and took into account such other matters as it deemed necessary, including its assessment of general economic and monetary conditions.

In giving its opinion, Imperial Capital relied upon the accuracy and completeness of the foregoing financial and other information and did not assume any responsibility for independent verification of such information or conduct or receive any current independent valuation or appraisal of any assets of SYS or Kratos or any appraisal or estimate of liabilities of SYS or Kratos. With the consent of SYS's Board, Imperial Capital assumed that all financial forecasts had been reasonably prepared on bases reflecting the best currently available estimates and judgments of management of SYS and Kratos as to the future financial performance of the companies. Imperial Capital also relied upon the assurances of management of both companies that they were unaware of any facts that would make the information or financial forecasts provided to it incomplete or misleading. It assumed no responsibility for, and expressed no view as to, such financial forecasts or the assumptions on which they are based. Imperial Capital's opinion was necessarily based on economic, market and other conditions as they existed and could be evaluated on the date of its opinion.

At the direction of SYS's Board, Imperial Capital was not asked to, and it did not, offer any opinion as to the terms, other than the exchange ratio to the extent expressly specified in Imperial Capital's opinion, of the merger agreement or any related documents or the form of the merger or any related transaction. Imperial Capital expressed no opinion as to what the value of Kratos common stock would be when issued pursuant to the transaction or the prices at which SYS common stock or Kratos common stock will trade at any time. Imperial Capital expressed no opinion as to the fairness of the amount or nature of any compensation to be received by any officers, directors or employees of any parties to the transaction or any class of such persons. Imperial Capital assumed, with the consent of SYS's Board that (i) the final executed form of the Merger Agreement would not differ in any material respect from the draft that Imperial Capital examined, (ii) the parties to the Merger Agreement would comply with all the material terms of the Merger Agreement, and (iii) the transaction would be consummated in accordance with the terms of the Merger Agreement without any adverse waiver or amendment of any material term or condition thereof. Imperial Capital also assumed that all governmental, regulatory or other consents and approvals necessary for the consummation of the transaction would be obtained without any material adverse effect on Kratos, SYS or the transaction. Except as described above, SYS's Board imposed no other instructions or limitations on Imperial Capital with respect to the investigations made or the procedures followed by Imperial Capital in rendering its opinion. The issuance of Imperial Capital's opinion was approved by an authorized committee of Imperial Capital.



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In connection with rendering its opinion to SYS's Board, Imperial Capital performed a variety of financial and comparative analyses that are summarized below. The following summary is not a complete description of all analyses performed and factors considered by Imperial Capital in connection with its opinion. The preparation of a financial opinion is a complex process involving subjective judgments and is not necessarily susceptible to partial analysis or summary description. With respect to the selected public companies analysis and the selected transactions analysis summarized below, no company or transaction used as a comparison was either identical or directly comparable to SYS, Kratos or the merger. These analyses necessarily involve complex considerations and judgments concerning financial and operating characteristics and other factors that could affect the public trading or acquisition values of the companies concerned.

Imperial Capital believes that its analyses and the summary below must be considered as a whole and that selecting portions of its analyses and factors or focusing on information presented in tabular format, without considering all analyses and factors or the narrative description of the analyses, could create a misleading or incomplete view of the processes underlying Imperial Capital's analyses and opinion. Imperial Capital did not draw, in isolation, conclusions from or with regard to any one factor or method of analysis for purposes of its opinion, but rather arrived at its ultimate opinion based on the results of all analyses undertaken by it and assessed as a whole.

The estimates of the future performance of Kratos and SYS provided by management of Kratos and SYS in or underlying Imperial Capital's analyses are not necessarily indicative of future results or values, which may be significantly more or less favorable than those estimates. In performing its analyses, Imperial Capital considered industry performance, general business and economic conditions and other matters, many of which are beyond the control of Kratos and SYS. Estimates of the financial value of companies do not purport to be appraisals or necessarily reflect the prices at which companies actually may be sold.

The exchange ratio in the transaction was determined through negotiation between Kratos and SYS, and the decision by SYS's Board to enter into the merger was solely that of SYS's Board. Imperial Capital's opinion and financial analyses were only one of many factors considered by SYS's Board in its evaluation of the merger and should not be viewed as determinative of the views of SYS's Board or management with respect to the merger or the exchange ratio.

The following is a brief summary of the material financial analyses performed by Imperial Capital and reviewed with SYS's Board in connection with Imperial Capital's opinion relating to the proposed merger. The financial analyses summarized below include information presented in tabular format. In order to fully understand Imperial Capital's financial analyses, the tables must be read together with the text of each summary. The tables alone do not constitute a complete description of the financial analyses. Considering the data below without considering the full narrative description of the financial analyses, including the methodologies and assumptions underlying the analyses, could create a misleading or incomplete view of Imperial Capital's financial analyses.

### ***Contribution Analysis***

Imperial Capital reviewed and compared each party's relative financial contribution to the pro forma combined entity. For each party, Imperial Capital considered the (1) pre-deal market capitalization as of February 15, 2008, (2) pre-transaction enterprise value, (3) revenue, gross profit, and EBITDA for the latest twelve-month period ending December 31, 2007, and (4) revenue, EBITDA, and net income estimated for the 2008 calendar year. Financial data for SYS and Kratos were based on the most recent available filings with the Securities and Exchange Commission and on projections

provided by the SYS and Kratos management. This analysis indicated the following relative financial contribution of each party to the pro forma combined entity:

	<b>SYS</b>	<b>Kratos</b>
	<u>          </u>	<u>          </u>
Pro Forma Equity Ownership per Proposed Deal	23.6%	76.4%
Pre-deal Market Cap	15.3%	84.7%
Pre-Transaction Enterprise Value	12.1%	87.9%
2007 Revenue	20.9%	79.1%
2007 Gross Profit	26.8%	73.2%
2007 EBITDA	9.7%	90.3%
2008 Revenue	21.3%	78.7%
2008 EBITDA	26.2%	73.8%
2008 Net Income	34.7%	65.3%

**Premiums Paid Analysis**

Imperial Capital reviewed and compared premiums paid per share of stock in selected change of control transactions to the premium to be received by SYS on a current, historical and volume weighted average basis. The implied per share consideration was calculated by multiplying the exchange ratio of 1.2582 by the Kratos closing stock price of \$2.09 per share on February 15, 2008. The result, \$2.63, was then compared to selected stock prices and volume weighted average prices from the previous six months to determine the implied per share consideration's premium. This analysis gave the following results:

	<b>Premium</b>
	<u>          </u>
Market Price as of 2/15/08	70.7%
30-Day Prior	60.3%
60-Day Prior	27.0%
90-Day Prior	25.2%
180-Day Prior	11.9%
30-Day Volume Weighted Average Price	73.0%
60-Day Volume Weighted Average Price	59.0%
90-Day Volume Weighted Average Price	43.5%
180-Day Volume Weighted Average Price	26.5%

The results of this analysis were then compared to the Control Premium Studies conducted by FactSet Mergerstat, LLC which revealed an average control premium of 27.0% and a median control premium of 22.1% for domestic deals completed during the first three quarters of 2007.

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### *Selected Public Companies Analysis*

Imperial Capital reviewed and compared selected financial information for SYS with corresponding financial information and multiples for the following publicly traded companies relevant to SYS:

Large Caps (> \$1 billion)	Medium Caps (\$200 million - \$1 billion)	Small Caps (< \$200 million)
CACI International Inc.	ICF International, Inc.	ATS Corporation
DynCorp International Inc.	MAXIMUS, Inc.	Dynamics Research Corp.
ManTech International Corp.	MTC Technologies, Inc.	Paradigm Holdings Inc.
QinetiQ Group Plc	NCI, Inc.	SM&A
SAIC, Inc.	SI International, Inc.	TechTeam Global, Inc.
SRA International Inc.	Stanley, Inc.	VSE Corp.

For each of the selected public companies, Imperial Capital considered, among other things, (1) market capitalization (computed using closing stock prices as of February 15, 2008), (2) enterprise values, (3) enterprise values as a multiple of the latest twelve month period and estimated 2008 revenue, and (4) enterprise values as a multiple of the latest twelve month period and estimated 2008 earnings before interest, taxes, depreciation and amortization, commonly referred to as EBITDA. Financial data for the selected public companies were based on the most recent available filings with the Securities and Exchange Commission and on the Institutional Brokers' Estimate System's and First Call estimates. Financial data for SYS and Kratos were based on the most recent available filings with the Securities and Exchange Commission and on estimates provided by SYS's and Kratos' managements. This analysis indicated the following implied equity value per share ranges of SYS based on selected small cap company trading multiples applied to SYS's revenue and EBITDA:

Based on	Implied Equity Value per Share		
	Low	Mid	High
2007 Revenue	\$ 1.31	\$ 1.70	\$ 2.09
2008 Revenue	\$ 1.32	\$ 1.75	\$ 2.18
2007 EBITDA	\$ 0.44	\$ 0.49	\$ 0.54
2008 EBITDA	\$ 1.43	\$ 1.61	\$ 1.79

This analysis also indicated the following implied equity value per share ranges of Kratos based on selected medium company trading multiples applied to Kratos' pro forma revenue and EBITDA including Haverstick:

Based on	Implied Equity Value per Share		
	Low	Mid	High
2007 Pro Forma Revenue	\$ 2.04	\$ 2.41	\$ 2.77
2008 Revenue	\$ 1.86	\$ 2.25	\$ 2.64
2007 Pro Forma EBITDA	\$ 1.07	\$ 1.18	\$ 1.30
2008 EBITDA	\$ 1.00	\$ 1.13	\$ 1.25

*Selected Transactions Analysis*

Imperial Capital reviewed and compared selected financial information for SYS with corresponding financial information for the following selected transactions involving companies relevant to SYS that closed in 2007:

<b>Date Closed</b>	<b>Target</b>	<b>Buyer</b>
December 2007	Haverstick Consulting, Inc.	Kratos Defense & Security Solutions
November 2007	Number Six Software, Inc.	ATS Corp
November 2007	Dragon Development Corporation	CACI International
October 2007	PA Corp	Quintegra Solutions Ltd
August 2007	Potomac Management Group	ATS Corp
June 2007	Wexford	CACI International
June 2007	Z-Tech Corp.	ICF International Inc.
June 2007	Karta Technologies Inc.	NCI, Inc.
June 2007	Logtec, Inc.	SI International, Inc.
June 2007	NewVectors	TechTeam Government Solutions
April 2007	ITS Corp.	QinetiQ Group PLC
January 2007	VTC, LLC	Fortress America Acquisition Corp.
January 2007	Advanced Technology Systems Inc	ATS Corp

In its review of selected transactions, Imperial Capital considered the enterprise value implied in each of the selected transactions as a multiple of revenue and EBITDA for the latest 12 months as of the time of the respective transaction, to the extent such data were publicly available. Imperial Capital then compared the multiples derived from the selected transactions with the corresponding multiples implied in the merger for SYS based on the exchange ratio. Multiples for the selected transactions were based on information from Mergerstat, Mergermarket, Capital IQ and company press releases. This analysis indicated the following implied equity value per share range of SYS based on selected M&A transaction multiples applied to SYS's revenue and EBITDA:

<b>Based on</b>	<b>Implied Equity Value per Share</b>		
	<b>Low</b>	<b>Mid</b>	<b>High</b>
2007 Revenue	\$ 3.53	\$ 3.92	\$ 4.32
2007 EBITDA	\$ 0.85	\$ 0.90	\$ 0.95

This analysis indicated the following implied equity value per share range of Kratos based on selected transaction multiples applied to Kratos' pro forma revenue and EBITDA including Haverstick:

<b>Based on</b>	<b>Implied Equity Value per Share</b>		
	<b>Low</b>	<b>Mid</b>	<b>High</b>
2007 Pro Forma Revenue	\$ 2.53	\$ 2.89	\$ 3.26
2007 Pro Forma EBITDA	\$ 1.35	\$ 1.46	\$ 1.58

**Discounted Cash Flow Analysis**

Imperial Capital performed a discounted cash flow analysis of SYS using projections and financial information for the period ranging from the beginning of fiscal year 2008 through the end of fiscal year 2012 (the "projection period") provided by SYS's management. Imperial Capital calculated the implied present values of free cash flows for SYS for the projection period using discount rates ranging from 16.0% to 18.0% based on the weighted average cost of capital. Imperial Capital calculated the terminal values for SYS based on multiples of 6.5x to 7.5x. Due to SYS's projected growth in EBITDA and unlevered free cash flow through fiscal year 2012, Imperial Capital applied the multiples method to calculate the terminal value only. The estimated terminal values were then discounted to implied present values using discount rates ranging from 16.0% to 18.0% based on the weighted average cost of capital. For each combination of discount rate and terminal value multiple, Imperial Capital added the implied present value of free cash flows to the implied present value of the terminal value to arrive at implied enterprise value for SYS. For each combination of discount rate and terminal value multiple, Imperial Capital then calculated the implied equity value of SYS as the implied enterprise value less the net debt as of December 31, 2007. Implied equity value per share of SYS common stock was calculated using fully-diluted shares outstanding of SYS, as provided by management of SYS. This analysis resulted in a range of implied equity values per share of SYS common stock of approximately \$2.78 to \$3.31.

**Exchange Ratio Comparison**

Imperial Capital calculated the average equity valuation per share of SYS and Kratos based on an equal weighting of the various valuation methodologies. The following represent the ranges calculated for SYS:

<b>Method</b>	<b>Low</b>	<b>High</b>
Premiums Paid Analysis	\$ 1.95	\$ 1.97
Selected Public Companies Analysis 2007 Revenue	\$ 1.31	\$ 2.09
Selected Public Companies Analysis 2007 EBITDA	\$ 0.44	\$ 0.54
Selected Public Companies Analysis 2008 Revenue	\$ 1.32	\$ 2.18
Selected Public Companies Analysis 2008 EBITDA	\$ 1.43	\$ 1.79
Selected Transaction Analysis 2007 Revenue	\$ 3.53	\$ 4.32
Selected Transaction Analysis 2007 EBITDA	\$ 0.85	\$ 0.95
Discounted Cash Flow Analysis	\$ 2.78	\$ 3.31
Average	\$ 1.70	\$ 2.14

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And the ranges calculated for Kratos:

Method	Low	High
Premiums Paid Analysis	\$ 2.64	\$ 2.67
Selected Public Companies Analysis 2007 Pro Forma Revenue	\$ 2.04	\$ 2.77
Selected Public Companies Analysis 2007 Pro Forma EBITDA	\$ 1.07	\$ 1.30
Selected Public Companies Analysis 2008 Revenue	\$ 1.86	\$ 2.64
Selected Public Companies Analysis 2008 EBITDA	\$ 1.00	\$ 1.25
Selected Transaction Analysis 2007 Pro Forma Revenue	\$ 2.53	\$ 3.26
Selected Transaction Analysis 2007 Pro Forma EBITDA	\$ 1.35	\$ 1.58
Average	\$ 1.78	\$ 2.21

Imperial Capital reviewed and compared the exchange ratio in the transaction with exchange ratios calculated using the high and low ranges for SYS and Kratos with the following results:

	Exchange Ratio
Exchange Ratio in the Transaction	1.2582
SYS Low / Kratos Low	\$1.70 / \$1.78 0.9524
SYS High / Kratos Low	\$2.14 / \$1.78 1.2011
SYS Low / Kratos High	\$1.70 / \$2.21 0.7689
SYS High / Kratos High	\$2.14 / \$2.21 0.9697

Under the terms of the agreement with Imperial Capital, SYS agreed to pay Imperial Capital a transaction fee of \$750,000 in connection with the sale of SYS and an opinion fee of \$150,000 due upon the delivery of a fairness opinion regardless of the conclusions reached therein. In addition, SYS agreed to pay all fees, disbursements and out-of-pocket expenses incurred by Imperial Capital in connection with its services in connection with the merger and to indemnify Imperial Capital and related parties against any liabilities arising out of or in connection with advice or services rendered or to be rendered pursuant to the engagement letter agreement.

SYS selected Imperial Capital as its financial advisor based on its experience with merger transactions and familiarity with the company. Imperial Capital is a full-service investment banking firm offering a wide range of advisory, finance and trading services. USBX and certain former USBX professionals, now employed by Imperial Capital, provided financial advisory and investment banking services for SYS in the past, including advising SYS on its acquisition of Ai Metrix, Inc. in October 2006 and its acquisition of Reality Based Information Technology Services, Ltd. in April 2006. In the ordinary course of its business, Imperial Capital may actively trade the debt and equity securities of SYS and Kratos for its own account and for the accounts of customers and, accordingly, may at any time hold a long or short position in such securities.

### Composition of Kratos Board of Directors

The size and composition of the Kratos board of directors will not be affected by this transaction.

### Interests of SYS Directors and Executive Officers in the Merger

In considering SYS's unanimous determination that the merger is fair and advisable and recommendation that SYS's stockholders vote "FOR" approval of the merger agreement, you should be

aware that members of SYS's board of directors and members of SYS's management team have agreements or arrangements that provide them with interests in the merger that differ from and are in addition to those of other SYS shareholders. The SYS board of directors was aware of these agreements and arrangements during its deliberations of the merits of the merger and in determining to recommend to you that you vote "FOR" approval of the merger agreement.

#### **Employment Agreement**

Kratos has required as a condition to the merger that Clifton L. Cooke, Jr., SYS's president and chief executive officer and a director, agree to enter into a Kratos employment agreement providing for his continued employment with Kratos immediately prior to the merger which employment agreement will be effective immediately after the merger.

#### **Voting Agreements**

SYS's president and chief executive officer and its chief financial officer, who in the aggregate beneficially own approximately 9.1% of SYS's common stock as of April 7, 2008, have agreed with Kratos to vote their SYS shares in favor of the approval of the merger agreement. See "Voting Agreements" on page 89 of this document.

#### *Treatment of SYS Options and Other Equity-Based Awards*

SYS has granted stock options to its employees, officers and directors under SYS's 1997 Incentive Stock Option and Restricted Stock Plan and the SYS 2003 Stock Option Plan. As of April 7, 2008, there are 2,117,100 options issued and outstanding under these plans. Of that amount 685,500 options are held by officers and directors.

All outstanding SYS stock options will become fully vested prior to the closing and may be exercised for SYS shares ("cashless exercise" being permissible) at or prior to closing in accordance with the terms of the stock option plans, which shares would then be exchanged for Kratos shares in accordance with the exchange ratio. Any such stock option exercises may be subject to withholding taxes as a result. No SYS stock options will be assumed by or converted into options of Kratos.

During 2003, the SYS board of directors approved the SYS 2003 Employee Stock Purchase Plan. The purpose of the SYS 2003 Employee Stock Purchase Plan is to provide employees of SYS and its designated subsidiaries with an opportunity to purchase SYS common stock. The 2003 Employee Stock Purchase Plan provides for enrollment on the first day of a six-month period in which the employees can elect payroll deductions for the purchase of SYS common stock. The 2003 Employee Stock Purchase Plan allows employees to designate a portion of their base compensation to be used to purchase SYS common stock at a purchase price per share at 85% of the lower of the fair market value on the first or last day of each offering period. Each offering period lasts six months.

Effective February 20, 2008, the date of executing the merger agreement, SYS terminated the then current six month stock purchase period for its Employee Stock Purchase Plan, and this Plan is not being assumed by Kratos. SYS employees who were enrolled in the Plan from the period January 1, 2008 through February 20, 2008 were eligible to purchase shares during this stub period consistent with the provisions of the Plan.

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The following table sets forth as of April 7, 2008, the unvested SYS stock options held by SYS directors and executive officers which will vest upon the effective time of the merger:

Name	Unvested SYS Stock Options
Clifton L. Cooke, Jr.	0
Edward M. Lake	61,100
Michael W. Fink	12,500
Thomas A. Page	7,200
Alfred M. Gray	7,200
John R. Hicks	6,300
Gail K. Naughton	6,300
Philip P. Trahanas	4,500
Charles E. Vanderveer	4,500

### Subordinated Convertible Notes

SYS has \$3,125,000 of convertible notes payable outstanding, which we refer to as the Notes. The Notes are unsecured and subordinate to its bank debt, bear interest at 10% per annum payable quarterly, are due February 14, 2009 and are convertible at any time into shares of common stock at a conversion rate of \$3.60 per share. The Notes are being assumed by Kratos subject to their existing terms and conditions.

Following the merger, the Notes will not be convertible into SYS common stock. Instead, they will be convertible into the merger consideration as if they had been converted into SYS stock immediately prior to the merger.

Certain officers and directors of SYS hold \$975,000 of these notes.

### Warrants

The following SYS warrants are outstanding:

Exercisable into 313,401 shares of common stock at \$2.50 per share that were issued in June 2005 in conjunction with the sale of common stock and expire in June 2010

Exercisable into 50,000 shares of common stock at \$3.85 per share that were issued in September 2005 in conjunction with the acquisition of technology from Lomasoft and expire in September 2010.

Exercisable into 110,000 shares of common stock at \$4.00 per share that were issued in October 2005 to the investment bankers that assisted with a private offering of SYS's common stock and expire October 2010.

Exercisable into 20,000 shares of common stock at \$2.44 per share that were issued in April 2006 related to the acquisition of Logic Innovations and expire in April 2011

Exercisable into 15,000 shares of common stock at \$2.25 per share that were issued on September 18, 2007 related to consulting services and expire on September 18, 2012

Holder of the foregoing warrants will, following the merger, be entitled to receive upon exercise of such warrants, the number of shares of Kratos common stock that they would have received pursuant to the merger had they exercised such warrants immediately prior to the merger.



### **Directors and Officers of SYS after the Merger**

The directors of Merger Sub will be the initial directors of SYS as the surviving corporation of the merger, and will serve until their successors have been duly elected or appointed and qualified, or until their earlier death, resignation or removal. The officers of Merger Sub will be the initial officers of SYS as the surviving corporation of the merger, subject to the authority of the board of directors of the surviving corporation, as provided by California law and the bylaws of the surviving corporation.

### **Indemnification and Insurance**

The merger agreement provides that for six years after the effective time of the merger and to the fullest extent permitted by law, Kratos will cause the surviving corporation to honor all rights to indemnification for acts or omissions prior to the effective time of the merger existing in favor of SYS directors or officers as provided in SYS's organizational documents and its indemnification agreements with such individuals. The merger agreement also provides that, prior to the effective time of the merger, SYS will purchase six-year "tail" officers' and directors' liability insurance policies on terms and conditions no less favorable than SYS's existing directors' and officers' liability insurance. If SYS cannot purchase these "tail" policies for 200% or less of the annual premium paid by SYS for its existing insurance, SYS will purchase as much insurance coverage as can be obtained within the 200% cap. Kratos and the surviving corporation are obligated to maintain such tail policies in full force and effect and continue to honor their respective obligations thereunder for the full term thereof.

### **Potential Change of Control or Severance Payments**

From and after the effective time of the merger, each of SYS's executive officers listed in the chart below may become eligible to receive Change of Control or severance payments for a period ranging from twelve months to twenty-four months, based on the terms of their existing employment agreements, which we refer to as the Agreements and their base salary, if terminated for any of the following reasons:

Their position or duties are modified in a way which materially reduces their responsibilities or the level of management to which they report;

A reduction in level of compensation as of the date of a change of control (including base salary and fringe benefits);

A relocation of their place of employment by more than 50 miles, provided and only if such change, reduction, or relocation is effected without the employee's express consent.

Notwithstanding the foregoing and pursuant to the Agreements, if any amounts due to any such officer pursuant to their agreement are determined to be "Parachute Payments" as such term is defined in Section 280G of the Internal Revenue Code of 1986, as amended, which we refer to as the Code, and the regulations promulgated thereunder, then the total compensation paid to such officer together with any other payment or the value of any benefit received or to be received by them which is treated as a Parachute Payment will not exceed 2.99 times such officer's Base Amount (as such term is defined in Section 280G of the Code). In the event a reduction of a change of control or severance payment is required such officer may select the compensation which will be reduced in order to fall within the 2.99 times Base Amount limitation.

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From and after the effective time of the merger, each of SYS's executive officers listed below may become eligible to receive severance payments subject to the parachute payment provision in their agreements as follows:

Name	Title	Approximate Amount of Potential Change of Control or Severance Payment
Edward M. Lake	Chief Financial Officer	\$ 138,250
Michael W. Fink	Secretary and Sr. Vice President	\$ 262,500

In addition, to these executive officers certain other SYS employees have employment agreements with similar terms and conditions.

As of April 7, 2008 directors and executive officers of SYS beneficially owned 4,870,433 shares of SYS common stock, which represented approximately 23.7% of the shares of SYS common stock then issued and outstanding. SYS's president and chief executive officer, and chief financial officer, who in the aggregate beneficially own approximately 9.1% of SYS common stock as of April 7, 2008, have agreed with Kratos to vote their shares of SYS's common stock to approve the merger agreement. For more information see "SYS Voting Agreement" at *Annex C*.

### Certain Arrangements between SYS and its Executive Officers, Directors and Affiliates

On December 6, 2007, the SYS Board approved an Incentive Compensation Plan as proposed by the Compensation and Nominating Committee. The Incentive Compensation Plan was established in the amount of \$1.65 million to be allocated to certain named executive officers and members of management in the event of the acquisition of SYS within certain financial parameters and subject to further specificity as to the allocation of the Incentive Compensation Plan Amount. On February 19, 2008, the SYS Board reviewed a preliminary proposed allocation of the Incentive Compensation Plan and authorized Clifton L. Cooke to make a final allocation recommendation to the Compensation and Nominating Committee and the SYS Board after taking into consideration any other retention or bonus arrangements being considered by Kratos and SYS.

On March 20, 2008, the Compensation and Nominating Committee met and approved a final allocation. Listed in the table below are the amounts approved for distribution upon closing of the merger for the SYS named executive officers which in total amounts to \$1.325 million of the \$1.65 million approved:

Name	Title	Amount of Incentive Compensation
Clifton L. Cooke	President and Chief Executive Officer	\$ 700,000
Edward M. Lake	Chief Financial Officer	\$ 500,000
Michael W. Fink	Secretary and Sr. Vice President	\$ 125,000

The remaining \$0.325 million has been allocated to four other members of the management team.

It should be further emphasized that the Incentive Compensation Plan has no impact on the consideration to be received by the SYS shareholders as there are no requirements pursuant to the merger agreement to deliver a specified amount of working capital on the closing balance sheet. The fixed exchange ratio was based on a fixed enterprise value of SYS less the subordinated convertible debt that is being assumed by Kratos.

### **Accounting Treatment**

The merger will be accounted for as an acquisition of SYS by Kratos under the purchase method of accounting in accordance with U.S. generally accepted accounting principles. Under the purchase method of accounting, the assets and liabilities of the acquired company are, as of completion of the merger, recorded at their respective fair values and added to those of the acquiror, including an amount for goodwill representing the difference between the purchase price and the fair value of the identifiable net assets. Financial statements of Kratos issued after the merger will reflect only the operations of SYS after the merger and will not be restated retroactively to reflect the historical financial position or results of operations of SYS.

All unaudited pro forma condensed combined financial statements contained in this Proxy Statement were prepared using the purchase method of accounting. The final allocation of the purchase price will be determined after the merger is completed and after completion of an analysis to determine the fair value of SYS's assets and liabilities. Accordingly, the final purchase accounting adjustments may be materially different from the unaudited pro forma adjustments. Any decrease in the fair value of the assets or increase in the fair value of the liabilities of SYS as compared to the unaudited pro forma information included in this Proxy Statement will have the effect of increasing the amount of the purchase price allocable to goodwill.

### **Restrictions on Sales of Shares of Kratos Common Stock Received in the Merger**

Kratos shares of common stock issued in the merger will not be subject to any restrictions on transfer arising under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except for Kratos shares issued to any SYS shareholder who may be deemed to be an "affiliate" of Kratos after completion of the merger. Former SYS shareholders who were affiliates of SYS at the time of the SYS special meeting and who are not affiliates of Kratos after the completion of the merger may sell their Kratos shares at any time. Former SYS shareholders who are or become affiliates of Kratos after completion of the merger will remain or be subject to the volume and sale limitations of Rule 144 under the Securities Act until they are no longer affiliates of Kratos. This Proxy Statement does not cover resales of Kratos common stock received by any person upon completion of the merger, and no person is authorized to make any use of this Proxy Statement in connection with any resale.

### **Dissenters' Rights and Appraisal Rights**

#### ***Kratos Stockholders***

Pursuant to Section 262 of the Delaware General Corporation Law, Kratos stockholders are not entitled to exercise dissenters' rights or appraisal rights or to demand payment for their shares of Kratos common stock under applicable law as a result of the merger.

#### ***SYS Shareholders***

The following summarizes Chapter 13 of the California General Corporation Law, which sets forth the procedures for SYS shareholders to dissent from the merger and to demand statutory dissenters' rights under the California General Corporation Law. This summary does not purport to be a complete statement of the provisions of California law relating to the rights of dissenting SYS shareholders and is qualified in its entirety by reference to Sections 1300 through 1313 of the California General Corporation Law, the full text of which is attached as *Annex F* to this Proxy Statement. Failure to follow the following procedures exactly could result in the loss of dissenters' rights.

If SYS shareholders approve the terms of the merger by a majority of the outstanding shares entitled to vote thereon and the merger agreement is not abandoned or terminated, SYS shareholders



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A vote against the merger does not in and of itself constitute a demand for appraisal under the California General Corporation Law.

No later than the date of SYS's special meeting, a Dissenting Shareholder must demand that SYS repurchase such shareholder's Dissenting Shares in a statement setting forth the number and class of Dissenting Shares held of record by such Dissenting Shareholder, that the Dissenting Shareholder demands that SYS repurchase such Dissenting Shares, and a statement of what the Dissenting Shareholder claims to be the fair market value of the Dissenting Shares as of the day before the announcement of the proposed merger. The statement of fair market value in such demand by the Dissenting Shareholder constitutes an offer by the Dissenting Shareholder to sell the Dissenting Shares at such price. An SYS shareholder who elects to exercise dissenters' rights pursuant to Chapter 13 should mail or deliver the written demand to:

SYS  
5050 Murphy Canyon Road, Suite 200  
San Diego, CA 92123  
Attention: Michael W. Fink, Corporate Secretary

If the shares are owned of record by a person in a fiduciary capacity, such as a trustee, guardian or custodian, the demand should be executed in that capacity. If the shares are owned of record by more than one person, as in a joint tenancy or tenancy in common, the demand should be executed by or on behalf of all owners. An authorized agent, including an agent for two or more joint owners, may execute a demand that SYS repurchase such shares on behalf of an SYS shareholder; however, the agent must identify the record owner or owners and expressly disclose the fact that, in executing the demand, the agent is acting as an agent for such owner or owners. A record holder, such as a broker who holds shares as nominee for several beneficial owners, may exercise dissenters' rights with respect to the shares held for one or more beneficial owners while not exercising these rights with respect to the shares held for one or more other beneficial owners. In this case, the written demand should set forth the number of shares as to which appraisal is sought, and, where no number of shares is expressly mentioned, the demand will be presumed to cover all shares held in the name of the record owner.

### ***Submission of Certificates for Endorsement***

Next, the Dissenting Shareholder must affirmatively vote his, her or its shares against the approval of the terms of the merger at SYS's special meeting. If a Dissenting Shareholder fails to vote at all, abstains from voting on the proposal regarding the terms of the merger or votes "FOR" that proposal at SYS's special meeting, he, she or it will lose the right to payments as a Dissenting Shareholder and such shareholder will be paid the merger consideration described in the merger agreement.

After SYS's special meeting, if SYS shareholders have approved the terms of the merger and, in the case of freely transferable shares, at least 5% of the SYS shareholders have properly delivered demands for payment to SYS and voted against the approval of the terms of the merger, SYS is required, within ten days, to mail to each appropriately Dissenting Shareholder notice of approval of the terms of the merger, a statement of the price determined by SYS to represent the fair market value of Dissenting Shares (which will constitute an offer by SYS to purchase such Dissenting Shares at such stated price), and a description of the procedures such holders should follow in order to exercise their rights as Dissenting Shareholders.

Within 30 days after the notice of approval of the terms of the merger is mailed to shareholders, the shareholder must also submit to SYS, for endorsement as Dissenting Shares, the stock certificates representing the SYS shares as to which the Dissenting Shareholder is exercising dissenters' rights.

*Payment for Dissenting Shares*

If upon the Dissenting Shareholder's surrender of the certificates representing the Dissenting Shares, SYS and a Dissenting Shareholder agree upon the price to be paid for the Dissenting Shares and agree that such shares are Dissenting Shares, then the agreed price is required by law to be paid to the Dissenting Shareholder with interest thereon at the legal rate on judgments from the date of the agreement within the later of 30 days after the date of such agreement or 30 days after any statutory or contractual conditions to the consummation of the merger are satisfied or waived.

If SYS denies that shares are Dissenting Shares or the SYS shareholder fails to agree with SYS as to the fair market value of the shares, then, within the time period provided by Section 1304(a) of the California General Corporation Law, any SYS shareholder who has made a valid written demand and has not voted in favor of approval of the terms and conditions of the merger may file a complaint in the Superior Court in the proper California county requesting a determination as to whether the shares are Dissenting Shares or as to the fair market value of the holder's shares, or both, or may intervene in any pending action brought by any other SYS shareholder.

On the trial of the action, the court determines the issues. If the status of the shares as Dissenting Shares is in issue, the court first resolves that issue. If the fair market value of the Dissenting Shares is in issue, the court determines, or appoints one or more impartial appraisers to determine, the fair market value of the shares.

If the court appoints an appraiser or appraisers, they proceed to determine the fair market value per share. Within the time fixed by the court, the appraisers, or a majority of the appraisers, make and file a report in the office of the clerk of the court. Thereafter, on the motion of any party, the report is submitted to the court and considered on such evidence as the court considers relevant. If the court finds the report reasonable, the court may confirm it.

If the single appraiser or a majority of the appraisers fails to make and file a report within 10 days after the date of their appointment or within such further time as the court allows, or if the court does not confirm the report, the court determines the fair market value of the Dissenting Shares. Subject to Section 1306 of the California General Corporation Law, judgment is rendered against the corporation for payment of an amount equal to the fair market value of each Dissenting Share multiplied by the number of Dissenting Shares that any dissenting shareholder who is a party, or who has intervened, is entitled to require the corporation to purchase, with interest at the legal rate from the date on which the judgment is entered.

The costs of the action, including reasonable compensation to the appraisers to be fixed by the court, is assessed or apportioned as the court considers equitable. However, if the price determined by the court is more than 125% of the price offered by the corporation, the corporation pays the costs (including, in the discretion of the court, attorneys' fees, fees of expert witnesses and interest at the legal rate on judgments from the date the shareholder made the demand and submitted shares for endorsement).

Except as expressly limited by Chapter 13 of the California General Corporation Law, holders of Dissenting Shares continue to have all the rights and privileges incident to their shares until the fair market value of their shares is agreed upon or determined.

For federal income tax purposes, SYS shareholders who receive cash for their shares of SYS common stock after exercising dissenters' rights will recognize taxable gain or loss.

If an SYS shareholder fails to perfect his, her or its dissenters' rights or effectively withdraws or loses such rights, such holder's SYS common stock will thereupon be deemed to have been canceled and converted as set forth in the merger agreement.

**Failure to follow the steps required by Chapter 13 of the California General Corporation Law for perfecting dissenters' rights may result in the loss of dissenters' rights, in which event you will be entitled to receive the consideration with respect to your Dissenting Shares in accordance with the merger agreement. In view of the complexity of the provisions of Chapter 13 of the California General Corporation Law, if you are an SYS shareholder and are considering exercising your dissenters' rights under the California General Corporation Law, you should consult your own legal advisor.**

**Listing of Kratos Common Stock on The Nasdaq Global Select Stock Market**

Kratos has agreed that, prior to the completion of the merger, it will cause the shares of Kratos common stock to be issued in the merger to be approved for listing on The Nasdaq Global Select Stock Market. Such approval is a condition to the completion of the merger.

**MATERIAL UNITED STATES FEDERAL INCOME TAX CONSEQUENCES**

**General.**

The following general discussion summarizes the material United States federal income tax consequences of the merger to Kratos, Merger Sub, SYS and to holders of common stock of SYS who are "United States persons," as defined for United States federal income tax purposes and who hold their SYS common stock as a capital asset within the meaning of Section 1221 of the Code. For United States federal income tax purposes, a "United States person" is:

a United States citizen or resident of the United States;

a corporation, partnership or other entity created or organized in the United States or under the laws of the United States, or any state within the United States;

an estate whose income is includible in gross income for United States federal income tax purposes regardless of its source;  
or

a trust, whose administration is subject to the primary supervision of a United States court and that has one or more U.S. persons who have the authority to control all substantial decisions of the trust.

The term "non-United States person" means a person or holder other than a "United States person."

This section does not discuss all of the United States federal income tax considerations that may be relevant to a particular shareholder in light of his or her individual circumstances or to shareholders subject to special treatment under the federal income tax laws, including, without limitation:

brokers or dealers in securities or foreign currencies;

shareholders who are subject to the alternative minimum tax provisions of the Code;

tax-exempt organizations;

shareholders who are "non-United States persons;"

expatriates;

shareholders that have a functional currency other than the United States dollar;

banks, mutual funds, financial institutions or insurance companies;

shareholders who acquired SYS common stock in connection with stock option or stock purchase plans or in other compensatory transactions;

shareholders who hold SYS common stock as part of an integrated investment, including a straddle, hedge, or other risk reduction strategy, or as part of a conversion transaction or constructive sale;



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shareholders who acquired their shares through SYS's 401(k) plan, deferred compensation plan or other retirement plan; or

shareholders whose SYS common stock is "qualified small-business stock" for purposes of Section 1202 of the Code.

No ruling has been or will be sought from the Internal Revenue Service as to the United States federal income tax consequences of the merger, and the following summary is not binding on the Internal Revenue Service or the courts. This discussion is based upon the Code, regulations, judicial authority, rulings and decisions in effect as of the date of this Proxy Statement, all of which are subject to change, possibly with retroactive effect. This summary does not address the tax consequences of the

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merger under state, local and foreign laws or under United States federal tax law other than income tax law.

**SYS shareholders are strongly urged to consult their tax advisors as to the specific tax consequences to them of the merger, including any applicable federal, state, local and foreign tax consequences.**

It is a condition to the obligation of Kratos to consummate the merger that Kratos receive an opinion from its counsel, DLA Piper US LLP, and it is a condition to the obligation of SYS to consummate the merger that SYS receive an opinion from its counsel, Luce, Forward, Hamilton & Scripps LLP, in each case, to the effect that, based upon certain facts, representations and assumptions, the merger will constitute a "reorganization" within the meaning of Section 368(a) of the Code and such opinions shall not have been withdrawn; provided, however, that if the counsel to either Kratos or SYS does not render such opinion, this condition shall be deemed to be satisfied if counsel to the other party renders the opinion to both parties that the merger will constitute a tax-free reorganization within the meaning of Section 368(a) of the Code. The issuance of the opinions is conditioned on, among other things, the receipt by DLA Piper US LLP and Luce, Forward, Hamilton & Scripps LLP, of representation letters from each of Kratos, Merger Sub and SYS, in each case, in form and substance reasonably satisfactory to DLA Piper US LLP and Luce, Forward, Hamilton & Scripps LLP. An opinion of counsel represents that counsel's best legal judgment and is not binding on the Internal Revenue Service or any court.

The following summary assumes that the merger will be completed as described in the merger agreement and this Proxy Statement and that the merger will constitute a "reorganization" within the meaning of Section 368(a) of the Code.

SYS shareholders will not recognize any gain or loss upon the receipt of Kratos common stock in exchange for SYS common stock in connection with the merger, except to the extent of cash received in lieu of a fractional share of Kratos common stock, as discussed below;

cash payments received by an SYS shareholder for a fractional share of Kratos common stock will be treated as if such fractional share had been issued in connection with the merger and then redeemed by Kratos for cash. SYS shareholders will recognize capital gain or loss with respect to such cash payment, measured by the difference, if any, between the amount of cash received and the tax basis in such fractional share;

the aggregate tax basis of the Kratos common stock received by an SYS shareholder in connection with the merger will be the same as the aggregate tax basis of the SYS common stock surrendered in exchange for Kratos common stock, reduced by any amount allocable to a fractional share of Kratos common stock for which cash is received;

the holding period of the Kratos common stock received by an SYS shareholder in connection with the merger will include the holding period of the SYS common stock surrendered in connection with the merger; and

Kratos, Merger Sub and SYS will not recognize gain or loss as a result of the merger.

### **Backup Withholding.**

If you are a non-corporate holder of SYS common stock you may be subject to information reporting and a 28% backup withholding on any cash payments received in lieu of a fractional share interest in Kratos common stock. You will not be subject to backup withholding, however, if you:

furnish a correct taxpayer identification number and certify that you are not subject to backup withholding on the substitute Form W-9 or successor form included in the letter of transmittal to be

delivered to you following the completion of the merger (or the appropriate Form W-8, as applicable); or

are otherwise exempt from backup withholding.

Any amounts withheld under the backup withholding rules will be allowed as a refund or credit against your United States federal income tax liability, provided you furnish the required information to the Internal Revenue Service.

**Tax Return Reporting Requirements.**

If you receive Kratos common stock as a result of the merger, you will be required to retain records pertaining to the merger, and you will be required to file with your United States federal income tax return for the year in which the merger takes place a statement setting forth certain facts relating to the merger as provided in Treasury Regulations Section 1.368-3.

