KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-K
February 28, 2019
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)	
ý	ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 30, 2018
..	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

Commission file number 001-34460
KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
(Exact name of Registrant as specified in its charter)

Delaware	13-3818604
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

10680 Treena St., Suite 600
San Diego, CA 92131
(858) 812-7300
(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)
SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT

Title of Each Class	Name of each exchange on which registered
Common Stock, par value $0.001	The NASDAQ Global Select Market

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT
None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý No ¨
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No ý
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ý No o
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter)is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer ý	Accelerated filer o

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

The aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates as of June 29, 2018, the last business day of the registrant's most recently completed second fiscal quarter, was approximately $1,013.2 billion, based on the closing sale price for shares of the registrant's common stock as reported by the NASDAQ Global Select Market on such date. This disclosure excludes shares of common stock held by executive officers, directors and stockholders whose individual ownership exceeds 10% of the common stock outstanding on June 29, 2018 because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for any other purpose.

As of February 22, 2019, 104,046,886 shares of the registrant's common stock were outstanding.

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Documents Incorporated by Reference

Items 10, 11, 12, 13 and 14 of Part III of this annual report on Form 10-K incorporate information by reference from the registrant’s definitive proxy statement to be filed pursuant to Regulation 14A in connection with the registrant’s 2019 Annual Meeting of Stockholders or an amendment to this annual report on Form 10-K to be filed with the Securities and Exchange Commission within 120 days after the close of the fiscal year covered by this annual report on Form 10-K.

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

FORWARD LOOKING STATEMENTS

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

PART I.

Item 1. Business.

Overview

Kratos is a government contractor at the forefront of the U.S. Department of Defense’s (the “DoD”) recapitalization of strategic weapon systems to address peer and near peer threats and its related Rapid Innovation Initiatives. Kratos is a leading technology, intellectual property, proprietary product and system company focused on the U.S. and its allies’ national security. Kratos is a recognized industry leader in the rapid development, demonstration and fielding of high technology systems and products at an affordable cost. A key element of our business plan is to make Company-funded investments related to key platforms, products and systems, so that we own the related intellectual property, providing us designed in, sole and single source positions with our offerings. We are an industry leader in high performance, jet powered, unmanned aerial drone target systems used to test weapon systems and to train the warfighter and a provider of high performance unmanned combat aerial systems for force multiplication and amplification. We are also an industry leader in space and satellite communications, microwave electronics, cyber security/warfare, missile defense, C5ISR (as defined below) and training systems. Our workforce is primarily engineering and technically oriented with a significant number of employees holding national security clearances. Much of our work is performed at customer locations, or in a secure facility. Our primary end customers are national and homeland security related agencies. We believe that our technology, intellectual property, proprietary products and designed-in positions on our customers’ programs, platforms and systems, and our ability to rapidly develop, demonstrate and field affordable leading technology systems gives us a competitive advantage and creates a high barrier to entry into our markets. Our entire organization is focused on executing our strategy of becoming the leading technology and intellectual property based company in our industry.

Industry Update

On February 9, 2018, the Congress approved and the President signed the Bipartisan Budget Act of 2018, which provided that:

1. spending limits created by the Budget Control Act of 2011 (“BCA”) would be increased by approximately $300 billion over the next two years;
2. defense spending would be increased by $80 billion in FY (as defined below) 2018 and by $85 billion in the current FY, to approximately $700 billion and $705 billion, respectively;
3. domestic spending would be increased by $63 billion in FY 2018 and by $68 billion in the current FY; and
4. Congress would suspend the debt limit through March 2019.

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The Congress and the President also executed a fifth continuing resolution authorization through March 23, 2018, to provide congressional appropriators the time required to appropriately document and allocate the authorized spending. On March 23, 2018, the President signed the Omnibus Appropriations Act for FY 2018, which provided $1.3 trillion in discretionary funding for federal agencies. In total for FY 2018, Congress appropriated approximately $700 billion for national security, including approximately $630 billion for base discretionary funding and approximately $70 billion in Overseas Contingency Operations (“OCO”) funding. The U.S. Government’s fiscal year (“FY”) ends September 30.

On September 28, 2018, full-year appropriations for FY 2019 were enacted representing over half of discretionary federal spending. For FY 2019, Congress appropriated approximately $716 billion for national security, including approximately $647 billion for base discretionary funding and approximately $69 billion in OCO funding. Continuing resolutions provided funding for certain agencies (including NASA and other civil agencies) through December 21, 2018. On December 22, 2018, U.S. Government agencies that had not yet received full-year appropriations and did not otherwise have funding entered into a temporary shutdown. On January 25, 2019, a third continuing resolution was enacted, which funded these agencies through February 15, 2019. On February 15, 2019 a spending bill was enacted to fund these agencies for the remainder of FY 2019. The federal budget and debt ceiling are expected to continue to be the subject of considerable debate, which could have a significant impact on defense spending broadly and the Company’s programs in particular.

The budget environment, including budget caps mandated by the BCA for fiscal years 2020 and 2021, and uncertainty surrounding the debt ceiling and the appropriations process, remain significant short and long-term risks. Considerable uncertainty exists regarding how future budget and program decisions will unfold, including the defense spending priorities of the Administration and Congress, what challenges budget reductions (required by the BCA and otherwise) will present for the defense industry and whether annual appropriations bills for all agencies will be enacted for FY 2020. If annual appropriations bills are not timely enacted for FY 2020 or beyond, the U.S. Government may again operate under a continuing resolution, restricting new contract or program starts, presenting resource allocation challenges and placing limitations on some planned program budgets, and we may face another government shutdown of unknown duration. If a prolonged government shutdown of the DoD were to occur, it could result in program cancellations, disruptions and/or stop work orders and could limit the U.S. Government’s ability to effectively progress programs and to make timely payments, and our ability to perform on our U.S. Government contracts and successfully compete for new work.

Additionally, funding for certain programs in which we participate may be reduced, delayed or cancelled, and budget cuts globally could adversely affect the viability of our subcontractors and suppliers, and our employee base. While we believe that our business is well-positioned in areas that the DoD and other customers have indicated are areas of focus for future defense spending, the long-term impact of the BCA, other defense spending cuts, challenges in the appropriations process, the debt ceiling and the ongoing fiscal debates remain uncertain.

Significant delays or reductions in appropriations; long-term funding under a continuing resolution; an extended debt ceiling breach or government shutdown; and/or future budget and program decisions, among other items, may negatively impact our business and programs and could have a material adverse effect on our financial position, results of operations and/or cash flows.

Current Reporting Segments

The Company has historically operated in three reportable segments. The Kratos Government Solutions (“KGS”) reportable segment is comprised of an aggregation of KGS operating segments, including our microwave electronic products, space and satellite communications, modular systems and defense and rocket support services operating segments. The Unmanned Systems (“US”) reportable segment consists of our unmanned aerial system and unmanned ground and seaborne system businesses. The Public Safety & Security reportable segment (which was divested in June 2018 and has been classified as discontinued operations - see Note 8 of the Notes to Consolidated Financial Statements contained within this Annual Report) previously provided independent integrated solutions for advanced homeland security, public safety, critical infrastructure, and security and surveillance systems for government and commercial applications.

On June 11, 2018, we completed the sale of all the issued and outstanding capital stock of Kratos Public Safety & Security Solutions, Inc., a Delaware corporation and wholly owned subsidiary of the Company ("PSS"), to Securitas Electronic Security, Inc., a Delaware corporation ("Buyer"). Pursuant to the terms of that certain Stock Purchase Agreement, dated February 28, 2018, by and among Kratos, PSS and the Buyer-, the Buyer agreed to purchase all of the issued and outstanding capital stock of PSS for a purchase price of $69 million in cash, subject to a closing net working capital adjustment (the "Transaction"). We are currently in a dispute with the Buyer regarding the closing net working capital adjustment. The amount in dispute is approximately $8 million. We currently expect to receive approximately $70 million of aggregate net cash proceeds from the Transaction, after taking into account amounts to be paid by us pursuant to a negotiated transaction services agreement between us and the Buyer, receipt of approximately $7.0 million in net working capital retained by the Company, and associated transaction fees and expenses, excluding the impact of the final settlement and determination of the closing net working capital adjustment. We currently expect that the net working capital retained by the Company will be collected by the first half of 2019 once certain legacy projects are completed and the project close-out process has been completed. The Company currently expects to recognize a net break-even on the sale of the Public Safety & Security business once the aggregate net proceeds described above have been collected, excluding the impact of the final settlement and determination of the closing net working capital adjustment. Any changes or adjustments to the expected net proceeds will be reflected in future periods.

We organize our business segments based primarily on the nature of the products, solutions and services offered. Transactions between segments are negotiated and accounted for under terms and conditions similar to other government and commercial contracts, and these intercompany transactions are eliminated in consolidation. For additional information regarding our reportable segments, see Note 13 of the Notes to Consolidated Financial Statements contained within this Annual Report. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Competitive Strengths

We believe that our intellectual property, proprietary products, and technology are strongly aligned with certain of the highest priority spending areas of the DoD, and the DoD’s focus on leveraging technology to defeat or deter peer and near-peer adversaries. We also believe that our proven ability to rapidly design, develop, demonstrate and field leading technology products and systems at an affordable cost differentiates us from our competitors. We believe that our longstanding customer relationships, and the designed-in position of our systems, technology and products into our customers’ platforms, programs and systems, provide a unique competitive advantage and position us well for accelerated growth.

Specialized national security focus aligned with mission-critical national security priorities. Continued concerns related to the threats posed by certain foreign nations, including nations with peer or near peer capabilities have caused the U.S. Government to identify national security as an area of functional and spending priority. Budget pressures, particularly related to DoD spending, have placed a premium on developing and fielding low-cost, high-technology solutions to assist in national security missions. While recent budget pressures have at times caused delays in orders for our business, current budget projections, including the pending fiscal 2020 DoD budget, suggest defense spending will increase over the next few years. The improving outlook for defense spending is primarily focused on enhanced power projection, warfighting readiness, lethality, and recapitalization of key strategic defense systems to address peer and near peer threats. Our primary capabilities and areas of focus, listed below, are strongly aligned with the objectives of the U.S. Government as outlined in the DoD’s Strategic Review Document which was released in 2018:

- Unmanned aerial drone, unmanned ground and unmanned seaborne systems
- Satellite communications and radio frequency interference detection location and mitigation
- Microwave electronics supporting warfare, missile, radar and communication systems
- Electronic warfare, attack, missile, and radar systems
- Intelligence, surveillance and reconnaissance
- Ballistic missile defense systems
- Command, control and combat systems
- Cyber security and information assurance
- Specialized training systems and operational readiness

IP-centric defense company with proprietary products and technology which address critical current and emerging threats faced by U.S. and allied militaries. As a technology-focused defense company at the forefront of the DoD’s strategy for technology rich and affordable systems, our current and growing portfolio of proprietary systems, products, solutions, and related intellectual property addresses some of the most critical needs of U.S. and allied militaries in the fields of unmanned systems, space & satellite communications, microwave electronics, cyber security/warfare, missile defense, combat and training systems. A key element of our customers' strategy, and where we have invested significantly, is the development of capabilities and intellectual property addressing the recent challenges faced by U.S. and allied militaries in Anti-Access and Aerial-Denial ("A2/AD") environments. This is evidenced by our significant investment in high-performance Unmanned Aerial Drone System ("UADS") platforms and technology, which has culminated in a series of Unmanned Combat Aerial System ("UCAS") contract wins. Additionally, with our space & satellite and terrestrial ground segment command, control, radio frequency interference monitoring, geolocation and mitigation products and capabilities, we believe we are well-positioned to capitalize on the 2019 DoD budget request of $9.3 billion for space investments, a significant portion of which is for the development and protection of U.S. national security space assets and infrastructure. Accordingly, our proprietary products, systems and technologies are developed and refined with the goal of enabling our customers to maintain an advantage over the advanced and constantly evolving threats of adversaries, at an affordable cost. In many instances, we are one of the few companies that produce the mission-critical technology our customers require, or we outperformed our peers in a competitive bidding process. We maintain a strategy of internally funding research and development and owning the intellectual property of many of these high-performance capabilities and systems.

Technology-driven company aligned with and supporting our customers' increased innovation, technology, and strategic national security initiatives, with focus on speed and affordability. As the DoD works to increase or maintain its technological advantage over adversaries, it has continued its efforts to create breakthrough technologies for national security, accelerate innovation to the warfighter, and repurpose current capabilities to create cost-effective, disruptive technology advances. With our focus on delivering proven leading edge systems, products and technologies that address the most critical current and emerging threats, our customers include some of the most technologically advanced organizations of the defense establishment, including the Defense Innovation Unit ("DIU") (formerly the Defense Innovation Unit Experimental ("DIUx")), Defense Advanced Research Projects Agency ("DARPA"), Air Force Research Laboratory ("AFRL"), the Strategic Capabilities Office (SCO), the Strategic Command (STRATCOM), the National Aeronautics and Space Administration, the U.S. intelligence community, and other confidential customers. We believe our focus on constant innovation, capability improvements across our product and solutions portfolio, speed of development, and production and affordability are key differentiators that align us with and address our customers' key initiatives.

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

Kratos is one of the industry leaders in high performance, jet powered, unmanned aerial target drone systems which are designed to replicate state of the art adversarial fighter aircraft, missiles and other threats. Kratos is the sole source or primary unmanned aerial target drone system provider to the U.S. Air Force, Navy, Army, and numerous allied foreign defense agencies. Leveraging off of this technology, for which Kratos owns the intellectual property, we made a significant investment over the past six years developing Kratos' first UCAS, our Unmanned Tactical Aerial Platform ("UTAP-22"), now formally called "Mako." After successfully achieving the Mako's first concept flights at the end of 2015, in 2016 we received a $12.6 million single-award contract to demonstrate certain payload integration and loyal wingman teaming with manned aircraft in a major military exercise. At the time, this contract was one of the largest awarded contracts by the DIUx. We are currently under contract with several additional customers related to Kratos' Mako.

A select sample of Kratos' other key Unmanned Aerial System ("UAS") products and contracts includes:

- In 2017, we successfully advanced to Phase II of the Gremlins program, awarded by DARPA, the U.S. Government's leader in breakthrough technologies for national security, teamed with our partner company, Dynetics. In 2018, as part of the Dynetics led team, we were selected for award on Phase III of the Gremlins program to demonstrate safe and reliable launch and aerial recovery of multiple unmanned drone system aircraft, capable of employing and recovering diverse distributed payloads in volley quantities.
- In 2016, we were awarded the AFRL Low Cost Attritable Strike Demonstration ("LCASD") UCAS single-award cost share contract. The LCASD is an approximately 30 foot by 22 foot unmanned strike aerial drone system. Our customer expects the initial flight of this leading technology UAS to occur in the first quarter of 2019.

We have redeveloped our Air Force Subscale Aerial Target BQM-167 into what we believe to be the highest performance unmanned aircraft in the world, the U.S. Navy Sub-Sonic Aerial Target ("SSAT") Drone BQM-177A, with low rate initial production awarded to Kratos in June 2017. In 2018, delivery of the first production aerial targets was made to the U.S. Navy. In addition, our customer, Naval Air Systems Command (NAVAIR) announced that it expects to award a quantity of up to 60 BQM-177As with deliveries in 2020 and

2021. We expect the SSAT program to become one of the largest and most important to Kratos in the near term.

- In 2018, we received a single award $109 million maximum value three year production contract for Air Force Subscale Aerial Target BQM-167A, with $27 million being initially obligated at the time of award for 30 Lot 14 BQM-167A aerial targets and production support.
- In 2018, we received a ten-year, sole source, single award framework contract from QinetiQ UK for Kratos' MQM-178 Firejet aerial targets, spares, ground support equipment, technical services, and training. In 2018, we were awarded a prime contract for the Aerial Target Systems 2 (ATS-2), Multiple Award Indefinite Delivery Indefinite Quantity ("IDIQ") Contract with a ceiling value of $93.3 million, and a five year period of performance.
- In 2018, we received a sole source, single award multi-year IDIQ contract from Swedish Defence Materiel Administration for our MQM-178 Firejet aerial target aircraft and associated ground support equipment, spares, payloads, components, expendables and support services. The first order under the three-year IDIQ contract is expected in the first half of 2019. Additionally, there are two three-year exercisable option periods for a total potential contract performance term of nine years.