**The preceding discussion does not purport to be a complete analysis or discussion of all potential tax effects relevant to the merger. SYS shareholders are urged to consult their own tax advisers as to the specific consequences of the merger to them, including tax return reporting requirements, the applicability and effect of federal, state, local, foreign and other tax laws and the effects of any proposed changes in the tax laws.**

## THE MERGER AGREEMENT

*The following discussion summarizes material provisions of the Agreement and Plan of Merger and Reorganization, which we refer to as the merger agreement, a copy of which is attached as Annex A to this Proxy Statement and is incorporated by reference herein. The rights and obligations of the parties are governed by the express terms and conditions of the merger agreement and not by this summary. This summary is not complete and is qualified in its entirety by reference to the complete text of the merger agreement. We urge you to read the merger agreement carefully in its entirety, as well as this Proxy Statement, before making any decisions regarding the merger.*

*The representations and warranties described below and included in the merger agreement were made by Kratos and SYS to each other as of specific dates. The assertions embodied in those representations and warranties were made solely for purposes of the merger agreement and may be subject to important qualifications and limitations agreed to by Kratos and SYS in connection with negotiating its terms, including, but not limited to, the qualifications and limitations listed in the disclosure schedules to the merger agreement. Moreover, the representations and warranties may be subject to a contractual standard of materiality that may be different from what may be viewed as material to stockholders, or may have been used for the purpose of allocating risk between Kratos and SYS rather than establishing matters as facts. The merger agreement is described in this Proxy Statement and included as Annex A only to provide you with information regarding its terms and conditions, and not to provide any other factual information regarding Kratos, SYS or their respective businesses. Accordingly, you should not rely on the representations and warranties in the merger agreement as characterizations of the actual state of facts about Kratos or SYS, and you should read the information provided elsewhere in this Proxy Statement, and in the documents which are incorporated by reference as exhibits to the registration statement of which this Proxy Statement is a part, for information regarding Kratos and SYS and their respective businesses. See "Where You Can Find More Information" beginning on page 215 of this Proxy Statement.*

### **The Merger**

Subject to the terms and conditions of the merger agreement and in accordance with Delaware law, Merger Sub will merge with and into SYS, and SYS will survive the merger as a wholly owned subsidiary of Kratos.

### **Closing and Effective Time of the Merger**

The merger will become effective upon the filing of a certificate of merger with the Secretary of State of the State of California or at such later time as may be agreed upon by SYS and Kratos and as specified in the certificate of merger. The filing of the certificate of merger will occur no later than three business days after the conditions to completion of the merger have been satisfied or waived.

### **Directors and Executive Management Following the Merger**

Kratos President and CEO Eric DeMarco will serve as President and CEO of the combined company.

The board of directors of Kratos will remain unchanged following the merger.

### **Company Locations Following the Merger**

Kratos' corporate headquarters will remain in San Diego, California, and Kratos will maintain a significant presence in Washington, D.C.; Marietta, Georgia; Newport, Delaware; Houston, Texas; Huntsville, Alabama; Alexandria, Virginia; Indianapolis, Indiana and various other locations in the United States. For further information please see "Properties" beginning on page 94.

## Consideration to be Received in the Merger

### *SYS Common Stock*

*SYS Common Stock.* At the effective time of the merger, each outstanding share of SYS common stock will be converted into the right to receive 1.2582 shares of Kratos common stock, together with any cash paid in respect of fractional shares.

*Fractional Shares.* Holders of SYS common stock will not receive any fractional Kratos shares in the merger. Instead, the total number of Kratos shares that each holder of SYS common stock will receive in the merger will be rounded down to the nearest whole number, and Kratos will pay cash for any resulting fractional share that an SYS shareholder otherwise would be entitled to receive. The amount of cash payable for a fractional share of Kratos common stock will be determined by multiplying the fraction by the average closing price for Kratos common stock on The Nasdaq Global Select Stock Market for the three days before the date the merger becomes effective.

*Example:* If you currently own 25 shares of SYS common stock, absent the treatment of the fractional shares described above, you would be entitled to receive  $(25 \times 1.2582)$  or 31.455 shares of Kratos common stock. Since fractional shares will not be issued, you will be entitled to 31 shares of Kratos common stock and a check for the market value of 0.455 shares of Kratos common stock based on its average closing price during the three days prior to the date the merger becomes effective.

### *Treatment of SYS Options*

At the effective time of the merger, each option to purchase shares of SYS common stock that is outstanding and unexercised immediately prior to the date the merger becomes effective will cease to represent a right to acquire SYS common stock and will be cancelled.

### *Adjustments to the Exchange Ratio*

The exchange ratio will be appropriately adjusted to reflect fully the effect of any stock split, reverse stock split, stock dividend, reorganization, recapitalization, reclassification or other like change with respect to Kratos common stock or SYS common stock prior to the effective time of the merger.

### *Procedures for Exchange of Certificates*

Kratos will appoint an exchange agent for the purpose of exchanging certificates and uncertificated shares of SYS common stock. As soon as reasonably practicable after the effective time of the merger, but in any event, within five business days thereof, the exchange agent will mail transmittal materials to each holder of record of SYS shares of common stock, advising such holders of the procedure for surrendering their share certificates and/or uncertificated shares to the exchange agent.

Each holder of a share of SYS common stock that has been converted into a right to receive the applicable merger consideration (including cash for fractional shares) will receive the applicable merger consideration upon surrender to the exchange agent of the applicable SYS common stock certificate or uncertificated shares, together with a letter of transmittal covering such shares and such other documents as the exchange agent may reasonably require.

After the effective time, each certificate that previously represented shares of SYS common stock will represent only the right to receive the applicable merger consideration as described above under "Consideration to be Received in the Merger," including cash for any fractional shares of Kratos common stock. In addition, SYS will not register any transfers of the shares of SYS common stock after the effective time of the merger.

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Holders of SYS common stock should not send in their SYS stock certificates until they receive and complete and submit a signed letter of transmittal sent by the exchange agent with instructions for the surrender of SYS stock certificates.

SYS and Kratos are not liable to holders of shares of SYS common stock for any amount delivered to a public official under applicable abandoned property, escheat or similar laws.

Kratos stockholders need not exchange their stock certificates.

### **Representations and Warranties**

The merger agreement contains a number of representations and warranties made by Kratos and SYS to each other. The representations and warranties are subject in some cases to specified exceptions and qualifications. The parties' reciprocal representations and warranties relate to, among other things:

organization, capital structure, corporate power and authority and execution and delivery of the merger agreement;

consents and approvals of third parties, and permissions and authorizations of governmental entities, required in connection with the merger agreement and the merger;

subsidiaries;

the approval of the merger agreement and the merger by the parties' respective boards of directors;

the stockholder votes required to approve the merger;

documents filed with the SEC and the accuracy of information contained in those documents;

financial statements and internal controls;

compliance with applicable legal requirements;

properties and assets;

intellectual property;

filing of tax returns, payment of taxes and other tax matters;

employee benefit plans and the Employee Retirement Income Security Act of 1974;

environmental matters;

insurance matters;

legal proceedings;

labor and employment matters;

absence of undisclosed liabilities;

interests of officers and directors;

compliance with export controls laws;

compliance with international trade laws;

brokers used in connection with the merger;

the absence of any material adverse effect or certain other changes or events since December 28, 2007; and

the receipt of fairness opinions from the parties' financial advisors.

In addition to the foregoing, the merger agreement contains representations and warranties made by SYS to Kratos regarding:

SYS's products and product warranties;

certain material contracts;

the absence of any stockholders rights plan; and

brokers used in connection with the merger.

### **Conduct of Business Pending the Merger**

Under the merger agreement, each of SYS, Kratos and each of their respective subsidiaries are required to carry on their respective businesses in the ordinary course consistent with past practice, pay their debts and taxes when due and use commercially reasonable efforts, consistent with past practices, to maintain and preserve their business organization, assets and properties, keep available the services of their present officers and employees and preserve their advantageous business relationships with customers, strategic partners, suppliers, distributors and others having business dealings with them.

In addition, each of SYS and Kratos and each of their respective subsidiaries may not, among other things and subject to certain exceptions, without the consent of the other party:

amend its charter or bylaws except as provided for in the merger agreement (a) with respect to Kratos, except as required by the SEC or The Nasdaq Global Select Stock Market or as would not have a material adverse effect upon Kratos and would not materially restrict the operations of Kratos, and (b) with respect to SYS, except as required by the SEC or American Stock Exchange.

merge with or acquire any business or material assets;

make any changes in accounting methods, principles or practices, except as required by a change in generally accepted accounting principles or legal requirements; or

make or rescind any material tax election, settle any proceeding related to taxes, enter into tax agreements with a governmental entity, or except as required by law, change any of its methods of reporting income or deductions for federal income tax purposes.

In addition, SYS each of its subsidiaries may not, among other things and subject to certain exceptions, without the consent of Kratos:

declare or pay any dividends on or make other distributions in respect of its capital stock;

split, combine or reclassify any of its capital stock;

issue or sell any shares of its capital stock or other voting securities, or any securities convertible into or exercisable or exchangeable for, or any rights, warrants or options to acquire, any such shares or voting securities, or enter into any agreement with respect to any of the foregoing, other than (a) with respect to SYS, the issuance of common stock required to



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be issued upon the exercise or settlement of SYS options, restricted stock units or other equity-based awards outstanding on the date of the merger agreement in accordance with the terms of the applicable award;

purchase or redeem any shares of capital stock or any other of its securities;

sell or lease any of its properties or assets, other than as part of sales of products, inventory and other properties and assets in the ordinary course of business consistent with past practice;

adopt or implement any stockholder rights plan;

except for certain permitted confidentiality agreements, enter into any agreement with respect to any merger, consolidation or disposition of all or substantially all of the assets of SYS and its subsidiaries;

incur any indebtedness for borrowed money, issue any guarantees, issue or amend any debt securities, make any loans or, other than in the ordinary course of business consistent with past practice, enter into any hedging arrangements;

make any capital expenditures in an amount in excess of \$250,000 in the aggregate other than in the ordinary course of business consistent with past practices;

change any assumption underlying or method of calculating any bad debt, contingency or other reserve, except as required by a change in generally accepted accounting principles or legal requirements;

pay or settle any claims or obligations in excess of \$250,000 in the aggregate except in the ordinary course of business consistent with past practice or, except as otherwise permitted by the merger agreement, waive or release any material benefit under or fail to enforce any confidentiality, standstill or similar agreements;

amend or terminate any material contract other than in the ordinary course of business consistent with past practice;

enter into any material contract or agreement or license any material intellectual property and/or technology to or from any third party, in each case other than in the ordinary course of business consistent with past practice;

except as required by law or pursuant to existing benefits plans, (a) enter into, amend or terminate any employee benefits plan; (b) increase the compensation or fringe benefits of any director, officer, employee, or consultant, (c) amend or accelerate the payment or vesting of any granted stock option, restricted stock unit or other benefits, (d) pay any benefit not required by any employee benefit plan, or (e) grant awards under any bonus or compensation plan, except for the grant to new hires of options to purchase SYS common stock;

initiate or settle any material litigation or arbitration;

open or close any facility or office;

fail to maintain insurance at levels substantially comparable to levels existing as of the date of the merger agreement; or

fail to pay accounts payable and other obligations in the ordinary course of business consistent with past practice, except with respect any amounts disputed in good faith by the company.

#### **Reasonable Best Efforts; Other Agreements**

##### ***Reasonable Best Efforts***

Kratos and SYS have each agreed to use their reasonable best efforts to take all actions necessary, proper or advisable under the merger agreement and applicable laws, rules and regulations to complete the merger and the other transactions contemplated by the merger agreement as promptly as practicable. Notwithstanding the foregoing, Kratos is not required to agree to or carry out any divestiture, sale, license or imposition of any material limitation on the ability of Kratos to conduct its business or to hold or exercise full ownership of the SYS shares, except in each case as would not involve any assets that are material to Kratos and its subsidiaries, taken as a whole.



***Proxy Statement; Stockholders' Meetings***

Kratos and SYS have agreed to cooperate in preparing and filing with the SEC this Proxy Statement and the registration statement of which it forms a part. Each has agreed to use its commercially reasonable efforts to resolve any SEC comments relating to this Proxy Statement and to have the registration statement of which it forms a part declared effective, and will cause this Proxy Statement to be mailed to its respective stockholders as early as practicable after it is declared effective. Each has also agreed to hold a stockholders' meeting as promptly as possible after the registration statement is declared effective and in any event within 45 days of such declaration.

***Listing on The Nasdaq Global Select Stock Market***

Kratos has agreed that, if required by the rules of The Nasdaq Global Select Stock Market, it will file with The Nasdaq Global Select Stock Market a notification form to list the additional shares to be issued to SYS's stockholders in connection with the merger.

***Other Agreements***

The merger agreement contains certain other agreements, including agreements relating to access to information and cooperation between Kratos and SYS during the pre-closing period, public announcements and certain tax matters.

**Conditions to Completion of the Merger**

Each party's obligation to effect the merger is subject to the satisfaction or waiver of various conditions, which include the following:

receipt of the approvals of the holders of SYS and Kratos capital stock required for the completion of the merger;

the receipt of such additional governmental authorizations, consents, orders and approvals as may be required in connection with the merger, subject to certain exceptions;

the effectiveness of the registration statement of which this Proxy Statement is a part, and the registration statement not being subject to any stop order or threatened stop order;

the absence of any order, preliminary or permanent injunction or other decree issued by any court of competent jurisdiction or other legal restraint making the merger illegal or otherwise preventing the consummation of the merger;

the receipt from each party's counsel of a written opinion to the effect that the merger will be treated for U.S. federal income tax purposes as a reorganization within the meaning of Section 368(a) of the Code;

the other party's representations and warranties being true and correct on the date of the merger agreement and on the date on which the merger is to be completed as if made as of that date or, if these representations and warranties expressly relate to an earlier date, then as of that specified date, in each case other than any failures to be true and correct that, individually or in the aggregate, have not had and would not reasonably be likely to have a material adverse effect on the other party, except for SYS's representations and warranties relating to its capitalization, which must be true and correct in all material respects;

the other party having performed its obligations under the merger agreement in all material respects;

with respect to the Kratos obligation to complete the merger, that: (a) Clifton L. Cooke, Jr. enter into an employment agreement with Kratos; (b) SYS deliver written resignation of all

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officers and directors of SYS effective as of the Effective Time; and (c) there is not any action or proceeding by any governmental entity seeking to restrain, prohibit or otherwise interfere with the ownership or operation by Kratos or its subsidiaries of the business of SYS or of Kratos or its subsidiaries or to compel Kratos or its subsidiaries to dispose of or hold separate all or any material portion of SYS's business or assets or of Kratos or its subsidiaries, except in each case for any action or proceeding seeking a remedy that Kratos would be required to agree to under the merger agreement; and

with respect to the SYS obligation to complete the merger, that the shares of Kratos common stock to be issued in the merger have been authorized for listing on The Nasdaq Global Select Stock Market.

The merger agreement provides that certain of the conditions described above may be waived by Kratos or SYS. Neither Kratos nor SYS currently expects to waive any material condition to the completion of the merger. If either Kratos or SYS determines to waive any condition to the merger that would result in a material adverse change in the terms of the merger to SYS or Kratos stockholders, including any change in the tax consequences of the transaction to SYS shareholders, proxies will be resolicited from the Kratos or SYS shareholders.

The merger agreement provides that none of the following shall be deemed to constitute a "material adverse effect" or be taken in account in determining whether one has occurred, other than in the case of an event or development that would have a material adverse effect on a party's ability to consummate the merger:

changes in economic conditions in any country in which the companies operate, except to the extent those changes have a materially disproportionate effect on the affected party and its subsidiaries as compared to similarly situated companies;

conditions affecting the industries or industry sectors in which the affected party operates, except to the extent those changes or events have a materially disproportionate effect on the affected party and its subsidiaries as compared to other companies in the same industries or industry sectors;

changes arising out of the announcement, pendency or consummation of the merger;

changes in the market price or trading volume of the affected party's stock;

changes in generally accepted accounting principles or legal requirements applicable to the affected party and its subsidiaries, except to the extent those changes have a materially disproportionate effect on the affected party and its subsidiaries as compared to other companies affected by such changes;

### **No Solicitation; Changes in Recommendations**

In the merger agreement SYS has agreed that its board will recommend that SYS's stockholders adopt and approve the merger agreement and that it will not directly or indirectly:

solicit, initiate, encourage or knowingly or intentionally encourage or facilitate any "acquisition proposal," as described below;

enter into or participate in any discussions or negotiations regarding, or furnish to any person any non-public information in connection with, or participate in, any acquisition proposal; or

withdraw, qualify or modify its recommendation to SYS's stockholders in a manner adverse to Kratos.



However, at any time before the date that the vote required to be obtained from its stockholders in connection with the merger has been obtained, SYS and its board of directors may:

furnish non-public information to and participate in discussions or negotiations with a third party in response to an unsolicited bona fide written acquisition proposal by such person, if the SYS board of directors, after consultation with outside legal counsel and financial advisors, determines in good faith that such acquisition proposal constitutes or is reasonably likely to result in a "superior proposal," as described below, and prior to providing any non-public information to such person SYS enters into a confidentiality agreement with such person on terms no less restrictive of the third party than the confidentiality agreement between Kratos and SYS; or

withdraw, qualify or modify its recommendation of the merger in response to (i) an unsolicited acquisition proposal that the SYS board of directors, after consultation with outside legal counsel and financial advisors, determines in good faith constitutes a superior proposal or (ii) a material development or change in circumstances that was not known to or reasonably foreseeable by the SYS board of directors as of the date of the merger agreement, in each case if and only if the SYS board of directors, after consultation with its outside legal counsel and financial advisors, determines in good faith that failure to effect a recommendation change would result in a breach of its fiduciary duties under applicable law; and provided that the SYS board of directors may not change its recommendation unless the board follows certain notice provisions and engages in good faith negotiations with Kratos to amend the merger agreement in such a way as to make the acquisition proposal no longer be a superior proposal (in the case of clause (i)) or obviate the need for a change of recommendation (in the case of clause (ii)).

The merger agreement also provides that SYS must notify Kratos of any acquisition proposal received by, any information related to an acquisition proposal requested from, SYS or any request or inquiry with respect to an acquisition proposal. SYS must keep Kratos reasonably informed in all material respects of the status and terms of any such acquisition proposal, the status and nature of all information requested and delivered, and the status and terms of any counterproposals or such discussions or negotiations.

#### **Termination**

Generally, the merger agreement may be terminated and the merger may be abandoned at any time prior to the completion of the merger (including after stockholder approval):

by mutual written consent of Kratos and SYS;

by either Kratos or SYS, if:

the merger is not consummated on or before August 20, 2008; except that such right is not available to any party whose failure to comply with the merger agreement has been the cause of, or resulted in, such failure and provided that this date (referred to herein as the "outside date") may be extended to February 20, 2009;

a governmental entity issues an order, decree or ruling or takes any other nonappealable final action permanently restraining, enjoining or otherwise prohibiting the merger;

the required Kratos or SYS shareholder vote has not been obtained at the applicable stockholder meeting, or any adjournment or postponement thereof, to approve the Kratos voting proposal (except that this right is not available to any party who is in material breach of or has materially failed to fulfill its obligations under the merger agreement); or

the other party breaches any of its agreements or representations in the merger agreement in such a way as would cause one or more of the conditions to closing not to be satisfied, and such breach is either incurable or is not cured after 30 days' written notice;

by Kratos, if:

the SYS board of directors fails to recommend that its shareholders vote in favor of the merger proposal or withdraws, qualifies, modifies or publicly proposes to withdraw, qualify or modify its recommendation as to the merger proposal;

the SYS board of directors or any committee thereof approves or recommends an alternative acquisition proposal;

SYS enters into an alternative acquisition agreement relating to an acquisition, as defined in the Merger Agreement;

the SYS board of directors or any committee thereof fails to reconfirm its recommendation as to the merger proposal within ten business days after Kratos requests in writing that SYS's board of directors do so, provided such request by Kratos may only be made in the event SYS has received an alternative acquisition proposal or amendment thereto; or

SYS willfully breaches its covenants with respect to non-solicitation of an alternative acquisition proposal or its obligations to call its shareholders meeting and mail this Proxy Statement to its shareholders.

by SYS to accept a proposal from a third party to acquire SYS that SYS's board of directors determines to be superior to the terms of Kratos' proposed acquisition of SYS, if SYS's board of directors changes or withdraws its recommendation of the merger in response to such superior proposal and pays the applicable termination fee (as described below).

### **Termination Fees and Expenses**

Pursuant to the merger agreement, SYS is required to pay a termination fee of \$2,394,000 dollars to Kratos in the event the merger agreement is terminated:

By Kratos, if:

the SYS board of directors fails to recommend that its shareholders vote in favor of the merger proposal or withdraws, qualifies, modifies or publicly proposes to withdraw, qualify or modify its recommendation as to the merger proposal;

the SYS board of directors or any committee thereof approves or recommends an alternative acquisition proposal;

SYS enters into an alternative acquisition agreement relating to an acquisition, as defined in the Merger Agreement;

the SYS board of directors or any committee thereof fails to reconfirm its recommendation as to the merger proposal within ten business days after Kratos requests in writing that SYS's board of directors do so, provided such request by Kratos may only be made in the event SYS has received an alternative acquisition proposal or amendment thereto; or



SYS willfully breaches its covenants with respect to non-solicitation of an alternative acquisition proposal or its obligations to call its shareholders meeting and mail this Proxy Statement to its shareholders.

By SYS, if its board of directors or any committee thereof has made an adverse recommendation change and SYS enters into an alternative acquisition agreement which was the subject of such adverse recommendation change.

Whether or not the merger is completed, all costs and expenses incurred in connection with the merger agreement and the transactions contemplated by the merger agreement will be paid by the party incurring those costs or expenses, except that Kratos and SYS will share equally the expenses incurred in connection with the printing and mailing of this Proxy Statement.

#### **Effect of Termination**

If the merger agreement is terminated as described in " Termination" above, the agreement will be void, and there will be no liability or obligation of any party except that:

each party will remain liable for any willful breach of the merger agreement, fraud or knowing misrepresentation; and

designated provisions of the merger agreement, including the provisions relating to confidential treatment of information and the allocation of fees and expenses (including, if applicable, the termination fees described above) will survive termination.

#### **Employee Matters**

The merger agreement provides that, with respect to SYS employees who remain employed for at least 180 days following completion of the merger, to the extent permissible, Kratos will treat the service of such employees prior to the completion of the merger as service rendered to Kratos for purposes of vesting, eligibility and minimum waiting periods under Kratos' benefit plans. Kratos will assume and perform SYS's employment and change of control severance agreements. Kratos will also use commercially reasonable efforts to provide that no new employee from SYS will be excluded under its benefit plans due to waiting period or pre-existing condition limitations.

#### **Indemnification and Insurance**

The merger agreement provides that for six years after the effective time of the merger and to the fullest extent permitted by law, Kratos will cause the surviving corporation to honor all rights to indemnification for acts or omissions prior to the effective time of the merger existing in favor of SYS directors or officers as provided in SYS's organizational documents and its indemnification agreements with such individuals. The merger agreement also provides that, prior to the effective time of the merger, SYS will purchase six-year "tail" officers' and directors' liability insurance policies on terms and conditions no less favorable than SYS's existing directors' and officers' liability insurance. If SYS cannot purchase these "tail" policies for 200% or less of the annual premium paid by SYS for its existing insurance, SYS will purchase as much insurance coverage as can be obtained within the 200% cap. Kratos and the surviving corporation are obligated to maintain such tail policies in full force and effect and continue to honor their respective obligations thereunder for the full term thereof.

#### **Amendment; Extension and Waiver**

Subject to applicable law:

the merger agreement may be amended by the parties in writing at any time. However, after approval by Kratos' and SYS's stockholders of the transactions contemplated by the merger agreement, the merger agreement may not be amended in a manner that would require further approval by either party's stockholders unless the parties obtain such approval; and

at any time before the completion of the merger, a party may extend the time for performance of any of the obligations or other acts of the other party to the merger agreement, waive any inaccuracies in the representations and warranties of the other party or waive compliance by the other party with any agreement or condition in the merger agreement.

### **Governing Law**

The merger agreement is governed by and will be construed in accordance with the laws of the State of Delaware.

### **Voting Agreements**

#### ***Kratos Voting Agreement***

Contemporaneously with the execution and delivery of the merger agreement, certain directors and executive officers of Kratos concurrently entered into voting agreements with SYS, in the form attached as *Annex B* to this Proxy Statement, the form of which is incorporated by reference into this Proxy Statement. According to the Kratos voting agreement, Kratos signatories in their individual capacity have agreed to vote in favor of the Share Issuance. The Kratos voting agreements apply to all shares of Kratos common stock held by the signatories at the record date for the relevant Kratos stockholder meeting. The Kratos voting agreements restrict the transfer of shares by the signatories, except under certain limited conditions.

#### ***SYS Voting Agreement***

Contemporaneously with the execution and delivery of the merger agreement, certain executive officers of SYS concurrently entered into voting agreements with Kratos, in the forms attached as *Annex C* to this Proxy Statement. The forms of each voting agreement are incorporated by reference into this Proxy Statement. All signatories of the voting agreements have agreed to vote in favor of the merger agreement and against any other proposal or offer to acquire SYS. The voting agreements apply to all shares of SYS common stock held by the signatories at the record date for the SYS shareholder meeting. The voting agreements restrict the transfer of shares by the signatories, except under certain limited conditions.

## INFORMATION ABOUT THE COMPANIES

### *KRATOS*

Kratos was initially incorporated in the state of New York on December 19, 1994, commenced operations in March 1995 and was reincorporated in Delaware in 1997. Kratos is an innovative provider of mission critical engineering, IT services and warfighter solutions. Kratos works primarily for the U.S. government and government agencies, but it also performs work for state and local agencies and commercial customers. Kratos' principle services are related to, but are not limited to, Command, Control, Communications, Computing, Combat Systems Intelligence, Surveillance and Reconnaissance, which we refer to as C5ISR, weapons systems lifecycle support and extension, military weapon range operations and technical services, missile and rocket and weapons system test and evaluation, mission launch services, public safety, security and surveillance systems, advanced network engineering and information technology services, advanced IT services, security and surveillance systems, and critical infrastructure design and integration services. Kratos offers its customers solutions and expertise to support their mission-critical needs by leveraging its skills across its core service areas.

Kratos derives a substantial portion of its revenue from contracts performed for federal government agencies, with the majority of its revenue currently generated from the delivery of mission-critical warfighter solutions, advanced engineering services, system integration and system sustainment services to defense and other non-DoD (Department of Defense) and civilian government agencies. Kratos believes its diversified and stable client base, strong client relationships, broad array of contracts, considerable employee base possessing government security clearances, extensive list of past performance qualifications, and significant management and operational capabilities position it for continued growth.

#### **Competitive Strengths**

Kratos is well positioned to meet the rapidly evolving needs of federal government agencies for high-end engineering services, IT solutions and other technical operations because it possesses the following key business strengths and performance qualifications:

#### ***Significant and Highly Specialized Experience***

Through the existing customer engagements and with the government-focused acquisitions it has completed over the past several years, Kratos has amassed significant and highly specialized experience in areas directly related to weapon systems life cycle extension and sustainment; missile, rocket and weapons test and evaluation; C5ISR; military range operations and technical services and other highly differentiated services and solutions. This collective experience, or 'past performance qualifications,' is a requirement of the majority of contract vehicles and customer engagements Kratos is involved in. Kratos believes this to be a significant barrier to entry and lends itself to advantageous positioning for long-term success.

#### ***In-Depth Understanding of Client Missions***

Kratos has a history of providing mission-critical services and solutions to its clients, enabling the it to develop an in-depth understanding of customer missions and technical needs. In addition, a significant number of Kratos employees are located at client sites, allowing for valuable strategic insight into clients' ongoing and future program requirements. Additionally, Kratos' in-depth understanding of its client missions, in conjunction with the strategic location of its employees, enables Kratos to offer technical solutions tailored to clients' specific requirements and consistent with their evolving mission objectives.

***Diverse Base of Key Contract Vehicles***

As a result of its business development focus on securing key contracts, Kratos is a preferred contractor on numerous multi-year government-wide acquisition contracts and multiple award contracts that provide Kratos with the opportunity to bid on hundreds of millions of dollars of business against a discrete number of other pre-qualified companies each year. These contracts include Seaport-e, GSA, Passive RFID EPC-1, PES, IT, LOG World, Mobis Millennia Lite, AMCOM Express, Consolidated Acquisition of Professional Services, referred to as CAPS, Support Services for Aviation, Air Defense and Missile Systems, Systems Engineering and Technical Assistance Contract, and Specialized Engineering, Development and Test Articles/Models. While the federal government is not obligated to make any awards under these vehicles, Kratos believes that holding preferred positions on these contract vehicles provides an advantage when seeking to expand the level of services it provides to clients.

***Strategic Geographic Locations and BRAC***

The federal government's Base Realignment and Closure, referred to as BRAC, Act of 2005 is the congressionally authorized process the Department of Defense has implemented to reorganize its base structure to more efficiently and effectively support U.S. armed forces, increase operational readiness and facilitate new ways of doing business. As a result of the DoD's BRAC transformation, Kratos has concentrated its business strategy on building a significant presence in key BRAC receiving locations where the federal government is relocating its personnel as well as related technical and professional services. As Kratos continues to entrench in these key locations, it expects this to be a significant competitive advantage.

***Highly Skilled Employees and an Experienced Management Team***

Kratos delivers its services through a highly skilled workforce of approximately 1,500 full-time, part-time and on-call employees in its on-going business. Kratos' senior managers have over 125 years of collective experience with federal government agencies, the U.S. military, and Federal Government contractors. Members of the Kratos Management Team have significant experience growing businesses organically, as well as through acquisitions.

The cumulative experience and differentiated expertise of Kratos' personnel in its core focus areas of C5ISR, weapons systems lifecycle extension and maintenance, missile and rocket test and evaluation, along with its sizable employee base with government security clearances, allows Kratos to qualify for and bid on larger projects in the prime contracting role.

***Services and Solutions***

Kratos provides a range of integrated engineering, war fighter, security and information technology services and solutions by leveraging its core service offerings: weapon systems life cycle support and extension; C5ISR; military range operations and technical services; missile and rocket test and evaluation; security systems integration; and advanced network engineering and IT services.

***Weapon Systems Life Cycle Support and Extension***

Kratos provides weapon systems life cycle support and extension services for the DoD and foreign governments. These services focus on maintaining, testing and repairing certain weapons systems for the war fighter.

***C5ISR (Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance)***

In the area of C5ISR, Kratos is involved in a wide range of services, including the installation, upgrade and maintenance of command, control, combat and surveillance systems for customers such as Joint Inter Agency Task Force-south and the Naval Undersea Warfare Center, which we refer to as NUWC.

***Military Range Operations and Technical Services***

A key area of differentiation for Kratos is within the range and technical service areas. Kratos has resources strategically located at virtually all major range locations throughout the United States, including NAWC Pt. Mugu, Hawaii Pacific Missile Range, Fort Bliss, Texas, and White Sands Missile Range, New Mexico. The services of Kratos include aerial targets operations and maintenance, surface targets operations and maintenance, missile systems operations and maintenance, range operations planning and support, hazardous materials management, supply and logistics support, and manufacturing.

***Missile and Rocket Test and Evaluation***

Through the acquisition of Haverstick Consulting, Inc., Kratos acquired expertise in the area of missile and rocket test and evaluation services. This includes exclusive rights to the design and manufacture of the motor on the Oriole Rocket System and ancillary hardware for sounding rockets, suborbital research and target services. Additionally, this area of business develops and produces low-cost ballistic missile defense targets.

***Security Systems Integration***

Kratos has broad experience integrating security services and solutions across a number of network and communications platforms. In particular, the non-federal business of Kratos has long-standing experience and has developed significant customer relationships by providing best-in-class systems integration services on a variety of platforms including digital (IP) surveillance and security, building automation systems and controls, fire and life safety systems, access control and perimeter protection, and service and maintenance of the aforementioned systems.

***Advanced Engineering & IT Services***

Kratos offers a full lifecycle of network engineering services to clients from the initial analysis of the requirements and design of the network through implementation and testing of the solution, including the design of disaster recovery contingency plans. Kratos' network engineering capabilities include architecture development, design, implementation, configuration, and operation of Local Area Networks (LAN), Metropolitan Area Networks (MAN) and Wide Area Networks (WAN). Kratos has extensive experience providing the following network engineering services for federal government clients which allows it to rapidly identify potential bottlenecks, security threats and vulnerabilities, and address these potential issues with cost-effective solutions in design, architecture, testing system, integration, deployment, security assessments, recovery plans, and certification.

Kratos has comprehensive experience providing engineering services at any phase of a project lifecycle including program management, engineering design, systems engineering, C5I System INCO, operations and maintenance, integrated logistics, test and evaluation, security/building mapping, propulsion research and development, advanced telecommunications, and warfare systems training.

In addition to these services, Kratos also offers a range of IT services and solutions from conceptual network planning to system service and maintenance. Kratos has extensive experience

building complex and secure networks for the federal government, and it possesses in-depth experience with network operations centers. Key services include network operations centers, help desks, system maintenance, system upgrades, configuration management, data warehousing, COTS selection and integration, and high performance computing.

### **Corporate Strategy**

From a strategic perspective, the objective of Kratos is to aggressively grow its business as a leading provider of highly-differentiated services in its core areas of focus as noted above by delivering comprehensive, high-end engineering services, technical solutions and information technology services to federal government agencies while improving overall profitability. To achieve this objective, Kratos intends to:

#### ***Accelerate Internal Growth***

Kratos is focused on accelerating its internal growth rate by capitalizing on its current contract base, expanding services provided to existing clients, expanding the client base and offering new, complementary services.

#### ***Pursue Strategic Acquisitions***

Kratos intends to supplement its organic growth by identifying, acquiring and integrating businesses that meet its primary objective of providing enhanced capabilities in order to pursue a broader cross section of the DoD, DHS and other government markets, complement and broaden the existing client base and expand primary service offerings. The senior management team of Kratos brings significant acquisition experience.

On December 31, 2007, Kratos completed the acquisition of Haverstick Consulting, Inc., an Indianapolis, Indiana based privately-held provider of rocket and missile test and evaluation, weapons systems support, and professional services to the U.S. Army, U.S. Air Force, U.S. Navy, NASA, and other federal, state and local agencies. In addition, on February 20, 2008, Kratos entered into a definitive merger agreement with San Diego-based C5ISR and net-centric warfare solutions provider SYS (AMEX:SYS) in a stock-for-stock transaction. These acquisitions will significantly broaden the Kratos portfolio of customers, contract vehicles and past performance qualifications.

### **Customers**

A representative list of Kratos' customers within the Kratos Government Solutions (KGS) segment during 2007 included the U.S. Air Force, U.S. Army, U.S. Navy, Missile Defense Agency, the Department of Homeland Security, NASA, FMS and the U.S. Southern Command. In the Kratos Public Safety and Security (PSS) segment, customers in 2007 included General Electric, Atlanta's Hartsfield-Jackson Airport, Lockheed Martin, the City of Houston, Texas, and the Toyota Center.

### **Employees**

As of December 31, 2007, including the employees from the Haverstick Consulting acquisition, Kratos employed approximately 1,500 full-time, part-time and on-call employees. Kratos has one collective bargaining unit of approximately 22 employees which is represented by the International Association of Machinists & Aerospace Workers, AFL-CIO, White Sands Local Lodge 2515, Alamogordo, New Mexico.

## Properties

Our principal executive offices for all business segments are located in approximately 93,000 square feet of office space in San Diego, California. The lease for such space expires in April 2010. Other corporate resource offices are located in the following locations: Washington, D.C.; Marietta, Georgia; Newport, Delaware; Houston, Texas; Huntsville, Alabama; Alexandria, Virginia; and Indianapolis, Indiana. We also lease office space to provide local support services to our customers in various regions throughout the United States. The leases on these spaces expire at various times through August 2016. We continually evaluate our current and future space capacity in relation to current and projected future staffing levels. We believe that our existing facilities are suitable and adequate to meet our current business requirements.

## Legal Proceedings

### *IPO Securities Litigation*

Beginning in June 2001, Kratos and certain of its officers and directors were named as defendants in several parallel class action shareholder complaints filed in the United States District Court for the Southern District of New York, now consolidated under the caption, *In re Wireless Facilities, Inc. Initial Public Offering Securities Litigation*, Case No. 01-CV-4779. In the amended complaint, the plaintiffs allege that Kratos, certain of its officers and directors, and the underwriters of Kratos' initial public offering, or IPO, violated section 11 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934 based on allegations that the Kratos registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of other public companies, which we refer to as the Issuers, that conducted IPOs of their common stock in the late 1990s and 2000. We refer to these cases as the IPO Cases.

In June 2004, the Issuers, including Kratos, executed a settlement agreement with the plaintiffs that would, among other things, result in the dismissal with prejudice of all claims against the Issuers and their officers and directors and the assignment of certain potential Issuer claims to the plaintiffs. On February 15, 2005, the court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the court reaffirmed class certification and preliminary approval of the modified settlement in a comprehensive Order. On February 24, 2006, the court dismissed litigation filed against certain underwriters in connection with certain claims to be assigned under the settlement. On April 24, 2006, the court held a Final Fairness Hearing to determine whether to grant final approval of the settlement. On December 5, 2006, the Second Circuit Court of Appeals vacated the lower court's earlier decision certifying as class actions the six IPO Cases designated as "focus cases." Thereafter, the District Court ordered a stay of all proceedings in all of the IPO Cases pending the outcome of plaintiffs' petition to the Second Circuit for rehearing en banc and resolution of the class certification issue. On April 6, 2007, the Second Circuit denied plaintiffs' rehearing petition, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. Accordingly, the stay remains in place and the plaintiffs and Issuers have stated that they are prepared to discuss how the settlement might be amended or renegotiated to comply with the Second Circuit's decision. Plaintiffs filed amended complaints in the six focus cases on or about August 14, 2007. On September 27, 2007, Plaintiffs filed a motion for class certification in the six focus cases. On November 13, 2007, the Issuer Defendants filed a motion to dismiss the amended complaints in the six focus cases. On November 14, 2007, the Underwriter Defendants filed a motion to dismiss the amended complaints in the six focus cases. The court has not yet set a deadline for the plaintiffs to file amended complaints in the other IPO lawsuits. Due to the inherent uncertainties of litigation, and because the settlement may not receive final approval from the Court, the ultimate outcome of this



matter cannot be predicted. In accordance with FASB No. 5, "Accounting for Contingencies" Kratos believes any contingent liability related to this claim is not probable or estimable and therefore no amounts have been accrued in regards to this matter.

#### **2004 Securities Litigation**

In August 2004, following its announcement on August 4, 2004 that Kratos intended to restate its financial statements for the fiscal years ended December 31, 2000, 2001, 2002 and 2003, Kratos and certain of its current and former officers and directors were named as defendants, which we refer to as the Defendants, in several securities class action lawsuits filed in the United States District Court for the Southern District of California. These actions were filed on behalf of those who purchased, or otherwise acquired, Kratos' common stock between April 26, 2000 and August 4, 2004. The lawsuits generally allege that, during that time period, Defendants made false and misleading statements to the investing public about Kratos' business and financial results, causing its stock to trade at artificially inflated levels. Based on these allegations, the lawsuits allege that Defendants violated the Securities Exchange Act of 1934, and the plaintiffs seek unspecified damages. These actions have been consolidated into a single action *In re Wireless Facilities, Inc. Securities Litigation*, Master File No. 04CV1589-JAH. Plaintiffs filed a First Amended Consolidated Class Action Complaint on April 1, 2005. Defendants filed their motion to dismiss this first amended complaint on April 14, 2005. The plaintiffs then requested leave to amend their first amended complaint. The plaintiffs filed their Second Amended Complaint on June 9, 2005, this time on behalf of those who purchased, or otherwise acquired, Kratos' common stock between May 5, 2003 and August 4, 2004. Defendants filed their motion to dismiss this Second Amended Complaint on July 14, 2005. The motion to dismiss was taken under submission on October 20, 2005 and on March 8, 2006, the Court granted the Defendants' motion. However, plaintiffs were granted the right to amend their complaint within 45 days and subsequently filed their Third Amended Consolidated Class Action Complaint on April 24, 2006. Defendants filed a motion to dismiss this complaint on June 8, 2006. On May 7, 2007, the Court denied the Defendants' motion to dismiss. Defendants' filed their answer to the plaintiffs' complaint on July 13, 2007. In February 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. Under the tentative settlement, plaintiffs and the class will dismiss all claims, with prejudice, in exchange for a cash payment in the total amount of \$12 million. The Kratos directors' and officers' liability insurers will pay the settlement amount in accordance with the Kratos insurance policies, less any applicable retention or co-insurance obligations that are expected to be paid directly by Kratos. Kratos estimates that the amount of its payment toward the settlement will be approximately \$2.4 million. Kratos has accrued approximately \$2.4 million as of December 31, 2007 related to this matter. The parties currently are in the process of documenting their agreement and then will seek a determination by the Court that the proposed settlement is fair, reasonable and adequate. Kratos makes no assurances at this time that the Court will approve the proposed settlement terms or that the matter ultimately will be settled. Despite the tentative settlement reached in this action, Kratos believes that the allegations lack merit.