We believe that our internally developed and owned intellectual property allows us to provide more capable jet powered, unmanned aircraft, designed to fly in A2/AD environments and with performance capabilities equal to or greater than fourth generation manned jet fighter aircraft, at an affordable cost. Kratos' tactical UAS provide force multiplication and augmentation for manned high performance fighter aircraft. We believe that there are very few high-performance UAS that are as advanced as our technologies addressing the A2/AD environment, which the DoD has identified as a U.S. capabilities gap. As such, consistent with the needs and requirements of the U.S. and allied militaries, we believe that our leadership in these types of high performance unmanned aircraft provides us with a future market opportunity of these types of low-cost, high-performance systems.

We are also an industry leader in ground-based command, control and communications systems for satellites, and a leader in related radio frequency interference identification, geolocation and mitigation. Our primary customers include the U.S. Air Force, Space Command and other agencies. Our microwave electronics business products have designed-in positions on critical combat system programs, including Barak, Gripen, Iron Dome, Sling of David, F-15, F-16, Gripen, and Arrow. Our advanced capabilities in the training systems and solutions market, including for aircraft and combat vehicles, have allowed us to successfully remain at the forefront of defense industry readiness initiatives. We believe our strategy of internally funding the research and development of many of our systems, products, solutions and capabilities will continue to solidify our position in high growth markets, such as high performance UADS, satellite communications, microwave electronics and training systems, and allow us to grow, over the long-term, at a rate greater than that of the industry.

Diverse base of key contracts with low concentration. Many of our contracts are single-award and/or sole source in nature, where we are the only awardee by the customer. In many cases, our ability to obtain single award, sole source contracts is due to our intellectual property, proprietary products, historical performance qualifications, relative experience and affordability. Additionally, as a result of our business development focus on securing key contracts, we are also a preferred contractor on numerous multi-year, government-wide acquisition contracts ("GWACs") and multiple award contracts. Our preferred contractor status provides us with the opportunity to bid on billions of dollars of business each year against a discrete number of other pre-qualified companies.

We have a highly diverse base of customers and contracts with no contract representing more than 6% of 2018 revenue. Our fixed-price contracts, the majority of which are production contracts, represent approximately 86% of our 2018 revenue. Our cost-plus-fee contracts and time and materials contracts represent approximately 9% and 5%, respectively, of our 2018 revenue. We believe our diverse base of key contracts and low reliance on any one contract provides us with a stable, balanced revenue stream. Our recent major contract awards, including a $93.3 million potential value contract with the U.S. Army's Target Management Office (TMO), $30 million in scope increases on multiple training platforms, $109 million maximum value three year production contract for the Air Force Subscale Aerial Target program, $38.6 million additional task orders awarded on Foreign Military Sales (FMS) to support the Royal Saudi Naval Forces, $67.5 million single award prime contract to support the Naval Warfare Center, Dahlgren Division Electromagnetic and Sensor Systems Department through their Radar Systems Division, and multiple space and satellite communications awards have continued to allow us to grow the business while maintaining a diverse contract base.

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Significant cash flow visibility driven by stable backlog. As of December 30, 2018 and December 31, 2017, our total backlog (see Backlog below) was approximately $620.7 million and $519.9 million respectively, of which approximately $537.2 million was funded in 2018 and $457.3 million was funded in 2017. The majority of our sales are from awards issued under long-term contracts, typically three to five years in duration. Our contract backlog provides visibility into stable future revenue and cash flow over a diverse set of contracts. Importantly, a number of our systems and products are designed-in on and support long term, multi-year/multi-decade programs, which provides significant operational and financial visibility to our Company.

Highly skilled employees and an experienced management team. We deliver our systems, products and services through a skilled and primarily engineering and technically oriented workforce of approximately 2,600 employees. Our senior managers have significant experience with U.S. Government agencies, the U.S. military and U.S. Government contractors. A significant number of Kratos employees hold national security clearances. Members of our management team have experience growing businesses both organically and through acquisitions and delivering significant value to stakeholders. We believe that the cumulative experience and differentiated expertise of our personnel in our core focus areas, coupled with our sizable and technically oriented employee base, allow us to qualify for and bid on larger programs and contracts in a prime contracting role.

Our Strategy

Our strategy is to focus on our core business areas, including unmanned systems, space and satellite communications, cyber security, microwave electronics, missile defense and training systems, which are closely aligned with the DoD's mission and funding priorities. We will continue to invest in differentiating systems, products, technology and intellectual property. We intend to be the leader in rapidly developing, demonstrating and delivering to the warfighter proven leading technology systems, at an affordable cost.

Internal Growth

We are focused on generating internal growth by capitalizing on our ability to rapidly develop, demonstrate and field leading technology systems and products at an affordable cost. We will make targeted discretionary investments in mission critical DoD priority areas, including unmanned systems, space and satellite communications, cyber security, microwave electronics, missile defense and training systems, which have the highest potential for growth based on recent DoD funding requests, and in which we will retain the intellectual property rights.

Expand technology product, solution and service offerings provided to existing customers. We are focused on expanding the technology, products, systems and solutions we provide to our current customers by leveraging our strong relationships, technical capabilities, intellectual property and past performance qualifications as well as by offering a wider range of comprehensive low-cost technology leading and proven products and solutions. In regard to areas of specialization, our product and solution offerings include the manufacturing of specialized defense electronics; integrated technology solutions for satellite command, control and communications; specialized high performance UADS and drone aircraft for tactical and threat representation target purposes; and Unmanned Ground Systems ("UGS") and Unmanned Seaborne Systems ("USS"). We believe our understanding of customer needs, missions, requirements and processes, and our ability to rapidly deliver low cost, technology leading systems, products and solutions, position us well for success in the current national security environment.

Capitalize on current contract base. We are pursuing new program and contract opportunities and awards as we build the business with our expanding technology base, intellectual property ownership, contract portfolio, and product, solution and service offerings. We are also aggressively pursuing several national security priority areas, including high performance UADS, satellite communications command, control, communication and signal monitoring products, microwave electronics for missiles, radars, electronic warfare and communications, cyber security solutions, specialized training systems, autonomy and artificial intelligence systems, robotics, directed energy systems, hypersonic systems, electromagnetic rail gun systems and next generation ballistic missile targets. We are also assessing new tactical program areas and platforms to pursue that are consistent with our core capabilities, technology and intellectual property.

Expand customer and contract base. We are focused on expanding our customer base into areas with significant growth opportunities as indicated by the FY 2019 DoD budget request and the DoD Strategic Document, by leveraging our technology, intellectual property, proprietary products, capabilities, industry reputation, long-term customer relationships and diverse contract base. We also believe that our ability to rapidly develop, demonstrate and field high technology systems and products at an affordable cost is a clear competitive differentiator for our Company. We anticipate that this overall expansion in our capabilities will enable us both to pursue larger program opportunities, higher value work and to further diversify our revenue base across additional U.S. Government, international and commercial customers.

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Improve operating margins. We believe that we have opportunities to increase our operating margins and improve profitability by capitalizing on our corporate infrastructure investments as our business grows, production of our products and systems increases and related revenues increase. We are proactively focused on continuously improving efficiencies, reducing costs, and concentrating our efforts on operational excellence.

Invest in strategic growth areas. Over the past several years, we have made significant internally funded investments in strategic growth areas including unmanned tactical aircraft drone systems. Specifically, we have increased internally funded research and development, capital expenditures and infrastructure investments, including executive management, bid, proposal and new business capture, pursuit and related expenses. We have made these investments with the intention of developing, demonstrating, fielding and bringing to production high performance jet powered unmanned aerial combat systems. These investments also allow us to retain the intellectual property rights, design and data packages for these platforms and systems, and to ultimately secure sole source production positions in these strategic growth areas. Specifically, since 2012, we have invested over $100 million in our UAS through internally funded research, development and contract design retrofit costs for new platforms under development and capital expenditures for aircraft and related equipment related to this strategic growth area.

- We invested in internally funded research, development and capital expenditures to build our own UTAP-22 (Mako) UAS from 2012 to 2015, and demonstrated the capabilities of the UTAP-22 Mako in a flight demonstration in the fall of 2015. As a result, we were awarded an initial $12.6 million prime contract from the DIUx for sensor integration and flight demonstration of our UTAP-22 Mako unmanned aerial system the following year. Under this effort, we integrated certain sensors into our UTAP-22 Mako and participated in a large, complex flight exercise in 2017.
- We received a $40.8 million single award, cost-share contract from the AFRL for the LCASD. Under the LCASD contract award, we are designing, developing, and will deliver, demonstrate and test a technical baseline for a high-speed long-range, low-cost limited life-strike UAS. For our investment, we will retain hard (including two LCASD aircraft) and other assets, and important intellectual property, software, data, platform and system rights, which we believe will be critically important and valuable over the expected long-term life of this platform, including with respect to future production opportunities. Our customer expects the initial flight of this leading technology UAS to occur in the first quarter of 2019.
- We were awarded one of four prime contract awards from DARPA for the Gremlins program. Under the Gremlins program, DARPA envisions a swarm of approximately 20 high performance unmanned aerial vehicles that are deployed by an inflight aircraft, and are later recovered, inflight, by an aircraft. The approximate $3.9 million Phase I contracts were awarded to four competing companies, with the intent to ultimately down select to one finalist company over a period of approximately 36 months. In 2017, we successfully advanced to Phase II of the Gremlin's program, teamed with our partner company Dynetics. In 2018, as part of the Dynetics-led team, we were selected for award on Phase III of the Gremlins program to demonstrate safe and reliable launch and aerial recovery of multiple unmanned drone system aircraft, capable of employing and recovering diverse distributed payloads in volley quantities.

Capitalize on corporate infrastructure investments. In recent periods, we have made significant investments in our senior management and corporate infrastructure related to cyber security threats to our Company, increased and changing regulations we are subject to, and the changing national security industry environment. These investments also included hiring senior executives with significant experience in the national security industry, hiring firms to support us on Capitol Hill, Congressionally and with our customers, strengthening our internal controls over financial reporting and accounting staff in support of increasing public company reporting requirements, expanding our infrastructure in response to increases in cyber security protection and related regulatory requirements, and expanding our backlog and bid and proposal pipeline. We expect to be allocating additional resources in our pursuit of new, larger and highly technical prime contract opportunities. We believe our management experience and corporate infrastructure can support a company with a much larger revenue base than ours. Accordingly, we believe that, to the extent our revenue grows, we will be able to leverage this infrastructure base and increase our operating margins.

Customers

A representative list of customers in our KGS and US segments during 2018 included the U.S. Air Force, U.S. Army, U.S. Navy, U.S. Marines, Missile Defense Agency, Space Command, the Department of Homeland Security, the National Aeronautics and Space Administration, FMS, the U.S. Southern Command, STRATCOM, the Strategic Capabilities Office (SCO), DIU or DIUx, the Rapid Capabilities Offices, the U.S. intelligence community and certain confidential customers.

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Revenue from the U.S. Government (which includes FMS) includes revenue from contracts for which we are the prime contractor as well as those for which we are a subcontractor and the ultimate customer is the U.S. Government. Revenues from U.S. Government agency customers in aggregate accounted for approximately 72%, 75% and 73% of total revenues in 2018, 2017, and 2016, respectively.

Revenues from foreign customers were approximately \$114.3 million or 19%, \$84.7 million or 14%, and \$80.1 million or 15% of total revenue for the years ended December 30, 2018, December 31, 2017, and December 25, 2016, respectively.

Backlog

Effective January 1, 2018, we adopted the requirements of Accounting Standards Codification 606, Revenue from Contracts with Customers (“ASC 606”), utilizing the modified retrospective method as discussed in Note 1 of the Notes to Consolidated Financial Statements contained within this Annual Report. Since our adoption of ASC 606, revenues from remaining performance obligations, also referred to as total backlog, are now calculated as the dollar value of our remaining performance obligations on executed contracts. As of December 30, 2018, our backlog was approximately \$620.7 million, of which \$537.2 million was funded. We expect to recognize approximately 66.7% of the remaining total backlog as revenue in 2019, an additional 13.7% in 2020 and the balance thereafter. The adoption of ASC 606 resulted in a reduction of approximately \$136.6 million of our total backlog as of December 31, 2017. Our comparable total backlog balance as of December 31, 2017, applying the requirements under ASC 606, was approximately \$519.9 million of which \$457.3 million was funded.

Total backlog is our estimate of the amount of revenue expected to be realized over the remaining life of awarded contracts and task orders that we have in hand as of the measurement date. Total backlog can include award fees, incentive fees, or other variable consideration estimated based on the most likely amount the Company is expected to be entitled to receive, to the extent that it is probable that a significant reversal of cumulative revenue recognized will not occur. Total backlog can include both funded and unfunded future revenue under government contracts. Total backlog does not include orders for which neither party has performed and which each party has the unilateral right to terminate a wholly unperformed contract without compensating the other party. As such, total backlog generally does not include options for additional performance obligations which have not been executed unless they are considered a material right of the base agreement/contract. For IDIQ contracts, only awarded or funded task orders are included for backlog purposes.

We define funded backlog as estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus an estimate of the future revenue expected to be realized from commercial contracts that are under firm orders. Funded backlog does not include the full potential value of the Company’s contracts because Congress often appropriates funds to be used by an agency for a particular program of a contract on a yearly or quarterly basis even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriation and the procuring agency allocates funding to the contract.

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

A significant number of the programs that Kratos' systems, products and solutions support are multi-year/multi-decade in nature. Accordingly, based on historical customer usage or operational tempo, the Company has reasonable expectations or visibility of what ultimate orders for Kratos' systems, products and solutions will be. The Company does not include these expected amounts in its backlog until a related contract award is received.

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

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Employees

As of December 30, 2018, we had a work force of approximately 2,600 full-time, part-time and on-call employees.

Competition

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

We believe that the principal competitive factors in our ability to win new business include our strategy of focusing on priority DoD requirements and funding areas, our intellectual property, proprietary products, technology and our ability to rapidly develop, demonstrate and deliver systems to the warfighter at an affordable cost. Also important is our past performance qualifications, customer relationships, domain and technology expertise, the ability to obtain and replace contract vehicles, the ability to deliver results within budget (time and cost), reputation, accountability, staffing flexibility, and project management expertise. Additionally, our ability to deliver cost effective systems, products, solutions and services that meet our customers' requirements is also a key differentiator.

In the U.S. defense, IT, and services markets, the U.S. Government has stressed competition and affordability in connection with its future procurement of products and services. This has led to fewer sole source awards, as well as more emphasis on cost competitiveness, with contract awards issued on a Low Price Technically Acceptable ("LPTA") basis rather than a best value basis, which has negatively impacted our Defense and Rocket Support Services ("DRSS") business in our KGS segment. In addition, competitor bid protests have become more prevalent in the current competitive environment, resulting in further delay of contract procurement activity.

The majority of our government services business is included in our DRSS business. This cost competitive environment resulted in an impairment in the carrying value of our DRSS business in the fourth quarter of 2017. Approximately 10% of Kratos' business for the year ended December 30, 2018 is IT or government services based. In 2010, Kratos changed its strategy to focus on being a system, product, technology and intellectual property based company and we deemphasized our focus in our legacy government services businesses. For 2018, our legacy government services business generated revenues of approximately $59.6 million. See Note 2 of the Notes to Consolidated Financial Statements contained within this Annual Report for further discussion.

Research and Development

We believe that our future success depends upon our ability to continue to rapidly develop new products and services, and enhancements to and applications for our existing products and services, to be delivered at an affordable cost. Our research and development expenses were $15.6 million, $17.8 million and $13.9 million in 2018, 2017, and 2016, respectively. We intend to continue our focus on research and development as a key strategy for growth, which will focus on investments in those fields that we believe will offer the greatest opportunity for growth and profitability. Our current primary internal research and development ("IR&D") focus areas include satellite communications and signal monitoring, unmanned systems, and electronic products.

Intellectual Property

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

As of December 30, 2018, we held a number of U.S. and foreign patents. We do not consider our business to be materially dependent upon any individual patent. We will continue to file and pursue patent applications when and where

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appropriate to attempt to protect our rights in our proprietary technologies. We also encourage our employees to continue to invent and develop new technologies so as to maintain our competitiveness in the marketplace.

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

Government Regulation

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

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

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

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

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

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

Material Availability

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

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Environmental

Our manufacturing operations are subject to many requirements under environmental laws. In the U.S., the U.S. Environmental Protection Agency and similar state agencies administer laws that restrict the emission of pollutants into the air, discharges of pollutants into bodies of water and disposal of pollutants in the ground. Violations of these laws can result in significant civil and criminal penalties and incarceration. The failure to obtain a permit for certain activities may be a violation of environmental law and subject the owner and operator to civil and criminal sanctions. Most environmental agencies also have the power to shut down an operation if it is operating in violation of environmental law. U.S. laws also allow citizens to bring private enforcement actions in some situations. Outside the U.S., the environmental laws and their enforcement vary and may be more burdensome. We have management programs and processes in place that are intended to minimize the potential for violations of these laws.