In 2004, two derivative lawsuits were filed in the United States District Court for the Southern District of California against certain of the current and former officers and directors of Kratos: *Pedicini v. Wireless Facilities, Inc.*, Case No. 04CV1663; and *Roth v. Wireless Facilities, Inc.*, Case No. 04CV1810. These actions were consolidated into a single action in *In re Wireless Facilities, Inc. Derivative Litigation*, Lead Case No 04CV1663-JAH. These lawsuits contain factual allegations that are substantially similar those made in the class action lawsuits, but the plaintiffs in these lawsuits assert claims for breach of fiduciary duty, gross mismanagement, abuse of control, waste of corporate assets, violation of Sarbanes Oxley Act section 304, unjust enrichment and insider trading. The plaintiffs in these lawsuits seek unspecified damages and equitable and/or injunctive relief. The lead plaintiff filed a consolidated complaint on March 21, 2005. On May 3, 2005, the defendants filed motions to dismiss this action, to stay this action pending the resolution of the consolidated non-derivative securities case pending in the

Southern District of California, and to dismiss the complaint against certain non-California resident defendants. Pursuant to a request by the Court, Defendants' motions were withdrawn without prejudice pending a decision on defendants' motion to dismiss the complaint against the non-California resident defendants. On March 20, 2007, the Court ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the federal derivative complaint. On March 27, 2007, plaintiffs filed an amended derivative complaint setting forth all of the same allegations from the original complaint and adding allegations regarding Kratos' stock option granting practices. Basically, plaintiffs allege that Kratos "backdated" or "springloaded" employee stock option grants so that the options were granted at less than fair market value. The amended complaint names all of the original defendants (including those dismissed for lack of jurisdiction) as well as nine new defendants. On July 2, 2007, the non-California resident defendants moved to dismiss the complaint for lack of personal jurisdiction. On October 17, 2007, the Court took the motion under submission without oral argument. On February 26, 2008, the Court again ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the amended federal derivative complaint. The parties have conferred and discussed the Court's order and have stipulated to a briefing schedule for any remaining motions to dismiss that Kratos, along with the individual defendants subject to the court's jurisdiction, may bring in an effort to dismiss the *Hameed* Action as to them. Pursuant to the parties' stipulation, such motions must be brought on or before June 5, 2008. Kratos believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will or will not have a material adverse effect on Kratos.

In April 2007, another derivative complaint was filed in the United States District Court for the Southern District of California, *Hameed v. Tayebi*, Case No. 07-CV-0680 BTM(RBB), which we refer to as the "*Hameed* Action", against several of the current and former officers and directors of Kratos. The allegations in this new derivative complaint mirror the amended allegations in the 2004 federal derivative action. Pursuant to the Court's order and agreement of the parties, the defendants' responses to the complaint in the *Hameed* Action were stayed until the Court ruled on the motion to dismiss for lack of personal jurisdiction in the 2004 derivative litigation. As noted above, on February 26, 2008, the Court ruled that it lacked personal jurisdiction over five of the non-California defendants named in the 2004 derivative action, including three that were also named in the *Hameed* Action. The parties have conferred and discussed the Court's order and have stipulated a briefing schedule for any remaining motions to dismiss that Kratos, along with the individual defendants subject to the court's jurisdiction, may bring in an effort to dismiss the *Hameed* Action as to them. Pursuant to the parties' stipulation, such motions must be brought on or before June 5, 2008. Kratos believes that the allegations lack merit and intends to vigorously defend all claims asserted. Currently, Kratos is unable to form a professional judgment that an unfavorable outcome is either probable or remote.

In August and September 2004, two virtually identical derivative lawsuits were filed in California Superior Court for San Diego County against certain of the current and former officers and directors of Kratos. These actions contain factual allegations similar to those of the federal lawsuits, but the plaintiffs in these cases assert claims for violations of California's insider trading laws, breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiffs in these actions seek unspecified damages, equitable and/or injunctive relief and disgorgement of all profits, benefits and other compensation obtained by defendants. These lawsuits have been consolidated into one action *In re Wireless Facilities, Inc. Derivative Litigation*, California Superior Court, San Diego County, Lead Case No. GIC 834253. The plaintiffs filed a Consolidated Shareholder Derivative Complaint on October 14, 2004. This action has been stayed pending a decision in federal court on a motion to dismiss the federal derivative lawsuits. In October 2007, the parties notified the Court of the status of the federal action and requested the court continue its stay of this action. Kratos anticipates that the court will continue to stay this matter and that the court will request the parties file an updated status report in April 2008. Kratos believes that the

allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will or will not have a material adverse effect on Kratos.

Kratos has recorded an accrual for a contingent liability associated with the legal proceedings related to the derivative actions of \$0.8 million based on its estimate of the potential amount it would have to pay, net of estimated amounts to be paid by the insurance carriers of Kratos, in relation to these lawsuits.

#### ***2007 Securities Litigation***

In March and April 2007, there were three federal class actions filed in the United States District Court for the Southern District of California against Kratos and several of its current and former officers and directors. These class action lawsuits followed the March 12, 2007 public announcement by Kratos that it was conducting a voluntary internal review of its stock option granting processes. These actions have been consolidated into a single action, *In re Wireless Facilities, Inc. Securities Litigation II*, Master File No. 07-CV-0482-BTM-NLS. The consolidated class action complaint was filed on November 19, 2007. In March 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. Under the settlement proposal, plaintiffs and the class will dismiss all claims, with prejudice, in exchange for a cash payment in the amount of \$4.5 million. The Kratos directors' and officers' liability insurers will pay the settlement amount, less any applicable retention or co-insurance obligations and contributions that are expected to be paid directly by Kratos. Kratos estimates that the total amount of its payment toward the settlement will be approximately \$1.7 million. Kratos has accrued approximately \$1.7 million as of December 31, 2007 related to this matter. The parties currently are in the process of documenting their agreement, and then will seek a determination by the Court that the proposed settlement is fair, reasonable and adequate. Kratos makes no assurances at this time that the Court will approve the proposed settlement terms or that the matter ultimately will be settled. Despite the tentative settlement reached in this action, Kratos believes that the allegations lack merit.

#### ***Other Litigation and Government Investigations***

In January 2005, a former independent contractor of Kratos filed a lawsuit in Brazil against WFI de Brazil, a subsidiary of Kratos to which he had been assigned for a period of time. He sought to be designated an employee of WFI de Brazil and entitled to severance and related compensation pursuant to Brazilian labor law. The individual sought back wages, vacation pay, stock option compensation and related benefits in excess of \$0.5 million. In July 2006, the labor court awarded the individual back wages, vacation pay and certain other benefits. Kratos filed an appeal in the matter on July 20, 2006. On August 22, 2007, the appeals court partially upheld the appeal, although it upheld the individual's designation as an employee. The labor court has awarded the individual the Brazilian currency equivalent of approximately \$0.6 million (based on the current currency exchange rate). Counsel of Kratos has filed motions for clarification of the judgment due to omissions in the decision. Kratos has accrued approximately \$0.6 million as of December 31, 2007 related to this matter.

On March 28, 2007, three plaintiffs, on behalf of a purported class of similarly situated employees and contractors, filed a lawsuit against Kratos in the Superior Court of the State of California, Alameda County. The suit alleges various violations of the California Labor Code and seeks payments for allegedly unpaid straight time and overtime, meal period pay and associated penalties. Kratos and the plaintiffs have agreed to venue for the suit in San Diego County. Although Kratos believes that the allegations lack merit, it has agreed in principle with the plaintiffs to settle their claims for an aggregate amount in the range of \$0.3 million to \$0.5 million, to include individual and incentive awards, attorneys' fees and administrative costs, subject to court approval. The actual amount paid by Kratos will depend upon the number of responses received from members of the purported class of

plaintiffs. Kratos has recorded an accrual for a contingent liability associated with this legal proceeding in the amount of \$0.3 million.

On May 3, 2007, Kratos announced that it had filed a lawsuit against a former employee who previously served as its stock option administrator and left Kratos in mid-2004, and his spouse. The lawsuit sought to recover damages resulting from the theft by a former employee of Kratos stock options and common stock valued in excess of \$6.3 million. The thefts, which appear to have taken place during 2002 and 2003, were discovered through the Kratos review of its past practices related to the granting and pricing of employee stock options with the assistance of its outside counsel and forensic computer consultants. The complaint also alleged that the former employee attempted to cover up the scheme by, among other things, deleting entries from the records of Kratos.

Kratos promptly reported to the SEC the discovery of the theft. The SEC initiated an informal inquiry and commenced an enforcement action against the former employee. The U.S. Attorney's Office also forwarded a grand jury subpoena to Kratos seeking records related to the former employee and Kratos' historical option granting practices. The SEC filed a federal lawsuit and obtained a temporary restraining order and asset freeze against the former employee and his spouse. The U.S. Attorney's Office indicted him for the theft and he pled guilty to federal criminal charges and has been sentenced to 46 months in prison and currently is incarcerated. On April 1, 2008, the SEC notified Kratos that it had completed its informal investigation and that it did not intend to recommend any enforcement action by the SEC against the Company. Kratos has cooperated with, and intends to continue to cooperate with the U.S. Attorney's Office on this matter and otherwise. The former employee and his wife entered into a settlement agreement with Kratos on October 5, 2007, turning over substantially all of their assets to Kratos in settlement of the damages incurred in the theft. On February 15, 2008, the SEC approved the settlement. On February 19, 2008, the court entered a final judgment approving the settlement. Kratos has obtained the assets, which aggregate approximately \$3.4 million, and is in the process of liquidating them.

In addition to the foregoing matters, from time to time, Kratos may become involved in various claims, lawsuits and legal proceedings that arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm Kratos' business. Kratos is currently not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse affect on its business, financial condition or operating results.

#### **Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Kratos' common stock is listed on the NASDAQ Global Select Market and has traded under the symbol "KTOS" since September 17, 2007. Kratos' common stock traded under the symbol "WFII" from November 5, 1999 through September 14, 2007.

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The following table sets forth the high and low sales prices for Kratos' common stock for the periods indicated, as reported by NASDAQ. Such quotation represents inter-dealer prices without retail markup, markdown or commission and may not necessarily represent actual transactions.

	High	Low
<b>Year Ended December 31, 2007:</b>		
Fourth Quarter	\$ 3.04	\$ 1.91
Third Quarter	\$ 2.75	\$ 1.73
Second Quarter	\$ 1.74	\$ 1.07
First Quarter	\$ 2.85	\$ 1.24
<b>Year Ended December 31, 2006:</b>		
Fourth Quarter	\$ 2.88	\$ 2.00
Third Quarter	\$ 2.93	\$ 1.91
Second Quarter	\$ 4.53	\$ 2.75
First Quarter	\$ 5.52	\$ 3.88

On April 8, 2008 the last sale price of Kratos' common stock as reported by NASDAQ was \$1.83 per share. On April 8, 2008, there were 214 shareholders of record of Kratos' common stock.

Kratos has not declared any cash dividends since becoming a public company. Kratos currently intends to retain any future earnings to finance the growth and development of the business and, therefore, do not anticipate paying any cash dividends in the foreseeable future. In addition, Kratos credit facility restricts its ability to pay dividends. Any future determination to pay cash dividends will be at the discretion of Kratos' board of directors and will be dependent upon the future financial condition, results of operations, capital requirements, general business conditions and other relevant factors as determined by Kratos' board of directors.

### Securities Authorized for Issuance Under Equity Compensation Plans

Information about Kratos' equity compensation plans as of December 31, 2007 is as follows (shares in thousands):

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance
Equity Compensation Plans Approved by Shareholders(1)	7,019	\$ 4.62	7,321(3)
Equity Compensation Plans Not Approved by Shareholders(2)	1,318	\$ 4.86	2,110
Total	8,337		9,431

(1) Includes 1997 Stock Option Plan, 1999 and 2005 Equity Incentive Plan and 1999 Employee Stock Purchase Plan

(2) Includes 2000 Non-Statutory Stock Option Plan

(3) Includes 351,811 shares reserved for issuance under the Employee Stock Purchase Plan which was suspended in 2006.

For more detailed information regarding Kratos' equity compensation plans, see Note 10 to Kratos' Consolidated Financial Statements.

**Performance Graph**

The following performance graph is a comparison of the five year cumulative stockholder return on Kratos' common stock against the cumulative total return of the NASDAQ Composite Index, the NASDAQ Telecommunications Index and a peer group composed of the Russell 2000 Stock Index and SYS Technologies, NCI, Inc., Stanley, Inc., SI International, Inc., MTC Technologies, Inc., and Dynamic Research Corporation for the period commencing December 31, 2002 and ending December 31, 2007. The performance graph assumes an initial investment of \$100 in Kratos' common stock and in each of the indices and peer group. The comparison also assumes that all dividends are reinvested and all returns are market-cap weighted. The historical information set forth below is not necessarily indicative of future performance.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

Among Kratos Defense & Security Solutions, Inc. The NASDAQ Composite Index,  
The NASDAQ Telecommunications Index And A Peer Group

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\*  
\$100 invested on 12/31/02 in stock or index-including reinvestment of dividends.

Fiscal year ending December 31.

The performance graph above and related text are being furnished solely to accompany this proxy statement/prospectus pursuant to Item 201(e) of Regulation S-K, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and are not to be incorporated by reference into any filing of ours, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

**Selected Financial Data**

As a result of the Engineering and Deployment Services divestitures in June and July 2007, respectively, the Wireless Network Services segment has been classified as a discontinued operation in this Proxy Statement and all prior year results presented herein have been reclassified to reflect these businesses as discontinued operations in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

In December 2005, Kratos' Board made the decision to exit Kratos' Mexican and South American deployment businesses. In December 2006, Kratos' Board made the decision to exit Kratos' EMEA and Brazilian businesses. Accordingly, all results of operations for these businesses have been reflected as discontinued operations for all years presented.

The selected consolidated financial data has been restated as a result of the discontinued businesses. The following selected consolidated financial data should be read in conjunction with Kratos' Consolidated Financial Statements and related Notes thereto and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" which are included in this Proxy Statement. Kratos' historical results are not necessarily indicative of operating results to be expected in the future.

	Year Ended December 31,				
	2003	2004	2005	2006	2007
(All amounts except per share data in millions)					
<b>Consolidated Statements of Operations Data:</b>					
Revenues	\$ 43.4	\$ 116.9	\$ 152.3	\$ 153.1	\$ 193.6
Gross profit	21.2	29.0	36.6	28.9	31.6
Operating income (loss) from continuing operations	(2.6)	(13.8)	3.2	(31.5)	(24.6)
Provision (benefit) for income taxes from continuing operations	(1.0)	(8.4)	(0.1)	13.8	1.3
Income (loss) from continuing operations	(0.8)	(8.2)	3.6	(46.2)	(28.2)
Income (loss) from discontinued operations	2.7	23.2	(2.0)	(11.7)	(12.6)
Net income (loss)	\$ 1.9	\$ 15.0	\$ 1.6	\$ (57.9)	\$ (40.8)
<b>Income (loss) from continuing operations per common share</b>					
Basic	\$ (0.01)	\$ (0.12)	\$ 0.05	\$ (0.63)	\$ (0.38)
Diluted	\$ (0.01)	\$ (0.12)	\$ 0.05	\$ (0.63)	\$ (0.38)
<b>Income (loss) from discontinued operations per common share</b>					
Basic	\$ 0.04	\$ 0.34	\$ (0.03)	\$ (0.16)	\$ (0.17)
Diluted	\$ 0.04	\$ 0.34	\$ (0.03)	\$ (0.16)	\$ (0.17)
<b>Net income (loss) per common share</b>					
Basic	\$ 0.03	\$ 0.22	\$ 0.02	\$ (0.79)	\$ (0.55)
Diluted	\$ 0.03	\$ 0.22	\$ 0.02	\$ (0.79)	\$ (0.55)
<b>Weighted average shares:</b>					
Basic	68.4	67.7	74.0	73.5	74.0
Diluted	68.4	67.7	75.0	73.5	74.0

As of December 31,

	2003	2004	2005	2006	2007
(All amounts in millions)					
<b>Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 75.8	\$ 50.4	\$ 7.7	\$ 5.4	\$ 8.6
Short-term investments	35.1	7.6			
Working capital	132.5	98.6	67.4	(3.8)	23.4
Total assets	279.3	330.7	342.0	337.7	335.3
Short-term debt	0.7	1.9	0.7	51.4	2.7
Long-term debt					74.0
Total stockholders' equity	\$ 191.9	\$ 219.6	\$ 229.7	\$ 187.1	\$ 167.2

Certain amounts in the selected consolidated financial data above have been reclassified to conform to the 2007 presentation. See Note 1 of Notes to Consolidated Financial Statements.

You should read this selected consolidated financial data together with the Consolidated Financial Statements and related Notes contained in this proxy statement/prospectus, as well as the section of this proxy statement/prospectus entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations."

#### Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")

*This Proxy Statement contains forward-looking statements. These statements relate to future events or Kratos' future financial performance. 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 statements are only predictions. Actual events or results may differ materially. Factors that may cause Kratos' results to differ include, but are not limited to: changes in the scope or timing of Kratos' projects; changes or cutbacks in spending by the U.S. Department of Defense which could cause delays or cancellations of key government contracts; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; failure to successfully consummate acquisitions or integrate acquired operations; the rate of growth of adoption of WLAN and wireless security systems by enterprises; and competition in the marketplace which could reduce revenues and profit margins.*

*Although Kratos' believes that the expectations reflected in the forward-looking statements are reasonable, Kratos cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither Kratos, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. Kratos is under no obligation to update any of the forward-looking statements after the filing of its Annual Report on Form 10-K to conform such statements to actual results or to changes in Kratos' expectations.*

*Certain of the information set forth herein, including costs and expenses that exclude the impact of stock compensation expense, amortization expense of purchased intangibles for 2006 and 2007, and the stock option investigation and related costs in 2007, may be considered non-GAAP financial measures. Kratos' believes this information is useful to investors because it provides a basis for measuring the operating performance of our business and our cash flow, excluding the effect of stock compensation expense that would normally be included in the most directly comparable measures calculated and presented in accordance with Generally Accepted Accounting Principles. Kratos' management uses these non-GAAP financial measures along with the most directly comparable GAAP financial measures in evaluating its operating performance, capital resources and cash flow. Non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information presented in compliance with GAAP, and non-financial measures we report may not be comparable to similarly titled amounts reported by other companies.*



*The following discussion should be read in conjunction with our audited consolidated financial statements and the related notes and other financial information appearing elsewhere in this proxy statement/prospectus and other reports and filings made with the Securities and Exchange Commission. Readers are also urged to carefully review and consider the various disclosures made by Kratos which attempt to advise interested parties of the factors which affect Kratos' business, including without limitation the disclosures made under the section Risk Factors.*

## **Overview**

Kratos provides mission critical engineering, IT services and warfighter solutions to the U.S. Government and government agencies, as well as to state and local agencies and commercial customers. Kratos is an innovative provider of mission critical engineering, IT services and warfighter solutions. Kratos' principal services are related to, but are not limited to, Command, Control, Communications, Computing, Combat Systems Intelligence, Surveillance and Reconnaissance, which we refer to as C5ISR, weapons systems lifecycle support and extension, military weapon range operations and technical services, missile, rocket and weapon test and evaluation, mission launch services, public safety, security and surveillance, advanced network engineering services and IT services, and critical infrastructure design and integration services. Kratos offer our customers solutions and expertise to support their mission-critical needs by leveraging its skills across these core service areas.

Historically, the majority of Kratos' business was concentrated in the area of wireless network services, and Kratos' business operated in three reportable segments: wireless network services, government network services, and enterprise network services. In 2006, Kratos was an independent provider of outsourced engineering and network deployment services, security systems engineering and integration services and other technical services for the wireless communications industry, the U.S. government, and enterprise customers.

In 2006 and 2007, Kratos undertook a transformation strategy whereby it divested its wireless-related businesses and chose to aggressively pursue business with the federal government, primarily the U.S. Department of Defense, through strategic acquisitions and organic growth. Kratos divested assets in its wireless network services segment and renamed its enterprise network services segment "Public Safety and Security." Today, under the new corporate name of Kratos Defense & Security Solutions, Inc., Kratos is organized into two primary operating segments: Kratos Government Solutions and Public Safety & Security.

### ***Divestiture of Wireless Network Business***

In December 2005, Kratos' Board made the decision to exit Kratos' Mexican operations and certain of its other deployment businesses in South America. Prior to this decision, these operations had been reported in Kratos' Wireless Network Services segment. Kratos determined that these operations met the criteria to be classified as held for sale. Accordingly, Kratos reflected these operations as discontinued in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Kratos' South American deployment operations were substantially shut down as of the end of 2005. Accordingly, all results for these operations for all periods presented have been reflected as discontinued.

On February 17, 2006, Kratos entered into a definitive agreement to divest all of its operations in Mexico for total approximate cash consideration of \$18.0 million, which approximated the net book value of the operations, including \$13.2 million of liabilities associated with a loss contingency. The transaction closed on March 10, 2006. The transaction was structured as a sale of our subsidiaries in Mexico, and the purchase price consisted of \$1.5 million in cash paid on February 17, 2006, plus a secured promissory note payable in installments through December 31, 2006. The note was secured by pledges of assets and a personal guaranty.

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The final closing balance sheet as of February 17, 2006 resulted in net asset adjustments aggregating to a total approximate \$18.9 million consideration, \$1.5 million of which was paid on February 17, 2006, with the remaining \$17.4 million payable by means of the promissory note in installments through December 31, 2006 with an interest rate of 7.5% per annum. The remaining note receivable balance was paid in December 2006. No amounts remain outstanding on the note receivable.

The purchaser, Sakoki LLC, was a newly-formed entity controlled by Massih Tayebi. Although Massih Tayebi has no current role with Kratos, he was one of its co-founders and served as its Chief Executive Officer from inception in 1994 through September 2000, and as a director from inception through April 2002. In addition, as of July 31, 2007, Massih Tayebi owned or controlled approximately 8.2% of the total voting power of Kratos' capital stock. He is also the brother of Masood Tayebi, who was the Chairman of Kratos' Board at the time of this transaction. Masood Tayebi is no longer on Kratos' Board and had no personal financial interest in the transaction and no role with the entity that purchased the Mexico operations.

On October 2, 2006, Kratos consummated the acquisition of Madison Research Corporation, which we refer to as MRC, for \$69.0 million in cash, subject to an adjustment paid in April 2007 which increased the total purchase price to approximately \$73.8 million, including transaction costs of \$0.2 million. Ten percent of the purchase price before adjustment, or \$6.9 million, was withheld as security for satisfaction of certain indemnification obligations and payable over eighteen months following the closing date of the merger pursuant to the terms of the merger agreement. In April 2007, approximately \$1.5 million of the holdback was released and paid to the former shareholders of MRC. In October 2007, a second scheduled holdback payment of \$2.8 million was made. The remaining holdback payment of approximately \$2.3 million is expected to be settled in April 2008 subject to the resolution of certain indemnification matters. The acquisition was funded by cash on hand and cash from Kratos' previous \$85 million Credit Facility with Key Bank National Association.

The MRC acquisition has been accounted for using the purchase method of accounting in accordance with Statement of Financial Accounting Standards No. 141, "Business Combinations" which we refer to as SFAS 141, whereby the total cost of the acquisition has been allocated to tangible and intangible assets acquired and liabilities assumed based upon a determination of fair values at the effective date of the acquisition. A valuation was performed by an independent appraiser to finalize the purchase price allocation based upon the fair value of the assets and liabilities acquired and the details of this valuation are included in Note 6 of our Consolidated Financial Statements.

On December 28, 2006, Kratos' Board approved a plan to divest portions of Kratos' business where critical mass had not been achieved. This plan involved the divestiture of Kratos' EMEA operations and Kratos' remaining South American operations. The EMEA operations were sold to LCC International, Inc., which we refer to as LCC, on March 9, 2007 for \$4.0 million in cash, \$3.3 million of which was received on that date. Kratos also received approximately \$1.8 million from our EMEA operations prior and subsequent to the closing date as payment on outstanding intercompany debt. The balance of the \$0.7 million sales price is being withheld as security for the satisfaction of certain indemnification obligations and is payable on a date that is the earlier of March 31, 2008 or the date that the buyer files its 10-K for the fiscal year ended December 31, 2007. Based upon its review of the most recently available financial statements of the buyer, as of December 31, 2007, Kratos has concern about its ability to pay this holdback, due to their available liquidity. Kratos has recorded a reserve of \$0.7 million for this receivable.

Kratos recorded an impairment charge of \$5.2 million in the fourth quarter of 2006 to reduce the current carrying value of its South American operations to their estimated fair value based upon current indications of interest. On April 20, 2007, Kratos entered into an Equity Purchase Agreement to sell all of the issued and outstanding equity of its interests of its wholly-owned subsidiary WFI de Brazil Techlogia en Telecomunicaciones LTDA to Strategic Project Services, LLC (SPS). The

consideration included the assumption of substantially all outstanding liabilities of WFI Brazil, nominal cash consideration, and additional earn-out consideration based on 25 percent of net receivables collected subsequent to the closing date.

On May 29, 2007, Kratos entered into an Asset Purchase Agreement with LCC for the sale of all of the assets used in the conduct of the operation of its engineering services business of Kratos' Wireless Network Services segment that provided engineering services to the non-government wireless communications industry in the United States, for aggregate consideration in of \$46 million. LCC delivered a subordinated promissory note for the principal amount of \$21.6 million, which we refer to as the Subordinated Promissory Note, paid \$17 million at closing and paid final working capital adjustments of \$2.4 million through an amendment to the Subordinated Promissory Note. Kratos retained an estimated \$5.0 million in net working capital. The transaction was completed on June 4, 2007.

On July 5, 2007, Kratos sold the \$21.6 million Subordinated Promissory Note to Silver Point Capital, L.P., which we refer to as Silver Point, in a transaction arranged by KeyBanc Capital Markets, which we refer to as KeyBanc. Kratos received approximately \$19.6 million in net cash proceeds, reflecting a discount from par value of less than five percent and aggregate transaction fees of approximately \$1 million, which includes a \$0.75 million fee to KeyBanc, an affiliate of Kratos' lender. On January 30, 2008, Kratos received net proceeds of approximately \$2.3 million on the working capital adjustment from Silver Point, net of a \$0.1 million discount from par value. Kratos did not provide any guaranty for LCC's payment obligations for the note.

On July 9, 2007, Kratos entered into a definitive agreement with an affiliate of Platinum Equity to sell the deployment services business of Kratos' wireless network services segment for total consideration payable of \$24 million, including \$18 million in cash at closing (subject to typical post closing working capital adjustments) and an aggregate \$6 million in a three-year earn-out arrangement. Kratos also agreed to provide certain transition services for a period of six months. The assets sold to Platinum Equity included all of Kratos' wireless deployment business and the Wireless Facilities name. The transaction closed on July 24, 2007.

On September 25, 2007, Kratos provided the working capital calculation to Platinum Equity, which indicated a working capital adjustment was due to Platinum primarily due to cash collected on accounts receivables by Kratos prior to the close of the transaction that exceeded its previous estimate of working capital to be delivered to Platinum. Platinum has reviewed Kratos' working capital calculation, and Kratos have not been able to come to an agreement on the working capital adjustment. In accordance with the terms of the acquisition agreement, Kratos and Platinum are currently in the process of choosing a firm to resolve this item. As of December 31, 2007 the balance of Kratos' calculation has been reflected in other current liabilities.

As a result of the engineering and deployment services divestitures in 2007, the Wireless Network Services segment has been classified as a discontinued operation in this Proxy Statement and all prior year results presented herein have been reclassified to reflect these businesses as discontinued operations in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets".

#### ***Recent Acquisitions***

On December 31, 2007 Kratos completed its acquisition of Indianapolis, Indiana headquartered Haverstick Consulting, Inc., which we refer to as Haverstick, as part of Kratos' Government Solutions Segment. Haverstick provides rocket and missile test and evaluation, weapons systems support, and professional services to the U.S. Army, U.S. Air Force, U.S. Navy, NASA, and other federal, state and local agencies. Through the Haverstick acquisition, Kratos expanded its customer relationship within the DoD and enhanced its presence with the U.S. Air Force, a key growth area for Haverstick.

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The total purchase price was \$90.2 million including transaction costs incurred by Kratos of \$0.5 million. The purchase price paid to Haverstick of \$89.7 million was paid in a combination of \$70.3 million of cash and common stock valued at \$19.4 million. We paid \$66.7 million in cash at closing, \$2.4 million in cash shortly thereafter and \$12.0 million of common stock. In addition, \$1.2 million in cash and \$7.4 million in stock was held back to secure any negative working capital adjustments required by the merger agreement and our indemnity rights. The holdback consideration will be released on the 12<sup>th</sup> month and 21<sup>st</sup> month of the anniversary date of the acquisition. In addition to the indemnity holdback, the Agreement also calls for a post closing working capital adjustment. To fund the acquisition, Kratos secured a new credit facility of \$85.0 million arranged by KeyBanc Capital Markets. The credit facility, which includes a \$25.0 million line of credit and \$60.0 million in term notes, replaced our previous credit facility, which had an outstanding principal balance of \$6.0 million on December 31, 2007.

On February 29, 2008 Kratos provided the working capital calculation to Haverstick, which indicated a working capital adjustment was due to Kratos primarily because the working capital, as calculated per the Agreement, was below the target amount. Haverstick has reviewed Kratos' working capital calculation and is in disagreement. Their response proposes that there is actually excess working capital of approximately \$1.5 million. In accordance with the Agreement, Kratos had fifteen days from the date of Haverstick's objection to resolve the disagreement. If resolution had not been achieved within the fifteen day period, Kratos and Haverstick would have had five days to agree on a nationally recognized independent accounting firm to resolve the disagreement.

In April 2008 Kratos and Haverstick resolved the disagreement with respect to the working capital adjustment. The agreed upon working capital adjustment exceeded the target amount by approximately \$1.45 million and as a result Kratos will issue approximately 700,000 shares of its common stock and make a cash payment of \$200,000 to the former shareholders of Haverstick. Both Kratos and Haverstick have agreed that the aforementioned payment is in complete and full satisfaction of the calculation of the net working capital as of closing and have released one another from any and all claims with respect to this adjustment.

Pursuant to the terms of the Merger Agreement, Kratos has agreed to use its reasonable best efforts to file a resale registration statement covering the shares issued in connection with the Merger promptly following the closing date. In the event that the Kratos common stock issued are not salable under rules promulgated under the Securities Acts, holders of the stock may elect to exchange such shares for a cash amount equal to \$2.74 per share in accordance with the terms of the Merger Agreement. Until the date on which the shares of stock are salable interest shall accrue on the value of the Closing Stock at a floating rate of one-month LIBOR plus four percent (4)% per annum.

In February 2008 Kratos entered into a definitive merger agreement with San Diego-based C5ISR and net-centric warfare solutions provider SYS Technologies (AMEX:SYS) in a stock-for-stock transaction. Under the terms of the agreement, SYS will merge into a wholly owned subsidiary of Kratos and all of SYS's outstanding common shares will be converted into Kratos common shares. Upon closing, Kratos will issue approximately 25 million shares of its common stock. The transaction is subject to customary closing conditions, including approval of the transaction by SYS's shareholders and the approval of Kratos' stockholders of the issuance of shares. The transaction is expected to close in the second quarter of 2008.

On September 12, 2007 Kratos changed its name from Wireless Facilities, Inc. to Kratos Defense & Security Solutions, Inc. to reflect its new strategic focus.

As of December 31, 2007, Kratos considers the following factors to be important in understanding its financial statements.

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Kratos Government Solutions' business with the U.S. government and prime contractors is generally performed under cost reimbursable, fixed-price or time and materials contracts. Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. Some cost reimbursable contracts include incentive fees that are awarded based on performance on the contract. Under fixed-price contracts, Kratos agrees to perform certain work for a fixed price. Under time and materials contracts, Kratos is reimbursed for labor hours at negotiated hourly billing rates and reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. Kratos' Public Security and Safety contracts are primarily fixed-price contracts whereby revenue is recognized using the percentage-of-completion method of accounting under the provisions of Statement of Position (SOP) 81-1, "Accounting for Performance of Construction Type and Certain Production Type Contracts." For contracts offered on a time and material basis, Kratos recognizes revenues as services are performed.

Cost of revenues includes direct compensation, living, travel and benefit expenses for project-related personnel, payments to third-party subcontractors, cost of materials project-related incentive compensation based upon the successful achievement of certain project performance goals, allocation of overhead costs and other direct project-related expenses.

Selling, general and administrative expenses include compensation and benefits for corporate service employees and similar costs for billable employees whose time and expenses cannot be assigned to a project (underutilization costs), expendable computer software and equipment, facilities expenses and other operating expenses not directly related and/or allocated to projects. General and administrative costs include all corporate and administrative functions that support existing operations and provide infrastructure to facilitate Kratos' future growth. Additionally, Kratos' sales personnel and senior corporate executives have, as part of their compensation packages, periodic and annual bonus/commission incentives based on the attainment of specified performance goals.

Kratos considers the following factors when determining if collection of a receivable is reasonably assured: comprehensive collection history; results of Kratos communications with customers; the current financial position of the customer; and the relevant economic conditions in the customer's country. If Kratos has had no prior experience with the customer, Kratos reviews reports from various credit organizations to ensure that the customer has a history of paying its creditors in a reliable and effective manner. If the financial condition of Kratos' customers were to deteriorate, and adversely affect their financial ability to make payments, additional allowances would be required. Additionally, on certain contracts whereby Kratos performs services for a prime/general contractor, a specified percentage of the invoiced trade accounts receivable may be retained by the customer until Kratos completes the project. Kratos periodically reviews all retainages for collectibility and record allowances for doubtful accounts when deemed appropriate, based on Kratos' assessment of the associated risks. Total retainages included in accounts receivable and current assets of discontinued operations were approximately \$1.7 million and \$0.0 million at December 31, 2007, respectively. In addition, \$0.6 million of retainages that are expected to be paid after 2007 are included in other assets (long term).

Kratos' PSS segment previously built, installed and operated a wireless LAN system at a number of shopping malls in the United States. This network was developed to offer internet connectivity for a fee to customers and tenants at the malls. The market for these services had changed in 2006 with the emergence of free WiFi and WiMAX and this resulted in significantly reduced expectations for future revenue and profits related to the realizability of this asset. Based upon an analysis of the expected future cash flows from this asset in accordance with SFAS No. 144, Kratos determined that the full value of this asset, approximately \$1.8 million, was impaired at the end of 2006. In January 2008, Kratos sold the LAN system network to the owner of the shopping malls for \$0.3 million. This transaction will be recorded in Kratos' first quarter of 2008 at the time of the transfer of the network.

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Due to a loss of management in early 2006 as a result of the completion of earn-outs on some of Kratos' PSS acquisitions at the end of 2005, its PSS operations experienced an underperformance relative to historic operating results in 2006 and this impacted Kratos' projected future performance. Kratos determined at the end of 2006 that the total amount of goodwill for its PSS segment, approximately \$18.3 million, was impaired. The fair value of the goodwill was estimated using these projections and a combination of a discounted cash flow model and a market approach model that takes into consideration comparable business and market transactions. Kratos also concluded based on this analysis the intangible assets for PSS were not impaired.

As of December 31, 2007, Kratos' annual effective tax rate was a negative 5% for the year ending December 31, 2007 which resulted in tax expense of \$1.3 million on a loss before income taxes of \$26.9 million. The rate differs from the federal and state statutory rates primarily due to the increase in the valuation allowance against deferred tax assets created during the year for which recognition is not considered to be "more likely than not".

Kratos' management currently considers the following events, trends and uncertainties to be important to understanding its financial condition and operating performance:

Kratos believes that its Kratos Government Solutions segment will build and expand its customer relationships within the U.S. Departments of Defense, Department of Homeland Security and other non-DoD state and local agencies by taking advantage of the significant opportunities for companies with substantial expertise in advanced engineering and information technology. Kratos believes it will experience continued growth in revenues and operating income from this operating segment. The acquisition of Haverstick on December 31, 2007 resulted in the addition of nearly 500 highly skilled technical professionals and engineers with expertise in the areas of military weapons and target range support as well as targets and missile operations and maintenance. The acquisition of MRC on October 2, 2006 provides Kratos with expanded presence in Huntsville, Alabama, which is a key strategic military location for this segment. MRC offers a broad range of technical, engineering and IT solutions, and has developed core competencies in weapons system lifecycle support, integrated logistics, test and evaluation, commercial off-the-shelf software and hardware selection and implementation, software development and systems lifecycle maintenance. The results of operations of Haverstick have not been included in Kratos' consolidated statement of operations as that transaction closed on December 31, 2007. The results of operations of MRC have been included in our consolidated results beginning from the closing date of October 2, 2006.

Kratos' restructuring assessments which occurred in the fourth quarter of 2006 included a critical review of its Public Safety & Security segment to take into consideration the overall enterprise related industry and market opportunities, as well as the management and performance setbacks that occurred in this segment during 2006. As a result of this analysis we made the decision to focus primarily on areas where Kratos have significant existing expertise, qualifications and relationships. For example, Kratos believes its expertise and overall qualifications provide a clear competitive differentiator on projects related to physical and other types of security system integrations at Department of Defense military bases, production facilities, and other state, local and municipal government locations.

**Results of Operations****Comparison of Results for the Year Ended December 31, 2006 to the Year Ended December 31, 2007**

*Revenues.* Revenues by operating segment for the years ended December 31, 2006 and 2007 are as follows (in millions):

	<u>2006</u>	<u>2007</u>	<u>\$change</u>	<u>% change</u>
Public Safety & Security Segment	\$ 55.6	\$ 51.1	\$ (4.5)	(8.1)%
Kratos Government Solutions Segment	97.5	142.5	45.0	46.2%
<b>Total revenues</b>	<b>\$ 153.1</b>	<b>\$ 193.6</b>	<b>\$ 40.5</b>	<b>26.5%</b>

Revenues increased \$40.5 million from \$153.1 million in 2006 to \$193.6 million in 2007, reflecting an increase of \$45.0 million in our Kratos Government Solutions segment, primarily due to the acquisition of MRC in October 2006, which contributed \$70.5 million in revenues in 2007 and \$17.2 million in 2006. This increase of \$53.3 million was partially offset by decreases due to the reduction of one program with annualized revenues of nearly \$5.7 million that was consolidated by one of Kratos' Federal Government customers as well as, to a lesser degree, other program delays and losses resulting in reduced revenues of \$2.6 million in other businesses within Kratos' Government Solutions segment. Reductions in Kratos' Public Safety & Security segment of \$4.5 million were primarily related to the exit of the municipal wireless business in the first quarter of 2007.

As described in the section "Critical Accounting Principles and Estimates" and in the footnotes to Kratos audited consolidated financial statements, a portion of its revenue is derived from fixed-price contracts whereby revenue is calculated using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. These estimates are reviewed monthly on a contract-by-contract basis, and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision. Significant management judgments and estimates, including the estimated costs to complete projects, which determine the project's percent complete, must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of Kratos revenue for any period if management makes different judgments or utilizes different estimates. During the reporting periods contained herein, we did experience revenue and margin adjustments of certain projects based on the aforementioned factors, but the effect of such adjustments, both positive and negative, when evaluated in total were determined to be immaterial to the consolidated financial statements.

*Cost of Revenues.* Cost of revenues increased \$37.8 million or 30.4% from \$124.2 million for the year ended December 31, 2006 to \$162.0 million for the year ended December 31, 2007 primarily due to the increase in total revenues. The increase was primarily attributable to cost of revenues of approximately \$14.6 million related to the MRC acquisition, offset by decreases in cost of revenues as a result of the reduced revenues in our PSS segment discussed above. Gross margin during the year ended December 31, 2007 of 16.3% decreased from a 2006 gross margin of 18.9%. The decrease in gross margin primarily resulted from a change in the mix of Government Services revenue versus Public Safety & Security revenue.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased 2.6% from \$38.5 million to \$39.5 million for the years ended December 31, 2006 and 2007, respectively. The increase of \$1.0 million is primarily due to an increase in costs reflecting the acquisition of MRC and an increase in external consulting and professional fees, such as legal and accounting, partially offset by a reduction in stock compensation expense of \$4.9 million from 2006, which decreased from \$5.9 million in 2006 to \$1.0 million in 2007. Included in the selling, general and administrative expenses (SG&A) for 2006 and 2007 is amortization of purchased intangibles of

\$2.0 million and \$2.8 million, respectively. The increase in amortization year over year is also a result of the MRC acquisition. As a percentage of revenues, selling, general and administrative expenses decreased from 25.1% in 2006 to 20.4% in 2007. Excluding the impact of the amortization of purchased intangibles and stock compensation expense, SG&A decreased from 20.0% to 19.0% of revenues for 2006 and 2007, respectively.

*Stock Option Investigation, Related Fees and Recoveries.* In the summer of 2006, Kratos' current executive management team, which has been in place since 2004, initiated an investigation of Kratos' past stock option granting practices, which we refer to as the Equity Award Review, in reaction to media reports regarding stock option granting practices of public companies. Kratos' 2007 costs of \$10.6 million included \$14.0 million in legal, accounting and other professional fees related to our Equity Award Review which was completed in September 2007 and the ongoing government inquiries by the Department of Justice and the SEC. This amount was partially offset by \$3.4 million related to the recovery of assets from Kratos' settlement with its former stock option administrator related to damages for the theft of Kratos' stock options and common stock which occurred in 2002 and 2003 and was discovered during Kratos' internal review of option granting practices. See "Legal Proceedings" on page 94 for a further discussion of these items.