Other environmental laws, primarily in the U.S., address the contamination of land and groundwater and require the clean-up of such contamination. These laws may apply not only to the owner or operator of an on-going business, but also to the owner of land contaminated by a prior owner or operator. In addition, if a parcel is contaminated by the release of a hazardous substance, such as through its historic use as a disposal site, any person or company that has contributed to that contamination, whether or not it has a legal interest in the land, may be subject to a requirement to clean up the parcel.

Available Information

We file reports with the Securities and Exchange Commission (“SEC”). We make available on our website under “Investor Relations/Financial Information/SEC Filings,” free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we electronically file such materials with or furnish them to the SEC. Our website address is www.kratosdefense.com. The SEC also maintains an Internet site that contains our reports, proxy and information statements, and other information at www.sec.gov.

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

Item 1A. Risk Factors.

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

Risks Related to Our Business

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

In fiscal 2018, 2017 and 2016, we generated 72%, 75% and 73%, respectively, of our total revenues from contracts with the U.S. Government (including all branches of the U.S. military and FMS), either as a prime contractor or a subcontractor. We expect to continue to derive most of our revenues from work performed under U.S. Government contracts. See the Industry Update section in Item 1 “Business” contained within this Annual Report for a discussion of the current budgetary and funding constraints on U.S. Government spending and legislation enacted to reduce the U.S. federal deficit. As a result, we have experienced and expect to continue to experience reduced or delayed awards on some of our programs, with a related negative impact to our revenues, earnings and cash flows. Competitor bid protests also have become more prevalent in the current competitive environment resulting from decreased government spending, which has led to further contract award delays. In addition, any future changes to the fiscal policies of the U.S. Government and foreign governmental entities may decrease overall government funding for defense and homeland security, result in delays in the procurement of our products and services due to lack of funding, cause the U.S. Government and government agencies to reduce their purchases under existing contracts, or cause them to exercise their rights to terminate contracts at-will or to abstain from exercising options to renew contracts, any of which would have an adverse effect on our business, financial condition, results of operations and/or cash flows.

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Significant delays or reductions in appropriations for our programs and U.S. Government funding more broadly may negatively impact our business and programs and could have a material adverse effect on our financial position, results of operations and/or cash flows.

U.S. Government programs are subject to annual congressional budget authorization and appropriation processes. For many programs, Congress appropriates funds on a fiscal year basis even though the program performance period may extend over several years. Consequently, programs are often partially funded initially and additional funds are committed only as Congress makes further appropriations. If we incur costs in excess of funds obligated on a contract, we may be at risk for reimbursement of those costs unless and until additional funds are obligated to the contract. We cannot predict the extent to which total funding and/or funding for individual programs will be included, increased or reduced as part of the annual budget process ultimately approved by Congress and the President or in separate supplemental appropriations or continuing resolutions, as applicable. Laws and plans adopted by the U.S. Government relating to, along with pressures on and uncertainty surrounding the federal budget, potential changes in priorities and defense spending levels, sequestration, the appropriations process, use of continuing resolutions (with restrictions, e.g., on new starts) and the permissible federal debt limit, could adversely affect the funding for individual programs and delay purchasing or payment decisions by our customers. In the event government funding for our significant programs becomes unavailable, or is reduced or delayed, or planned orders are reduced, our contract or subcontract under such programs may be terminated or adjusted by the U.S. Government or the prime contractor.

The federal budget and debt ceiling are expected to continue to be the subject of considerable debate, which could have a significant impact on defense spending broadly and our programs in particular.

The budget environment, including budget caps mandated by the BCA for fiscal years 2020 and 2021, and uncertainty surrounding the debt ceiling and the appropriations process, remain significant short and long-term risks. Considerable uncertainty exists regarding how future budget and program decisions will unfold, including the defense spending priorities of the Administration and Congress, what challenges budget reductions (required by the BCA and otherwise) will present for the defense industry and whether annual appropriations bills for all agencies will be enacted for FY 2020. If annual appropriations bills are not timely enacted for FY 2020 or beyond, the U.S. Government may again operate under a continuing resolution, restricting new contract or program starts, presenting resource allocation challenges and placing limitations on some planned program budgets, and we may face another government shutdown of unknown duration. If a prolonged government shutdown of the DoD were to occur, it could result in program cancellations, disruptions and/or stop work orders and could limit the U.S. Government's ability to effectively progress programs and to make timely payments, and our ability to perform on our U.S. Government contracts and successfully compete for new work.

We believe continued budget pressures would have serious negative consequences for the security of our country, the defense industrial base, including the Company, and the customers, employees, suppliers, investors, and communities that rely on companies in the defense industrial base. It is likely budget and program decisions made in this environment would have long-term implications for us and the entire defense industry.

Additionally, funding for certain programs in which we participate may be reduced, delayed or cancelled, and budget cuts globally could adversely affect the viability of our subcontractors and suppliers, and our employee base. While we believe that our business is well-positioned in areas that the DoD and other customers have indicated are areas of focus for future defense spending, the long-term impact of the BCA, other defense spending cuts, challenges in the appropriations process, the debt ceiling and the ongoing fiscal debates remain uncertain.

Significant delays or reductions in appropriations; long-term funding under a continuing resolution; an extended debt ceiling breach or government shutdown; and/or future budget and program decisions, among other items, may negatively impact our business and programs and could have a material adverse effect on our financial position, results of operations and/or cash flows.

If we fail to establish and maintain important relationships with government agencies and prime contractors, our ability to successfully maintain and develop new business may be adversely affected.

Our reputation and relationship with the U.S. Government, and in particular with the agencies of the DoD and the U.S. intelligence community, are key factors in maintaining and developing new business opportunities. In addition, we often act as a subcontractor or in "teaming" arrangements in which we and other contractors bid together on particular contracts or programs for the U.S. Government or government agencies. We expect to continue to depend on relationships with other prime contractors for a portion of our revenue for the foreseeable future. Negative press reports regarding conflicts of interest, poor contract performance, employee misconduct, information security breaches or other aspects of our business, regardless of accuracy, could harm our reputation. Additionally, as a subcontractor or team member, we often lack control over fulfillment of a contract, and poor performance on the contract could tarnish our reputation, even when we perform as required. As a result, we may be unable to successfully maintain our relationships with government agencies or prime contractors, and any failure to do so could adversely affect our ability to maintain our existing business and compete successfully for new business.

Many of our contracts contain performance obligations that require innovative design capabilities, are technologically complex, require state-of-the-art manufacturing expertise, or are dependent upon factors not wholly within our control. Failure to meet these obligations could adversely affect our profitability and future prospects. Early termination of client contracts or contract penalties could adversely affect our results of operations.

We design, develop, and manufacture technologically advanced and innovative products and services, which are applied by our customers in a variety of environments. Problems and delays in development or delivery as a result of issues with respect to design, technology, licensing and intellectual property rights, labor, inability to achieve learning curve assumptions, manufacturing materials or components could prevent us from meeting requirements. Either we or the customer may generally terminate a contract as a result of a material uncured breach by the other. If we breach a contract or fail to perform in accordance with contractual service levels, delivery schedules, performance specifications, or other contractual requirements set forth therein, the other party thereto may terminate such contract for default, and we may be required to refund money previously paid to us by the customer or to pay penalties or other damages. Even if we have not breached, we may deal with various situations from time to time that may result in the amendment or termination of a contract. These steps can result in significant current period charges and/or reductions in current or future revenue. Other factors that may affect revenue and profitability include inaccurate cost estimates, design issues, unforeseen costs and expenses not covered by insurance or indemnification from the customer, diversion of management focus in responding to unforeseen problems, and loss of follow-on work.

If our subcontractors or suppliers fail to perform their contractual obligations, our performance and reputation as a contractor and our ability to obtain future business could suffer.

As a prime contractor, we often rely upon other companies as subcontractors to perform work we are obligated to perform for our customers. As we secure more work under certain of our contracts, we expect to require an increasing level of support from subcontractors that provide complementary and supplementary services to our offerings. We are responsible for the work performed by our subcontractors, even though in some cases we have limited involvement in that work. If one or more of our subcontractors fails to satisfactorily perform the agreed-upon services on a timely basis or violates U.S. Government contracting policies, laws or regulations, our ability to perform our obligations as a prime contractor or meet our customers' expectations may be compromised. In extreme cases, performance or other deficiencies on the part of our subcontractors could result in a customer terminating our contract for default. A termination for default could expose us to liability, including liability for the agency's costs of re-procurement, could damage our reputation and could hurt our ability to compete for future contracts.

We also are required to procure certain materials and parts from supply sources approved by the U.S. Government. The inability of a supplier to meet our needs or the appearance of counterfeit parts in our products could have a material adverse effect on our financial position, results of operations or cash flows.

Our earnings and profitability depend, in part, on subcontractor and supplier performance and product availability. We rely on other companies to provide major components for our products. For instance, we build the airframe, electronics and flight control systems for our unmanned aerial systems. We rely on our suppliers to provide the engines and parachutes for landing the aircraft. Disruptions or performance problems caused by our subcontractors and suppliers, or a misalignment between our contractual obligations to our customers and our agreements with our subcontractors and suppliers, could have an adverse effect on our ability to meet our commitments to customers.

Our ability to perform our obligations on time could be adversely affected if one or more of our subcontractors or suppliers were unable to provide the agreed-upon products or materials or perform the agreed-upon services in a timely, compliant and cost-effective manner or otherwise to meet the requirements of the contract. Changes in economic conditions, including changes in defense budgets or credit availability, or other changes impacting a subcontractor or supplier (including changes in ownership or operations) could adversely affect the financial stability of our subcontractors and suppliers and/or their ability to perform. The inability of our suppliers to perform, or their inability to perform adequately, could also result in the need for us to transition to alternate suppliers, which could result in significant incremental cost and delay or the need for us to provide other resources to support our existing suppliers.

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In connection with our U.S. Government contracts, we are required to procure certain materials, components and parts from supply sources approved by the customer. We also are facing increased and changing regulatory requirements, many of which apply to our subcontractors and suppliers. In some cases, there may be only one supplier for certain components. If a sole source supplier cannot meet our needs or is otherwise unavailable, we may be unable to find a suitable alternative.

Our procurement practices are intended to reduce the likelihood of our procurement of counterfeit, unauthorized or otherwise non-compliant parts or materials. We rely on our subcontractors and suppliers to comply with applicable laws and regulations, including regarding the parts or materials we procure from them; in some circumstances, we rely on certifications provided by our subcontractors and suppliers regarding their compliance. We also rely on our subcontractors and suppliers to effectively mitigate the risk of cyber and security threats or other disruptions with respect to the products and components they deliver to us and the information entrusted to them by us or our customers.

If we are unable to procure, or experience significant delays in subcontractor or supplier deliveries of, needed materials, components, intellectual property or parts; if our subcontractors or suppliers do not comply with all applicable laws and regulations; if the certifications we receive from them are inaccurate; or if what we receive is counterfeit or otherwise improper, it could have a material adverse effect on our financial position, results of operations and/or cash flows.

We face intense competition from many competitors that have greater resources than we do, which could result in price reductions, reduced profitability or loss of market share.

We operate in highly competitive markets and generally encounter intense competition to win contracts from many other firms, including mid-tier federal contractors with specialized capabilities, large defense contractors and IT service providers. Competition in our 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, or the reduction in the overall number of government contracts. We may also face competition from prime contractors for whom we currently serve as subcontractors or teammates if those prime contractors choose to offer customer services of the type that we are currently providing. In addition, we may face competition from our subcontractors who, from time-to-time, seek to obtain prime contractor status on contracts for which they currently serve as a subcontractor to us.

Many of our competitors have greater financial, technical, marketing and public relations resources, larger customer bases and greater brand or name recognition than we do. Such competitors may be able to utilize their substantially greater resources and economies of scale to, among other things:

- divert sales from us 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 and the recent trend of making award determinations on a LPTA basis;
- divert sales from us by the award of government contracts to our competitors who may be willing to bid at substantially lower prices;
- force us to charge lower prices; or
- adversely affect our relationships with current customers, including our ability to continue to win competitively awarded engagements in which we are the incumbent.

In the event that the market for products in our US segment expands, we expect that competition will intensify as additional competitors enter the market and current competitors expand their product lines. In order to secure contracts successfully when competing with larger, well-financed companies, we may be forced to agree to contractual terms that provide for lower aggregate payments to us over the life of the contract, which could adversely affect our margins. In addition, larger diversified competitors serving as prime contractors may be able to supply underlying products and services from affiliated entities, which would prevent us from competing for subcontracting opportunities on these contracts. If we lose business to our competitors or are forced to lower our prices, our revenue and operating profits could decline.

Our business is dependent upon our ability to keep pace with the latest technological changes.
The market for our 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 our business and operating results. We have derived, and we expect to continue to derive, a substantial portion of our 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, our success will depend, in part, on our ability to develop and market service offerings that respond in a timely manner to the technological advances of our customers, evolving industry standards and changing customer preferences.

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We believe that, in order to remain competitive in the future, we will need to continue to invest significant financial resources to develop new offerings and technologies or to adapt or modify our existing offerings and technologies, including through internal research and development, acquisitions and joint ventures or other teaming arrangements. These expenditures could divert our attention and resources from other projects, and we cannot be sure that these expenditures will ultimately lead to the timely development of new offerings and technologies or identification of and expansion into new markets. Due to the design complexity of our products, we may, in the future, experience delays in completing the development and introduction of new products. Any delays could result in increased costs of development or deflect resources from other projects. In addition, there can be no assurance that the market for our products will develop or continue to expand or that we will be successful in newly identified markets as we currently anticipate. The failure of our technology to gain market acceptance could significantly reduce our revenues and harm our business. Furthermore, we cannot be sure that our competitors will not develop competing technologies that gain market acceptance in advance of our products.

Additionally, the possibility exists that our competitors might develop new technology or offerings that might cause our existing technology and offerings to become obsolete. If we fail in our new product development efforts or our products or services fail to achieve market acceptance more rapidly as compared to our competitors, our ability to procure new contracts could be negatively impacted, which could negatively impact our results of operations and financial condition.

If the UAS and UGS markets do not experience significant growth, if we cannot expand our customer base or if our products do not achieve broad acceptance, then we may not be able to achieve our anticipated level of growth.

For the fiscal year ended December 30, 2018, our US segment accounted for 21.5% of our total revenue. We cannot accurately predict the future growth rate or size of this market. Demand for our products may not increase, or may decrease, either generally or in specific markets, for particular types of products or during particular time periods. There are only a limited number of programs under which the U.S. military, our primary customer, is currently funding the development or purchase of our UAS and UGS products. Although we are seeking to expand our US customer base to include foreign governments, domestic non-military agencies and commercial customers, we cannot assure that our efforts will be successful. The expansion of the UAS and UGS markets in general, and the market for our products in particular, depends on a number of factors, including the following:

- customer satisfaction with these types of systems as solutions;
- the cost, performance and reliability of our products and products offered by our competitors;
- customer perceptions regarding the effectiveness and value of these types of systems;
- limitations on our ability to market our US products and services outside the U.S. due to U.S. government regulations; and
- marketing efforts and publicity regarding these types of systems.

Even if UAS and UGS gain wide market acceptance in general, our specific products may not adequately address market requirements or may not gain market acceptance. If these types of systems generally, or our products specifically, do not gain wide market acceptance, then we may not be able to achieve our anticipated level of growth and our revenue and results of operations may suffer.

Loss of our General Services Administration ("GSA") contracts or GWACs could impair our ability to attract new business.

We are a prime contractor under several GSA contracts and GWAC vehicles. We believe that our 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 we were to lose our position as prime contractor on one or more of these contracts, we 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 customer's discretion to extend the contract for one or more years. We cannot be assured that our government customers will continue to exercise the options remaining on our current contracts, nor can we be assured that our future customers will exercise options on any contracts we may receive in the future.

Government contracts differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty.

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

- terminate our existing contracts;
- reduce potential future income from our existing contracts;

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- modify some of the terms and conditions in our existing contracts;
- suspend or permanently prohibit us from doing business with the U.S. Government or with any specific government agency;
- impose fines and penalties;
- subject us 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 us.