*Estimated Cost for Settlement of Securities Litigation.* In March 2008, following a voluntary mediation of 2004 and 2007 securities litigation, the parties reached a tentative agreement to settle the class action. See "Legal Proceedings" on page 94 for a further discussion of these items. Kratos has accrued an estimated \$4.9 million related to its costs for the settlement of these litigations.

*Contingent Acquisition Consideration and Restatement Fees.* In September 2004, Kratos amended the purchase agreements related to two of the companies acquired in its ENS segment in 2003 to more accurately reflect the intent of the transactions, resulting in a rescission of the continuous employment clauses from the earn-out arrangements, for which Kratos recorded a \$12.4 million accrual at that time. Kratos had \$0.1 million in expense associated with contingent acquisition consideration based upon the final payments on these agreements in 2006. There were no charges incurred in 2007.

*Impairment and Restructuring Charges.* Impairment and restructuring charges decreased \$20.6 million from \$21.8 million in 2006 to \$1.2 million in 2007. During 2006, Kratos recorded \$21.8 million in impairment and restructuring charges as a result of a change in strategic focus of its PSS segment and a consolidation of its headquarter facilities, which included \$18.3 million for goodwill impairment related to acquisitions made in the PSS segment. This was due in part to changes in the industry and the strategic focus, the impact of recent and future expected operating performance, as well as operational challenges from significant employee turnover that Kratos encountered after the completion of the earn-out periods in early 2006. The balance of the charge was related to an asset impairment of approximately \$1.8 million, an unused facility charge of approximately \$1.4 million related to facilities consolidation and severance costs associated with restructuring activities of approximately \$0.3 million. The costs in 2007 of \$1.2 million included \$0.8 million for an excess facility accrual for obligations under facility leases with unused office space as a result of the recent divestitures of Kratos wireless network services businesses, \$0.2 million related to the impairment of leasehold improvements for these facilities and \$0.2 million related to an impairment of fixed assets.

*Other Expense, Net.* For the year ended December 31, 2006, net other expense was \$0.9 million compared to net other expense of \$2.3 million for the year ended December 31, 2007. The other expense in 2006 was due to interest income on the note receivable relating to the sale of Kratos' Mexican subsidiary and interest expense for the borrowings on the line of credit used to fund the acquisition of MRC in October 2006. In 2007, in accordance with EITF 87-24, *Allocation of Interest to Discontinued Operations*, interest expense on the debt of \$2.2 million that was required to be repaid as a result of the sales of Kratos' wireless network services business was allocated to discontinued operations for the periods presented. See Note 4 of Notes to Consolidated Financial Statements of this



proxy statement/prospectus. Consequently, in 2007 the interest cost for the Line of Credit borrowings used to fund the MRC acquisition was primarily allocated to discontinued operations. The net other expense of \$2.3 million in 2007 was primarily attributable to approximately \$1.8 million of an impairment charge, recorded in the fourth quarter of 2007, related to the carrying value of investments to fair value as well as \$1.2 million of interest expense incurred on Kratos' credit facility.

*Provision (benefit) for Income Taxes.* Kratos' effective income tax rate for the year ended December 31, 2006 represented a negative 43% income tax provision compared to a negative 5% income tax provision for the year ended December 31, 2007. The tax provision of \$13.8 million for the year ended December 31, 2006 included an increase to the valuation allowance of \$15.9 million against the deferred tax assets. The tax provision for the year ended December 31, 2007 included an increase to the valuation allowance of \$9.8 million against the deferred tax assets.

*Income (Loss) from Discontinued Operations.* Loss from discontinued operations increased from a loss of \$11.7 million in 2006 to a loss of \$12.6 million during 2007. The increase was primarily due to the impairment of assets related to the wireless deployment business of \$13.4 million, an impairment of goodwill of \$7.2 million related to this business, a \$1.9 million loss from the disposal of Kratos' deployment business and a \$1.1 million excess facility accrual. These charges were all partially offset by a gain of \$14.8 million on the sale of the wireless engineering services business operations and a gain of \$2.6 million on the sale of the EMEA business. Revenues and net loss before taxes generated by these businesses in 2006 were approximately \$201.7 million and \$9.8 million, respectively, compared to \$85.7 million and \$12.7 million, respectively, in 2007. The decrease year over year was impacted by the divestitures of the wireless network services businesses in 2007. See Note 4 to the Notes to the Consolidated Financial Statements for further discussion of these transactions.

**Comparison of Results for the Year Ended December 31, 2005 to the Year Ended December 31, 2006**

*Revenues.* Revenues by operating segment for the years ended December 31, 2005 and 2006 are as follows (in millions):

	2005	2006	\$change	% change
Public Safety & Security Segment	\$ 67.3	55.6	(11.7)	(17.4)%
Government Solutions Segment	85.0	97.5	12.5	14.7%
<b>Total revenues</b>	<b>\$ 152.3</b>	<b>\$ 153.1</b>	<b>\$ 0.8</b>	<b>0.1%</b>

Revenues increased \$0.8 or 0.1% from \$152.3 million in 2005 to \$153.1 million in 2006. The increase in revenues included an increase of \$12.5 million in Kratos' Government Solutions segment, substantially offset by reduced revenue in Kratos' Public Safety & Security segment.

The decreased revenues in the PSS segment of \$11.7 million from 2005 to 2006 was primarily a result of significant employee turnover, particularly management sales and business development personnel, that occurred in Kratos' Atlanta and Houston offices following the completion of the three year acquisition earn-out periods at the beginning of 2006. The increased revenue in the Government Network Services segment is a result of the acquisition of MRC in the fourth quarter of 2006, which contributed \$17.6 million in revenues in 2006, offset partially by decreases due to program delays and program reductions from two of Kratos' DOD Customers.

*Cost of Revenues.* Cost of revenues increased \$8.5 million or 7.3% from \$115.7 million for the year ended December 31, 2005 to \$124.2 million for the year ended December 31, 2006. Gross margin during the year ended December 31, 2005 of 24.0% decreased to a gross margin of 18.9% for the year ended December 31, 2006. The increase in cost of revenues was partially attributable to cost of revenues of approximately \$14.6 million related to the MRC acquisition. The decrease in gross margins resulted from an increased mix of government network services business, which generally reports the

classification of cost elements based upon definitions in accordance with government contracting regulations. As a result, cost of revenues in the 2006 periods includes certain cost elements that would otherwise be classified as SG&A expense under a commercial contract arrangement. In addition, the overall decrease in gross margin percentage was partially attributable to a stock-based compensation expense of \$0.9 million in 2006 related to Kratos' adoption of SFAS No. 123(R) in January 2006, compared to \$0.0 million in 2005 and the impact of cost overruns in the PSS sector as a result of employee and management turnover that occurred following the completion of the earn-out periods in early 2006.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased 8.5% from \$35.5 million to \$38.5 million for the years ended December 31, 2005 and 2006, respectively. As a percentage of revenues, selling, general and administrative increased from 23.3% in 2005 to 25.1% in 2006. The increase of \$3.0 million is primarily due to the cost of stock-based compensation which was \$5.9 million in 2006 or 3.9% of revenues versus \$0.2 million, net of related tax adjustments, in 2005 or 0.1% of revenues partially offset by a reduction in consulting fees. Excluding the stock-based compensation expense, SG&A decreased from \$35.3 million, or 23.2% of revenues, in 2005 to \$32.6 million, or 21.3% of revenues, in 2006.

*Contingent Acquisition Consideration and Restatement Fees.* In September 2004, Kratos amended the purchase agreements related to two of the companies acquired in its ENS segment in 2003 to more accurately reflect the intent of the transactions, resulting in a rescission of the continuous employment clauses from the earn-out arrangements, for which Kratos recorded a \$12.4 million accrual at that time. In September 2005, Kratos reduced \$2.5 million of its contingent acquisition earn-out accruals that was determined to be excess based on the projected performance of the division compared to the minimum performance targets as defined in the earn-out arrangements. In December 2005, Kratos increased its contingent acquisition earn-out accruals by \$0.4 million, to reflect the financial performance of one of the acquired entities that exceeded its previously projected performance. Kratos had \$0.1 million in expense associated with contingent acquisition consideration based upon the final payments on these agreements in 2006.

*Impairment and Restructuring Charges.* During 2006, Kratos recorded \$21.8 million in impairment and restructuring charges as a result of a change in strategic focus of its ENS segment and a consolidation of its headquarter facilities, which included \$18.3 million for goodwill impairment related to acquisitions made in the ENS segment. This was due in part to changes in the industry and Kratos' strategic focus, the impact of recent and future expected operating performance, as well as operational challenges from significant employee turnover that we encountered after the completion of the earn-out periods in early 2006. The balance of the charge was related to an asset impairment of approximately \$1.8 million, an unused facility charge of approximately \$1.4 million related to facilities consolidation and severance costs associated with restructuring activities of approximately \$0.3 million. No impairment or restructuring charges were incurred in 2005.

*Other Income (Expense), Net.* For the year ended December 31, 2005, net other income was \$0.3 million compared to net other expense of \$0.9 million for the year ended December 31, 2006. The increase in net other expense of \$1.2 million was primarily due to the interest that was incurred on the Key Bank credit facility as a result of the MRC acquisition, partially offset by the interest income earned on the note receivable for the sale of Mexico.

*Provision (benefit) for Income Taxes.* Kratos' effective income tax rate for the year ended December 31, 2005 represented a 3% income tax benefit compared to a negative 43% income tax provision for the year ended December 31, 2006. The tax benefit of \$0.1 million for the year ended December 31, 2005 included a decrease to the valuation allowance on deferred tax assets based upon Kratos' projections of taxable income for 2006, including the reversal of temporary differences. The reduction in the valuation allowance was primarily a result of Kratos' projected forecasts of 2006

taxable income, the estimated timing of reversal of temporary differences and the expected utilization of net operating loss carryforwards. In 2006, the income tax expense of \$13.8 million is a result of an increase of \$15.9 million in Kratos' valuation allowance for deferred tax assets.

*Loss from Discontinued Operations.* Loss from discontinued operations increased from a loss of \$2.0 million in 2005 to a loss of \$11.7 million during 2006. Included in the loss from discontinued operations of \$2.0 million for the year ended December 31, 2005 is an approximate \$5.0 million charge related to a write off of unrecoverable contract costs incurred on sites Kratos was building for its customers in Mexico and South America which were cancelled prior to the completion of the sites. Although Kratos was under contractual arrangement with these customers to build these sites, these costs were contractually unrecoverable from its customers due to the termination clauses in the contracts, which did not provide for reimbursement for in process cancelled sites, unless agreed upon by the customer. Also included in Kratos' loss from discontinued operation in 2005 is an impairment charge of \$0.9 million related to accumulated foreign currency translation losses as well as a \$4.4 million valuation allowance established against the deferred tax assets of Kratos' discontinued operations. Included in the loss from discontinued operations of \$11.7 million for the year ended December 31, 2006 is an impairment charge of approximately \$5.2 million to reduce the current carrying value of the South American operations to their estimated fair value based upon current indications of interest. Also included in Kratos' loss from discontinued operations in 2006 is an impairment charge of \$1.7 million related to accumulated foreign currency translation losses. Revenues and net income (loss) before taxes generated by these businesses in 2005 were approximately \$265.1 million and net income of \$7.1 million, respectively, compared to \$201.7 million and a net loss of \$9.8 million, respectively, in 2006. The reduction in revenues in 2006 from 2005 reflects the sale of our Latin American operations in February 2006. See Note 4 to the Notes to the Consolidated Financial Statements for further discussion of these transactions.

### Liquidity and Capital Resources

As of December 31, 2007, Kratos had consolidated cash and cash equivalents of \$8.6 million, consolidated long-term and short-term debt of \$76.7 million, and consolidated stockholders equity of \$167.2 million. Kratos' principal sources of liquidity are cash flows from operations and borrowings under its credit facility.

### Net Cash from Operations

Kratos' operating cash flow is used to finance trade accounts receivable, fund capital expenditures, fund Kratos' ongoing litigation and government inquiries, and make selective acquisitions. Financing trade accounts receivable is necessary because, on average, our customers do not pay us as quickly as Kratos pay its vendors and employees for their goods and services. Cash from continuing operations is primarily derived from Kratos' customer contracts in progress and associated changes in working capital components. A summary of Kratos' net cash provided by operating activities from continuing operations from its consolidated statement of cash flows is as follows (in millions):

	Years Ended December 31,		
	2005	2006	2007
Net cash used in operating activities of continuing operations	\$ (3.4)	\$ (3.9)	\$ (1.1)

Cash used in operating activities of continuing operations for 2007 decreased by \$2.7 million from 2006 primarily due to a decrease in days sales outstanding from 109 days to 101 days, after adjustment for the MRC transaction in 2006 and the Haverstick transaction in 2007, partially offset by payment related to Kratos' internal stock option investigation, as well as the timing of payments of Kratos' expenses.

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Cash used in investing activities from continuing operations are summarized as follows (in millions):

	2005	2006	2007
<b>Investing activities:</b>			
Sale/maturity of short-term investments	\$ 7.6	\$	\$
Cash paid for contingent acquisition consideration	(17.1)	(8.5)	(8.9)
Cash paid for acquisitions, net of cash acquired	(33.6)	(59.1)	(63.9)
Proceeds from the disposition of discontinued operations		18.9	57.3
Cash transferred from (to) restricted cash		(1.0)	1.0
Capital expenditures	(4.0)	(1.2)	(0.9)
	\$ (47.1)	\$ (50.9)	\$ (15.4)

Cash paid for acquisitions and contingent acquisition consideration accounted for the most significant outlays for investing activities in each of the three years from 2005 to 2007 as a result of the implementation of Kratos' strategies to diversify its business while focusing on its core competencies. These acquisitions included Haverstick in 2007, MRC in 2006, and TLA in 2005.

Investing activities in 2006 and 2007 also included proceeds of \$18.9 million and \$57.3 million respectively, directly attributable to our sale of Kratos' wireless discontinued operations.

Capital expenditures consist primarily of investment in computer hardware and software and improvement of Kratos' physical properties in order to maintain suitable conditions to conduct its business.

Cash provided by financing activities from continuing operations are summarized as follows (in millions):

	2005	2006	2007
<b>Financing activities:</b>			
Proceeds from issuance of common stock	\$ 0.1	\$ 0.4	\$
Proceeds from issuance of common stock under employee stock purchase plan	0.8		
Borrowings under credit facility and line of credit		85.0	88.5
Repayment under line of credit		(34.0)	(64.0)
Repayment of capital lease obligations	(0.4)	(0.3)	(0.4)
Debt issuance costs	(0.3)	(1.2)	(3.0)
	\$ 0.2	\$ 49.9	\$ 21.1

In 2005, Kratos entered into a \$15 million credit facility with KeyBank National Association, which we refer to as KeyBank, for general working capital requirements and to fund future acquisitions. Kratos did not draw on this facility until 2006 and in October 2006 Kratos replaced this facility with an \$85 million facility from KeyBank to fund the acquisition of MRC. During 2007, Kratos entered into two amendments to its credit facility, one in March and the other in June, which reduced the total facility to \$35 million as a result of the divestitures of its wireless network services businesses. In December 2007, Kratos successfully negotiated a new \$85.0 million credit facility with Key Bank, which was used primarily to fund the Haverstick acquisition.

Proceeds from the issuance of common stock in 2005 through 2006 are related to the exercise of employee stock options.

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Cash provided by (used in) discontinued operations are summarized as follows (in millions):

	2005	2006	2007
Operating cash flows	\$ 7.7	6.4	\$ 0.2
Investing cash flows	(5.1)	(6.6)	(1.6)
Financing cash flows	4.0	0.1	
Effect of exchange rates on cash and cash equivalents	1.0	2.7	0.0
	\$ 7.6	\$ 2.6	\$ (1.4)

Investing cash flow consists of capital expenditures incurred by Kratos' wireless network services segment. Financing cash flows is the result of proceeds received on the exercise of stock options by the wireless network services employees.

### **Off Balance Sheet Arrangements**

Kratos has no material off-balance sheet arrangements as defined in Regulation S-K 303(a)(4)(ii).

### **Contractual Obligations and Commitments**

In connection with Kratos' business acquisitions, it has agreed to make additional future payments to sellers based on final purchase price adjustments and the expiration of certain indemnification obligations. Pursuant to the provisions of SFAS No. 141, such amounts are accrued, and therefore, recorded by Kratos when the contingency is resolved beyond a reasonable doubt and, hence, the additional consideration becomes payable. In 2007, Kratos paid \$4.6 million of working capital adjustments and approximately \$4.3 million of the holdback amounts to the former MRC shareholders in accordance with the Purchase Agreement. As of December 31, 2007, Kratos has approximately \$3.5 million of cash holdback amounts that will be released subject to indemnity rights due for the MRC and Haverstick acquisitions. The MRC payment of approximately \$2.3 million was scheduled to be released in April 2008, but Kratos currently expects that no amounts will be released until July 2008, if at all, to provide sufficient time to resolve outstanding indemnification claims. The remaining amounts for Haverstick of \$1.2 million are due in December 2008 and September 2009. The holdback arrangements accrue interest in accordance to terms in the purchase agreements.

In addition to the indemnity holdback, the Haverstick Agreement also calls for a post closing working capital adjustment. On February 29, 2008 Kratos provided the working capital calculation to Haverstick, which indicated a working capital adjustment was due to Kratos primarily because the working capital, as calculated per the Agreement, was below the target amount. Haverstick has reviewed Kratos' working capital calculation and is not in agreement. Their response proposes that there is actually excess working capital of approximately \$1.5 million. In accordance with the Agreement, Kratos had fifteen days from the date of Haverstick's objection to resolve the disagreement. If resolution had not been achieved within the fifteen day period, Kratos and Haverstick would have had five days to agree on a nationally recognized independent accounting firm to resolve the disagreement.

In April 2008 Kratos and Haverstick resolved the disagreement with respect to the working capital adjustment. The agreed upon working capital adjustment exceeded the target amount by approximately \$1.45 million and as a result Kratos will issue approximately 700,000 shares of its common stock and make a cash payment of \$200,000 to the former shareholders of Haverstick. Both Kratos and Haverstick have agreed that the aforementioned payment is in complete and full satisfaction of the calculation of the net working capital as of closing and have released one another from any and all claims with respect to this adjustment.

Any amounts earned by shareholders of acquired companies for which there were no continuous employment clauses will result in additional goodwill recorded for those acquisitions when the earn-out consideration is earned. There were no earn-out considerations in connection with the MRC or Haverstick acquisitions, but in connection with future acquisitions, Kratos may agree to make additional payments to sellers contingent upon achievement of performance milestones by the acquired entities.

On December 31, 2007, Kratos entered into a new credit facility of \$85.0 million with KeyBanc Capital Markets which replaced the October 2, 2006 credit agreement with Key Bank. This credit facility provides for two term loans consisting of a first lien term note of \$50.0 million and a second lien term note of \$10.0 million, as well as, a first lien \$25 million revolving line of credit. The \$10.0 million term loan has a five and one half year term with principal payments required quarterly beginning on March 31, 2008 of \$25,000 through March 31, 2013 with the final balance of \$9.5 million due on June 30, 2013. The \$50.0 million term loan has a five year term with principal payments required quarterly beginning on March 31, 2008 of \$0.6 million in 2008, \$1.3 million in 2009, \$2.5 million in 2010, and \$4.1 million in 2011 and 2012. The term loans have a provision which states that once the full amount of the note has been borrowed, the notes cannot be paid down and reborrowed again. The revolving line of credit has a four year term which expires on December 31, 2011 and contains provisions typical in such arrangements. All loans under the new credit facility have an interest rate equal to a base rate defined as a fluctuating rate per annum equal to the higher of (a) the Federal Funds Rate plus  $\frac{1}{2}$  of 1% and (b) the rate of interest in effect for such day as publicly announced from time to time by KeyBank as its "prime rate" plus a margin for the term loans of 6.5% to 7.5% and a margin of 1.0% to 3.25% on the revolving line of credit. The applicable margin at date of borrowing is determined by the ratio of Kratos' aggregate debt to its EBITDA for the previous four fiscal quarters. Kratos used the credit facility to fund the acquisition of Haverstick and to retire outstanding debt under its October 2006 credit facility with Key Bank. The terms of the new credit agreement require Kratos to provide certain customary covenants for a credit agreement, including certain financial covenants which vary by quarter. See schedules 7.12(a) through (e) to both the First Lien Credit Agreement and the Second Lien Credit Agreement which are filed as Exhibits 10.1 and 10.2 respectively, to Kratos' Current Report on Form 8-K filed with the SEC on January 7, 2008.

As of December 31, 2007, Kratos' outstanding balance on the facility was \$75.5 million and the weighted average interest rate on the debt borrowed during 2007 was 8.3%. This includes \$3.5 million of interest expense and financing costs related to the October 2006 credit facility and the new facility dated December 31, 2007. The replacement of the October 2006 facility resulted in a write-off of \$1.0 million in deferred financing costs. Kratos has \$3.3 million in deferred financing costs outstanding as of December 31, 2007 which are related to the new facility and are being amortized over the four, five and five and one half year life of the respective underlying notes.

On February 11, 2008, Kratos entered into three interest swap agreements with Key Bank, to fix the LIBOR rate to an average of 3.16% for the term of the swap agreements. The effective date of the swaps were February 14, 2008. The notional amounts and expiration dates of the swap agreements are \$15 million and March 31, 2010; \$22.5 million and March 31, 2011; and \$32.5 million and March 31, 2011.

In March 2008 Kratos entered into a tentative agreement to settle the 2004 and 2007 securities class action litigation actions (described in "Legal Proceedings" on page 94), and as a result, Kratos recorded a \$4.9 million charge in the quarter ended December 31, 2007 to accrue its share of the settlement amounts, and an estimate for a contingent liability associated with legal proceedings related to the derivative actions, net of the amounts to be covered by Kratos' insurance carriers. As a consequence of recording this legal settlement, Kratos did not meet certain of the financial covenants in accordance with the Credit Agreement. Accordingly, on March 27, 2008, Kratos obtained an amendment and waiver from its lenders to waive the impact of the legal settlement amounts on its financial covenants as of December 31, 2007 and the affected future periods. The amendment also

amended the Credit Agreement to provide for an increase in the LIBOR floor rate to 4.25% and to require that Kratos set aside in a restricted account approximately 50% of the proceeds of the recovery from the theft of stock options by its former stock option administrator, or approximately \$1.7 million, to fund these settlement amounts. The lenders have also reserved the right to require Kratos to utilize the entire amount of the \$3.4 million in proceeds received from the theft of stock options to permanently pay down indebtedness. This right can be exercised no earlier than 60 days from March 27, 2008 and expires upon Kratos' compliance with financial covenants under the Credit Agreement for the four consecutive quarters commencing after January 1, 2008.

The net benefit of the swap agreements entered into by Kratos on February 11, 2008 has been reduced by the LIBOR floor included in the amendment and waiver discussed above. The cost related to this amendment will be recorded as deferred financing costs for the credit facility in the first quarter of 2008.

The following table summarizes Kratos' currently existing contractual obligations and other commitments at December 31, 2007, and the effect such obligations could have on Kratos' liquidity and cash flow in future periods (in millions):

	<b>Payments due/forecast by Period</b>				
	<b>Total</b>	<b>2008</b>	<b>2009-2010</b>	<b>2011-2012</b>	<b>2013 and After</b>
Long-term debt, net of interest(1)	\$ 75.5	\$ 1.9	\$ 24.0	\$ 43.6	\$ 6.0
Capital leases(5)	1.2	0.1	0.2	0.3	0.6
Estimated interest on debt(2)	21.6	7.4	10.6	3.5	0.1
Other liabilities(3)	3.5	2.9	0.6		
Purchase orders(4)	43.7	40.7	1.5	0.6	0.9
Operating leases(5)	16.3	5.6	8.0	1.8	0.9
Interpretation 48 obligations, including interest and penalties(6)	3.9	1.4	1.2	0.5	0.8
<b>Total commitments and recorded liabilities</b>	<b>\$ 165.7</b>	<b>\$ 60.0</b>	<b>\$ 46.1</b>	<b>\$ 50.3</b>	<b>\$ 9.3</b>

- (1) The Key Bank Credit Facility. The payments shown are Kratos' present forecast which contemplates that it will pay off the Key Bank Credit Facility by the due date of June 2013. The annual payment requirements for long-term debt obligations are \$2.6 million in 2008, \$15.2 million in 2009 to 2010, \$32.7 million in 2011 to 2012, and \$9.5 million in 2013. See "Notes to Consolidated Financial Statements" Note 8(a) for further details.
- (2) Includes interest payments based on current interest rates for variable rate debt and fixed rate debt based upon our swap arrangements. See "Notes to Consolidated Financial Statements" Note 8(a) for further details.
- (3) Primarily the obligations under the working capital adjustment clause and holdback payments related to the acquisition of MRC and Haverstick. See "Notes to Consolidated Financial Statements" Note 6 for further details.
- (4) Purchase orders include commitments in which a written purchase order has been issued to a vendor, but the goods have not been received or services have not been performed.
- (5) See "Notes to Consolidated Financial Statements" Note 10 for further details.
- (6) The FIN 48 obligations shown in the above table represent certain uncertain tax positions. The years for which the uncertain tax positions will reverse have been estimated in scheduling the obligations in the table above.





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As of December 31, 2007 Kratos had \$2.4 million of standby letters of credit outstanding. Kratos' letters of credit are related to its workers compensation program, as support for its performance bond program and for its work overseas. Additional information regarding Kratos' financial commitments at December 31, 2007 is provided in the notes to Kratos' consolidated financial statements. See "Notes to Consolidated Financial Statements, Note 16 Commitments and Contingencies."

### ***Other Liquidity Matters***

Kratos intends to fund its cash requirements with cash flows from operating activities, and borrowings under its current Credit Facilities and future Credit Facilities. Kratos believes these sources should be sufficient to meet its cash needs for at least the next 12 months. However, Kratos expects to pay for the settlement of its shareholder litigation in the second half of 2008 as discussed in Note 17 Legal Matters to its audited Consolidated Financial Atatements proxy statement/prospectus, and Kratos may need to raise additional funds to pay for this settlement. In addition, if Kratos becomes subject to significant judgments, settlements or fines related to the matters discussed in Note 17 Legal Matters to its audited Consolidated Financial Statements, or any other matters, or incur legal fees in excess of Kratos' current expectations, it could be required to make significant payments that could materially and adversely affect its financial condition, potentially impacting its ability to access the capital markets and its compliance with our debt covenants.

Kratos' quarterly and annual operating results have fluctuated in the past and may vary in the future due to a variety of factors, many of which are external to its control. If the conditions in Kratos' industry deteriorate or our customers cancel or postpone projects or if we are unable to sufficiently increase our revenues or further reduce its expenses, Kratos may experience, in the future, a significant long-term negative impact to its financial results and cash flows from operations. In such a situation Kratos could fall out of compliance with its financial and other covenants which, if not waived, could limit its liquidity and capital resources. See "Risk Factors" on page 24 for a further discussion of these items.

### **Critical Accounting Principles and Estimates**

Kratos has identified the following critical accounting policies that affect its more significant judgments and estimates used in the preparation of its consolidated financial statements. The preparation of Kratos' financial statements in conformity with accounting principles generally accepted in the United States of America requires it to make estimates and judgments that affect the reported amounts of assets and liabilities, stockholders' equity, revenues and expenses, and related disclosures of contingent assets and liabilities. On a periodic basis, as deemed necessary, Kratos evaluates its estimates, including those related to revenue recognition, allowance for doubtful accounts, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance, accruals for partial self-insurance, contingencies and litigation and contingent acquisition consideration. Kratos explains these accounting policies in the notes to the audited consolidated financial statements and at relevant sections in this discussion and analysis. These estimates are based on the information that is currently available and on various other assumptions that are believed to be reasonable under the circumstances. Actual results could vary from those estimates under different assumptions or conditions.

### ***Revenue recognition***

Kratos derives a significant percentage of its revenue from long-term contracts and account for these contracts under the provisions of Statement of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." Revenue on time and materials contracts is recognized as services are rendered at contracted labor rates plus material and other direct costs incurred. The portion of Kratos' revenue derived from fixed-price contracts accounted for

approximately 51.1% of its revenues for 2007. Revenue on fixed-price contracts is recognized using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. Estimates of costs to complete include material, direct labor, overhead, and allowable general and administrative expenses for Kratos' government contracts. These cost estimates are reviewed and, if necessary, revised monthly on a contract-by-contract basis. If, as a result of this review, Kratos determines that a loss on a contract is probable, then the full amount of estimated loss is charged to operations in the period it is determined that it is probable a loss will be realized from the full performance of the contract. In certain instances in which it is impractical to estimate the final outcome of the project margin, but it is certain that Kratos will not incur a loss on the project, it may record revenue equal to cost incurred, at zero margin. In the event that its cost incurred to date may be in excess of Kratos' funded contract value, it may defer those costs until the associated contract value has been funded by the customer. Once the final estimate of the outcome of the project margin is determined, Kratos will record revenue using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to the estimated total costs to complete the project. Significant management judgments and estimates, including but not limited to the estimated costs to complete projects, must be made and used in connection with the revenue recognized in any accounting period. The revenue Kratos may recognize in a given reporting period depends on: (1) the costs it has incurred for individual projects; (2) its then current estimate of the total remaining costs to complete individual projects; and (3) the current estimated contract value associated with the projects. If, in any period, Kratos increases or decreases its estimate of the total costs to complete a project, and/or reduce or increase the associated contract value, revenue for that period would be impacted. As a result, Kratos' gross margin in such period and in future periods may be affected. To the extent that its estimates fluctuate over time or differ from actual results, gross margins in subsequent periods may vary significantly from our estimates. Material differences may result in the amount and timing of Kratos' revenue for any period if management made different judgments or utilized different estimates.

A cancellation, schedule delay, or modification of a fixed-price contract which is accounted for using the percentage-of-completion method may adversely affect our gross margins for the period in which the contract is modified or cancelled. Under certain circumstances, a cancellation or negative modification could result in Kratos having to reverse revenue that Kratos recognized in a prior period, thus significantly reducing the amount of revenues Kratos may recognize for the period in which the adjustment is made. Correspondingly, a positive modification may positively affect Kratos' gross margins. In addition, a schedule delay or modifications can result in an increase in estimated cost to complete the project, which would also result in an impact to its gross margin.

In addition, many of Kratos' contracts include milestone billings. If a contract is terminated or if the scope of a contract changes prior to a milestone billing, the amount of revenue Kratos could recognize may change, based upon the specific termination clauses of the contract, which would affect its revenue and gross margin in the period in which the contract is terminated or the scope is changed.

During the reporting periods contained herein, Kratos did experience revenue and margin adjustments of certain projects based on the aforementioned factors.

#### *Allowance for doubtful accounts*

Kratos maintains an allowance for doubtful accounts for estimated losses resulting from the potential inability of certain customers to make required future payments on amounts due to Kratos. Management determines the adequacy of this allowance by periodically evaluating the aging and past due nature of individual customer accounts receivable balances and considering the customer's current financial situation as well as the existing industry economic conditions and other relevant factors that would be useful towards assessing the risk of collectibility. If the future financial condition of Kratos' customers were to deteriorate, resulting in their inability to make specific required payments, additions to the allowance for doubtful accounts may be required. In addition, if the financial condition of Kratos' customers improves and collections of amounts outstanding commence or are reasonably assured, then we may reverse previously established allowances for doubtful accounts. Changes to estimates of contract value are recorded as adjustments to revenue and not as a component of the allowance for doubtful accounts. Kratos writes off accounts receivable when they become uncollectible and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

***Long-lived and Intangible Assets.***

Kratos account for long-lived assets in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which we refer to as SFAS 144. SFAS 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This Statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability is measured by comparing the carrying amount of an asset to the expected future net cash flows generated by the asset. If it is determined that the asset may not be recoverable and if the carrying amount of an asset exceeds its estimated fair value, an impairment charge is recognized to the extent of the difference. SFAS 144 requires companies to separately report discontinued operations, including components of an entity that either have been disposed of (by sale, abandonment or in a distribution to owners) or classified as held for sale. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

In accordance with SFAS 144, Kratos assesses the impairment of identifiable intangibles and long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors Kratos considers important which could individually or in combination trigger an impairment review include the following:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of Kratos' use of the acquired assets or the strategy for its overall business;

significant negative industry or economic trends;

significant decline in Kratos' stock price for a sustained period; and

Kratos' market capitalization relative to net book value.

If Kratos determined that the carrying value of intangibles and long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, it would record an impairment equal to the excess of the carrying amount of the asset over its estimated fair value.

On a quarterly basis, Kratos assesses whether events or changes in circumstances have occurred that potentially indicate the carrying value of long-lived assets may not be recoverable.

***Goodwill and Purchased Intangible Assets.***

Kratos evaluates its goodwill and intangible assets for impairment pursuant to SFAS No. 142, *Goodwill and Other Intangible Assets* which we refer to as SFAS 142. SFAS142 provides that goodwill and other intangible assets with indefinite lives are not amortized but tested for impairment annually or more frequently if circumstances indicate potential impairment. The impairment test is comprised of two steps:

(1) A reporting unit's fair value is compared to its carrying value. The carrying values of each reporting unit are determined by specifically identifying and allocating the assets and liabilities of the Company to each reporting unit based on headcount, relative revenues or costs, or other methods as deemed appropriate by management. If the fair value is less than its carrying value, impairment is indicated;

(2) if impairment is indicated in the first step, it is measured by comparing the implied fair value of goodwill and intangible assets to their carrying value at the reporting unit level.

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*Accounting for income taxes and tax contingencies.* In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" which we refer to as Interpretation No. 48. Interpretation No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." Interpretation No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Interpretation No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Kratos adopted the provisions of Interpretation No. 48 effective January 1, 2007.

As part of the process of preparing its consolidated financial statements Kratos is required to estimate its provision for income taxes in each of the tax jurisdictions in which it conducts business. This process involves estimating Kratos' actual current tax expense in conjunction with the evaluation and measurement of temporary differences resulting from differing treatment of certain items for tax and accounting purposes. These temporary differences result in the establishment of deferred tax assets and liabilities, which are recorded on a net basis and included in Kratos' consolidated balance sheet. Kratos then assesses on a periodic basis the probability that its net deferred tax assets will be recovered and, therefore realized from future taxable income and to the extent it believes that recovery is not more likely than not, a valuation allowance is established to address such risk resulting in an additional related provision for income taxes during the period.

Significant management judgment is required in determining Kratos' provision for income taxes, its deferred tax assets and liabilities, tax contingencies, unrecognized tax benefits, and any required valuation allowance, including taking into consideration the probability of the tax contingencies being incurred. Kratos' management assesses this probability based upon information provided to Kratos by its tax advisors, its legal advisors and similar tax cases. If at a later time our assessment of the probability of these tax contingencies changes, Kratos' accrual for such tax uncertainties may increase or decrease.

Kratos has a valuation allowance at December 31, 2007, due to management's overall assessment of risks and uncertainties related to our future ability to realize and, hence, utilize certain deferred tax assets, primarily consisting of net operating losses, carry forward temporary differences and future tax deductions resulting from certain types of stock option exercises, before they expire.

The 2007 effective tax rate at December 31, 2007 for annual and interim reporting periods could be impacted if uncertain tax positions that are not recognized at December 31, 2007 are settled at an amount which differs from Kratos' estimate. Finally, during 2008, if Kratos is impacted by a change in the valuation allowance as of December 31, 2007 resulting from a change in judgment regarding the realizability of deferred tax assets beyond December 31, 2007, such effect will be recognized in the interim period in which the change occurs.

### *Accrual for partial self-insurance.*

Kratos maintains an accrual for its health and workers compensation partial self-insurance, which is a component of total accrued expenses in the consolidated balance sheets. Management determines the adequacy of these accruals based on a monthly evaluation of its historical experience and trends related to both medical and workers compensation claims and payments, information provided to Kratos by its insurance broker, industry experience and average lag period in which claims are paid. If such information indicates that Kratos' accruals require adjustment, it will, correspondingly, revise the assumptions utilized in its methodologies and reduce or provide for additional accruals as deemed appropriate. Kratos also carries stop-loss insurance that provides coverage limiting its total exposure related to each medical and workers compensation claim incurred, as defined in the applicable

insurance policies. The medical and workers compensation limits per claim are \$100,000 and \$250,000, respectively.

***Contingencies and litigation.***

Kratos is currently involved in certain legal proceedings. Kratos estimates a range of liability related to pending litigation where the amount and range of loss can be estimated. Kratos records its estimate of a loss when the loss is considered probable and estimable. Where a liability is probable and there is a range of estimated loss and no amount in the range is more likely than any other number in the range, Kratos records the minimum estimated liability related to the claim in accordance with SFAS No. 5, "Accounting for Contingencies." As additional information becomes available, Kratos assesses the potential liability related to its pending litigation and revise its estimates. Revisions in its estimates of potential liability could materially impact its results of operations. See "Legal Proceedings" on page 94 for additional information.

***Share-Based Payments.***

Beginning in fiscal year 2006, Kratos accounts for share-based compensation arrangements in accordance with the provisions of Statement of Financial Accounting Standards No. 123R, which we refer to as SFAS 123R, "Share-Based Payments," which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. Prior to adoption of SFAS 123R, Kratos accounted for share-based compensation using the intrinsic value-based method in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." Kratos adopted SFAS 123R using the modified prospective transition method.

The valuation provisions of SFAS 123R apply to new awards and to awards that are outstanding on the effective date and subsequently modified or cancelled. Under the modified prospective application, which Kratos used, prior periods are not revised for comparative purposes. Kratos uses the Black-Scholes option valuation model to estimate the fair value of its stock options at the grant date. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. Kratos' employee stock options are generally subject to vesting restrictions and are generally not transferable.

Option pricing models require the input of highly subjective assumptions including the expected stock price volatility over the term of the award, the expected life of an option and the number of awards ultimately expected to vest. Changes in these assumptions can materially affect the fair value estimates of an option. Furthermore, the estimated fair value of an option does not necessarily represent the value that will ultimately be realized by an employee. Kratos used historical data to estimate the expected forfeiture rate, intrinsic and historical data to estimate the expected price volatility, and a weighted-average expected life formula to estimate the expected option life. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option.

Estimates of share-based compensation expenses are significant to Kratos' consolidated financial statements, but these expenses are based on option valuation models and will never result in the payment of cash by us. For this reason, and because Kratos does not view share-based compensation as related to our operational performance, Kratos exclude estimated share-based compensation expense when evaluating the business performance of its operating segments.

**Quantitative and Qualitative Disclosures About Market Risk**

Kratos is exposed to market risk in connection with changes in interest rates, primarily in connection with outstanding balances under Kratos' credit facility with KeyBank National Association.

Based on Kratos' average outstanding balances during the year ended December 31, 2007 a 1% change in the LIBOR rate would impact Kratos' financial position and results of operations by approximately \$0.4 million over the next year. Kratos did not utilize any derivative financial instruments to hedge interest rate risks in 2007 or in prior years. Cash and cash equivalents as of December 31, 2007 were \$8.6 million and are primarily invested in money market interest bearing accounts. A hypothetical 10% adverse change in the average interest rate on Kratos' money market cash investments and short-term investments would have had no material effect on net income for the year ended December 31, 2007.

#### Recently Issued Accounting Pronouncements

In June 2006, FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that Kratos recognize the impact of a tax position in its financial statements, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The application of this Statement reduced Kratos' retained earnings on January 1, 2007 by \$0.1 million to increase reserves for uncertain tax positions.

The SEC issued Staff Accounting Bulletin No. 108, which we refer to as SAB 108, in September 2006. SAB 108 expresses the views of the SEC staff regarding the process of quantifying the materiality of financial misstatements. SAB 108 requires both the balance sheet and income statement approaches be used when quantifying the materiality of misstatement amounts. In addition, SAB 108 contains guidance on correcting errors under the dual approach and provides transition guidance for correcting errors existing in prior years. SAB 108 was effective in Kratos' fourth quarter of 2006. The adoption of SAB 108 did not have a material impact on Kratos' consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which we refer to as SFAS 157. This new standard provides guidance for using fair value to measure assets and liabilities and information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. This framework is intended to provide increased consistency in how fair value determinations are made under various existing accounting standards which permit, or in some cases require, estimates of fair market value. SFAS 157 also expands financial statement disclosure requirements about a company's use of fair value measurements, including the effect of such measures on earnings. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007. Kratos is in the process of determining the impact of this statement on its consolidated financial statements.

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. This option is available to all entities, including not-for-profit organizations. Most of the provisions in Statement 159 are elective; however, the amendment to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* applies to all entities with available-for-sale and trading securities. Some requirements apply differently to entities that do not report net income. The FASB's stated objective in issuing this standard is as follows: "to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions."

The fair value option established by Statement 159 permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance

indicator if the business entity does not report earnings) at each subsequent reporting date. A not-for-profit organization will report unrealized gains and losses in its statement of activities or similar statement. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments.

Statement 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurements*. Kratos is in the process of determining the impact of this statement on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007) ("SFAS 141R"), "Business Combinations" and SFAS No. 160, which we refer to as SFAS 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No. 51". SFAS 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. The provisions of SFAS 141R and SFAS 160 are effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is not permitted. Kratos is in the process of determining the impact of these statements on its consolidated financial statements.

For more information on Kratos, see "Where You Can Find More Information" on page 215.

## SYS

SYS and its subsidiaries provide information connectivity solutions that capture, analyze and present real-time information to customers in the Department of Defense, Department of Homeland Security, other government agencies and commercial companies. Using interoperable communications software, sensors, digital video broadcast and surveillance technologies, wireless networks, network management, decision-support tools and Net-Centric technologies, SYS's technical experts enhance complex decision-making. Founded in 1966, SYS is a California corporation headquartered in San Diego and has its principal offices in California and Virginia.

Historically, SYS's revenues have been generated by providing information technology, systems integration and program and financial management services under long term contracts for the Department of Defense and in particular the U.S. Navy. More recently, through a combination of acquisitions and internal growth initiatives, SYS has expanded and leveraged its technical engineering services with complementary products and has broadened its customer base to include other government agencies and commercial enterprises beyond the Department of Defense.

These expanded products and services capabilities, together with SYS's longstanding expertise in situational awareness and systems engineering, has enabled SYS to develop a set of information technology solutions to complement its services offerings for the Information Technology services and Public Safety and Security markets. SYS customers in these markets such as federal, state and local governments, public safety first-responders, large corporations, schools and universities, all share a common need for decision support products and services that enhance or enable connecting real-time data to decision makers.

SYS delivers its solutions through two reportable segments, the Defense Solutions Group and the Public Safety, Security and Industrial Systems Group. The Defense Solutions Group focuses on engineering, technical and management services to Federal Government agencies. The Public Safety,

Security and Industrial Systems Group focuses on providing "right-time" situation status and mission execution support solutions to government and commercial customers.

SYS also provides solution lifecycle support with program, financial, test and logistical services, including classroom and online training.

For additional information, visit [www.systechnologies.com](http://www.systechnologies.com). The information on this website is not incorporated by reference into this proxy statement/prospectus.

### **Industry Overview/Market Opportunity**

SYS's services and products are designed to address the information connectivity needs of its target customers in the Information Technology and Public Safety and Security markets. All of these customers have a need for decision support solutions in order to respond quickly to an incident and to share information with other agencies or organizations in a collaborative effort.

### **Solutions**

SYS's solutions include the following:

#### ***Systems Engineering***

SYS has a longstanding history of providing top quality systems engineering assistance to both government and industry customers. Using a diverse team of subject matter experts, SYS applies a robust systems engineering approach that delivers the proper balance of total system performance and total ownership costs within a family-of-systems, systems-of systems context. SYS's engineers have broad experience in all aspects of systems engineering from requirements setting, component design and testing to production. SYS achieves synergy by bringing together its expertise in many disciplines to build solutions which connect data to decisions.

SYS provides a variety of Test and Evaluation core competencies geared to the methodologies of the Department of Defense C4ISR system acquisition. SYS delivers an end-to-end solution providing Test and Evaluation support in program and administrative acquisition through the entire Test and Evaluation lifecycle.

#### ***Network Security and Management***

SYS's solutions address the growing technological complexity, heightened security awareness and operations infrastructure needs in an increasingly net-centric world.

SYS's NeuralStar product is a network management platform that monitors networks in real-time, analyzes performance metrics and captures, correlates and stores performance and alarm events for network devices, applications and services. NeuralStar is a network management platform that gives organizations the ability to manage heterogeneous data, voice, video, wireless and satellite systems as a single environment, also allowing them to take direct control by issuing commands to network elements and automating manually intensive processes.

SYS's NSMG solutions have been proven in some of the world's most intensive, high-security military environments, including serving the core network management component for the Department of Defense's backbone network, known as the Global Information Grid. SYS network management solutions serve mission-critical roles at the Ballistic Missile Defense Agency, the National Guard and the Defense Advanced Research Projects Agency. Net-centered enterprises and service providers, including Microsoft, BNSF, Broadwing and Cincinnati Bell, use SYS solutions to increase service quality, efficiency and profitability.



### ***Software Engineering***

SYS's software engineering organization has a core expertise in a broad set of application domains such as enterprise information management and visualization computing problems utilizing state of the art tools to address a wide range of futuristic operational and technical requirements. The group has an established reputation for technology transition. The software group's predominant customer-base includes military command and control, homeland security, public safety, and related areas. Within the military domain, SYS has provided software solutions for situation awareness, decision support, weather, anti-submarine warfare, network management, and distance learning. Non military domains include enterprise video systems for surveillance and satellite broadcast, online training systems, and first-responder incident management and emergency response.

### ***Public Safety and Security***

SYS provides integrated solutions for data interoperability and real-time situational awareness including collaboration, command and control, and accountability for safer emergency operations.

SYS's initial product focus is in the areas of increasing overall preparedness and improving information sharing. SYS is addressing this through its Vigily's solution which can be used to more effectively manage incident response operations and enable efficient sharing of time critical information between responders in the field and supporting operations centers, and between cooperating private, local, county, state, federal, and Department of Defense agencies.

Vigily's is a software based tactical operations system designed for public safety agencies seeking to improve response capabilities and effectiveness. The Vigily's solution delivers relevant and actionable real-time information to and from the scene of an incident for improved decision-making, resource allocation and response coordination. The Vigily's product suite consists of the Vigily's Conductor, Vigily's Mobile and Vigily's Commander.

### ***Enterprise Video Solutions***

#### *Video Surveillance*

SYS's Marathon product suite includes integrated video surveillance, security, and loss prevention solutions that enhance operational management, security & safety and loss control. SYS's products are used by customers in market segments including point-of-sale (POS), central alarm monitoring, and homeland security. SYS's Marathon Digital Video Recorder (DVR) software utilizes patented software-based video compression technology and state-of-the-art digital recording which is designed to make video more practical by improving the usability of video and data through scalable networked digital video solutions.

SYS's video surveillance management systems provide: (i) security surveillance for safety of employees and customers; (ii) recording and observing in store operations for operational improvement, theft or accidents; (iii) POS software integrating video clips with cash register transactions to reduce shrinkage and (iv) the ability to be remotely monitored by a remote central station service.

SYS's scalable PC network technology addresses the customer's operation as a whole, providing efficiencies and cost savings through an integrated approach.

#### *Video Distribution*

SYS's video distribution products represent the convergence of broadcast and Internet technologies by providing head-end (transmission) equipment and edge device (reception) equipment to provide the infrastructure for this key data and video powered distribution capability. SYS's products leverage its industry expertise in the video distribution market with specific concentration on the key convergence

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technologies (MPEG-4 AVC/H.264, ATSC, DVB, IPv6, etc.) and an engineering approach to building scalable and modular products that respond rapidly to changes in the marketplace. SYS offers products, technologies and solutions in the following areas:

Content management

IP-based content distribution

Set top box IRD's (integrated receiver-decoders)

Video on demand

ATSC (American Television Standards Committee) digital broadcasting

DVB (Digital Video Broadcast) satellite and terrestrial broadcasting

SYS's enterprise video solutions are distinguished by:

IP-centric video delivery products for internet, satellite, and terrestrial networks;

Strong reputation and presence in the satellite and broadcast video markets and the security industry;

In-house integration technology for rapidly integrating third-party systems and information sources.

SYS's solutions address the customer's operation as a whole, providing efficiencies and cost savings through an integrated approach based on feature-rich:

Scalable network technology, including technology from SYS's flag-ship network management product, NeuralStar

Best-of-breed SYS proprietary compression technology originally developed under a grant from the National Institute of Standards and Technology (NIST), as well as best-of-breed standards-based compression technologies (MPEG-4 H.264 AVC)

Data interoperability integration technology from the SYS Vigilys product suite

### *Learning and Performance*

SYS's learning and performance solutions consist of a broad range of products and services capabilities to deliver training solutions and web-enabled or satellite based interactive distance learning (IDL) for customers in the Department of Defense, other government and commercial organizations.

SYS's training solutions include services, product development, and tools addressing a breadth of related disciplines that include human performance factors, job & task analysis, competencies definition, skills & knowledge building via multiple deliver mediums, tracking, assessment, evaluation, and trend analysis.

SYS's HSI solutions focus on improving human performance and readiness through workload analysis, process improvement, manpower optimization, human factors engineering, and advanced training delivery methods/integrated learning environments. This area of work results in

improved human performance, manpower optimization, and a higher state of readiness that reduce SYS's customer's total ownership cost.

SYS's IDL solutions utilize its established strengths in digital, audio and video broadcast products and expertise in its web-based learning management solutions through which it has created a very robust, feature rich solution called Global Learning Solutions (GLS) which is targeted for the sizable interactive distance learning market including university, government, defense, homeland security and company training and education programs.

GLS is a comprehensive learning management system with complete broadcast infrastructure that enhances the distance learning experience. GLS incorporates a unique blend of content distribution products and web-based system architecture to provide flexible content and delivery options that easily accommodate future expansion. SYS customizes solutions tailored to its clients' needs and deliver them via the Internet and/or by satellite. The system facilitates various types of live and on-demand learning including e-learning, instructor-led training, web and audio casts, live high-definition video, assessments/certifications, collaboration tools and the flexibility to include third party courseware integration.

### ***Management Support Services***

SYS's program management and logistics group provides solutions support and services to meet the needs of its customers in business operations, program management, financial management, engineering and maintenance services, enterprise solutions development and implementation and logistics support. Program management includes all elements of operational and financial execution to meet required objectives and results. Logistics support includes life-cycle supportability and in-service engineering services to support current and planned equipment, in a variety of platforms.

### **Business Strategy**

SYS's business objectives are to diversify and grow its revenues, broaden its customer base and improve operating margins. SYS's strategy to achieve these objectives is based on leveraging its core strengths in C4ISR, information technology, systems integration and program and financial management while adding complementary products and capabilities that will allow it to grow its markets in these areas as well as expand into other markets, including commercial markets. SYS has affected this strategy through acquisitions and through productizing capabilities and solutions developed through its engineering services. SYS believes that this strategy will enable it to diversify its revenue sources, compete for larger Department of Defense programs and grow its operating margins, especially through the inclusion of products. Three key aspects of this strategy are as follows:

**Timing.** The process of transforming from a pure service provider to providing a mix of high technology services and products is targeted to occur in a staged fashion. As growth rates in revenues from SYS's engineering and program management services decrease or plateau, revenues from products or new customers need to be generated in a synchronized fashion;

**Products.** As SYS acquires or develops new products its strategy is threefold; (i) to continue and grow the markets for which those products were initially developed; (ii) to adapt those products for sale into its government related businesses and (iii) to integrate these products such that SYS can pursue programs that require a broader mix of capabilities to deliver a complete solution;

**Acquisitions.** SYS has expanded its capabilities and broadened its markets by acquiring companies that have products or niche service offerings. As SYS continues to execute on this strategy, it will build the existing infrastructure to accommodate these new organizations as they adapt to SYS's systems and methodologies.

### **Recent Acquisitions and Technology Purchases**

On March 31, 2004, SYS acquired all of the outstanding stock of Polexis, a privately held, San Diego-based provider of advanced data management software in support of enterprise operations and mission-critical decision-making.

On December 16, 2004, SYS acquired all of the assets of Xsilogy, a privately held, San Diego-based provider of wireless sensor network technologies and applications.

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On January 6, 2005, SYS acquired all of the outstanding stock of Antin, a defense contractor that provided information technology, C4ISR, and technical support services.

Effective August 22, 2005, SYS acquired the assets of Web Technologies, LLC (Web Tech), a provider of e-learning and web application development for customers in the automotive, environmental, financial, technology, and hospitality industries, as well as the U.S. government.

On September 27, 2005, SYS entered into an agreement to purchase certain technology and intellectual property rights related to the ForceViz technology of Lomasoft Corporation.

On November 7, 2005, SYS acquired all of the outstanding stock of Logic Innovations, Inc. (Logic), a privately held, San Diego-based provider of solutions that helped to ensure the fast and efficient delivery of digital audio, video and data to the broadcasting, communications and consumer electronics industries.

On December 2, 2005, SYS acquired all of the assets and assumed certain specified liabilities of cVideo, Inc., a San Diego-based provider of interactive video and information analysis products for business surveillance and security applications.

On April 2, 2006, SYS acquired Realty Based Information Technology Services, Ltd. (RBIS), a provider of Information Technology security engineering which developed, implemented and maintained convergent security services that are delivered by personnel with high level U.S. government clearances.

On October 17, 2006, SYS acquired all the outstanding common stock of Ai Metrix, a Reston, Virginia provider of innovative network management software solutions delivered to government and commercial customers.

### U.S. Government Contracts

SYS has derived a majority of its revenues from contracts with government agencies, the vast majority of which are with the Federal Government, under which it acts as a prime or subcontractor. During fiscal 2007, approximately 88% of SYS's total annual revenues were derived from contracts with government agencies and 12% was derived from commercial customers. SYS intends to focus on retaining and trying to increase the percentage of its business as prime contractor because it provides SYS with client relationships that generate higher levels of revenue and makes SYS less dependent on other prime contractors. The following table shows SYS's revenues from each of these types of contracts as a percentage of its total contracts based revenues for the three and six months ended December 28, 2007 and December 29, 2006:

	Three Months Ended		Six months Ended	
	2007	2006	2007	2006
Cost reimbursable	75%	79%	76%	77%
Time and materials	16%	15%	16%	18%
Fixed price	9%	6%	8%	5%
Total	100%	100%	100%	100%

SYS's costs of revenues are affected by the mix of contract types (cost reimbursement, fixed-price or time and materials) as well as the mix of prime contracts versus subcontracts. Further, with the recent inclusion of products, SYS's cost of revenues will be affected by the cost and availability of materials and components, product mix and other fixed and variable costs. Significant portions of SYS's contracts are time and materials and cost reimbursement contracts. Subject to contract limits, SYS is reimbursed for labor hours at negotiated hourly billing rates and other direct expenses under time and materials contracts and reimbursed for all actual allowable costs, plus a fee, or profit, under cost reimbursement contracts. The financial risks under these contracts are generally lower than those

associated with other types of contracts such as fixed price contracts; however, the margins are also typically lower than those on fixed-price contracts. The U.S. Government also has awarded SYS fixed-price contracts. Such contracts carry higher financial risks because SYS must deliver the products, systems or contract services at a cost below the fixed contract value in order to earn a profit.

### **Contract backlog**

SYS defines backlog as the amount of revenues it expects to realize over the remaining base contract performance period and for signed contracts in existence as of the measurement date. SYS does not include contract ceiling values under MAC or ID/IQ contracts in its backlog calculation. SYS also does not include in backlog (i) the expected amount of revenues that would be realized if, and when, it were successful in the re-compete of signed contracts in existence as of the measurement date or (ii) the expected amount of revenues that would be realized from future unidentified growth on signed contracts and task orders in existence as of the measurement date.

SYS defines funded backlog as the portion of its backlog for which funding currently is appropriated and obligated to it under a signed contract or task order by the purchasing agency, or otherwise authorized for payment to it by a customer upon completion of a specified portion of work, less the amount of revenue it has previously recognized under the contract. SYS's funded backlog does not include the full potential value of its contracts, because Congress often appropriates funds to be used by an agency for a particular program or 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 appropriations and the procuring agency allocates funding to the contract.

Total backlog as of December 28, 2007 was \$40.2 million, of which \$24.0 million was funded and \$16.2 million had been ordered, but not yet funded. Total backlog as of December 29, 2006 was \$43.5 million, of which \$30.0 million was funded and \$13.5 million had been ordered, but not yet funded.

All of SYS's U.S. government contracts are subject to audit and various cost controls and include standard provisions for termination for the convenience of the U.S. government. Multi-year U.S. government contracts and related orders are subject to cancellation if funds for contract performance for any subsequent year become unavailable.

The preceding information regarding contract backlog and future revenues to be derived therefrom is forward-looking and is subject to certain risks and uncertainties including, but not limited to, the inherent difficulty of predicting future contract potential, a dependence on the continued funding of Government programs and contract procurements, and the risk of contract termination.

**Customers**

SYS is engaged in multiple contracts as both a prime and subcontractor. Its customers include (but are not limited to) the following:

<b>Defense</b>	<b>Other Government</b>	<b>Commercial</b>
U.S. Navy: NAVSEA SPAWAR NAVAIR ONR Other Department of Defense Entities: DARPA Missile Defense Agency NASA DISA Lockheed-Martin Northrop Grumman L-3 Communications Titan Cubic Corporation Boeing	Department of Homeland Security Delaware County, PA California Office of Emergency Services  California Department of Transportation  Orange County Public Schools	American Honda Motor Co., Inc. Fox Networks General Electric Corporation HBO IntelSat Lehigh University Motorola PanAmSat Pratt & Whitney Primemedia Sempra Energy Southern California Edison United Airlines Volkswagen of America

**COMPETITIVE CONDITIONS**

*Defense Solutions Group*

A significant portion of SYS's business is awarded through competitive procurements. The engineering and management services industry consists of many companies with which SYS competes and who can provide the same or similar type of services. Many of SYS's competitors are larger and have greater financial resources than it does. SYS obtains much of its business on the basis of proposals to new and existing customers. Competition usually centers on successful past performance, technical capability, management, personnel experience and price.

SYS has many competitors who compete for the same customers. They are competent, experienced and continuously working to take work and projects away from SYS. These competitors range in size from small businesses to multi-billion dollar corporations. Much of SYS's business is long term and continuous. SYS recognizes that the SYS niche areas are desirable to other professional service firms, and it continuously seeks to improve within these niches.

Competition is intense in Department of Defense contracting. Typically, work is contracted to experienced incumbents who have existing business relationships with the contracting organization. Breaking into new markets is difficult and time consuming. Though competitors have a difficult time competing in those areas where SYS is entrenched, SYS has also experienced difficulties breaking into new Department of Defense markets, where competitors are entrenched. In Department of Defense contracting, there is a blurred line between competitors and partners. Often companies are in competition in bidding for one contract, while they are cooperating team members in winning another. Generally, SYS faces competition from three categories of competitors:

*Large Department of Defense Contractors.* Large Department of Defense contractors, such as Lockheed-Martin, Northrop Grumman, L-3 Communications, Raytheon and others, represent serious competition to SYS in areas of systems engineering and in-service engineering. These and others compete in information systems and communications. Large management consulting firms compete with

SYS for management consulting, strategic planning and information technology work. These companies also team with smaller companies. Companies in this category include Booz, Allen & Hamilton, Bearing Point and Accenture. These large companies can rely upon considerable monetary and labor resources to win government contracts. They are broadly focused in the types of work they will seek to obtain and are often teamed with small businesses and minority-owned businesses in subcontract arrangements.

*Mid-Tier Competitors.* Mid-tier competitors include NCI, Inc., MTC Technologies, Kratos, and Dynamics Research Corp.

*Small Business Department of Defense Contractors and Small Disadvantaged Department of Defense Contractors.* Small business Department of Defense contractors are generally more focused in their contracting strategies. They have fewer resources unless teamed with larger competitors. However, according to Department of Defense policy, a certain portion of Department of Defense work is set aside for small businesses, creating an environment of fierce competition among these companies for the allocated work. The U.S. Government, according to policy, also sets aside certain contracts for companies owned by members of statutorily identified disadvantaged groups. Because SYS does not qualify, it cannot compete in this arena, except as a subcontractor to qualified businesses. These qualified small disadvantaged businesses, however, are free to compete for all government issued contracts.

SYS believes that the principal competitive factors in its ability to win new business include past performance, qualifications, 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. SYS believes its ability to compete also depends on a number of additional factors including the ability of its customers to perform the services themselves, and competitive pricing for similar services.

#### ***Public Safety, Security and Industrial Systems Group***

SYS competes for both products and services based opportunities. On the services side many of the same competitors and competitive factors discussed under Defense Solutions Group apply equally to the Public Safety, Security and Industrial Systems Group business. With regards to products the competitors are generally industry or market specific, with some examples as follows:

Network Management (HP OpenView; Micromuse(IBM); EMC Smarts; SolarWinds)

Video Surveillance(Honeywell; Kalatel (G.E.); I3DVR; ImageVault)

Digital/Audio Broadcast (Tandberg; Thompson; Helius; Wegener)

E-training/learning solutions (General Physics; Learn.com)

In addition to the competitors listed above, as newer technologies are developed, many larger companies are forming strategic alliances to pursue market opportunities as opposed to developing their own in-house proprietary solutions.

#### ***Intellectual Property and Other Proprietary Rights***

SYS has filed for a number of copyright protections on several of its products. In addition, it has also registered a number of trademarks to protect its intellectual property.

In connection with the acquisition of the net assets of Xsilyo, SYS acquired two issued patents and numerous filed pending patents. The two issued patents are in the fields of flow sensors and sensing pressure. The patents pending are in the fields of sensors and sensor network architecture.



SYS believes that its intellectual property is important to its success, and it tries to protect it as described above and through the maintenance of trade secrets. SYS feels that name brand recognition will make its products and services stand out.

However, the steps SYS takes to protect its intellectual property may be inadequate. Unauthorized parties may try to disclose, obtain or use SYS's proprietary information, which could harm its business. Others may claim that SYS has violated its proprietary rights or infringed on its intellectual property. Any such claims could subject SYS to significant liability for damages and invalidate its proprietary rights. Any efforts to protect or defend SYS's rights could be time-consuming and costly. Other parties may also independently develop similar or competing technology.

*Employees*

On March 31, 2008, SYS employed 405 employees. None of these employees are subject to a collective bargaining agreement, and there is no union representation within SYS. SYS believes its employee relations are good.

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

You should read the following discussion together with SYS's consolidated financial statements and the related notes to those financial statements that are included in this proxy statement/prospectus. Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties. SYS's future results could differ materially from those discussed here.

**Overview**

Revenues and profits for the fiscal year ended June 30, 2007 were significantly impacted by three major themes. First, SYS's mix of revenues has changed as a result of products based revenues growing from 5% of revenues in 2006 to 8% in 2007 which has directly resulted in its overall gross margins growing from 20% in 2006 to 24% in 2007. Second, while SYS's services based revenues have been impacted by both funding delays and program reductions, SYS has had year over year growth in its services business. Third, SYS's operating costs and expenses have increased significantly because (i) selling, general and administrative expenses as a result of the acquisitions in April and October 2006 and the expansion of the sales and marketing efforts to support SYS's growth and (ii) SYS has made investments in research, engineering and development to further develop and expand its product offerings.

SYS's business areas that encompass engineering and program management services have been in a continuous slow decline for the past five years while during this same period SYS's C4ISR business has steadily grown. SYS anticipates that this trend of decreases in engineering and program management will continue as the Department of Defense continues to implement their information transformation strategy focusing on enhanced information technology and communications systems, data acquisition and real time situational awareness.

SYS's cost of revenues is affected by the mix of contract types (cost reimbursement, fixed-price or time and materials) as well as the mix of prime contracts versus subcontracts and the mix of product sales revenue versus services revenue. Significant portions of SYS's contracts are time and materials and cost reimbursement contracts. SYS is reimbursed for labor hours at negotiated hourly billing rates and other direct expenses under time and materials contracts and reimbursed for all actual costs, plus a fee, or profit, under cost reimbursement contracts. The financial risks under these contracts are generally lower than those associated with other types of contracts, and margins are also typically lower than those on fixed-price contracts. The U.S. Government also has awarded SYS fixed-price contracts. Such contracts carry higher financial risks because SYS must deliver the products, systems or contract services at a cost below the fixed contract value in order to earn a profit.

The following table shows SYS's revenues from each of these types of contracts as a percentage of SYS's total revenues for the fiscal years ended June 30, 2007, 2006 and 2005:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Cost reimbursement	78%	77%	70%
Time and materials	16%	15%	20%
Fixed price	6%	8%	10%
	<u>          </u>	<u>          </u>	<u>          </u>
Total	100%	100%	100%
	<u>          </u>	<u>          </u>	<u>          </u>

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The following table sets forth certain statements of operations data, including the amounts stated as a percentage of revenues, for the fiscal years ended June 30, 2007, 2006 and 2005 (amounts in millions):

	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Revenues	\$ 75.8	\$ 55.9	\$ 45.8	100.0%	100.0%	100.0%
Cost of revenues	58.0	44.6	37.4	76.5%	79.9%	81.7%
Selling, general and administrative expenses	15.5	8.5	4.9	20.4%	15.2%	10.7%
Research, engineering and development expenses	4.0	3.6	0.7	5.3%	6.4%	1.5%
Impairment charges		1.3			2.3%	
Income (loss) from operations	(1.7)	(2.1)	2.8	(2.2)%	(3.8)%	6.1%
Other (income) expense, net	0.7	0.3	0.4	0.9%	0.5%	0.9%
Income(loss) before income taxes	(2.4)	(2.4)	2.4	(3.2)%	(4.3)%	5.2%
Income tax (benefit) provision	(0.7)	(0.7)	1.0	(0.9)%	(1.3)%	2.1%
Net income (loss)	\$ (1.7)	\$ (1.7)	\$ 1.4	(2.2)%	(3.0)%	3.1%

Revenues by reportable business segments for years ended June 30, 2007, 2006 and 2005 were as follows (amounts in thousands):

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Defense Solutions Group	\$ 50.1	\$ 45.2	\$ 43.7
Public Safety, Security and Industrial Systems Group	25.7	10.7	2.1
<b>Total</b>	<b>\$ 75.8</b>	<b>\$ 55.9</b>	<b>\$ 45.8</b>

### Results of Operations

#### Fiscal Year 2007 vs. Fiscal Year 2006

**Revenues.** Revenues increased by approximately \$19.9 million or 35.6% during fiscal 2007. The increase included approximately \$11.4 million from acquisitions, \$1.1 million from products sales, and \$11.6 million from increases in training, software engineering services and engineering and program management services which were partially offset by decreases of (\$4.2) million in certain software development activities within SYS's Net-Centric programs. Acquisition related revenues were primarily attributable to the acquisition of Ai Metrix in fiscal 2007 and the acquisitions of WebTech, Logic, cVideo and RBIS, Ltd. in fiscal 2006.

Effective July 1, 2006 certain business activities that were managed and reported under the Defense Solutions Group were moved into the Public Safety, Security and Industrial Systems Group and are now managed and reported within that business group. The activities consisted principally of training related services and certain software services based contracts that are inter-related with other activities in the Public Safety, Security and Industrial Systems Group. Prior period amounts have been reclassified to reflect the inclusion of these activities in the Public Safety, Security and Industrial Systems Group.

The growth in the Defense Solutions Group of \$4.9 million is attributable to the acquisition of RBIS, Ltd., which added revenues of \$5.7 million and increases of \$3.4 million in revenues from training, software engineering services and engineering and program management services. These increases were partially offset by decreases of (\$4.2) million in certain software development activities within SYS's Net-Centric programs.

The growth in the Public Safety, Security and Industrial Systems Group of \$15.0 million is attributable to i) growth in training related services of \$8.1 million due to a combination of expansion of existing customer business, new business opportunities, and cross-selling opportunities within the

SYS customer base, ii) \$1.1 million increase in enterprise video product sales, and iii) \$5.8 million increase from acquisitions of Ai Metrix, WebTech, cVideo and Logic Innovations.

**Costs of revenue.** Costs of revenue for services includes all direct costs such as labor, materials and subcontractor costs. Costs of revenue for services also includes indirect overhead costs such as facilities, indirect labor, fringe benefits and other discretionary costs which are pooled and allocated to contracts on a pro rata basis. Generally, changes in direct costs for services are correlated to changes in revenue as resources are consumed in the production of that revenue. Costs of revenue for products includes the direct costs and manufacturing indirect expenses associated with manufacturing SYS's products.

As a percentage of revenue, costs of revenue were 76.5% and 79.9% for fiscal 2007 and 2006, respectively, resulting in gross margins of 23.5% and 20.2%, respectively. The increase in gross margins was the direct result of increased product sales that carry a higher gross margin than do SYS's services.

**Selling, general and administrative expenses.** Selling, general and administrative expenses (SG&A) include labor, fringe benefits, sales and marketing, bid and proposal (B&P) and other indirect costs. During 2007 SG&A expenses increased by approximately \$7.0 million or 82.4% over the prior year. Increases in SG&A are attributable to the SG&A of the acquisitions in the current fiscal year and also continue to be driven by (i) increased spending for sales and marketing efforts of approximately \$2.3 million, (ii) increased spending for SYS's infrastructure support of approximately \$1.6 million, (iii) increased amortization expense attributable to acquisitions of approximately \$0.4 million, (iv) increased bad debt expense of approximately \$0.3 million, (v) increased facility related expenses of approximately \$1.0 million, and (vi) and an increase in all other expenses of approximately \$1.4 million.

**Research, engineering and development expenses.** Research, engineering and development (R&D) expenses include burdened labor and material costs to develop new products as well as maintaining and enhancing SYS's existing product capabilities. R&D expenses increased \$0.4 million or 11.1% over the prior year. The increase in these expenses is primarily attributable to research and development as well as sustaining engineering related to SYS's enterprise video and network security and management product lines.

**Loss from operations.** SYS incurred a loss from operations of (\$1.7) million as compared to a loss from operations of (\$2.1) million in the prior fiscal year. The prior year loss from operations included a \$1.3 million impairment charge. Accordingly, the loss from operations increased from the prior year net of the impairment charge. This increase in loss from operations is primarily due to the increased spending for SG&A and R&D.

Loss from operations includes share-based compensation expense of approximately \$0.4 million in fiscal 2007 and \$0.5 million in fiscal 2006. These expenses include non-cash expenses associated with stock options granted to employees, the employee stock purchase plan and, in fiscal 2006, non-cash expenses related to an employee stock purchase agreement. The recognition of these share-based compensation expenses is in accordance with SFAS No. 123R, which was adopted as of the beginning of the fiscal 2006.

**Other (income) expense.** Other (income) expense includes interest expense on SYS's outstanding convertible notes and borrowings made under its credit facility and interest and other income. Other expense was \$0.7 million as compared to \$0.3 million in the prior year. The increase in other expense is due primarily to a net increase in interest expense related to the issuance of approximately \$3.1 million in convertible notes in February 2006 and interest on SYS's term note issued in connection with the RBIS acquisition in the fourth quarter of fiscal 2006, partially offset by the decrease in interest expense resulting from the conversion of convertible notes during fiscal 2006 and 2007.

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**Income tax benefit.** The income tax benefit was (\$0.7) million as compared to (\$0.7) million in the prior year. SYS's effective tax rate was 28.4% as compared to 28.3% in the prior year. SYS's effective tax rate is directly affected by share-based compensation expenses related to SFAS 123R, which are not deductible for tax purposes, but which are considered in estimating the annual effective tax rate. These factors can lead to large fluctuations in the estimated effective tax rate from quarter to quarter.

**Dividends.** There were no dividends authorized or paid in 2007 or 2006.

### Results of Operations

The following table sets forth selected items, including consolidated revenues for the three and six months ended December 28, 2007 and December 29, 2006 (in millions):

	Three Months Ended				Six Months Ended			
	2007	Percent	2006	Percent	2007	Percent	2006	Percent
Revenues	\$ 18.1	100.0%	\$ 19.2	100.0%	\$ 38.6	100.0%	\$ 35.5	100.0%
Costs of revenues	13.5	74.6%	14.7	76.6%	28.4	73.6%	27.2	76.6%
Selling, general & administrative	3.4	18.8%	3.6	18.8%	6.8	17.6%	6.7	18.9%
Research, engineering and development	1.1	6.0%	1.1	5.6%	2.2	5.7%	2.0	5.6%
Income (loss) from operations	0.1	0.6%	(0.2)	(1.0)%	1.2	3.1%	(0.4)	(1.1)%
Other expense (income)	0.1	0.6%	0.2	1.0%	0.1	0.3%	0.3	0.8%
Income tax provision (benefit)		0.0%		0.0%	0.5	1.3%	(0.3)	0.8%

**Revenues.** For the three months ended December 28, 2007, revenues were \$18.1 million, a decrease of \$1.1 million or 5.7% compared to the same period in fiscal 2007. The decrease in revenues consisted of a \$0.9 million decrease in service related revenues and a \$0.4 million decrease in product related revenues, which were partially offset by an increase of \$0.2 million of acquisition revenues related to Ai Metrix (acquired in October 2006). The decrease in services related revenues was primarily attributable to decreases in certain software engineering and Information Technology support programs that were partially offset by growth in learning and performance training solutions and in public safety solutions. For the six months ended December 28, 2007, revenues were \$38.6 million, an increase of \$3.1 million or 8.7% compared to the same period in fiscal 2007. The increase in revenues was attributable to \$2.6 million of acquisition revenues related to Ai Metrix and \$0.5 million of net increases in other products and services.

Revenues by reportable segment for the three and six months ended December 28, 2007 and December 29, 2006 were as follows (in millions):

	Three Months Ended				Six Months Ended			
	2007	2006	Change	%	2007	2006	Change	%
Defense Solutions Group	\$ 9.8	\$ 12.5	\$ (2.7)	(21.6)%	\$ 22.1	\$ 24.9	\$ (2.8)	(11.2)%
Public Safety, Security and Industrial Systems Group	8.3	6.7	1.6	23.9%	16.5	10.6	5.9	55.7%
<b>Total revenues</b>	<b>\$ 18.1</b>	<b>\$ 19.2</b>	<b>\$ (1.1)</b>	<b>(5.7)%</b>	<b>\$ 38.6</b>	<b>\$ 35.5</b>	<b>\$ 3.1</b>	<b>8.7%</b>

The decline in the Defense Solutions Group segment revenue of \$2.7 million and \$2.8 million in the three and six month periods, respectively, is primarily attributable to decreases in certain engineering services and Information Technology support programs that were partially offset by growth in enterprise solutions services.

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The growth in the Public Safety, Security and Industrial Systems Group segment revenue of \$1.6 million and \$5.9 million for the three and six month periods, respectively, is attributable to the acquisition of Ai Metrix which added \$0.2 million and \$2.5 million of revenues in the three and six month periods respectively, and growth in network management services, learning and performance training solutions, and public safety solutions, which combined contributed increased revenues of \$1.4 million and \$3.4 million in the three and six month periods, respectively.

Costs of revenue. Costs of revenue for services includes all direct costs such as labor, materials and subcontractor costs. Costs of revenue for services also includes indirect overhead costs such as facilities, indirect labor, fringe benefits and other discretionary costs which are pooled and allocated to contracts on a pro rata basis. Generally, changes in direct costs for services are correlated to changes in revenue as resources are consumed in the production of that revenue. Costs of revenue for products include the direct costs and manufacturing indirect expenses associated with manufacturing SYS's products.

As a percentage of revenue, costs of revenue were 74.6% for the three months ended December 28, 2007 compared to 76.6% for the same period in fiscal 2007 resulting in gross margins of 25.4% and 23.4%, respectively. For the six months ended December 28, 2007 costs of revenue were 73.6% compared to 76.6% for the same period in fiscal 2007 resulting in gross margins of 26.4% and 23.4%, respectively. During the three months ended December 28, 2007, the growth in the gross margin resulted from higher margins from services revenues which were 23.0% as compared to 19.5% in the prior year as a result of an increase in the gross margins on certain time and material contracts. During the six months ended December 28, 2007 the increase in gross margins was the result of increased product sales that carry a higher gross margin than do SYS's services together with the increased services margins previously discussed.

Selling, general and administrative expenses. Selling, general and administrative expenses (SG&A) include labor, fringe benefits, sales and marketing, bid and proposal (B&P) and other indirect costs. SG&A expenses decreased approximately \$0.2 million or 5.6%, to \$3.4 million in the three months ended December 28, 2007 compared to the same period in fiscal 2007. For the six months ended December 28, 2007, there was essentially no change to SG&A expenses compared to the same period in fiscal 2007. The decrease in SG&A during the three month period is primarily attributable to personnel reductions that were implemented at the end of FY07.

Research, engineering and development expenses. Research, engineering and development (R&D) expenses include burdened labor and material costs to develop new products as well as maintaining and enhancing SYS's existing product capabilities. During the three months ended December 28, 2007, there was essentially no change to R&D expenses compared to the same period in fiscal 2007. During the six months ended December 28, 2007, R&D expenses increased approximately \$.2 million or 10.0% compared to the same period in fiscal 2007. The increase in these expenses is primarily attributable to research and development as well as sustaining engineering related to SYS's network security and management product lines that were partially offset by decreases in SYS's IP video and data distribution product lines.

Income (loss) from operations. SYS had income from operations of approximately \$0.1 million in the three months ended December 28, 2007 compared to a loss from operations of approximately \$0.2 million in the same period in fiscal 2007. For the six months ended December 28, 2007, SYS had income from operations of approximately \$1.2 million compared to a loss of approximately \$0.4 million for the same period in fiscal 2007. The increase in income from operations is primarily due to the increase in gross margins from SYS's product sales.

Income (loss) from operations includes share-based compensation expense of approximately \$0.1 million and \$0.2 million for the three and six month periods ended December 28, 2007, respectively and the same amounts for each of these same periods in fiscal 2007. These expenses include non-cash expenses associated with stock options granted to employees, the employee stock

purchase plan. The recognition of these share-based compensation expenses is in accordance with SFAS 123R, which was adopted as of the beginning of the fiscal 2006.

Other (income) expense. Other (income) expense includes interest expense on SYS's outstanding convertible notes and borrowings made under its credit facility and interest and other income. Other expense was approximately \$0.1 million in the three months ended December 28, 2007 compared to \$0.2 million in the same period in fiscal 2007 and \$0.1 million for the six months ended December 28, 2007 compared to \$0.3 million for the same period in fiscal 2007. The decrease in other expense is due primarily to a decrease in interest expense related to a reduction of approximately \$2.1 million in convertible notes that matured and were converted to stock or paid down in cash during the prior fiscal year.

Income tax provision (benefit). SYS's effective tax rates were 33.8% and 49.1% for three and six month periods ended December 28, 2007, respectively, compared to 9.3% and 39.8% for the comparable periods in fiscal 2007, respectively. SYS's effective tax rate is directly affected by share-based compensation expenses related to SFAS 123R, which are not deductible for tax purposes, but which are considered in estimating the annual effective tax rate as well as SYS's forecast of annual income before taxes. These factors can lead to large fluctuations in the estimated effective tax rate from quarter to quarter. The 33.8% effective tax rate for the three month period ended December 28, 2007 was the result of revising the estimated annual effective tax rate to 49.1% from the 50.1% rate used at September 28, 2007. The 9.3% effective tax rate for the three month period ended December 29, 2006 was the result of revising SYS's estimated annual effective tax rate used for fiscal 2007 from the 69.9% rate estimated at September 29, 2006 to the 39.8% rate estimated at December 29, 2006.

### **Liquidity and Capital Resources**

Historically, SYS has financed its operations and met its capital expenditure requirements through cash flows provided from operations, long-term borrowings (including the sale of convertible notes), sales of equity securities and the use of its line of credit. The significant components of SYS's working capital are liquid assets such as cash, trade accounts receivable, inventories and income taxes receivable, reduced by accounts payable, accrued expenses, line of credit, the current portion of SYS's term note, the current portion of its convertible notes payable, the current portion of its deferred tax liabilities and deferred revenue. Working capital was \$10.7 million at December 28, 2007 compared to \$8.2 million at June 30, 2007.

Cash flows from operating activities. Cash flows used in operating activities were approximately \$1.5 million for the six months ended December 28, 2007 compared to cash flows provided from operating activities of \$0.4 million for the same period in fiscal 2007. The increased use of cash in the current fiscal year was attributable to: (i) a significant amount of liabilities for subcontractor and other trade payables and incentive compensation accrued at the end of fiscal 2007 that were paid during the first quarter of fiscal 2008 and (ii) an increase in the percentage of SYS's accounts receivable in the 60 to 90 day category which drove its DSO's from an average of 75 days to 90 days during the second quarter. A significant portion of those receivables were collected subsequent to the end of the quarter.

Cash flows from investing activities. Cash flows used in investing activities were approximately \$0.5 million in the six months ended December 28, 2007 compared to \$0.2 million for the same fiscal period in 2007. The primary reason for the increase of cash related to financing activities in the current fiscal year relates to approximately \$0.2 million of cash from Ai Metrix that exceeded acquisition costs when acquired in October 2007, which partially offset other cash used in investing activities in the prior fiscal year.

Cash flows from financing activities. Cash flows provided by financing activities were approximately \$1.4 million in the six months ended December 28, 2007 compared to \$0.9 million in the same period

in fiscal 2007. The increase was due primarily to borrowings exceeding payments on SYS's credit facility in the current fiscal year.

One of SYS's regular sources of liquidity is its revolving line of credit facility with Comerica for \$4.0 million, which expires on December 28, 2008. The outstanding balance on SYS's revolving \$4.0 million line of credit at December 28, 2007 was \$1.1 million. SYS's \$4.0 million revolving line of credit facility allows SYS to use (i) the full \$4.0 million for working capital purposes or (ii) under a Sub Facility, up to \$2.0 million of the credit facility for permitted acquisition purposes and \$750,000 for minority investment purposes. The line of credit is subject to certain restrictions on permitted acquisitions and minority investments, and in some cases, SYS must receive the lender's consent prior to using the facility for such purposes. If used for permitted acquisitions or minority investments, these advances must be repaid over 48 months.

During fiscal 2006, in connection with the purchase of RBIS, SYS utilized \$1.0 million of this line for payment of a portion of the purchase consideration. In accordance with the terms of the credit facility, the \$1.0 million was converted to a term note effective June 10, 2006. The term note is payable in monthly installments of \$20,833 plus interest for fiscal years 2007 through 2010, with payments beginning October, 2006. In June 2007, SYS elected to pre-pay principal of \$0.25 million which represented the amount of principal due for the next twelve months. The balance of the term note as of December 28, 2007 was \$0.5 million, of which \$0.1 million is classified as a current liability. A total of \$0.25 million of principal amounts of this note are due annually in fiscal years 2009 and 2010. The outstanding balance related to the Sub Facility reduces the maximum borrowings available under the line of credit. As a result, as of December 28, 2007, the maximum borrowing under the line of credit was \$3.5 million and the remaining available borrowing capacity on the line of credit was approximately \$2.4 million.