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 government 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 us. In many cases, unsuccessful bidders for government contracts are provided the opportunity to formally protest certain contract awards through various agencies, administrative and judicial channels. We have experienced an increase in competitor bid protests on contracts on which we were the successful bidder due to the competitive environment resulting from decreased government spending. In addition, we have formally protested procurement awards in which we were not the initial successful bidder, but believed that the source selection process was flawed. The protest process may substantially delay a successful bidder’s contract performance, result in cancellation of the contract award entirely and distract management. We may not be awarded contracts for which we bid, and substantial delays or cancellation of purchases may follow our successful bids as a result of such protests. We believe that this environment of protracted competitive bidding processes and competitor bid protests will continue.
Certain of our government contracts also contain “organizational conflict of interest” clauses that could limit our ability to compete for certain related follow-on contracts. For example, when we work on the design of a particular solution, we may be precluded from competing for the contract to install that solution. While we actively monitor our contracts to avoid these conflicts, we cannot guarantee that we will be able to avoid all organizational conflict of interest issues.
We may not receive the full amounts estimated under the contracts in our backlog, which could reduce our revenue in future periods below the levels anticipated. This makes backlog an uncertain indicator of future operating results.
Backlog is typically subject to large variations from quarter to quarter and comparisons of backlog from period to period are not necessarily indicative of future revenues. The contracts comprising our backlog may not result in actual revenue in any particular period or at all, and the actual revenue from such contracts may differ from our backlog estimates. The timing of receipt of revenues, if any, on projects included in backlog could change because many factors affect the scheduling of projects. Cancellation of or adjustments to contracts may occur. Additionally, all U.S. Government contracts included in backlog, whether or not funded, may be terminated at the convenience of the U.S. Government. The failure to realize all amounts in our backlog could adversely affect our revenues and gross margins. As a result, our funded, unfunded and total backlog as of any particular date may not be an accurate indicator of our future earnings.
A preference for minority-owned, small and small disadvantaged businesses could impact our ability to be a prime contractor and limit our opportunity to work as a subcontractor on certain governmental procurements.
As a result of the Small Business Administration (“SBA”) set-aside program, the federal government may decide to restrict certain procurements only to bidders that qualify as minority-owned, small, or small disadvantaged businesses. As a result, we would not be eligible to perform as a prime contractor on those programs and in general would be restricted to no more than 49% of the work as a subcontractor on those programs. An increase in the amount of procurements under the SBA set-aside program may impact our ability to bid on new procurements as a prime contractor, limit our opportunity to work as a subcontractor or restrict our ability to compete on incumbent work that is placed in the set-aside program.
U.S. Government in-sourcing could result in loss of business opportunities and personnel.

The U.S. Government has continued to reduce the percentage of contracted services in favor of more federal employees through an initiative called "in-sourcing." Over time, in-sourcing could have an adverse effect on our business, financial condition and results of operations. Specifically, as a result of in-sourcing government procurements for services could be fewer and smaller in the future. In addition, work we currently perform could be in-sourced by the federal government and, as a result, our revenues could be reduced. Moreover, our employees could also be hired by the government. This loss of our employees would necessitate the need to retain and train new employees. Accordingly, the effect of in-sourcing or the

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continuation of in-sourcing at a faster-than-expected rate could have an adverse effect on our business, financial condition, and results of operations.

Our business could be negatively impacted by security threats, including cyber security threats, and other disruptions.

Many of the systems we develop, install and maintain involve managing and protecting information involved in intelligence, national security and other sensitive or classified U.S. Government functions. We face various security threats, including cyber security threats, to gain unauthorized access to this sensitive information. Such threats can come from external as well as internal sources. We also face threats to the safety of our directors, officers, and employees; threats to the security of our facilities and infrastructure; and threats from terrorist acts. Although we utilize various procedures and controls to monitor these threats and mitigate our exposure to such threats, there can be no assurance that these procedures and controls will be sufficient in preventing security threats from materializing. If any of these events were to materialize, they could lead to the loss of sensitive information, critical infrastructure, personnel or capabilities essential to our operations and prevent us from being eligible for further work on sensitive or classified systems for U.S. Government customers. Further, any losses we incur from such a security breach could exceed the policy limits under our errors and omissions and product liability insurance. Any losses we incur, any damage to our reputation or any limitations on our eligibility for additional work resulting from a security breach could materially reduce our revenue and could have a material adverse effect on our business, financial condition and results of operations.

Cybersecurity attacks in particular are evolving and include, but are not limited to, malicious software, attempts to gain unauthorized access to data, and other electronic security breaches that could lead to disruptions in mission critical systems, unauthorized release of confidential or otherwise protected information and corruption of data. We have experienced cybersecurity attacks and may experience them in the future. These events could damage our reputation and lead to financial losses from remedial actions, loss of business, loss of proprietary and trade secret information or potential liability.

If we experience systems or service failure, our reputation could be harmed and our customers could assert claims against us for damages or refunds.

We create, implement and maintain IT solutions that are often critical to our customers' 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 our work. If we experience these problems, we may:

- lose revenue due to adverse customer reaction;
- be required to provide additional services to a customer at no charge;
- cause customers to postpone, cancel or fail to renew contracts;
- receive negative publicity, which could damage our reputation and adversely affect our ability to attract or retain customers; and
- suffer claims for substantial damages.

We cannot ensure that provisions in our customer contracts will be legally sufficient to protect us if we are 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 us could seriously harm our business. Even if not successful, these claims may result in significant legal and other costs, be a distraction to our management and harm our reputation.

Our products are complex and could have unknown defects or errors, which may increase our costs, harm our reputation with customers, give rise to costly litigation, or divert our resources from other purposes.

Our products, including but not limited to unmanned vehicles, aerial targets, UAS and ballistic missile targets, are extremely complex and must operate successfully with complex products from other vendors. Despite testing, our products have contained defects and errors and may in the future contain defects or errors, or experience performance problems when first introduced, when new versions or enhancements are released, or even after these products have been used by our customers for a period of time. These problems could result in expensive and time-consuming design modifications or warranty charges, delays in the introduction of new products or enhancements, significant increases in our service and maintenance costs, diversion of our personnel's attention from our product development efforts, exposure to liability for damages, damaged customer relationships, and harm to our reputation, any of which could materially harm our results of operations. In addition, increased development and warranty costs could be substantial and could reduce our operating margins.

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The existence of any defects, errors, or failures in our products or the misuse of our products could also lead to lawsuits against us, result in injury, death, or property damage, and significantly damage our reputation and support for our products in general.

Although we maintain insurance policies, we cannot provide assurance that this insurance will be adequate to protect us from all material judgments and expenses related to potential future claims or that these levels of insurance will be available in the future at economical prices or at all. A successful liability claim could result in substantial cost to us. Even if we are fully insured as it relates to a claim, the claim could nevertheless diminish our brand and divert management's attention and resources, which could have a negative impact on our business, financial condition, and results of operations.

Due to the volatile and flammable nature of certain components of our products and equipment, fires or explosions may
disrupt our business or cause significant injuries, which could adversely affect our financial results.
The development and manufacture of certain of our products involves the handling of a variety of explosive and flammable materials as well as high power equipment. From time to time, these activities may result in incidents that could cause us to temporarily shut down or otherwise disrupt some manufacturing processes, causing production delays and resulting in liability for workplace injuries and/or fatalities. We have safety and loss prevention programs that require detailed reviews of process changes and new operations, along with routine safety audits of operations involving explosive materials, to mitigate such incidents, as well as a variety of insurance policies. However, we cannot ensure that we will not experience such incidents in the future or that any such incidents will not result in production delays or otherwise have a material adverse effect on our business and financial condition.

Our financial results may vary significantly from quarter to quarter.

We expect our 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. We 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. We may also incur additional expenses when contracts are terminated or expire and are not renewed.

In addition, payments due to us from our customers 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 U.S. 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, our customers may have to suspend engagements that we are working on until a budget has been approved. Any such suspensions may reduce our revenue in the fourth quarter of the federal fiscal year or the first quarter of the subsequent year. The U.S. Government's fiscal year end can also trigger increased purchase requests from customers for equipment and materials. Any increased purchase requests we receive as a result of the U.S. Government's fiscal year end would serve to increase our third or fourth quarter revenue, but will generally decrease profit margins for that quarter, as these activities generally are not as profitable as our typical offerings.
Additional factors that may cause our financial results to fluctuate from quarter to quarter include those addressed elsewhere in this Item 1A "Risk Factors" and the following factors, among others:

- the terms of customer contracts that affect the timing of revenue recognition;
- variability in demand for our services and solutions;
- commencement, completion or termination of contracts during any particular quarter;
- timing of shipments and product deliveries;
- timing of award or performance incentive fee notices;
- timing of significant bid and proposal costs;

- the costs of remediating unknown defects, errors or performance problems of our product offerings;
- variable purchasing patterns under GSA contracts, GWACs, blanket purchase agreements and other IDIQ contracts;
- restrictions on and delays related to the export of defense articles and services;
- costs related to government inquiries;
- strategic decisions by us or our 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 our staff utilization rates;

- changes in our effective tax rate, including changes in our judgment as to the necessity of the valuation allowance recorded against our deferred tax assets; and
- the length of sales cycles.