On September 27, 2006, SYS and the lender agreed to amend the terms of the line of credit to eliminate the minimum quarterly net income covenant and the ratio of senior debt to EBITDA covenant and modify the tangible effective net worth covenant and cash flow coverage ratio covenant.

SYS has the option of being charged prime plus 0.25% or LIBOR plus 300 basis points on the credit facility and prime plus 0.50% or LIBOR plus 325 basis points on the sub facility subject to minimum advance amounts and duration under the LIBOR option. The loan is collateralized by all of SYS's assets including accounts receivable. Borrowings are limited to 80% of SYS's billed accounts receivable that are less than 90 days old.

Management believes that SYS will have sufficient cash flow from operations and funds available under the revolving credit agreement to finance its operating and capital requirements for at least the next twelve months.

Long-term liquidity and continued acquisition related growth will depend on SYS's ability to manage cash, raise cash through debt and equity financing transactions and maintain profitability. SYS may seek to raise additional capital from time to time as market conditions permit and subject to Board approval. SYS's losses in the two prior fiscal years may impact its ability to raise capital.

In January 2008, the Internal Revenue Service (IRS) completed its examination of SYS's U.S. income tax returns for fiscal years ended June 30, 2004 through June 30, 2006. SYS has agreed to IRS adjustments to reverse the acceleration of the deduction of certain expenses incurred in a subsequent year for the tax years under audit resulting in a payment in January 2008 for taxes of \$483,000. This amount was included in the income taxes payable as of June 30, 2007 and December 28, 2007.

#### **Recent Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board, which we refer to as FASB, issued Statement of Financial Accounting Standards ("SFAS") No. 141 (revised 2007), Business Combinations,



which replaces SFAS No 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for SYS beginning July 1, 2009 and will apply prospectively to business combinations completed on or after that date.

On July 1, 2007, SYS adopted the provisions of the FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which provides a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, SYS may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Upon adoption, SYS recognized a \$19,000 charge to its beginning retained deficit as a cumulative effect of a change in accounting principle. See Note 10 Income Tax.

In May 2007, the FASB issued FASB Staff Position ("FSP") FIN 48-1 Definition of Settlement in FASB Interpretation No. 48 (FSP FIN 48-1). FSP FIN 48-1 provides guidance on how to determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN 48-1 is effective for SYS beginning July 1, 2007. The implementation of this standard had no significant impact on SYS's condensed consolidated financial statements.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 ("SFAS 159"). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for SYS beginning July 1, 2008. SYS is in the process of determining the impact of this statement on its consolidated financial statements.

In September 2006, the FASB issued Statement No. 157 ("SFAS 157"), Fair Value Measurements. SFAS 157 prescribes a single definition of fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The accounting provisions of SFAS 157 will be effective for SYS beginning July 1, 2008. SYS is in the process of determining the impact of this statement on its consolidated financial statements.

For more information on SYS, see "Where You Can Find More Information" on page 215.

## KRATOS ANNUAL MEETING

### Date, Time and Place

These proxy materials are delivered in connection with the solicitation by the Kratos board of directors of proxies to be voted at the Kratos annual meeting, which is to be held at 4810 Eastgate Mall, San Diego, CA \_\_\_\_\_, 2008, at 10:00 a.m., local time, on \_\_\_\_\_, 2008. On or about \_\_\_\_\_, 2008, Kratos commenced mailing this Proxy Statement and the enclosed form of proxy to its stockholders entitled to vote at the meeting.

### Purpose of the Kratos Annual Meeting

Kratos stockholders will be asked to vote on the following six proposals:

1. To elect five directors for one-year terms or until their successors are elected and duly qualified.
2. To ratify the selection of Grant Thornton LLP as our independent auditors for the fiscal year ending December 28, 2008.
3. To approve the amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the plan by 1,500,000 shares.
4. To approve an amendment to the Kratos 2005 Equity Incentive Plan to increase the aggregate number of shares that may be issued under the plan by 3,000,000 shares
5. To approve the issuance of Kratos common stock, par value \$0.001 per share, pursuant to the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS, as the same may be amended from time to time.
6. To approve any motion to adjourn or postpone the annual meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the annual meeting to approve the first five proposals listed above.
7. To transact such other business as may properly come before the annual meeting or any adjournment or postponement thereof.

### Kratos Record Date;

Only stockholders of record as of the close of business on [ \_\_\_\_\_ ], 2008 (the official record date) will be entitled to notice of and to vote at the annual meeting or at any subsequent meeting due to an adjournment of the original meeting. **We are mailing this proxy statement and the accompanying proxy card on or about [ \_\_\_\_\_ ], 2008 to all stockholders of record as of [ \_\_\_\_\_ ], 2008.**

### Shares Outstanding and Voting Rights

On the record date, [ \_\_\_\_\_ ], 2008, Kratos had two classes of voting stock outstanding, common stock and preferred stock. At April 8, 2008, 78,998,922 shares of common stock were issued and outstanding and 10,000 shares of Series B Convertible Preferred Stock were issued and outstanding. Each outstanding share of common stock entitles the holder to one vote and each outstanding share of Series B Convertible Preferred Stock entitles the holder to one hundred votes, on all matters to be voted upon at the annual meeting.

A complete list of stockholders entitled to vote at the Kratos annual meeting will be available for examination by any Kratos stockholder at Kratos' headquarters, for purposes pertaining to the Kratos

annual meeting, during normal business hours for a period of ten days before the Kratos annual meeting, and at the time and place of the Kratos annual meeting.

#### **Quorum and Votes Required**

In order to carry on the business of the meeting, Kratos must have a quorum. A quorum requires the presence, in person or by proxy, of the holders of a majority of the votes entitled to be cast at the meeting.

#### ***Required vote to elect Scott I. Anderson, Bandel L. Carano, Eric M. DeMarco, William A. Hoglund and Scot B. Jarvis to the Kratos Board of Directors (Item 1 on the Proxy Card)***

Directors are elected by a plurality of the votes present in person or by proxy and entitled to vote at a meeting at which a quorum is present.

#### ***Required vote to ratify the selection of Grant Thornton LLP as independent auditors for Kratos (Item 2 on the Proxy Card)***

The affirmative vote of a majority of the shares of Kratos common stock entitled to vote at the meeting is required to approve the selection of Grant Thornton LLP as independent auditors for Kratos.

#### ***Required vote to approve the amendment to the 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the Plan by 1,500,000 shares (Item 3 on the Proxy Card)***

The affirmative vote of a majority of the shares of Kratos common stock entitled to vote at the meeting is required to approve the amendment to the 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the Plan by 1,500,000 shares.

#### ***Required vote to approve the amendment to the 2005 Equity Incentive Plan to increase the aggregate number of shares that may be issued under the Plan by 3,000,000 shares (Item 4 on the Proxy Card)***

The affirmative vote of a majority of the shares of Kratos common stock entitled to vote at the meeting is required to approve the amendment to the 2005 Employee Incentive Plan to increase the aggregate number of shares that may be issued under the Plan by 3,000,000 shares.

#### ***Required Vote to Approve the Share Issuance (Item 5 on the proxy card)***

The affirmative vote of a majority of the shares of Kratos common stock entitled to vote at the meeting is required to approve the Share Issuance.

#### ***Required Vote to approve any motion to adjourn or postpone the annual meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the annual meeting to approve the Share Issuance (Item 6 on the proxy card).***

The affirmative vote of a majority of the shares of Kratos common stock represented at the meeting either in person or by proxy is required to adjourn or postpone the annual meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the annual meeting to approve the Share Issuance.

#### **Treatment of Abstentions, Non-Voting and Incomplete Proxies**

Brokers who hold shares of Kratos common stock in "street name" for a beneficial owner of those shares typically have the authority to vote in their discretion on routine proposals when they have not received instructions from beneficial owners. However, under the rules that govern brokers, brokers are

not allowed to exercise their voting discretion with respect to the approval of matters that are "non-routine," such as approval of the issuance of shares of Kratos common stock pursuant to the merger agreement, without specific instructions from the beneficial owner. These non-voted shares are referred to as "broker non-votes." If your broker holds your Kratos common stock in "street name," your broker will vote your shares only if you provide instructions on how to vote by filling out the voter instruction form sent to you by your broker with this joint Proxy Statement.

If you return a proxy card but fail to indicate your vote with respect to a proposal, an incomplete proxy, your shares will be voted in favor of the proposal in accordance with the recommendation of the board of directors.

Abstentions, incomplete proxies and "broker non-votes" will be counted as present and entitled to vote for purposes of determining whether a quorum is present at the meeting.

For Proposal 1, because directors are elected by a plurality of the votes cast, abstentions will not be counted in determining which nominees received the largest number of votes cast. Broker non-votes are not expected to result from the vote on Proposal 1.

For Proposal 2, abstentions will have the same effect as voting against the ratification of the selection of Grant Thornton LLP as independent auditors of Kratos. Broker non-votes are not expected to result from the vote on Proposal 2.

For Proposal 3, abstentions will have the same effect as voting against the amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the Plan by 1,500,000 shares. Brokers and other nominees will not have discretionary voting authority on this proposal and thus broker non-votes will result from the vote on Proposal 3.

For Proposal 4, abstentions will have the same effect as voting against the amendment to the Kratos 2005 Equity Incentive Plan to increase the aggregate number of shares that may be issued under the Plan by 3,000,000 shares. Brokers and other nominees will not have discretionary voting authority on this proposal and thus broker non-votes will result from the vote on Proposal 4.

For Proposal 5, abstentions will have the same effect as voting against approval of the issuance of shares of Kratos common stock pursuant to the merger agreement. Brokers and other nominees will not have discretionary voting authority on this proposal and thus broker non-votes will result from the vote on Proposal 5.

For Proposal 6, abstentions will have the same effect as voting against approval of an adjournment. Broker non-votes are not expected to result from the vote on Proposal 6.

#### **Voting by Kratos Directors and Executive Officers**

On the Kratos record date, directors and executive officers of Kratos and their affiliates owned and were entitled to vote [ ] shares of Kratos common stock, or approximately [ ]% of the total voting power of the shares of Kratos common stock and shares of Kratos capital stock outstanding on that date. Each of Kratos' directors and executive officers have executed voting agreements pursuant to which each has agreed to vote their shares of common stock in favor of the items listed on the Proxy Card.

#### **Voting of Proxies**

Giving a proxy means that a Kratos stockholder authorizes the persons named in the enclosed proxy card to vote its shares at the Kratos annual meeting in the manner it directs. A Kratos

stockholder may vote by proxy or in person at the meeting. To vote by proxy, a Kratos stockholder may use one of the following methods if it is a registered holder (that is, it holds its stock in its own name):

**Telephone voting**, by dialing the toll-free number and following the instructions on the proxy card;

**Via the Internet**, by going to the web address [www.proxyvote.com](http://www.proxyvote.com) and following the instructions on the proxy card; or

**Mail**, by completing and returning the proxy card in the enclosed envelope. The envelope requires no additional postage if mailed in the United States.

Kratos requests that Kratos stockholders complete and sign the accompanying proxy and return it to Kratos as soon as possible in the enclosed postage-paid envelope. When the accompanying proxy is returned properly executed, the shares of Kratos stock represented by it will be voted at the Kratos annual meeting in accordance with the instructions contained on the proxy card.

If any proxy is returned without indication as to how to vote, the Kratos stock represented by the proxy will be considered a vote in favor of all matters for consideration at the Kratos annual meeting. Unless a Kratos stockholder checks the box on its proxy card to withhold discretionary authority, the proxy holders may use their discretion to vote on other matters relating to the Kratos annual meeting.

If a Kratos stockholder's shares are held in "street name" by a broker or other nominee, the stockholder should check the voting form used by that firm to determine whether it may vote by telephone or the Internet.

**Every Kratos stockholder's vote is important. Accordingly, each Kratos stockholder should sign, date and return the enclosed proxy card, or vote via the Internet or by telephone, whether or not it plans to attend the Kratos annual meeting in person.**

#### **Revocability of Proxies and Changes to a Kratos Stockholder's Vote**

A Kratos stockholder has the power to change its vote at any time before its shares are voted at the annual meeting by:

notifying Kratos' Corporate Secretary, Laura L. Siegal, in writing at 4810 Eastgate Mall, San Diego, CA 92121 that you are revoking your proxy;

executing and delivering a later dated proxy card or submitting a later dated vote by telephone or in the internet; or

voting in person at the annual meeting.

**However, if a Kratos stockholder has shares held through a brokerage firm, bank or other custodian, it may revoke its instructions only by informing the custodian in accordance with any procedures it has established.**

#### **Solicitation of Proxies**

The solicitation of proxies from Kratos stockholders is made on behalf of the Kratos board of directors. Kratos and SYS will generally share equally the cost and expenses of printing and mailing this Proxy Statement and all fees paid to the SEC. Kratos will pay the costs of soliciting and obtaining these proxies, including the cost of reimbursing brokers, banks and other financial institutions for forwarding proxy materials to their customers. Proxies may be solicited, without extra compensation, by Kratos officers and employees by mail, telephone, fax, personal interviews or other methods of communication. Kratos has engaged the firm of Georgenson Shareholder to assist Kratos in the distribution and solicitation of proxies from Kratos stockholders and will pay Georgenson Shareholder

an estimated fee of \$8,850 plus out-of-pocket expenses for its services. SYS will pay the costs of soliciting and obtaining its proxies and all other expenses related to the SYS special meeting.

**Internet Availability of Proxy Materials and Delivery of Proxy Materials to Households Where Two or More Stockholders Reside**

As permitted by the Exchange Act, only one copy of this Proxy Statement is being delivered to stockholders residing at the same address, unless Kratos stockholders have notified Kratos of their desire to receive multiple copies of the Proxy Statement. This is known as householding.

Kratos will promptly deliver, upon oral or written request, a separate copy of this Proxy Statement to any stockholder residing at an address to which only one copy was mailed. Requests for additional copies for this year or future years should be directed to: Kratos Defense & Security Solutions, Inc., Attention: Corporate Secretary, 4810 Eastgate Mall, San Diego, CA 92121.

All Kratos stockholders may view this Proxy Statement on the internet at: [www.kratosdefense.com](http://www.kratosdefense.com).

**Attending the Meeting**

Subject to space availability, all stockholders as of the record date, or their duly appointed proxies, may attend the meeting. Since seating is limited, admission to the meeting will be on a first-come, first-served basis. Registration and seating will begin at \_\_\_\_\_ a.m., local time.

If you are a registered stockholder (that is, if you hold your stock in certificate form), an admission ticket is enclosed with your proxy card. If you wish to attend the annual meeting, please vote your proxy but keep the admission ticket and bring it with you to the annual meeting.

If your shares are held in "street name" (that is, through a bank, broker or other holder of record) and you wish to attend the annual meeting, you need to bring a copy of a bank or brokerage statement to the annual meeting reflecting your stock ownership as of the Kratos record date.

**PROPOSAL 1**

**ELECTION OF DIRECTORS**

The Kratos board of directors has designated the persons named below as nominees for election of directors, for one-year terms, expiring at its 2009 Annual Meeting of Stockholders. All nominees are currently serving as directors of Kratos.

The Kratos board of directors is elected annually and currently consists of five members, all of whom are standing for re-election to the board of directors at the annual meeting.

**Vote Required and the Kratos Board of Directors' Recommendation**

Each director is elected by a plurality of the votes cast. The persons named in the enclosed proxy will vote the proxies they receive FOR the election of the nominees named below, unless a particular proxy card withholds authorization to do so, or provides contrary instructions. Abstentions will be counted as present for purposes of determining the presence of a quorum, but will not have any effect on the outcome of voting with respect to the election of directors. Broker non-votes are not expected to result from this proposal. Each of the nominees has indicated that he is willing and able to serve as a director. If, before the annual meeting, any nominee becomes unable to serve, an event that is not anticipated by the Kratos board of directors, the proxies will be voted for the election of whomever the Kratos board of directors may designate.

**The Kratos board of directors recommends that stockholders  
vote FOR the election of each of the nominees for director listed below.**

**Nominees For Election:**

Name	Age	Committees
Scott I. Anderson	49	Audit Committee Chair and Nominating and Corporate Governance Committee
Bandel L. Carano	46	Compensation Committee and Nominating and Corporate Governance Committee
Eric M. DeMarco	44	
William A. Hoglund	54	Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee Chair
Scot B. Jarvis	47	Audit Committee, Compensation Committee Chair and Nominating and Corporate Governance Committee

Scott I. Anderson, 49, has been a director since February 1997. Since 1997, Mr. Anderson has been a principal of Cedar Grove Partners, LLC, an investment and advisory concern. Since 1998, Mr. Anderson has also been a principal of Cedar Grove Investments, LLC, a private seed capital firm. Mr. Anderson was with McCaw Cellular/AT&T Wireless, most recently as Senior Vice President of the Acquisitions and Development group. Mr. Anderson served on the board of directors of SunCom Wireless until its acquisition by T-Mobile in February 2008 and also serves on the boards of directors of, mInfo, Inc. and GotVoice, Inc.; CosComm International, Inc., Globys, Inc. and Anvil Corp. Mr. Anderson is a member of the control groups of Von Donop Inlet PCS, LLC and LCW Wireless, LLC, both wireless licensees. He holds a B.A. in History from the University of Washington, Magna Cum Laude, and a J.D. from the University of Washington Law School, with highest honors.

Bandel L. Carano, 46, originally served as a director from August 1998 to June 2001, and re-joined the Kratos board of directors in October 2001. Since 1987, he has been a general partner of Oak Investment Partners, a multi-stage venture capital firm. Mr. Carano also serves on the Investment Advisory Board of the Stanford Engineering Venture Fund, the boards of directors of Airspan Networks, Inc. and FiberTower Corporation, the supervisory board of Tele Atlas N.V. and the board of directors of numerous private companies, including MobiTV, NeoPhotonics, nLight Photonics, Tensilica and Visto Corporation. Mr. Carano holds a B.S. and an M.S. in Electrical Engineering from Stanford University. Mr. Carano was nominated and elected as one of our directors pursuant to the terms of a purchase agreement among Kratos and certain of its stockholders in connection with the sale of Kratos' Series A Convertible Preferred Stock in October 2001.

Eric M. DeMarco, 44, joined Kratos in November 2003 as President and Chief Operating Officer. Mr. DeMarco was appointed a director and assumed the role of Chief Executive Officer effective April 1, 2004. Prior to coming to Kratos, Mr. DeMarco most recently served as President and Chief Operating Officer of The Titan Corporation ("Titan"), a Delaware corporation. Prior to his being named President and Chief Operating Officer, Mr. DeMarco served as Executive Vice President and Chief Financial Officer of Titan. Prior to joining Titan, Mr. DeMarco served in a variety of public accounting positions primarily focusing on large multinational corporations and publicly traded companies. Mr. DeMarco holds a Bachelor of Science, Business Administration and Finance, Summa Cum Laude, from the University of New Hampshire.

William A. Hoglund, 54, has been a director since February 2001. Mr. Hoglund is also a member of Safeboats International, LLC. From 1996 to 2000 Mr. Hoglund served as the Vice President and Chief Financial Officer of Eagle River, LLC, a private investment company. During his tenure at Eagle River, Mr. Hoglund was also a director of Nextel Communications, Inc. and Nextlink

Communications, Inc. Mr. Hoglund holds a B.A. in Management Science and German Literature from Duke University and an MBA from the University of Chicago.

Scot B. Jarvis, 47, joined the Kratos board of directors in February 1997. Mr. Jarvis co-founded Cedar Grove Partners, LLC in 1997, an investment and consulting/advisory partnership, and currently is its managing member. Prior to co-founding Cedar Grove, Mr. Jarvis served as a senior executive of Eagle River, Inc., a McCaw investment firm. While at Eagle River he founded Nextlink Communications on behalf of McCaw and served as its president. He also served as a regional president for Nextel Communications. From 1985 to 1994, Mr. Jarvis served in several executive capacities at McCaw Cellular Communications up until it was sold to AT&T. Mr. Jarvis serves on the corporate boards of Cantata Technology, Inc., Wavelink Corporation, Visto Corporation, SkyPipeline and Slingshot Sports. Mr. Jarvis holds a B.A. in Business Administration from the University of Washington.

### **Corporate Governance Guidelines**

The Kratos board of directors has adopted corporate governance guidelines to assist the Kratos board of directors in the exercise of its responsibilities and to serve the interests of Kratos and our stockholders. The corporate governance guidelines are available for review on our website at [www.kratosdefense.com](http://www.kratosdefense.com). The information on Kratos' website is not a part of this prospectus.

### **Director Independence**

The Kratos board of directors has unanimously determined that four of our directors standing for election, Messrs. Anderson, Carano, Hoglund and Jarvis, who constitute a majority of the Kratos board of directors, are "independent" as that term is defined by the NASDAQ Marketplace Rule 4200(a)(15). In making this determination, the Kratos board of directors has affirmatively determined, considering broadly all relevant facts and circumstances regarding each independent director, that none of the independent directors has a material relationship with Kratos (either directly or as a partner, stockholder, officer or affiliate of an organization that has a relationship with Kratos). In addition, based upon such standards, the Kratos board of directors determined that Mr. DeMarco is not "independent" because he is the President and Chief Executive Officer.

### **Nominations for Directors**

The Nominating and Corporate Governance Committee is responsible for screening potential director candidates and recommending qualified candidates to the Board for nomination. The committee will consider and evaluate any recommendation for director nominees proposed by a stockholder who (i) has continuously held at least 1% of the outstanding shares of Kratos' common stock entitled to vote at the annual meeting of stockholders for at least one year by the date the stockholder makes the recommendation and (ii) undertakes to continue to hold the common stock through the date of the meeting. In order to be evaluated in connection with Kratos' established procedures for evaluating potential director nominees, any recommendation for director nominee submitted by a qualifying stockholder must be received by Kratos no later than 120 days prior to the anniversary of the date proxy statements were mailed to stockholders in connection with the prior year's annual meeting of stockholders. Any stockholder recommendation for director nominee must be submitted to the Corporate Secretary in writing at 4810 Eastgate Mall, San Diego, California 92121 and must contain the following information:

A statement by the stockholder that he/she is the holder of at least 1% of Kratos' common stock and that the stock has been held for at least a year prior to the date of the submission and that the stockholder will continue to hold the shares through the date of the annual meeting of stockholders;



The candidate's name, age, contact information and current principal occupation or employment;

A description of the candidate's qualifications and business experience during, at a minimum, the last five years, including his/her principal occupation and employment and the name and principal business of any corporation or other organization in which the candidate was employed;

The candidate's resume; and

Three references.

The goal of the Nominating and Corporate Governance Committee of the Kratos board of directors is to assemble a board of directors that brings a variety of perspectives and skills derived from high quality business and professional experience to Kratos. In doing so, the Nominating and Corporate Governance Committee also considers candidates with appropriate non-business backgrounds.

Other than the foregoing, there are no stated minimum criteria for director nominees. However, the Nominating and Corporate Governance Committee may also consider such other factors as it may deem are in Kratos' best interests and that of its stockholders. The Nominating and Corporate Governance Committee does, however, recognize that under applicable regulatory requirements at least one member of the Kratos board of directors must meet the criteria for an "audit committee financial expert" as defined by SEC rules, and that at least a majority of the members of the Kratos board of directors must meet the definition of "independent director" under the NASDAQ Marketplace Rules or the listing standards of any other applicable self regulatory organization. The Nominating and Corporate Governance Committee also believe it to be appropriate for certain key members of Kratos' management to participate as members of the Kratos board of directors.

The Nominating and Corporate Governance Committee identifies nominees by first evaluating the current members of the Kratos board of directors willing to continue to serve. Current members of the Kratos board of directors with skills and experience that are relevant to Kratos' business and who are willing to continue in service are considered for re-nomination, balancing the value of continuity of service by existing members of the Kratos board of directors with that of obtaining a new perspective. If any member of the Kratos board of directors up for re-election at an upcoming annual meeting of stockholders does not wish to continue in service, the Nominating and Corporate Governance Committee identifies the desired skills and experience of a new nominee in light of the criteria above. All of the members of the Kratos board of directors will be polled for suggestions as to individuals meeting the criteria for nomination to the Kratos board of directors. Research may also be performed to identify qualified individuals. If the Nominating and Corporate Governance Committee believes that the Kratos board of directors requires additional candidates for nomination, the Nominating and Corporate Governance Committee may explore alternative sources for identifying additional candidates. This may include engaging, as appropriate, a third party search firm to assist in identifying qualified candidates.

All directors and director nominees will submit a completed form of directors' and officers' questionnaire as part of the nominating process. The process may also include interviews and additional background and reference checks for non-incumbent nominees, at the discretion of the Nominating and Corporate Governance Committee.

#### **Communications with Directors**

The Kratos board of directors has adopted a Communications with Directors Policy. The Communications with Directors Policy is available for review on its website at [www.kratosdefense.com](http://www.kratosdefense.com). The information on Kratos' website is not a part of this prospectus. Stockholders and other interested parties may communicate with one or more members of the Kratos board of directors or the non management directors as a group in writing by regular mail. Those who wish to send such communications may do so by addressing their communication to: Chairman of the Kratos Board of

Directors or Board of Directors, c/o Corporate Secretary, Kratos Defense & Security Solutions, Inc., 4810 Eastgate Mall, San Diego, California, 92121.

The Kratos board of directors has instructed the Secretary to review all communications so received and to exercise his or her discretion not to forward to the Kratos board of directors correspondence that is inappropriate such as business solicitations, frivolous communications and advertising, routine business matters and personal grievances. However, any director may at any time request the Secretary to forward any and all communications received by the Secretary but not forwarded to the directors.

#### **Code of Ethics**

The Kratos board of directors has adopted a Code of Ethics that applies to all of its directors, officers and employees. The Code of Ethics is available for review on its website at [www.kratosdefense.com](http://www.kratosdefense.com). The information on Kratos' website is not a part of this prospectus. The Code of Ethics is also available in print, without charge, to any stockholder who requests a copy by writing to Kratos Defense & Security Solutions, Inc., 4810 Eastgate Mall, San Diego, California, 92121, Attention: Investor Relations. Each of Kratos' directors, officers, including the chief executive officer, chief financial officer and corporate controller, and all of its other principal executive officers and employees is required to be familiar with the Code of Ethics and to certify compliance annually. There have not been any waivers of the Code of Ethics relating to any of its executive officers or directors in the past year.

#### **Meetings and Committees of the Kratos Board of Directors**

The Kratos board of directors is responsible for overseeing the management of Kratos's business. Kratos's management keeps directors informed of the business at meetings and through reports and analyses presented to the Kratos board of directors and the committees of the Kratos board of directors. Regular communications between directors and management also occur apart from meetings of the Kratos board of directors and committees of the Kratos board of directors.

#### **Meeting Attendance**

The Kratos board of directors normally meets quarterly, but may hold additional meetings as required. During fiscal 2007, the Kratos board of directors held four regularly scheduled meetings and nine special meetings and acted by unanimous written consent ten times. Each of its directors attended at least 75% of the Kratos board of directors meetings he was eligible to attend, with the exception of Mr. Carano who attended 38% of the meetings he was eligible to attend. Each director attended at least 75% of the meetings of each committee of the Kratos board of directors on which he was serving, with the exception of Mr. Carano, who attended 33% of the Compensation Committee meetings he was eligible to attend, and Mr. Høglund, who attended 71% of the Audit Committee meetings he was eligible to attend. Three directors attended last year's annual meeting of stockholders.

The Kratos board of directors has adopted a "Director Attendance at Annual Meeting Policy" which is available for review on our website at [www.kratosdefense.com/governance.htm](http://www.kratosdefense.com/governance.htm). The information on Kratos' website is not a part of this prospectus.

#### **Committees of the Kratos Board of Directors**

The Kratos board of directors currently has three standing committees to facilitate and assist the Kratos board of directors in the execution of its responsibilities: the Audit Committee; the Compensation Committee; and the Nominating and Corporate Governance Committee. The Audit Committee has been established in accordance with Section 3(a)58(A) of the Exchange Act. In accordance with NASDAQ Marketplace listing standards, each committee is comprised solely of non-employee, independent directors. Charters for each committee are available on our website at [www.kratosdefense.com](http://www.kratosdefense.com).

***Audit Committee***

Our Audit Committee consists of Messrs. Anderson (Chairperson), Hogle and Jarvis. The Kratos board of directors has affirmatively determined that each member of the Audit Committee is independent under NASDAQ Marketplace Rule 4200(a)(15), and meets all other qualifications under NASDAQ Marketplace Rule 4350(d)(2), the Sarbanes-Oxley Act of 2002 and applicable rules of the Securities and Exchange Commission. The Kratos board of directors has also affirmatively determined that Mr. Hogle qualifies as an "audit committee financial expert" as such term is defined in Regulation S-K of the Securities Act of 1933. During 2006, the Audit Committee held four regular meetings and three special meetings.

The Audit Committee acts pursuant to a written charter, which charter is reviewed at least annually by the Audit Committee. The Audit Committee Charter is also available for review on our website at [www.kratosdefense.com](http://www.kratosdefense.com). The information on Kratos' website is not a part of this prospectus. The Audit Committee Charter was reviewed and revised by the Audit Committee in September 2006 and the Audit Committee believes that its Charter, as revised, adequately meets the needs of Kratos as well as the requirements of NASDAQ Marketplace Rule 4350(d)(1).

Under its Charter, the Audit Committee:

Is directly and solely responsible for the appointment, compensation, retention, and as necessary, the termination of our independent auditors;

Oversees the audit activities of our independent auditors with such independent auditors reporting directly to the Audit Committee;

Reviews and discusses with our independent auditors, the scope, results and integrity of our annual audit and financial statements, our compliance with legal and regulatory requirements and the performance of our internal auditors;

Oversees risk management, legal compliance and ethics and reviews related party transactions;

Consults with our independent auditors to ensure rotation of the lead audit partner at least every five years and the timing of such rotation;

Oversees the independence of our independent auditors;

Evaluates our independent auditors' performance; and reviews and considers our independent auditors' comments as to controls, adequacy of staff and management performance and procedures in connection with audit and financial controls; and

Reviews compliance with certain corporate policies and discharges such other duties as may from time to time be assigned to it by the Kratos board of directors.

***Compensation Committee***

Our Compensation Committee consists of Messrs. Carano, Hogle and Jarvis (Chairperson). The Kratos board of directors has affirmatively determined that each member of the Compensation Committee is independent as such term is defined under NASDAQ Marketplace Rule 4200(a)(15). During 2007, the Compensation Committee met three times and acted by unanimous written consent five times. The Compensation Committee operates pursuant to a charter, which is available for review on our website at [www.kratosdefense.com/governance.htm](http://www.kratosdefense.com/governance.htm). The information on Kratos' website is not a part of this prospectus.

Under its Charter, the Compensation Committee:

Takes any and all action which may be taken by the Kratos board of directors with respect to fixing the compensation level of our officers and employees, including the compensation of our chief executive officer;

Develops and implements compensation policies that will clearly articulate the relationship of corporate performance to executive compensation and will attract and retain high quality executives;

Proposes for adoption by the Kratos board of directors and, if applicable, ratification by our stockholders, compensation plans, including but not limited to, stock option, stock appreciation rights, pension and profit sharing, stock purchase and deferred compensation plans and other similar programs and any amendments thereto or terminations thereof;

Grants rights, sets participation guidelines and interests in compensation plans to eligible participants;

Reviews and approves other such compensation matters referred to the Compensation Committee by the Kratos board of directors or the chief executive officer;

Prepares a report to be filed with the Proxy Statement or Information Statement disclosing our compensation policies which are applicable to our executive officers; and

Reports from time to time to the Kratos board of directors on the Compensation Committee's actions.

#### ***Nominating and Corporate Governance Committee***

Effective September 5, 2007, the Kratos board determined that a standing nominating and corporate governance committee of the Board was not necessary given the relatively small size of the Kratos board and management team, the limited scope of operations and the simplicity of the Kratos business model. At that time, in accordance with the NASDAQ Marketplace Rule 4200(a)(15), the Kratos board determined that only the members of the Kratos board who qualified as "independent directors" would then perform the functions of the nominating committee.

On February 27, 2008 the board of directors of Kratos reevaluated the need for a Nominating and Corporate Governance Committee and determined that it would be in the best interests of Kratos and its stockholders to reinstate the Nominating and Corporate Governance Committee.

The Nominating and Corporate Governance Committee is composed of Messrs. Andersen, Carano, Hoglund (Chairperson) and Jarvis. The Nominating and Corporate Governance Committee evaluates and recommends to the Board of Directors nominees for each election of Directors. The Nominating and Corporate Governance Committee met two times in 2007. The Kratos board of directors has adopted a charter for the Nominating and Corporate Governance Committee and a copy of that charter is available for review on our website at [www.kratosdefense.com](http://www.kratosdefense.com). The information on Kratos' website is not a part of this prospectus.

In fulfilling its responsibilities, the Nominating and Corporate Governance Committee considers the following factors:

The appropriate size of the Kratos board and its committees;

Development and recommendation to the board a set of corporate governance principles applicable to Kratos;

Developments in corporate governance and makes recommendations to the board regarding changes in governance policies and practices;

Management succession plans and oversees the evaluation of management;

The evaluation of the Board, including conducting an annual evaluation of the performance of the Board and Board committees;



The needs of Kratos with respect to the particular talents and experience of its directors;

The knowledge, skills and experience of nominees, including experience in the government contracting industry, business, finance, administration or public service, in light of prevailing business conditions and the knowledge, skills and experience already possessed by other members of the board;

Each directors experience with accounting rules and practices;

Applicable regulatory and securities exchange/association requirements;

Appreciation of the relationship of the Company's business to the changing needs of society.

**THE KRATOS BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT STOCKHOLDERS VOTE FOR THE ELECTION OF EACH OF THE NOMINEES FOR DIRECTOR.**

**PROPOSAL 2**

**RATIFICATION OF SELECTION OF INDEPENDENT AUDITORS**

The Kratos board of directors has selected Grant Thornton LLP, which we refer to as Grant Thornton, as Kratos' independent auditors for the fiscal year ending December 28, 2008 and has further directed that management submit the selection of independent auditors for ratification by Kratos' stockholders at the annual meeting. Grant Thornton has audited Kratos' financial statements since July 2005. Representatives of Grant Thornton are expected to be present at the annual meeting, will have an opportunity to make a statement if they so desire and will be available to respond to appropriate questions.

Stockholder ratification of the selection of Grant Thornton as Kratos' independent auditors is not required by Bylaws or otherwise. However, the Kratos board of directors is submitting the selection of Grant Thornton to the stockholders for ratification as a matter of good corporate practice. If the stockholders fail to ratify the selection, the Audit Committee will reconsider whether or not to retain Grant Thornton. Even if the selection is ratified, the Audit Committee may, in its discretion, direct the appointment of different independent auditors at any time during the year if they determine that such a change would be in Kratos' and its stockholders best interests.

As part of its duties, the Audit Committee considers whether the provision of services, other than audit services, during the fiscal year ended December 31, 2007 by Grant Thornton is compatible with maintaining the auditor's independence. The following table sets forth the aggregate fees billed to Kratos for the fiscal year ended December 31, 2007 by Grant Thornton:

	<u>Fiscal 2006</u>	<u>Fiscal 2007</u>
<i>Audit Fees(1)</i>	\$ 3,045,734	\$ 1,700,000
<i>Audit-Related Fees(2)</i>	\$	\$ 587,000
<i>Tax Fees(3)</i>	\$	\$
<i>All Other Fees(4)</i>		

(1) *Audit Fees* consist of fees billed and expected to be billed for professional services rendered for the integrated audit of Kratos' consolidated annual financial statements and review of the interim consolidated financial statements included in quarterly reports and services that are normally provided by Grant Thornton in connection with statutory and regulatory filings or engagements.

(2) *Audit-Related Fees* consist of fees billed and expected to be billed for assurance and related services that are reasonably related to the performance of the audit or review of Kratos' consolidated financial statements and are

not reported under "Audit Fees." General assistance with implementation of the requirements of SEC rules or listing



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standards promulgated pursuant to the Sarbanes-Oxley Act of 2002, including approximately \$270,000 related to the sale of our engineering division to LCCI and \$326,000 related to the acquisition of Haverstick Consulting, Inc. for 2007.

(3)

*Tax Fees* consist of fees billed and expected to be billed for professional services rendered for tax compliance, tax advice and tax planning. These services include assistance regarding federal state and local tax compliance, planning and advice; international tax compliance, planning and advice; review of federal, state, local and international income franchising and other tax returns.

(4)

*All Other Fees* consist of fees for products and services other than the services reported above.

The Audit Committee's policy is to pre-approve all audit and permissible non-audit services provided by Kratos' independent auditors. These services may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services. The Audit Committee has delegated pre-approval authority to the Audit Committee Chairperson. The independent auditor and management are required to periodically report to the Audit Committee regarding the extent of services provided by the independent auditor in accordance with this pre-approval.

### **Vote Required and Kratos Board of Directors' Recommendation**

Approval of this proposal requires the affirmative vote of a majority of the shares entitled to vote on this proposal, at a meeting at which a quorum is present. Abstentions and broker non-votes will each be counted as present for purposes of determining the presence of a quorum. Abstentions will have the same effect as a vote against this proposal. Broker non-votes are not expected to result from this proposal.

### **Report of the Audit Committee**

The Audit Committee oversees our financial reporting process on behalf of the Kratos board of directors. Management has the primary responsibility for the financial statements and the reporting process including the systems of internal controls. Grant Thornton is responsible for performing an audit of our annual consolidated financial statements in accordance with generally accepted accounting principles (GAAP) and for issuing a report on those statements and expressing an opinion on the conformity of these audited financial statements. Grant Thornton also reviews Kratos' interim financial statements in accordance with Statement on Auditing Standards No. 100 (interim financial information). The Audit Committee oversees the financial reporting process and internal control structure on behalf of the Kratos board of directors. The Audit Committee met 16 times during 2007, including meeting regularly with Grant Thornton and our internal auditors, both privately and with management present.

In fulfilling its oversight responsibilities, the Audit Committee reviewed and discussed with management and Grant Thornton the audited and interim financial statements, including Management's Discussion and Analysis, included in Kratos' Reports on Form 10-K for fiscal year ended December 31, 2007. These reviews included a discussion of:

Kratos' critical accounting policies;

the reasonableness of significant financial reporting judgments made in connection with the financial statements, including the quality (and not just the acceptability) of Kratos' accounting principles;

the clarity and completeness of financial disclosures;

the effectiveness of our internal control over financial reporting, including management's and Grant Thornton's reports thereon, the basis for the conclusions expressed in those reports and changes made to Kratos' internal control over financial reporting during 2007;

items that could be accounted for using alternative treatments within GAAP, the ramifications thereof and the treatment preferred by Grant Thornton;

unadjusted audit differences noted by Grant Thornton during its audit of Kratos' annual financial statements; and

the potential effects of regulatory and accounting initiatives on Kratos' financial statements.

In connection with its review of Kratos' annual consolidated financial statements, the Audit Committee also discussed with Grant Thornton other matters required to be discussed with the auditors under Statement on Auditing Standards No. 61, as modified or supplemented (communication with audit committees) and those addressed by Grant Thornton's written disclosures and its letter provided under Independence Standards Board Standard No. 1, as modified or supplemented (independence discussions with audit committees).

The Audit Committee is responsible for the engagement of the independent auditors and appointed Grant Thornton to serve in that capacity during 2005, 2006 and 2007. In that connection, the Committee:

reviewed Grant Thornton's independence from Kratos and management, including Grant Thornton's written disclosures described above;

reviewed periodically the level of fees approved for payment to Grant Thornton and the pre-approved non-audit services it has provided to us to ensure their compatibility with Grant Thornton's independence; and

reviewed Grant Thornton's performance, qualifications and quality control procedures.

Among other matters, the Audit Committee also:

reviewed the scope of and overall plans for the annual audit and the internal audit program;

consulted with management and Grant Thornton with respect to our processes for risk assessment and risk management;

reviewed the adequacy of certain of our financial policies;

reviewed and approved our policy with regard to the hiring of former employees of the independent auditors;

reviewed and approved our policy for the pre-approval of audit and permitted non-audit services by the independent auditors;

received reports pursuant to our policy for the submission and confidential treatment of communications from employees and others about accounting, internal controls and auditing matters;

reviewed with management the scope and effectiveness of our disclosure controls and procedures, including for purposes of evaluating the accuracy and fair presentation of our financial statements in connection with certifications made by the Chief Executive Officer and Chief Financial Officer; and

reviewed significant legal developments and our processes for monitoring compliance with law and Kratos policies.

Based on the reviews and discussions referred to above, the Audit Committee recommended to the Kratos board of directors the audited financial statements be included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007 for filing with the SEC.

Respectfully submitted,  
THE AUDIT COMMITTEE

Scott I. Anderson, Chairperson  
Scot B. Jarvis  
William A. Høglund

This report of the Audit Committee shall not be deemed incorporated by reference by any general statement incorporating by reference this Proxy Statement into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that we specifically incorporate this information by reference, and shall not otherwise be deemed filed under such acts.

**THE KRATOS BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR THIS ITEM (ITEM 2).**

### PROPOSAL 3

#### **APPROVAL OF AMENDMENT TO THE KRATOS 1999 EMPLOYEE STOCK PURCHASE PLAN TO INCREASE THE AGGREGATE NUMBER OF SHARES THAT MAY BE ISSUED UNDER THE PLAN BY 1,500,000 SHARES**

At the Annual Meeting, the stockholders will be asked to approve an amendment to the Kratos Defense & Security Solutions, Inc. 1999 Employee Stock Purchase Plan, which we refer to as the Purchase Plan, to increase the maximum number of shares of Common Stock that may be issued under the Purchase Plan by 1,500,000 shares. Kratos' stockholders have previously approved the reservation of 2,850,000 shares of Kratos' common stock for purchase by employees under the Purchase Plan. As of April 1, 2008, a total of 351,811 shares remain available for future purchases, without giving effect to the proposed amendment.

The Board of Directors believes that the Purchase Plan benefits Kratos and its stockholders by providing its employees with an opportunity to purchase shares of common stock through payroll deductions, which helps to attract, retain and motivate valued employees. To provide a reasonable reserve of shares to permit Kratos to continue offering this opportunity to its employees, the Board of Directors has adopted, subject to stockholder approval, an amendment to increase the number of shares of common stock remaining reserved for issuance under the Purchase Plan by 1,500,000 shares.

Employees who actively participate in the Purchase Plan may have up to 15% of their earnings for the period withheld pursuant to the Purchase Plan. The amount withheld is used at various purchase dates within the offering period to purchase shares of Kratos' common stock. The price paid for common stock at each such purchase date equals the lower of 85% of the fair market value of the common stock at the commencement date of that offering period or 85% of the fair market value of the common stock on the relevant purchase date. Employees may end their participation in the offering at any time during the offering period, and participation ends automatically upon termination of employment.

## Summary of the Purchase Plan

The following summary is qualified in its entirety by the specific language of the Purchase Plan, a copy of which is available to any stockholder upon request.

**General.** At the beginning of each offering under the plan, which we refer to as an Offering, each participant in the Purchase Plan is granted the right to purchase, through accumulated payroll deductions, up to a number of shares of Kratos' common stock determined on the first day of the Offering, which we refer to as a Purchase Right. The Purchase Right is automatically exercised on each purchase date during the Offering unless the participant has withdrawn from participation in the Purchase Plan prior to such date. The Purchase Plan is intended to qualify as an "employee stock purchase plan" under section 423 of the Internal Revenue Code.

**Authorized Shares.** Currently, a maximum of 2,850,000 of the Company's authorized but unissued or reacquired shares of common stock remain available for issuance under the Purchase Plan, subject to appropriate adjustment in the event of any stock dividend, stock split, reverse stock split, recapitalization or similar change in Kratos' capital structure, or in the event of any merger, sale of assets or other reorganization of Kratos. If any Purchase Right expires or terminates, the shares subject to the unexercised portion of such Purchase Right will again be available for issuance under the Purchase Plan.

**Administration.** The Purchase Plan is administered by the Board of Directors or a committee of the Board. (For purposes of this discussion, the term "Board" refers to either the Board of Directors or such committee.) Subject to the provisions of the Purchase Plan, the Board determines the terms and conditions of Purchase Rights granted under the plan. The Board has the authority to interpret the Purchase Plan and Purchase Rights granted thereunder, and any such interpretation of the Board will be binding.

**Eligibility.** Any employee of the company or any parent or subsidiary of the company designated by the Board for inclusion in the Purchase Plan is eligible to participate in an Offering under the plan so long as the employee is customarily employed for at least 20 hours per week and more than five months in any calendar year. As of April 8, 2008, approximately 1,200 employees, including all executive officers, were eligible to participate in the Purchase Plan.

**Offerings.** Generally, each Offering under the Purchase Plan extends for a period of six months, which we refer to as an Offering Period. New Offering Periods begin every six months and do not overlap. Offering Periods generally commence on January 1 and July 1 of each year, each referred to as an Offering Date and end on June 30 and December 31, respectively, of the second year following the Offering Date. Each Offering Period is generally comprised a six-month purchase period, each referred to as a Purchase Period. Shares are purchased on the last day of each Purchase Period each referred to as a Purchase Date. The Board may establish a different term for any Offering (not to exceed 27 months) or Purchase Period or different commencement or ending dates for an Offering or a Purchase Period.

**Participation and Purchase of Shares.** Participation in an Offering under the Purchase Plan is limited to eligible employees who authorize payroll deductions prior to the first day of an Offering Period. Payroll deductions may not exceed fifteen 15% percent of an employee's earnings on any payday during the Offering Period, provided that the Board may establish a different limit from time to time. An employee who becomes a participant in the Purchase Plan will automatically participate in each Offering beginning immediately after the last day of the Offering Period in which he or she is a participant until the employee withdraws from the Purchase Plan, becomes ineligible to participate, or terminates employment.

Subject to any uniform limitations or notice requirements imposed by the company, a participant may increase or decrease his or her rate of payroll deductions or withdraw from the Purchase Plan at any time during an Offering. Upon withdrawal, the company will refund without interest the participant's accumulated payroll deductions not previously applied to the purchase of shares. Once a participant withdraws from an Offering, that participant may not again participate in the same Offering at any later time. If the fair market value of a share of common stock on the Offering Date of the current Offering in which employees are participating is greater than such fair market value on the Offering Date of a new Offering, then, unless a participant elects otherwise, each participant will be automatically withdrawn from the current Offering after purchasing shares and enrolled in the new Offering.

On each Purchase Date, we issue to each participant in the Offering the number of shares of our common stock equal to the amount of payroll deductions accumulated for the participant during the Purchase Period divided by the purchase price, limited in any case by the number of shares subject to the participant's Purchase Right for that Offering. The price at which shares are sold under the Purchase Plan is established by the Board but may not be less than 85% of the lesser of the fair market value per share of common stock on the Offering Date or on the Purchase Date. The fair market value of the common stock on any relevant date generally will be the closing price per share as reported on the NASDAQ Global Select Market. On April 8, 2008, the closing price of our common stock as reported on the NASDAQ Global Select Market was \$1.83 per share. Any payroll deductions under the Purchase Plan not applied to the purchase of shares will be returned to the participant without interest, unless the amount remaining is less than the amount necessary to purchase a whole share of common stock, in which case the remaining amount may be applied to the next Purchase Period.

**Termination or Amendment.** The Purchase Plan will continue until terminated by the Board or until all of the shares reserved for issuance under the plan have been issued. The Board may amend or terminate the Purchase Plan at any time, except that the approval of Kratos' stockholders is required within 12 months of the adoption of any amendment increasing the number of shares authorized for issuance under the Purchase Plan, or changing the categories of corporations that may be designated by the Board as corporations whose employees may participate in the Purchase Plan.

#### **Shares Purchased by Certain Persons**

The aggregate numbers of shares of common stock purchased by certain persons under the Purchase Plan from its inception through April 8, 2008 are as follows: (i) Eric M. DeMarco, President and Chief Executive Officer, no shares; (ii) Deanna Lund, Chief Financial Officer and Senior Vice President, no shares; (iii) James R. Edwards, former General Counsel and Senior Vice President, 3,965 shares (Mr. Edwards is no longer employed by us); (iv) D. Robin Mickle, President of the Government Services Division, no shares; (v) Laura Siegal, Vice President and Controller, 458 shares; (vi) all current executive officers as a group, an aggregate of 4,423 shares; and (vii) all employees, including current officers who are not executive officers, as a group, an aggregate of 137,500 shares. None of our directors who are not executive officers are eligible to participate in the Purchase Plan. Since its inception, no shares have been issued under the Purchase Plan to any other nominee for election as a director, or any associate of any such director, nominee or executive officer, and no other person has been issued five percent or more of the total amount of shares issued under the Purchase Plan.

#### **Summary of U.S. Federal Income Tax Consequences**

The following summary is intended only as a general guide as to the U.S. federal income tax consequences of participation in the Purchase Plan and does not attempt to describe all possible federal or other tax consequences of such participation or tax consequences based on particular circumstances.

Generally, there are no tax consequences to an employee of either becoming a participant in the Purchase Plan or purchasing shares under the Purchase Plan. The tax consequences of a disposition of shares vary depending on the period such stock is held before its disposition. If a participant disposes of shares within two years after the Offering Date or within one year after the Purchase Date on which the shares are acquired (such disposition being referred to as a "disqualifying disposition"), the participant recognizes ordinary income in the year of disposition in an amount equal to the difference between the fair market value of the shares on the Purchase Date and the purchase price. Such income may be subject to tax withholding by the employer. Any additional gain or any loss recognized by the participant resulting from the disposition of the shares is a capital gain or loss. If the participant disposes of shares at least two years after the Offering Date and at least one year after the Purchase Date on which the shares are acquired, the participant recognizes ordinary income in the year of disposition in an amount equal to the lesser of (i) the difference between the fair market value of the shares on the date of disposition and the purchase price or (ii) the difference between the fair market value of the shares on the Offering Date and the purchase price (determined as if the Purchase Right were exercised on the Offering Date). Any additional gain recognized by the participant on the disposition of the shares is a capital gain. If the fair market value of the shares on the date of disposition is less than the purchase price, there is no ordinary income, and the loss recognized is a capital loss. If the participant still owns the shares at the time of his or her death, the lesser of (i) the difference between the fair market value of the shares on the date of death and the purchase price or (ii) the difference between the fair market value of the shares on the Offering Date and the purchase price (determined as if the Purchase Right were exercised on the Offering Date) is recognized as ordinary income in the year of the participant's death.

If the participant disposes of the shares in a disqualifying disposition, we should be entitled to a deduction equal to the amount of ordinary income recognized by the participant as a result of the disposition, except to the extent such deduction is limited by applicable provisions of the Internal Revenue Code.

#### **Vote Required and Board of Director's Recommendation**

Approval of this proposal requires the affirmative vote of a majority of the shares entitled to vote on this proposal at a meeting at which a quorum is present. Abstentions and broker non-votes will each be counted as present for purposes of determining the presence of a quorum. Abstentions will have the same effect as a vote against this proposal. Broker non-votes will have no effect on the outcome of this vote.

**THE KRATOS BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR THIS ITEM (ITEM 3).**

#### **PROPOSAL 4**

##### **APPROVAL OF AMENDMENT TO THE KRATOS 2005 EQUITY INCENTIVE PLAN TO INCREASE THE AGGREGATE NUMBER OF SHARES THAT MAY BE ISSUED UNDER THE PLAN BY 3,000,000 SHARES**

At the Annual Meeting, the stockholders will be asked to approve an amendment to the Kratos Defense & Security Systems, Inc. 2005 Equity Incentive Plan, which we refer to as the 2005 Plan, to increase by 3,000,000 the maximum number of shares of common stock that may be issued under the 2005 Plan, to 6,500,000 shares. On February 26, 2008, Kratos' Compensation Committee unanimously adopted, subject to stockholder approval, an increase to the share reserve of the 2005 Plan of shares. Kratos' stockholders have previously authorized the company to issue up to 3,500,000 shares of common stock under the 2005 Plan (subject to adjustment upon certain changes in the capital structure).

Kratos is asking its stockholders to approve the increase to the 2005 Plan. The primary purpose of the 2005 Plan is to attract and to encourage the continued employment and service of, and maximum efforts by, officers, employees and other individuals by offering those persons an opportunity to acquire or increase a direct proprietary interest in Kratos' operations and future success. Since January 2007, Kratos has pursued this goal primarily through the grant of restricted stock units. The company believes that in its heavily human-capital intensive business, restricted stock units are an important factor in hiring and retaining talented personnel.

The Compensation Committee and the Board of Directors believe that in order to successfully attract and retain the best possible candidates for positions of responsibility, Kratos must continue to offer a competitive equity incentive program. As of April 8, 2008, only 111,298 shares remained available for the future grant of stock awards, including restricted stock unit awards, under the 2005 Plan, and the Board of Directors believes that additional shares must be made available to meet the company's anticipated needs. Therefore, as described above, the Compensation Committee has unanimously adopted, subject to stockholder approval, an amendment to increase the maximum number of shares of common stock issuable under the 2005 Plan by 3,000,000 shares to a total of 6,500,000 shares (subject to adjustment upon certain changes in the capital structure of the company), to ensure that the company will continue to have available a reasonable number of shares available for its restricted stock unit award program.

In connection with its approval of the increase to the share reserve of the 2005 Plan, the Compensation Committee further resolved to discontinue making equity award grants under Kratos' other equity incentive plans, including the Kratos 1999 Equity Incentive Plan and the Kratos 2000 Nonstatutory Stock Option Plan, and to cancel the remaining shares available for grant upon approval of this Share increase to the 2005 Plan by the Kratos stockholders. Finally, in recommending the approval of this amendment to the 2005 Plan, the Compensation Committee noted that Kratos' option overhang is relatively low, especially after taking into account the Compensation Committee's resolution to discontinue making equity award grants under the company's other equity incentive plans. Assuming approval of the issuance of all awards thereunder and the cancellation of all shares available for grant under the Kratos 1999 Equity Incentive Plan and the Kratos 2000 Nonstatutory Stock Option Plan, shares issuable pursuant to the 2005 Plan and pursuant to any Kratos equity incentive plan, upon the exercise of options or rights to acquire Kratos stock pursuant to restricted stock unit awards, would represent approximately 15% of our outstanding shares of common stock on a fully-diluted basis.

#### ***Summary of the 2005 Plan***

A summary of the 2005 Plan is set forth below. This summary is qualified in its entirety by the specific language of the 2005 Plan, a copy of which is available to any Kratos stockholder upon request.

#### ***Administration***

The 2005 Plan is administered by the Compensation Committee. Subject to the terms of the 2005 Plan, the Compensation Committee may select participants to receive awards, determine the types of awards, and terms and conditions of awards, and interpret provisions of the 2005 Plan. The Compensation Committee determines at what time or times each award may be exercised or settled and the period of time, if any, after retirement, death, disability or termination of employment during which such awards may be exercised, vested or settled. The exercisability and vesting of any award may be accelerated by the Compensation Committee. The 2005 Plan forbids, without stockholder approval, the repricing of any outstanding stock option or stock appreciation right by an amendment which lowers the exercise price of such awards. However, the 2005 Plan does authorize, without stockholder approval, a stock option exchange program where such stock options or stock appreciation rights are either transferred to a financial institution for a cash payment or cancelled and replaced with new stock options or stock appreciation rights. The Board of Directors may terminate or amend the 2005 Plan at



any time and for any reason. However, amendments will be submitted for stockholder approval to the extent required by the Internal Revenue Code or other applicable laws.

### *Common Stock Reserved for Issuance*

The common stock issued or to be issued under the 2005 Plan consists of authorized but unissued shares and treasury shares. If any shares covered by an award are not purchased or are forfeited, or if an award otherwise terminates without delivery of any common stock, then the number of shares of common stock counted against the aggregate number of shares available under the plan with respect to the award will, to the extent of any such forfeiture or termination, again be available for making awards under the 2005 Plan.

### *Eligibility*

Awards may be made under the 2005 Plan to employees, directors and consultants of Kratos, or any present or future parent or subsidiary corporation. Incentive stock options may be granted only to employees who, as of the time of grant, are employees of Kratos or any parent or subsidiary corporation of Kratos.

### *Stock Options*

The 2005 Plan permits the granting of options to purchase shares of common stock intended to qualify as incentive stock options under the Internal Revenue Code and stock options that do not qualify as incentive stock options. The exercise price of each stock option may not be less than 100% of the fair market value of our common stock on the date of grant. In the case of certain 10% stockholders who receive incentive stock options, the exercise price may not be less than 110% of the fair market value of our common stock on the date of grant. An exception to these requirements is made for options that Kratos grants in substitution for options held by employees of companies that Kratos acquires. In such a case the exercise price is adjusted to preserve the economic value of the employee's stock option from his or her former employer. The exercise price of each indexed stock option, and the terms and adjustments which may be made to such an option, will be determined by the Compensation Committee in its sole discretion at the time of grant. On March 25, 2008, the closing price of Kratos' common stock on the Nasdaq Global Select Market was \$1.93 per share.

The 2005 Plan provides that the option exercise price may be paid in cash, by check, or in cash equivalent, by the assignment of the proceeds of a sale with respect to some or all of the shares being acquired upon the exercise of the option, to the extent legally permitted, by tender of shares of common stock owned by the optionee having a fair market value not less than the exercise price, by a net exercise procedure, or such other lawful consideration as approved by the Compensation Committee, or by any combination of these. Nevertheless, the Compensation Committee may restrict the forms of payment permitted in connection with any option grant. No option may be exercised unless the optionee has made adequate provision for federal, state, local and foreign taxes, if any, relating to the exercise of the option, including, if permitted or required by Kratos, through the optionee's surrender of a portion of the option shares to Kratos.

Options will become vested and exercisable at such times or upon such events and subject to such terms, conditions, performance criteria or restrictions as specified by the Compensation Committee. The maximum term of any option granted under the 2005 Plan is ten years, provided that an incentive stock option granted to a 10% stockholder must have a term not exceeding five years. The Compensation Committee will specify in each written option agreement, and solely in its discretion, the period of post-termination exercise applicable to each option.

Generally, stock options are nontransferable by the optionee other than by will or by the laws of descent and distribution, and are exercisable during the optionee's lifetime only by the optionee.

However, a nonstatutory stock option may be assigned or transferred to the extent permitted by the Compensation Committee in its sole discretion.

#### ***Stock Appreciation Rights***

A stock appreciation right gives a participant the right to receive the appreciation in the fair market value of Kratos common stock between the date of grant of the award and the date of its exercise. Kratos will pay the appreciation only in the form of shares of common stock. The Compensation Committee may grant stock appreciation rights under the 2005 Plan in tandem with a related stock option or as a freestanding award. A tandem stock appreciation right is exercisable only at the time and to the same extent that the related option is exercisable, and its exercise causes the related option to be canceled. Freestanding stock appreciation rights vest and become exercisable at the times and on the terms established by the Compensation Committee. The maximum term of any stock appreciation right granted under the 2005 Plan is ten years. Stock appreciation rights are generally nontransferable by the participant other than by will or by the laws of descent and distribution, and are generally exercisable during the participant's lifetime only by the participant.

#### ***Restricted Stock Awards***

The Compensation Committee may grant restricted stock awards under the 2005 Plan in the form of a restricted stock bonus, for which the participant furnishes consideration in the form of services to Kratos. Restricted stock awards may be subject to vesting conditions based on such service or performance criteria as the Compensation Committee specifies, and the shares acquired may not be transferred by the participant until vested. Unless otherwise provided by the Compensation Committee, a participant will forfeit any shares of restricted stock as to which the restrictions have not lapsed prior to the participant's termination of service. Participants holding restricted stock will have the right to vote the shares and to receive any dividends paid, except that dividends or other distributions paid in shares will be subject to the same restrictions as the original award.

#### ***Restricted Stock Units***

The Compensation Committee may grant restricted stock units under the 2005 Plan, which represent a right to receive shares of common stock at a future date determined in accordance with the participant's award agreement. No monetary payment is required for receipt of restricted stock units or the shares issued in settlement of the award, the consideration for which is furnished in the form of the participant's services to Kratos. The Compensation Committee may grant restricted stock unit awards subject to the attainment of performance goals similar to those described below in connection with performance shares and performance units, or may make the awards subject to vesting conditions similar to those applicable to restricted stock awards. Participants have no voting rights or rights to receive cash dividends with respect to restricted stock unit awards until shares of common stock are issued in settlement of such awards. However, the Compensation Committee may grant restricted stock units that entitle their holders to receive dividend equivalents, which are rights to receive additional restricted stock units for a number of shares whose value is equal to any cash dividends we pay.

#### ***Performance Awards***

The Compensation Committee may grant performance awards subject to such conditions and the attainment of such performance goals over such periods as the Compensation Committee determines in writing and sets forth in a written agreement between Kratos and the participant. These awards may be designated as performance shares or performance units. Performance shares and performance units are unfunded bookkeeping entries generally having initial values, respectively, equal to the fair market value determined on the grant date of a share of common stock and a dollar amount per unit which may be determined by the Compensation Committee. Performance awards will specify a predetermined

amount of performance shares or performance units that may be earned by the participant to the extent that one or more predetermined performance goals are attained within a predetermined performance period. To the extent earned, performance awards may be settled in cash, shares of common stock (including shares of restricted stock) or any combination thereof.

Unless otherwise provided by the Compensation Committee, if a participant's service terminates due to the participant's death, disability or retirement prior to completion of the applicable performance period, the final award value will be determined at the end of the performance period on the basis of the performance goals attained during the entire performance period but will be prorated for the number of months of the participant's service during the performance period. If a participant's service terminates prior to completion of the applicable performance period for any other reason, the 2005 Plan provides that, unless otherwise determined by the Compensation Committee, the performance award will be forfeited. No performance award may be sold or transferred other than by will or the laws of descent and distribution prior to the end of the applicable performance period.

#### ***Deferred Stock Awards***

The 2005 Plan provides that certain participants who are executives or members of a select group of highly compensated employees may elect to receive, in lieu of payment in cash or stock of all or any portion of such participant's cash and/or stock compensation, an award of deferred stock units. A participant electing to receive deferred stock units will be granted automatically, on the effective date of such deferral election, an award for a number of stock units equal to the amount of the deferred compensation divided by an amount equal to the fair market value of a share of Kratos' common stock as quoted by the national or regional securities exchange or market system on which the common stock is listed on the date of grant. A stock unit is an unfunded bookkeeping entry representing a right to receive one share of our common stock in accordance with the terms and conditions of the deferred stock unit award. Participants are not required to pay any additional cash consideration in connection with the settlement of a deferred stock unit award. A participant's compensation not paid in the form of a deferred stock unit award will be paid in cash in accordance with Kratos' normal payment procedures.

Each deferred stock unit award will be evidenced by a written agreement between Kratos and the participant specifying the number of stock units subject to the award and the other terms and conditions of the deferred stock unit award, consistent with the requirements of the 2005 Plan. Deferred stock unit awards are fully vested upon grant and will be settled by distribution to the participant of a number of whole shares of common stock equal to the number of stock units subject to the award on a date set forth in the participant's written agreement in accordance with the terms of the 2005 Plan at the time of his or her election to receive the deferred stock unit award. A holder of stock unit has no voting rights or other rights as a stockholder until shares of common stock are issued to the participant in settlement of the stock unit. However, participants holding stock units will be entitled to receive dividend equivalents with respect to any payment of cash dividends on an equivalent number of shares of common stock. Such dividend equivalents will be credited in the form of additional whole and fractional stock units determined by the fair market value of a share of common stock on the dividend payment date. Prior to settlement, no deferred stock unit award may be assigned or transferred other than by will or the laws of descent and distribution.

#### ***Other Stock-Based Awards***

The Compensation Committee may also grant one or more awards not specifically identified by the terms of the 2005 Plan that would provide a participant with either: (i) a share of stock; (ii) the right purchase a share of stock; (iii) a value derived from a share of stock; or (iv) an exercise or conversion privilege related to a share of stock. Other stock-based awards may be subject to vesting conditions

based on such service or performance criteria as the Compensation Committee specifies, and any such award may not be transferred by the participant until vested.

***Change in Control***

The 2005 Plan defines a "Change in Control" of Kratos as any of the following events upon which the stockholders of the company immediately before the event do not retain immediately after the event, in substantially the same proportions as their ownership of shares of the company's voting stock immediately before the event, direct or indirect beneficial ownership of a majority of the total combined voting power of the voting securities of the company, its successor or the corporation to which the assets of the company were transferred: (i) a sale or exchange by the stockholders in a single or series of related transactions of more than 50% of the company's voting stock; (ii) a merger or consolidation in which the company is a party; (iii) the sale, exchange or transfer of all or substantially all of the assets of the company; or (iv) a liquidation or dissolution of the company. If a Change in Control occurs, the surviving, continuing, successor or purchasing corporation or parent corporation thereof may either assume all outstanding awards or substitute new awards having an equivalent value.

In the event of a Change in Control and the outstanding stock options and stock appreciation rights are not assumed or replaced, then all unexercisable, unvested or unpaid portions of such outstanding awards will become immediately exercisable, vested and payable in full immediately prior to the date of the Change in Control.

Any award not assumed, replaced or exercised prior to the Change in Control will terminate. The 2005 Plan authorizes the Compensation Committee, in its discretion, to provide for different treatment of any award, as may be specified in such award's written agreement, which may provide for acceleration of the vesting or settlement of any award, or provide for longer periods of exercisability, upon a Change in Control.

***Adjustments for Stock Dividends and Similar Events***

The Compensation Committee will make appropriate adjustments in outstanding awards and the number of shares available for issuance under the 2005 Plan, including the individual limitations on awards, to reflect common stock dividends, stock splits and other similar events.

***Section 162(m) of the Internal Revenue Code***

Section 162(m) of the Internal Revenue Code, which we refer to as the Code, limits publicly-held companies such as Kratos to an annual deduction for federal income tax purposes of \$1,000,000 for compensation paid to its chief executive officer, chief financial officer and the three most highly compensated executive officers (other than the chief executive officer and the chief financial officer) determined at the end of each year (the "covered employees"). However, performance-based compensation is excluded from this limitation. The 2005 Plan is designed to permit the Compensation Committee to grant awards that qualify as performance-based for purposes of satisfying the conditions of Section 162(m). To qualify as performance-based:

the compensation must be paid solely on account of the attainment of one or more pre-established, objective performance goals;

the performance goal under which compensation is paid must be established by a Compensation Committee comprising two or more directors who qualify as outside directors for purposes of the exception;

the material terms under which the compensation is to be paid must be disclosed to and subsequently approved by stockholders of the corporation before payment is made in a separate vote; and

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the Compensation Committee must certify in writing before payment of the compensation that the performance goals and any other material terms were in fact satisfied.

In the case of compensation attributable to stock options and stock appreciation rights, the performance goal requirement (summarized above) is deemed satisfied, and the certification requirement (summarized above) is inapplicable, if the grant or award is made by the Compensation Committee; the plan under which the option or stock appreciation right is granted states the maximum number of shares with respect to which options and stock appreciation rights may be granted during a specified period to an employee; and under the terms of the option or stock appreciation rights, the amount of compensation is based solely on an increase in the value of the stock after the date of grant.

One or more of the following business criteria, on a consolidated basis, and/or with respect to specified subsidiaries or business units (except with respect to the total stockholder return and earnings per share criteria), are used by the Compensation Committee in establishing performance goals:

revenue;

gross margin;

operating margin;

operating income;

pre-tax profit;

earnings before interest, taxes, depreciation and amortization;

net income;

cash flow;

the market price of Common Stock;

earnings per share; and

return on stockholder equity.

Under the Section 162(m) of the Code, a director is an "outside director" if he or she is not a current employee of the corporation; is not a former employee who receives compensation for prior services (other than under a qualified retirement plan); has not been an officer of the corporation; and does not receive, directly or indirectly (including amounts paid to an entity that employs the director or in which the director has at least a five percent ownership interest), remuneration from the corporation in any capacity other than as a director.

In order to comply with Section 162(m) of the Code and ensure compensation attributable to awards under the 2005 Plan are performance based compensation, the maximum number of shares subject to stock options or stock appreciation rights that can be awarded under the 2005 Plan to any person is 2,000,000 per year. However, the company may also make a one-time additional grant of stock options or stock appreciation rights, in an additional amount of 1,000,000 shares, to any newly-hired person bringing such person's first year maximum award to 3,000,000 shares. The maximum number of shares that can be awarded under the 2005 Plan to any person pursuant to restricted stock or restricted stock units is also 2,000,000 per year, which may also be increased by an additional 1,000,000 shares for the first year for any newly-hired person. The maximum number of shares that may be granted as performance shares to any person is 2,000,000 per fiscal year. The maximum amount that may be earned as a performance unit or an annual incentive award or other performance cash award in any fiscal year by any one person is \$1,000,000.



**Federal Income Tax Consequences of the 2005 Plan**

***Incentive Stock Options***

The grant of an option will not be a taxable event for the grantee or for us. A grantee will not recognize taxable income upon exercise of an incentive stock option, except that the alternative minimum tax may apply, and any gain realized upon a disposition of our common stock received pursuant to the exercise of an incentive stock option will be taxed as long-term capital gain if the grantee holds the shares for at least two years after the date of grant and for one year after the date of exercise (the "holding period requirement"). We will not be entitled to any business expense deduction with respect to the exercise of an incentive stock option, except as discussed below. For the exercise of an option to qualify for the foregoing tax treatment, the grantee generally must be our employee or an employee of one of our subsidiaries from the date the option is granted through a date within three months before the date of exercise of the option. In the case of a grantee who is disabled, the three-month period for exercise following termination of employment is extended to one year. In the case of a grantee who dies, both the time for exercising incentive stock options after termination of employment and the holding period for stock received through the exercise of the option are waived. If all of the foregoing requirements are met except the holding period requirement mentioned above, the grantee will recognize ordinary income upon the disposition of the common stock in an amount generally equal to the excess of the fair market value of the common stock at the time the option was exercised over the option exercise price (but not in excess of the gain realized on the sale). The balance of the realized gain, if any, will be capital gain. We will be allowed a business expense deduction to the extent the grantee recognizes ordinary income, subject to our compliance with Section 162(m) of the Code.

In the event an incentive stock option is amended in certain respects, such option may be considered deferred compensation and subject to the rules of Section 409A of the Code. An option subject to Section 409A of the Code which fails to comply with the rules of Section 409A can result in the acceleration of income recognition, an additional 20% tax obligation, plus potential penalties and interest. In addition, the amendment of an incentive stock option may convert the option from an incentive stock option to a nonqualified stock option.

***Non-Qualified Options***

The grant of an option will not be a taxable event for the grantee or us. Upon exercising a non-qualified option, a grantee will recognize ordinary income in an amount equal to the difference between the exercise price and the fair market value of the common stock on the date of exercise. Upon a subsequent sale or exchange of shares acquired pursuant to the exercise of a non-qualified option, the grantee will have taxable gain or loss, measured by the difference between the amount realized on the disposition and the tax basis of the shares (generally, the amount paid for the shares plus the amount treated as ordinary income at the time the option was exercised). If we comply with the restrictions of Section 162(m) of the Code, we will be entitled to a business expense deduction in the same amount and generally at the same time as the grantee recognizes ordinary income.

A grantee who has transferred a non-qualified stock option to a family member by gift will realize taxable income at the time the non-qualified stock option is exercised by the family member. The grantee will be subject to withholding of income and employment taxes at that time. The family member's tax basis in the shares of common stock will be the fair market value of the shares of common stock on the date the option is exercised. The transfer of vested non-qualified stock options will be treated as a completed gift for gift and estate tax purposes. Once the gift is completed, neither the transferred options nor the shares acquired on exercise of the transferred options will be includable in the grantee's estate for estate tax purposes.

Absent special limitations on exercisability, in the event a nonqualified stock option is granted with an exercise price that is below fair market value or is amended in certain respects, such option may be considered deferred compensation and subject to the rules of Section 409A of the Code, which provides rules regarding the timing of payment of deferred compensation. An option subject to Section 409A of the Code which fails to comply with the rules of Section 409A can result in the acceleration of income recognition, an additional 20% tax obligation, plus potential penalties and interest.

***Restricted Stock***

A grantee who is awarded restricted stock will not recognize any taxable income for federal income tax purposes in the year of the award, provided that the shares of common stock are subject to restrictions (that is, the restricted stock is nontransferable and subject to a substantial risk of forfeiture). However, the grantee may elect under Section 83(b) of the Code to recognize compensation income in the year of the award in an amount equal to the fair market value of the common stock on the date of the award, determined without regard to the restrictions. If the grantee does not make such a Section 83(b) election, the fair market value of the common stock on the date the restrictions lapse will be treated as compensation income to the grantee and will be taxable in the year the restrictions lapse. If we comply with the restrictions of Section 162(m) of the Code, we will be entitled to a deduction for compensation paid in the same amount treated as compensation income to the grantee in the year the grantee is taxed on the income.

***Deferred Common Stock***

There are no immediate tax consequences of receiving an award of deferred common stock under the 2005 Plan. A grantee who is awarded deferred common stock will be required to recognize ordinary income in an amount equal to the fair market value of shares issued to such grantee at the distribution date(s) under the deferral election, reduced by the amount, if any, paid for such shares. If we comply with the restrictions of Section 162(m) of the Code, we will be entitled to a deduction for compensation paid in the same amount treated as compensation income to the grantee in the year the grantee is taxed on the income.

Deferred common stock can be considered non-qualified deferred compensation and subject to Section 409A of the Code. A grant of a deferred common stock that does not meet the requirements of Section 409A of the Code can result in the acceleration of income recognition, an additional 20% tax obligation, plus penalties and interest.

***Restricted Stock Units***

There are no immediate tax consequences of receiving an award of restricted common stock units under the 2005 Plan. A grantee who is awarded restricted common stock units will be required to recognize ordinary income in an amount equal to the fair market value of shares issued to such grantee at the end of the restriction period or, if later, the payment date. If we comply with the restrictions of Section 162(m) of the Code, we will be entitled to a deduction for compensation paid in the same amount treated as compensation income to the grantee in the year the grantee is taxed on the income.

***Stock Appreciation Rights***

There are no immediate tax consequences of receiving an award of stock appreciation rights under the 2005 Plan. Upon exercising a stock appreciation right, a grantee will recognize ordinary income in an amount equal to the difference between the exercise price and the fair market value of the common stock on the date of exercise. If we comply with the restrictions of Section 162(m) of the Code, we will



be entitled to a business expense deduction in the same amount and generally at the same time as the grantee recognizes ordinary income.

A stock appreciation right can be considered non-qualified deferred compensation and subject to Section 409A of the Code. A stock appreciation right that does not meet the requirements of Section 409A of the Code can result in the acceleration of income recognition, an additional 20% tax obligation, plus penalties and interest.

#### ***Performance Stock Awards***

There are no immediate tax consequences of receiving an award of performance shares under the 2005 Plan. A grantee who is awarded performance shares will be required to recognize ordinary income in an amount equal to the fair market value of shares issued to such grantee pursuant to the award, reduced by the amount, if any, paid for such shares. If we comply with the restrictions of Section 162(m) of the Code, we will be entitled to a deduction for compensation paid in the same amount treated as compensation income to the grantee in the year the grantee is taxed on the income. Upon a grantee's disposition of performance shares, any gain realized in excess of the amount reported as ordinary income will be reportable by the grantee as a capital gain, and any loss will be reportable as a capital loss. Capital gain or loss will be long-term if the grantee has held the shares for at least one year. Otherwise, the capital gain or loss will be short-term.

Performance stock awards can be considered non-qualified deferred compensation and subject to Section 409A of the Code. A grant of a performance stock award that does not meet the requirements of Section 409A of the Code can result in the acceleration of income recognition, an additional 20% tax obligation, plus penalties and interest.

#### ***Performance and Annual Incentive Awards***

The award of a performance or annual incentive award will have no federal income tax consequences for us or for the grantee. The payment of the award is taxable to a grantee as ordinary income. If we comply with the restrictions of Section 162(m) of the Code, we will be entitled to a business expense deduction in the same amount and generally at the same time as the grantee recognizes ordinary income.

Performance and annual incentive awards can be considered non-qualified deferred compensation and subject to Section 409A of the Code. A grant of a performance or annual incentive award that does not meet the requirements of Section 409A of the Code can result in the acceleration of income recognition, an additional 20% tax obligation, plus penalties and interest.

#### ***Amended 2005 Plan Benefits***

Options granted under the 2005 Plan from the 3,000,000 share reserve increase will be granted at the discretion of the Compensation Committee, and there are no specific plans to make any grants with respect to such increase, and, accordingly, are not yet determinable. Benefits under the 2005 Plan from the 3,000,000 share reserve increase will depend on a number of factors, including the fair market value of Kratos' common stock on future dates, actual performance against performance goals established with respect to performance awards and decisions made by the participants. Consequently it is not possible to determine the benefits that might be received by participants under the 2005 Plan, except that Kratos will issue an annual restricted stock unit grant to each non-employee director as provided under the 2005 Plan.

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The following table sets forth information with respect to restricted stock units granted under the 2005 Plan during fiscal 2007:

Executive Officer and Position	Number of Restricted Stock Unit Awards Granted in Fiscal 2007
Eric M. DeMarco, Chief Executive Officer	1,481,250
Deanna Lund, Senior Vice President and Chief Financial Officer	300,000
James R. Edwards, Former Senior Vice President and General Counsel(1)	255,000
D. Robin Mickle, President, Government Services Division	75,000
Laura Siegal, Vice President, Controller and Principal Accounting Officer	67,500
All current executive officers as a group(2)	1,991,250
All current employees as a group (excluding executive officers)(2)	505,200

(1) Mr. Edwards' employment with Kratos terminated in November 2007. His restricted stock unit awards vested upon the termination of his employment.

(2) Does not include Mr. Edwards.

### Vote Required and Board of Directors Recommendation

Approval of this proposal requires the affirmative vote of a majority of the shares entitled to vote on this proposal at a meeting at which a quorum is present. Abstentions and broker non-votes will each be counted as present for purposes of determining the presence of a quorum. Abstentions will have the same effect as a vote against this proposal. Broker non-votes will have no effect on the outcome of this vote.

**THE KRATOS BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR THIS ITEM (ITEM 4).**

### PROPOSAL 5

#### TO APPROVE ISSUANCE OF KRATOS COMMON STOCK IN CONNECTION WITH THE MERGER

It is a condition to completion of the merger that Kratos issue shares of Kratos common stock in the merger. When the merger becomes effective, each share of SYS common stock outstanding immediately before the merger will be converted into the right to receive 1.2582 shares of Kratos common stock. Under Marketplace Rule 4350(i) promulgated by The Nasdaq Stock Market, a company listed on The Nasdaq Stock Market is required to obtain stockholder approval in connection with a merger with another company if the number of shares of common stock or securities convertible into common stock to be issued is in excess of 20% of the number of shares of common stock then outstanding. If the merger is completed, Kratos will issue up to approximately 25.3 million shares of Kratos common stock in the merger. On an as converted basis, the aggregate number of shares of Kratos common stock to be issued in the merger will exceed 20% of the shares of Kratos common stock outstanding on the record date for the Kratos special meeting, and for this reason Kratos must obtain the approval of Kratos stockholders for the issuance of these securities to SYS shareholders in the merger.

**Vote Required and Board of Directors Recommendation**

Approval of this proposal requires the affirmative vote of a majority of the shares entitled to vote on the proposal at a meeting at which a quorum is present. Abstentions and broker non-votes will each be counted as present for purposes of determining the presence of a quorum. Abstentions will have the same effect as a vote against this proposal. Broker non-votes will have no effect on the outcome of this vote.

Kratos is asking its stockholders to approve the Share Issuance. The issuance of these securities to SYS shareholders is necessary to effect the merger. The approval of this Proposal 5 is required for completion of the merger.

**THE KRATOS BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR THIS ITEM (ITEM 5).**

**PROPOSAL 6**

**POSSIBLE ADJOURNMENT OR POSTPONEMENT OF THE KRATOS ANNUAL MEETING**

The Kratos annual meeting may be adjourned or postponed to another time or place to permit, among other things, further solicitation of proxies if necessary to obtain additional votes in favor of the items listed on the Proxy Card.

**Vote Required and Board of Directors Recommendation**

Approval of this proposal requires the affirmative vote of a majority of the total votes cast on the proposal at a meeting at which a quorum is present. Abstentions and broker non-votes will each be counted as present for purposes of determining the presence of a quorum. Abstentions will have the same effect as a vote against this proposal. Broker non-votes will have no effect on the outcome of this vote.

**THE KRATOS BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR THIS ITEM (ITEM 6).**

**OTHER MATTERS**

Kratos' management does not know of any other matters that may come before Kratos' annual meeting. However, if any other matters are properly presented to Kratos' annual meeting, it is the intention of the persons named in the accompanying proxy to vote, or otherwise act, in accordance with their judgment on such matters.

By Order of the Kratos Board of Directors,

Eric M. DeMarco  
*President and Chief Executive Officer*

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**KRATOS STOCK OWNERSHIP OF CERTAIN  
BENEFICIAL OWNERS AND MANAGEMENT**

**Principal Stockholders**

**Ownership of more than 5%**

The following tables show stock ownership information as of April 8, 2008 with respect to beneficial ownership of Kratos' common stock and Series B Convertible preferred stock by each person known to Kratos to be the beneficial owner of more than 5% of such stock. As of April 8, 2008, there were 78,998,922 shares of Kratos common stock and 10,000 shares of Kratos Series B preferred stock issued and outstanding.

Information with respect to beneficial owners of more than 5% of the common stock is based upon the most recent Schedule 13G or 13D these owners have filed with SEC.

**Non-Affiliated Stockholders**

Identity of Owner or Group	Beneficial Ownership(1)					
	Common Stock		Series B Convertible Preferred Stock		Common Shares On An As-Converted Basis	
	Shares	% Ownership	Shares	% Ownership	Shares	% Ownership
T. Rowe Price 100 E. Pratt Street Baltimore, MD 21202	7,656,005(2)	9.69%			7,656,005	9.57%
State of Wisconsin Investment Board P.O. Box 7842 Madison, WI 53707	7,397,886	9.36%			7,397,886	9.25%
Massih Tayebi BridgeWest LLC 4350 La Jolla Village Drive, Suite 450 San Diego, CA 92121	5,554,898(3)	7.03%			5,554,898	6.94%
Masood Tayebi BridgeWest LLC 4350 La Jolla Village Drive, Suite 450 San Diego, CA 92121	5,749,185(4)	7.28%			5,749,185	7.19%

- (1) This table is based upon information supplied by officers, directors and principal stockholders and Schedules 13G filed with the SEC, and the information is not necessarily indicative of beneficial ownership for any other purpose. Under such rules, beneficial ownership includes any shares as to which the individual or entity has sole or shared voting power or investment power and any shares as to which the individual or entity has the right to acquire beneficial ownership within 60 days of April 8, 2008 through the exercise of any stock option or other right. The inclusion of such shares, however, does not constitute an admission that the named stockholder is a direct or indirect beneficial owner of, or receives the economic benefit from, such shares. Applicable percentages are based on 78,998,922 shares of common stock, and 10,000 shares of Series B convertible preferred stock outstanding on April 8, 2008.
- (2) These securities are owned by various individual and institutional investors, which Price Associates serves as an investment adviser with power to direct investments and/or sole power to vote the securities. For purposes of the reporting requirements of the Exchange Act, Price Associates is deemed to be a beneficial owner of such securities; however Price Associates expressly disclaims that it is, in fact, the beneficial owner of such securities.
- (3) Does not include 52,762 shares held by spouse of Massih Tayebi. Massih Tayebi disclaims beneficial ownership of such shares.
- (4) Includes 5,749,185 shares held directly by Masood K. Tayebi or over which Dr. Tayebi has sole voting power. Excludes: 404,693 shares held directly by Dr. Tayebi's spouse; 2,000,000 shares held in a revocable living trust of which Dr. Tayebi's spouse is trustee; and 646,137 shares held in a grantor retained annuity trust of which Dr. Tayebi's spouse is trustee. Dr. Tayebi disclaims beneficial ownership of all such shares.



**Ownership by Directors and Executive Officers**

The following table shows the amount of Kratos' common stock and Series B convertible preferred stock beneficially owned by (i) Kratos' directors, (ii) each of the named executive officers in the Summary Compensation Table, and (iii) Kratos' directors and executive officers as a group. All information in the following table is presented as of April 8, 2008. Unless otherwise indicated in the table set forth below, each person named below has an address in care of Kratos' principal executive offices.

Identity of Owner or Group	Beneficial Ownership(1)					
	Common Stock		Series B Convertible Preferred Stock		Common Shares On An As-Converted Basis	
	Shares	% Ownership	Shares	% Ownership	Shares	% Ownership
<b>Directors</b>						
Scott I. Anderson c/o Cedar Grove Investments, LLC 3825 Issaquah Pine Lake Road Sammamish, WA 9807	734,012(2)	*			734,012	*
Bandel L. Carano Oak Investment Partners 525 University Avenue, Suite 1300 Palo Alto, CA 94302	5,547,434(3)	7.02%			5,547,434	6.93%
Eric M. DeMarco	2,032,949(4)	2.57%			2,032,949	2.54%
William A. Hoglund 434 35th Avenue Seattle, WA 98122	195,000(5)	*			195,000	*
Scot B. Jarvis c/o Cedar Grove Investments, LLC 3825 Issaquah Pine Lake Road Sammamish, WA 9807	734,012(6)	*			734,012	*
<b>Officers</b>						
Deanna Lund	407,615(7)	*			407,615	*
James R. Edwards	7,251(8)	*			7,251	*
Laura L. Siegal	130,881(9)	*			130,881	*
D. Robin Mickle	155,823(10)	*			155,823	*
<b>All Directors and Officers as a Group</b>						
<b>(8 persons, does not include Mr. Edwards)</b>	<b>9,937,726</b>	<b>12.58%</b>			<b>9,937,726</b>	<b>12.42%</b>
Total Shares Outstanding	<b>78,998,922</b>					
Adjusted for Preferred Shares Conversion Series B						
If Converted Additional Shares	1,000,000					
Adjusted Common Shares (If Converted)	<b>79,998,922</b>					

\* Less than one percent.

(1) This table is based upon information supplied by officers, directors and principal stockholders and Schedule 13G filed with the Securities and Exchange Commission (the "SEC"), and the information is not necessarily indicative of beneficial ownership for any other purpose. Under such rules, beneficial ownership includes any shares as to which the individual or entity has sole or shared voting power or investment power and any shares as to which the individual or entity has the right to acquire beneficial ownership within 60 days of April 8, 2008 through the exercise of any stock option or other right. The inclusion of such shares, however, does not constitute an admission that the named stockholder is a direct or indirect beneficial ownership of, or receives the economic benefit from, such shares. Applicable percentages are based on 78,998,922 shares of common stock, and 10,000 shares of Series B convertible preferred stock outstanding on April 8, 2008.

(2) Includes 130,000 shares subject to options exercisable within 60 days of April 8, 2008.

(3)

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Includes 149,546 shares subject to options exercisable within 60 days of April 8, 2008. Includes 2,554 shares of common stock held directly by Mr. Carano, 14,828 shares of common stock held by Oak Investment Partners VI, L.P., 346 shares of common stock held by Oak VI Affiliates Fund, L.P., 1,402,084 shares of common stock held by Oak Investment Partners IX, Limited Partnership, 14,942 shares of common stock held by Oak IX Affiliates Fund, Limited Partnership, 33,655 shares

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of common stock held by Oak IX Affiliates Fund-A, Limited Partnership, 48,597 shares held by Oak IX Affiliates, LLC, 3,808,026 shares of common stock held by Oak Investment Partners X, Limited Partnership, 61,123 shares of common stock held by Oak X Affiliates Fund, Limited Partnership. Bandel Carano is a general partner of Oak Investment Partners VI, L.P., Oak VI Affiliates Fund, L.P., Oak Investment Partners IX, L.P., Oak IX Affiliates Fund, L.P., Oak IX Affiliates Fund-A, L.P., Oak IX Affiliates, LLC, Oak Investment Partners X, L.P. and Oak X Affiliates Fund, L.P. Mr. Carano has indirect ownership of these shares and has shared power to vote and dispose of these shares. Mr. Carano disclaims beneficial ownership of the shares held by Oak Investment Partners VI, L.P., Oak VI Affiliates Fund, L.P., Oak Investment Partners IX, L.P., Oak IX Affiliates Fund, L.P., Oak IX Affiliates Fund-A, L.P., Oak IX Affiliates, LLC, Oak Investment Partners X, L.P. and Oak X Affiliates Fund, L.P.

- (4) Includes 7,949 shares held in Kratos' 401(k) Plan and 1,975,000 shares subject to options exercisable within 60 days from April 8, 2008.
- (5) Includes 195,000 shares subject to options exercisable within 60 days from April 8, 2008.
- (6) Includes 130,000 shares subject to options exercisable within 60 days from April 8, 2008.
- (7) Includes 7,615 shares held in Kratos' 401(k) Plan and 400,000 shares subject to options exercisable within 60-days from April 8, 2008.
- (8) Includes 7,251 shares held in Kratos' 401(k) Plan Mr. Edwards' employment with the Company terminated in November 2007.
- (9) Includes 4,835 shares held in Kratos' 401(k) Plan and 122,588 shares subject to options exercisable within 60 days from April 8, 2008.
- (10) Includes 5,823 shares held in Kratos' 401(k) Plan and 150,000 shares subject to options exercisable within 60-days of April 8, 2008.

### Management

Kratos' executive officers and their respective positions are set forth in the following table. Biographical information of each executive officer who is not also a director is set forth following the table. There are no family relationships between any director or executive officer and any other directors or executive officers. Executive officers serve at the discretion of the Kratos Board.

#### *Executive Officers*

Name	Position	Age	Year in Which He/She Became Officer
Eric M. DeMarco	Chief Executive Officer and President	44	2003
Deanna H. Lund	Senior Vice President and Chief Financial Officer	40	2004
Laura L. Siegal	Vice President, Corporate Controller and Acting Secretary	45	2006
D. Robin Mickle	President, Government Services Division	52	2006

The term of office of each executive officer is until his or her respective successor is elected and has been qualified, or until his or her earlier death, resignation or removal. Historically, the Board has elected officers annually at its first meeting following the Annual Meeting of Stockholders.

Mr. DeMarco's biographical information is included with those of the other members of the Kratos Board.

*Ms. Lund* has served as Kratos' Senior Vice President and Chief Financial Officer since April 2004. Prior to joining Kratos, Ms. Lund most recently served as Vice President of The Titan Corporation from July 1998 and Titan's Corporate Controller from December 1996. Ms. Lund was also Titan's Corporate Manager of Operations Analysis from 1993 to 1996. Prior thereto, Ms. Lund worked for Arthur Andersen LLP. Ms. Lund received her bachelor's degree in accounting from San Diego State University, magna cum laude, and is a Certified Public Accountant.



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*Ms. Siegal* has served as Kratos' Vice President and Corporate Controller since April 4, 2006. Prior thereto *Ms. Siegal* served as Vice President, Finance and Treasurer and Risk Management since September 2004. *Ms. Siegal* joined Kratos in August 2000 and has served as Treasurer since December 2003, our Director of Corporate Planning from August 2002 to December 2003, Director of Financial Planning and Analysis from January 2001 to August 2002, and Director of Purchasing from August 2000 to January 2001. Throughout her career, *Ms. Siegal* has held a variety of financial management positions in technology and consulting companies including Controller of MEC Analytical Systems. *Ms. Siegal* received a bachelor's degree in Economics from the University of California, San Diego.

*Mr. Mickle* has served as President of Kratos' wholly-owned subsidiary Kratos Government Solutions, Inc. and the Government Network Services Segment since December 2005. *Mr. Mickle* joined Kratos in January 2005 as a vice president in the Government Network Services segment. Prior thereto, *Mr. Mickle* had been Vice President of the Fleet Systems Engineering Business Unit at Northrop Grumman Mission Systems since June 1996. From January 1994 to June 1996, *Mr. Mickle* had been an Executive Manager of Naval Engineering Services, Western Operations. *Mr. Mickle* is a retired Captain of the U.S. Naval Reserve and served in the U.S. Navy from 1977 to 1983. *Mr. Mickle* is a graduate of the U.S. Naval Academy and received an MBA in Management Science from San Diego State University.

### CERTAIN RELATIONSHIPS AND RELATED PERSON TRANSACTIONS

On May 30, 2002, Kratos issued an aggregate of 90,000 shares of Series B Convertible Preferred Stock, at an aggregate purchase price of \$45.0 million, in a private placement to entities affiliated with one of the directors of Kratos (40,000 shares), to a brother of the previous Chairman and Chief Executive Officer of Kratos (10,000 shares) and to an unrelated third-party investor (40,000 shares). Kratos received \$44.9 million of net proceeds. Each share of Series B Convertible Preferred Stock is initially convertible into 100 shares of common stock for a conversion price of \$5.00 per share, which was the fair market value of the common stock at the closing, at the option of the holder at any time, subject to certain provisions in the Series B Preferred Stock Purchase Agreement. Prior to December 31, 2004, 64,517 shares of Series B Convertible Preferred Stock were converted into 6,451,700 shares of the Kratos' common stock. On April 5, 2006, 15,483 shares of Series B Convertible Preferred Stock were converted into 1,548,300 shares of Kratos' common stock.

Through December 31, 2007, Kratos has received notices from the holders to convert an aggregate number of 80,000 shares of Series B Convertible Preferred Stock into an aggregate 8,000,000 shares of Kratos' common stock. On December 31, 2007, the total liquidation preference equaled \$5.0 million.

On February 17, 2006, Kratos entered into a definitive agreement to divest all of its operations in Mexico for total approximate cash consideration of \$18.0 million subject to adjustments for the closing net asset calculations, with \$1.5 million payable in cash on signing of the Equity Purchase Agreement and \$16.5 million by means of a secured promissory note payable in installments through December 2006, which approximates the net book value of the operations. The purchaser, Sakoki LLC, is a newly-formed entity controlled by Massih Tayebi. Although Massih Tayebi has no current role with Kratos, he was a co-founder of Kratos, having served as Chief Executive Officer from inception in 1994 through September 2000 and as a director from inception through April 2002. In addition, as of July 31, 2007, Massih Tayebi owns or controls approximately 8.2% of the total voting power of Kratos' capital stock. He is also the brother of Masood Tayebi, who was Kratos' Chairman of the board of directors until March 6, 2007. Masood Tayebi had no personal financial interest in the transaction and has no role with the entity that has purchased the Mexico Operations. The transaction was approved by the disinterested members of Kratos' board of directors after consideration of other expressions of interest and an independent valuation analysis.

The final closing balance sheet as of February 17, 2006 resulted in net asset adjustments aggregating to a total approximate \$18.9 million consideration, \$1.5 million which was paid on February 17, 2006, with the remaining \$17.4 million payable by means of the promissory note in installments through December 31, 2006 with an interest rate of 7.5% per annum. On June 26, 2006, Kratos entered into an Addendum with the buyer to finalize the closing net asset calculations, pursuant to which the parties agreed that the resulting total purchase price was \$18.9 million. The Addendum also provided for a conditional waiver that permits the purchaser to make the payment due on August 17, 2006 by September 30, 2006, and for the installments due on November 17, 2006 and December 31, 2006 to be made on or before December 29, 2006. Failure to make the payments on such later dates would have resulted in a restoration of the original terms of the note. The first scheduled note payment of \$3.3 million was received from the buyer on May 19, 2006, and the second scheduled note payment of \$5.5 million was received in installments of \$5.2 million on September 29, 2006 and \$0.3 million on October 10, 2006. The remaining note receivable balance of \$9.5 million which included accrued interest through December 29, 2006, was paid in full on December 29, 2006.

Other than as disclosed above, since January 1, 2005, there has not been, nor is there currently proposed, any transaction or series of similar transactions to which Kratos was or is a party in which the amount involved exceeds \$120,000 and in which any director, officer or beneficial holder of more than 5% of any class of voting securities or member of such person's immediate family had or will have a direct or indirect material interest.

#### **Procedures for Approval of Related Party Transactions**

Under its charter the Audit Committee of the Kratos board of directors is charged with reviewing all potential related party transactions. Kratos' policy has been that the Audit Committee, which is comprised solely of independent, disinterested directors, then recommends such related party transactions to the entire Kratos board of directors for further review and approval. All such related party transactions are then required to be reported under applicable SEC rules. Otherwise, Kratos has not adopted procedures for review of, or standards for approval of, these transactions, but instead reviews such transactions on a case-by-case basis.

## KRATOS EXECUTIVE COMPENSATION

### Compensation Discussion and Analysis

#### *Overview*

This compensation discussion and analysis explains the material elements of the compensation awarded to, earned by, or paid to each of the Kratos executive officers who served as named executive officers of Kratos during the last completed fiscal year.

#### *Compensation Program Objectives and Philosophy*

The Compensation Committee of the Kratos board of directors, which we refer to in this section as the Committee, currently oversees the design and administration of the executive compensation program at Kratos. The Committee has adopted an executive compensation policy that has as its primary objective serving Kratos' stockholders by attracting, retaining and motivating talented and qualified individuals to manage and lead Kratos' business. The Committee's primary objectives in structuring and administering the executive compensation policy are to:

attract, motivate and retain talented and dedicated executive officers;

tie annual and long-term cash and stock incentives to achievement of measurable corporate and individual performance objectives;

reward individual performance; and

reinforce business strategies and objectives for enhanced stockholder value.

The Committee evaluates both performance and compensation of employees to ensure that Kratos has the ability to attract and retain employees and that compensation provided to employees remains competitive relative to the compensation paid to similarly situated employees of peer companies. The Committee endeavors to ensure that the total paid to executive officers is fair, reasonable and competitive.

The principal elements of the current executive compensation program are base salary, annual incentive cash bonus awards, long-term equity incentives in the form of restricted stock units, a deferred compensation plan, other benefits and perquisites, post-termination severance and accelerated vesting of previously granted equity awards upon termination and/or a change in control. Other benefits and perquisites at Kratos consist of life and health insurance benefits and a qualified 401(k) savings plan equivalent to those offered to all employees.

The Committee views these components of compensation as related but distinct. Although the Committee does review total compensation, Kratos does not believe that significant compensation derived from one component of compensation should negate or offset compensation from other components. Kratos determines the appropriate level for each compensation component based in part, but not exclusively, on compensation for similar positions at peer companies, the Committee's view of internal equity and consistency, and other considerations it deems relevant, such as rewarding extraordinary performance.

#### *Determination of Compensation Awards*

The Committee has historically performed at least annually a strategic review of executive officers' compensation to determine whether they provide adequate incentives and motivation to Kratos' executive officers and whether they adequately compensate executive officers relative to comparable officers in other similarly situated companies. The Committee's most recent review occurred in March 2008.

Committee meetings typically have included, for all or a portion of each meeting, not only the Committee members but also Kratos' chief executive officer, chief financial officer and general counsel. For compensation decisions relating to executive officers other than the chief executive officer, the Committee typically considers recommendations from the chief executive officer. When determining compensation for the chief executive officer, the Committee takes into account, but does not rely upon, the recommendation of the chief executive officer. Compensation for the chief executive officer has been determined by discussion among and action by the members of the Committee acting in consultation with the other independent members of the Board and market data obtained on behalf of the Committee.

It is Kratos' policy generally to qualify compensation paid to executive officers for deductibility under Section 162(m) of the Internal Revenue Code. Section 162(m) generally prohibits the company from deducting the compensation of officers that exceeds \$1,000,000 unless that compensation is based on the achievement of objective performance goals. Kratos believes that its 1999 and 2005 Equity Incentive Plans, which we refer to collectively as the Equity Plans, are structured to qualify stock options, restricted share and stock unit awards under such Equity Plans as performance-based compensation and to maximize the tax deductibility of such awards. However, Kratos reserves the discretion to pay compensation to its officers that may not be deductible.

#### ***Base Compensation***

Kratos provide its named executive officers and other executives with base salaries that it believes enables it to hire and retain individuals in a competitive environment and to reward individual performance and contribution to its overall business goals, while taking into account the unique circumstances of the company. Kratos reviews base salaries for its named executive officers annually and increases, if any, are based on the executive's success in contributing to its short-term and long-term objectives as well as unique challenges faced by it. Kratos also takes into account the base compensation that is payable by companies that it believes to be its competitors and by other public companies with which we believe we generally compete for executives in our market and geography. The base salary of our chief executive officer is reviewed and recommended by the Committee acting in consultation with the other independent members of our Board.

In April 2007, the Committee applied the principals described above and increased the base salary of our chief executive officer, Eric DeMarco, by 10% to \$440,000, effective as of April 1, 2007. The Committee considered, among other things, Mr. DeMarco's effectiveness in dealing with the challenges related to the divestiture of certain of Kratos business segments and the refocusing of the business on the Kratos Government Solutions business segment. The Committee reviewed similar considerations for each of the other named executives, and in April 2007 increased the base salaries of the other named executive officers as follows: Deanna Lund, senior vice president and chief financial officer, by 10.9% to \$305,000; James Edwards, former senior vice president and general counsel, by 12.5% to \$270,000; Laura Siegal, vice president, controller and principal accounting officer, by 10.8% to \$205,000; and D. Robin Mickle, president of the Government Services division, by 7.3% to \$220,000, all effective as of April 1, 2007. In April 2008, the Committee applied the above principles and decided to maintain the executive officers' salaries at their current levels through the remainder of 2008.

#### ***Retention Cash Bonus Awards***

All members of the Kratos corporate management team (including all named executive officers other than Mr. Mickle) were eligible to receive cash retention awards under the Kratos 2007 retention cash bonus awards program (the "Retention Program"). In establishing the Retention Program, the Committee considered the significant challenges faced by the Kratos corporate management team related to, among other things, the divestiture of the commercial wireless-related businesses and the refocusing of the business as a defense contractor and security systems integrator for the federal

government and for state and local agencies, as well the recently completed investigation of Kratos' past stock option granting practices and related securities litigation. The Committee determined that the Retention Program should be established in order to retain these key executive officers through this difficult transition period for Kratos.

The cash awards under the Retention Program vested over the course of fiscal 2007, with the last vesting date occurring on January 1, 2008, and were paid out in increments over this period. These awards were contingent only upon continued employment through the vesting period. If the executive officer's employment terminated during fiscal 2007, the executive forfeited all subsequent payouts. The value of the award for each executive officer was determined at the recommendation of the chief executive officer based on an assessment of the retention risk for each executive officer and that individual's impact on the organization.

The following table sets forth the awards and vesting periods for each of the named executive officers under this program.

<b>Named Executive Officer</b>	<b>Vesting July 1, 2007</b>	<b>Vesting October 1, 2007</b>	<b>Vesting January 1, 2008</b>	<b>Total Possible Payments</b>	<b>Total Payments Received</b>
Eric DeMarco	\$ 220,000	\$ 110,000	\$ 220,000	\$ 550,000	\$ 550,000
Deanna Lund	114,375	57,188	114,375	285,938	285,938
James Edwards	81,000	40,500	81,000(a)	202,500	121,500
D. Robin Mickle(b)					
Laura Siegal	41,000	20,500	41,000	102,500	102,500

(a) Mr. Edwards' employment with us terminated in November 2007; as a result, he was not eligible to receive this payment.

(b) Mr. Mickle was not eligible to participate in the Retention Program.

In April 2008, the Committee considered the factors identified above and determined to continue the Retention Program for fiscal 2008, with cash bonuses to vest on July 1, 2008, October 1, 2008 and January 1, 2009, for the same executive officers at the same compensation level as 2007.

**Annual Cash Bonus Awards**

In addition to base salary, Kratos has in the past provided executive officers and other key managers the opportunity to receive incentive compensation in the form of annual discretionary bonuses of cash based upon the achievement of certain individual and company performance objectives during the fiscal year. Typically, target cash bonus awards are based upon a percentage of the executive's salary and range from 25% to 100% of the executive officer's salary. In determining the appropriate level of target bonus for each officer, the Committee considers the recommendation of the chief executive officer and other information collected from public sources for similar positions at peer companies. Under the bonus plan, each executive typically received 50% of his or her target bonus amount if the executive achieves specific individualized operational objectives and the other 50% if we achieved certain financial targets for the fiscal year, which typically include targets related to some combination of earnings per share, EBITDA, cash flow, revenues and gross profits. If the financial metrics fell within a certain specified range (with the target metric at the high end of the range), then the executive would typically receive a pro rata percentage of their bonus target based on linear interpolation between the bottom and top of the range. Generally, the executive would not receive any of the company performance-based portion of the target bonus if the financial metrics fall below the bottom of the range.

The Committee retains wide discretion to interpret the terms of the cash bonus plan and to identify the extent to which an individual's performance objectives have been met in any particular fiscal year. The Committee also retains the right to exclude extraordinary charges or other special circumstances in determining whether the objectives were met during any particular fiscal year and may decide to grant 100% of the targeted cash bonus award even if our earnings per share do not fall within the specified range, based upon an evaluation of business conditions and industry trends. In addition, the Committee may approve cash bonuses outside of the cash bonus plan. For example, the Committee may approve bonus awards in connection with an executive officer's efforts and accomplishments with respect to our strategic initiatives and milestones, and such bonus awards may overlap with or be in addition to bonus awards under the cash bonus plan.

Mr. Mickle, who serves as president of Kratos' Government Services division, was the only named executive officer eligible to participate in the above cash bonus award plan for fiscal 2007. Under the plan, Mr. Mickle was eligible to receive up to a maximum of \$110,000, or 50% of his annual salary. He was eligible to receive up to 25% of his annual target bonus amount if he achieved certain individualized performance targets such as improvement in identifying, winning and retaining new business through implementation of better processes, improvement of program management, aggressive management of overhead and utilization rates, limitation of unallowable usage compared to budgets, improvement of voluntary retention, improvement of division proposal skills, and support of corporate initiatives, and 75% of his annual target bonus amount if Kratos achieved certain financial targets such as earnings per share goals of Kratos, and the Kratos' Government Services division achieving EBIT, revenue, win rate, and cash collection goals. In April 2008, Mr. Mickle received a cash payment equal to \$92,000.

As described in more detail above, for fiscal 2007, the Committee did not establish a cash bonus award plan for Kratos' other named executive officers. Instead, these annual cash bonus awards were replaced for fiscal 2007 by the cash awards under the Retention Program described above for all named executive officers other than Mr. Mickle. As a result, Mr. DeMarco, Ms. Lund and Ms. Siegal did not participate in the cash bonus award plan in 2007. As described above, the Committee expects to continue the Retention Program for these executive officers in 2008, and expects to reestablish a cash bonus award plan for all executive officers consistent with prior year plans for fiscal 2009.

#### ***Equity Compensation***

Kratos believes that equity ownership by its executive officers provides important incentives to make decisions and take actions that maximize long-term stockholder value. The Committee develops its equity award determinations based on its judgments as to whether the complete compensation packages provided to Kratos' executives, including prior equity awards, provide sufficient incentive to build stockholder value and align the interests of executive officers with its stockholders, and are sufficient to retain, motivate and adequately award each of its executives. This judgment is based in part on information provided by reviewing the equity compensation practices of companies that Kratos believes to be its competitors and by other public companies with which it believes it generally competes for executives.

Kratos grants equity compensation to its executive officers and other employees under its Equity Plans. Most initial option grants currently vest over a four year period from the date of grant, with 25% vesting on the first anniversary of the date of grant and the balance vesting monthly over a three year period. Subsequent option grants to employees with over one year of service vest on a monthly basis over a four year period. Our stock options have a 10-year contractual term. Beginning on January 1, 2006, Kratos began accounting for stock-based payments in accordance with the requirements of FASB Statement 123R. In addition, as of April 1, 2008, its employees, including its executive officers, are able to purchase shares of Kratos common stock under our 1999 Employee Stock Purchase Plan.

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The Committee reviews and approves all grants made to its officers under the Equity Plans and in connection with the initial hiring, promotions, extraordinary achievements or compensation adjustments. In addition to these factors, the size and timing of grants are generally subject to policies established by the Committee regarding the position of the grantee within the company, the overall number of options actually granted to the optionee in the past and the extent of vesting of prior grants. In general, the option grants are also subject to post-termination and change in control provisions. In January 2007, for various business reasons, Kratos generally discontinued the use of stock options as a form of equity compensation and instead began to issue restricted stock units on a limited basis. No options were granted to executive officers during fiscal 2006 or 2007.

On December 28, 2006, the Kratos Board approved the acceleration of vesting of all unvested options to purchase shares of Kratos common stock issued prior to June 30, 2006 held by its employees and directors under the 1999 Equity Incentive Plan and 2000 Nonqualified Stock Option Plan. The acceleration was effective as of December 29, 2006. Executive officers held options to purchase 687,000 shares at a weighted average exercise price of \$6.28 per share.

Beginning in fiscal 2007, the Board adopted a policy of equity ownership to Kratos' executive officers through restricted stock units. These restricted stock units vest at the earlier of (i) ten years from the date of grant, (ii) upon a change in control of the company, or (iii) upon termination of employment without cause. Consistent with its belief that equity ownership by executive officers provides important incentives to make decisions and take actions that maximize long-term stockholder value, on January 30, 2007, the Committee granted restricted stock unit awards to named executive officers, as follows:

Eric M. DeMarco: 987,500 shares

Deanna Lund: 200,000 shares

James R. Edwards: 170,000 shares

D. Robin Mickle: 75,000 shares

Laura L. Siegal: 45,000 shares

In view of the significant challenges facing Kratos related primarily to legacy issues which pre-date the current management team, on March 26, 2007, the Committee granted restricted stock unit awards as a retention tool as follows:

Eric M. DeMarco: 493,750 shares

Deanna Lund: 100,000 shares

James R. Edwards: 85,000 shares

Laura L. Siegal: 22,500 shares

In connection with the termination of Mr. Edwards' employment in November 2007, 100% of his above restricted stock unit awards vested in their entirety.

In addition, on January 4, 2008, the Committee granted additional restricted stock unit awards as follows:

Eric M. DeMarco: 450,000 shares

Deanna Lund: 100,000 shares

Laura L. Siegal: 22,500 shares



***Deferred Compensation Plan***

In fiscal 2007 and in prior years Kratos has provided its executive officers and other eligible highly compensated employees with the opportunity to defer up to 80% of their cash compensation derived from base salary, bonus awards and/or commissions pursuant to a Nonqualified Deferred Compensation Plan ("Deferred Compensation Plan"). The deferrals reduce a participant's current taxable income and allow the participant to accumulate savings on a tax deferred basis. In addition, Kratos may, in its sole and absolute discretion, make annual discretionary contributions, including matching contributions, to the Deferred Compensation Plan. To date, Kratos has not made any such contributions. Deferrals and contributions (if applicable) are adjusted for gain or loss based on the performance of one or more investment options selected by the participant from among investment funds chosen by a Committee appointed by the Committee to administer the Deferred Compensation Plan. Generally, all distributions under the Deferred Compensation Plan will be made in a single lump sum, although participants that terminated their employment as a result of retirement may elect to receive distributions in annual installments.

In December 2007, the Committee determined to "freeze" the plan such that no new deferral elections will be permitted after December 31, 2007. Irrevocable deferral elections that have already been made will continue in effect for compensation for services performed in 2007 that would otherwise be payable in 2008. On December 1, 2008 any remaining account balances will be distributed to participants in a single lump sum.

***Executive Benefits and Perquisites***

All of Kratos executives are eligible to participate in our employee benefit plans, including medical, dental, life insurance and 401(k) plans. These plans are available to all salaried employees and do not discriminate in favor of executive officers. It is generally our policy not to extend significant perquisites to executives that are not available to employees generally. Kratos has no current plans to make changes to levels of benefits and perquisites provided to executives.

***Change in Control and Severance Benefits***

Pursuant to an employment agreement with Mr. DeMarco and change in control agreements with Ms. Lund and Ms. Siegal, Kratos provides these officers the opportunity to receive additional compensation and benefits in the event of severance or change in control. Severance and change in control provisions are summarized below in "Employment Agreements; Potential Payments upon Termination or Change in Control." The Committee's analysis indicates that Kratos' severance and change in control provisions are consistent with the provisions and benefit levels of other companies disclosing such provisions as reported in public SEC filings. Kratos believes its arrangements with its executive officers are reasonable. As further described below, Kratos entered into an agreement with Mr. Edwards in connection with the termination of his employment with us, the terms of which are described below.

**COMPENSATION COMMITTEE REPORT**

The Committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) of Regulation S-K with management and, based on such review and discussions, the Committee recommended to the Kratos board of directors that the Compensation Discussion and Analysis be included in our Annual Report on Form 10-K and this proxy statement.

THE COMPENSATION COMMITTEE

Bandel L. Carano  
Scot B. Jarvis, Chairperson  
William A. Hoglund

**Compensation Committee Interlocks and Insider Participation**

The Compensation Committee is comprised entirely of independent directors. None of the members of the Compensation Committee is or has ever been one of our officers or employees. No interlocking relationship exists between the Kratos board of directors or Compensation Committee and the board of directors or compensation committee of any other entity.

## FISCAL YEAR 2007 SUMMARY COMPENSATION TABLE

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(i)	(j)
Name and Principal Position	Year	Salary (\$)	Bonus \$(1)	Stock Awards \$(2)	Option Award(s) \$(2)	Non-Equity Incentive Plan Compensation \$(3)	All Other Compensation (\$)	Total Compensation (\$)
Eric M. DeMarco President and Chief Executive Officer	2007	440,000		295,466		550,000	12,750(4)	1,298,216
	2006	373,465	200,000		1,988,385		12,750(4)	2,574,600
Deanna Lund Senior Vice President and Chief Financial Officer	2007	305,000		59,841		285,938		650,779
	2006	261,767	82,500		550,716			894,983
James R. Edwards(5) Former Senior Vice President, General Counsel and Secretary	2007	270,000		584,800		121,500		976,300
	2006	234,215	72,000		467,187			773,402
D. Robin Mickle President, Advanced Technical Solutions Division	2007	220,000		16,231		92,000		328,231
	2006	206,054			470,382	51,250		727,686
Laura L. Siegal Vice President, Corporate Controller and Acting Secretary	2007	205,000		13,464		102,500		320,964
	2006	181,118	37,000		120,602			338,720

- (1) Represents cash bonus awards to named executive officers earned in the referenced fiscal year as set forth above. Annual cash bonus awards under Kratos' cash bonus plans are typically paid based on the achievement of certain objectives approved by the Committee as described in further detail above.
- (2) The amounts shown in columns (e) and (f) represent the compensation costs of restricted stock unit awards and stock options for financial reporting purposes for fiscal years 2006 and 2007 under FAS 123(R), rather than an amount paid to or realized by the named executive officer. A discussion of the relevant fair value assumptions is set forth in note 18 to Kratos' consolidated financial statements included in its 2007 Annual Report on Form 10-K. Kratos cautions that the amount ultimately realized from the restricted stock unit awards and option awards will likely vary based on a number of factors, including the company's actual operating performance, stock price fluctuations and the timing of exercises (in the case of options only) and sales.
- (3) Represents bonus under the cash bonus plan to named executive officers earned in 2007 and paid in 2007 and 2008 as described in further detail above. Annual cash bonus awards under the cash bonus plan are typically paid based on the achievement of certain individual and Kratos performance objectives approved by the Committee as described in further detail above. For fiscal 2007, the chief executive officer, not the Committee, determined individualized and company performance objectives for Mr. Mickle's cash bonus award. However, the Committee evaluated whether Mr. Mickle achieved his individualized performance objectives and approved the payment of his bonus under the cash bonus plan.
- (4) Represents the taxable income attributable to Mr. DeMarco for his use of a company automobile in the referenced fiscal year.
- (5) Mr. Edwards' employment with Kratos terminated in November 2007.

## FISCAL YEAR 2007 GRANTS OF PLAN-BASED AWARDS

(a) Name	(b) Approval Date Grant Date		(c) Estimated Future Payouts Under Non-Equity Incentive Plan Awards(1)			(i) All Other Stock Awards: Number of Shares of Stock or Units (#)(2)	(l) Grant Date Fair Value of Stock and Option Awards (\$)(3)
			(c) Threshold (\$)	(d) Target (\$)	(e) Maximum (\$)		
Eric M. DeMarco	1/10/2007	1/30/2007				987,500	2,330,500
	2/28/2007	3/26/2007				493,750	1,066,500
		7/1/2007		220,000			
		10/1/2007		110,000			
		1/2/2008		220,000			
Deanna H. Lund	1/10/2007	1/30/2007				200,000	472,000
	2/28/2007	3/26/2007				100,000	216,000
		7/1/2007		91,500			
		10/1/2007		45,750			
	1/2/2008		91,500				
James R. Edwards(4)	1/10/2007	1/30/2007				170,000	401,200
	2/28/2007	3/26/2007				85,000	183,600
		7/1/2007		81,000			
		10/1/2007		40,500			
D. Robin Mickle	1/10/2007	1/30/2007				75,000	177,000
		N/A	0	100,000	110,000		
Laura L. Siegal	1/10/2007	1/30/2007				45,000	106,200
	2/28/2007	3/26/2007				22,500	48,600
		7/1/2007		41,000			
		10/1/2007		20,500			
		1/2/2008		41,000			

- (1) Amounts shown in columns (d) are the estimated possible payouts for fiscal year 2007 under the Retention Program set forth above for Mr. DeMarco, Ms. Lund, Mr. Edwards and Ms. Siegal, and under the annual cash bonus program for Mr. Mickle, based on certain assumptions. The actual bonuses awarded to the named executive officers for the 2007 fiscal year are reporting in the Fiscal Year 2007 Summary Compensation Table under the column "Non-Equity Incentive Plan Compensation."
- (2) Amounts shown in column (i) represent restricted stock unit awards to the named executive officers in fiscal year 2007 as more fully described above.
- (3) Amounts shown in column (l) represent the FAS 123(R) "fair value" of such Restricted Stock Unit Awards to the named executive officers on the date of grant.
- (4) Mr. Edwards' employment with Kratos terminated in November 2007.

Kratos did not grant any equity based awards under incentive compensation plans to any named executive officers during the fiscal year ended December 31, 2007.



OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

(a)	(b)	(e)	(f)	(g)	(h)
Option Awards				Stock Awards	
Name	Number of Securities Underlying Unexercised Options (#) Exercisable (1)	Option Exercise Price (\$)	Option Expiration Date (2)	Number of Shares or Units of Stock That Have Not Vested (#)(9)	Market Value of Shares or Units of Stock That Have Not Vested \$(10)
Eric M. DeMarco	1,250,000	6.19(3)	11/17/2013		
	500,000	6.05(8)	8/18/2014		
	225,000	5.38(8)	8/9/2015		
				1,481,250	3,480,937
Deanna Lund	200,000	6.19(4)	4/20/2014		
	100,000	6.05(8)	8/18/2014		
	100,000	5.38(8)	8/9/2015		
				300,000	705,000
James R. Edwards(12)					
D. Robin Mickle	40,000	6.19(5)	4/12/2015		
	10,000	5.90(8)	9/29/2015		
	100,000	5.43(8)	12/20/2015		
				75,000	176,250
Laura L. Siegal	5,088	4.47(6)	10/1/2011		
	36,000	4.23(6)	4/30/2012		
	20,000	6.19	5/23/2013		
	18,000	6.19	10/2/2013		
	8,500	6.05(7)	8/19/2015		
	35,000	5.38(7)	8/9/2015		
				67,500	158,625

- (1) All options listed are fully vested and exercisable.
- (2) Expiration date assumes that optionee remains in service of the company through the full term of the stock option grant.
- (3) Represents option shares originally granted to Mr. DeMarco on November 17, 2003 with respect to which the vesting was accelerated on May 18, 2005 pursuant to the Compensation Committee's determination to accelerate the vesting on all outstanding and unvested stock options held by employees, officers and directors of the company with an exercise price of more than \$10.00 per share. The option was cancelled and re-issued on December 30, 2005 as part of a repricing of all outstanding employee stock options that were originally granted at exercise prices greater than 120% of the company's closing stock price on the Nasdaq Global Select Market on December 30, 2005.
- (4) Represents option shares originally granted to Ms. Lund on April 20, 2004 with respect to which the vesting was accelerated on May 18, 2005 pursuant to the Compensation Committee's determination to accelerate the vesting on all outstanding and unvested stock options held by employees, officers and directors of the company with an exercise price of more than \$10.00 per share. These options were cancelled and re-issued on December 30, 2005 as part of a repricing of all outstanding employee stock options that were originally granted at exercise prices greater than



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120% of the company's closing stock price on the Nasdaq Global Select Market on December 30, 2005.

- (5) Represents option shares granted to Mr. Mickle on April 12, 2005, which options were cancelled and re-issued on December 30, 2005 as part of a repricing of all outstanding employee stock options that were originally granted at exercise prices greater than 120% of the company's closing stock price on the Nasdaq Global Select Market on December 30, 2005. The vesting of these options was subsequently accelerated on December 31, 2006 when the Board of Directors approved the acceleration of vesting on all outstanding options issued prior to June 30, 2006 under our 1999 Equity Incentive and 2000 Nonqualified Stock Option Plans.
- (6) Represents option shares that were originally granted to Ms. Siegal on May 23, 2003 with respect to which the vesting was accelerated on September 19, 2005 pursuant to the Compensation Committee's determination to accelerate the vesting on all outstanding and unvested stock options held by employees, officers and directors of the company with an exercise price of more than \$8.00 per share. The option was cancelled and re-issued on December 30, 2005 as part of a repricing of all outstanding employee stock options that were originally granted at exercise prices greater than 120% of the company's closing stock price on the Nasdaq Global Select Market on December 30, 2005.
- (7) Represents option shares originally granted to Ms. Siegal on October 2, 2003, with respect to which the vesting was accelerated on May 18, 2005 pursuant to the Compensation Committee's determination to accelerate the vesting on all outstanding and unvested stock options held by employees, officers and directors of the company with an exercise price of more than \$10.00 per share. The option was cancelled and re-issued on December 30, 2005 as part of a repricing of all outstanding employee stock options that were originally granted at exercise prices greater than 120% of the company's closing stock price on the Nasdaq Global Select Market on December 30, 2005.
- (8) Represents option shares granted to Ms. Lund, Ms. Siegal and Messrs. DeMarco and Mickle with respect to which the vesting was subsequently accelerated on December 29, 2006, when the Board of Directors approved the acceleration of vesting of all outstanding options issued prior to June 30, 2006 under the 1999 Equity Incentive and 2000 Nonqualified Stock Option Plans.
- (9) Amounts listed in column (g) reflect restricted stock unit awards to the named executive officers outstanding at December 31, 2007 as described more fully above, including 987,500 shares for Mr. DeMarco, 200,000 shares for Ms. Lund, 45,000 shares for Ms. Siegal and 75,000 shares for Mr. Mickle, all of which vest at the earlier of (a) 10 years from the date of grant; (b) upon a change in control of the issuer; or (c) upon termination of employment without cause, and 493,750 shares for Mr. DeMarco, 100,000 shares for Ms. Lund and 22,500 shares for Ms. Siegal, all of which vest at the earlier of (a) 10 years from the date of grant; (b) upon a change in control of the issuer; or (c) upon termination of employment without cause, except in the case of voluntary termination of employment within the first two years from date of grant.
- (10) Amounts listed in column (h) represent the aggregate market value of the unvested restricted stock units awards held by the named executive officers as of December 31, 2007 based on the closing price of a share of Kratos common stock of \$2.35 on December 31, 2007.
- (11) All restricted stock unit awards vested in connection with the termination of Mr. Edwards' employment with us in November 2007.
- (12) Mr. Edwards' employment with Kratos terminated in November 2007.



**FISCAL YEAR 2007 OPTIONS EXERCISES AND STOCK VESTED**

None of the named executive officers acquired any shares of Kratos common stock through the exercise of stock options during the fiscal year ended December 31, 2007.

The following table shows stock vested for the named executive officers during the fiscal year ended December 31, 2007:

(a)