Significant fluctuations in our operating results for a particular quarter could cause us to fall out of compliance with the financial covenants related to our debt, which if not waived, could restrict our access to capital and cause us to take extreme measures to pay down the debt, if any, under our $90.0 million Amended and Restated Credit and Security Agreement, dated November 20, 2017 (as amended, the “Credit Agreement”), by and among the Company, the lenders named therein, SunTrust Bank, as Agent (the “Agent”), and SunTrust Robinson Humphrey, Inc. as Lead Arranger and Sole Book Runner. In addition, fluctuations in our financial results could cause our stock price to decline. See the risks and uncertainties related to our ability to raise additional capital below in “We may need additional capital to fund the growth of our business, and financing may not be available on favorable terms or at all.”

Our margins and operating results may suffer if we experience unfavorable changes in the proportion of cost-plus-fee or fixed price contracts in our 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 we enter into, fixed-price contracts typically provide higher profit opportunities because we may be able to benefit from cost savings and operating efficiencies. In contrast, cost-plus-fee contracts are subject to statutory limits on profit margins and generally are the least profitable of our contract types. Our U.S. Government customers typically determine what type of contract we enter into. Cost-plus-fee and fixed-price contracts in our federal business accounted for approximately 13% and 82%, respectively, of our federal business revenues for the year ended December 30, 2018. To the extent that we enter into more cost-plus-fee or less fixed-price contracts in proportion to our total contract mix in the future, our margins and operating results may suffer.

Our cash flow and profitability could be reduced if expenditures are incurred prior to the final receipt of a contract.
We provide various professional services, specialized products, and sometimes procure equipment and materials on behalf of our customers under various contractual arrangements. From time to time, in order to ensure that we satisfy our customers’ delivery requirements and schedules, we may elect to initiate procurement in advance of receiving final authorization from the government customer or a prime contractor. If our government or prime contractor customer’s requirements should change or if the government or the prime contractor should direct the anticipated procurement to another contractor or if the equipment or materials become obsolete or require modification before we are under contract for the procurement, our investment in the equipment or materials might be at risk if we cannot efficiently resell them. This could reduce anticipated earnings or result in a loss, negatively affecting our cash flow and profitability.
We have incurred and may continue to incur goodwill impairment charges in our reporting entities, which could harm our profitability.
As of December 30, 2018, goodwill represented approximately 42% of our total assets. We periodically review the carrying values of our goodwill to determine whether such carrying values exceed the fair value. 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. The identification and measurement of impairment involves the estimation of the fair value of reporting units. Accounting for impairment contains uncertainty because management must make judgments in determining appropriate assumptions to be used in the measurement of fair value. The estimates of fair value of reporting units are based on the best information available as of the date of the assessment, incorporate management assumptions about expected future cash flows and contemplate other valuation techniques. Future cash flows can be affected by changes in industry or market conditions, among other things.

Given the current market conditions and continued economic uncertainty in the U.S. defense industry, including sequestration and issues surrounding the national debt ceiling, our future revenues, profits and cash flows could be substantially lower than our current projections. Current market conditions including increased price competitiveness specifically in the government services space, and procurements awarded on an LPTA rather than best value basis, can significantly impact our current projections, which specifically resulted in an impairment of the carrying value in 2017 of our goodwill balance in our DRSS reporting unit within our KGS reportable segment. In addition, our ability to penetrate new international markets could also impact our current projections. Additional market factors could impact our projections and our ability to successfully develop new products and platforms. For example, our US reporting unit forecasts include the successful completion of certain

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performance criteria on new unmanned systems platforms, and acceptance of new unmanned systems platforms on a technical basis as well as from a political and government budgetary standpoint. In addition, market-based inputs to the calculations in the impairment test, such as weighted average cost of capital, and market multiples, could also be negatively impacted. Such circumstances may result in the future deterioration of the fair value of our reporting units and an impairment of our goodwill. Due to continual changes in market and general business conditions, we cannot predict whether, and to what extent, our goodwill and long-lived intangible assets may be impaired in future periods. Any resulting impairment loss could harm our profitability and financial condition.

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

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

We use estimates when accounting for contracts, and any changes in such estimates could have an adverse effect on our profitability and our overall financial performance.

When agreeing to contractual terms, our management makes assumptions and projections about future conditions and events, many of which extend over long periods. These projections assess the productivity and availability of labor, complexity of the work to be performed, cost and availability of materials, impact of delayed performance and timing of product deliveries. Contract accounting requires judgment relative to assessing risks, estimating contract revenues and costs, and making assumptions for schedule and technical issues. Due to the size and nature of many of our contracts, the estimation of total revenues and costs at completion is complicated and subject to many variables. For example, assumptions are made regarding the length of time to complete a contract since costs also include expected increases in wages, prices for materials and allocated fixed costs. Similarly, assumptions are made regarding the future impact of our efficiency initiatives and cost reduction efforts. Incentives, awards or penalties related to performance on contracts are considered in estimating revenue and profit rates and are recorded when there is sufficient information to assess anticipated performance. Suppliers' assertions are also assessed and considered in estimating costs and profit rates.

Because of the significance of the judgment and estimation processes described above, it is possible that materially different amounts could be obtained if different assumptions were used or if the underlying circumstances were to change. Changes in underlying assumptions, circumstances or estimates may have a material adverse effect upon the profitability of one or more of the affected contracts, future period financial reporting and performance.

Our ability to utilize our net operating loss carryforwards and certain other tax attributes may be limited.

Federal and state income tax laws impose restrictions on the utilization of net operating loss ("NOL") and tax credit carryforwards in the event that an "ownership change" occurs for tax purposes, as defined by Section 382 of the Internal Revenue Code of 1986, as amended. We believe we underwent an ownership change in March 2010 that limited the Company's federal annual utilization of NOL carryforwards. If the entire limitation amount is not utilized in a year, the excess can be carried forward and utilized in future years. For the year ended December 30, 2018, there was no impact of such limitations on the income tax provision since the amount of taxable income did not exceed the cumulative annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also cause an "ownership change." If and when any other "ownership change" occurs, utilization of the NOL or other tax attributes may be further limited.

We expect to incur substantial research and development costs and devote significant resources to identifying and developing new products and services, which could significantly reduce our profitability and may never result in revenue to us.

Our future growth depends on penetrating new markets, adapting existing products to new applications, and introducing new products and services that achieve market acceptance. We plan to incur substantial research and development

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costs as part of our efforts to design, develop and commercialize new products and services and enhance existing products. We spent $15.6 million, or 2.5% of our revenue, in our fiscal year ended December 30, 2018 on internally funded research and development activities. We believe that there are significant investment opportunities in a number of business areas. Because we account for research and development as an operating expense, these expenditures will adversely affect our earnings in the future. Further, our research and development programs may not produce successful results, and our new products and services may not achieve market acceptance, create additional revenue or become profitable, which could materially harm our business, prospects, financial results and liquidity.

Risks Related to Our Operations

We may need additional capital to fund the growth of our business, and financing may not be available on favorable terms or at all.

We currently anticipate that our available capital resources, including the cash we raised in our recent equity offerings, the net proceeds from the divestiture of our PSS business, amounts available under our Credit Agreement and operating cash flow will be sufficient to meet our expected working capital and capital expenditure requirements for at least the next 12 months. However, these resources may not be sufficient to fund the long-term growth of our business, especially in the event that we are awarded future multiple sizable production awards related to our tactical drone programs which require significant amounts of working capital to fund such growth. If we determine that it is necessary to raise additional funds, either through an expansion or refinancing of our Credit Agreement or through public or private debt offerings or additional equity financings, additional financing may not be available on terms favorable to us, or at all. Disruptions in the capital and credit markets could adversely affect our ability to access these markets. Limitations on our borrowing base contained in our Credit Agreement may limit our access to capital, and we could fall out of compliance with financial and other covenants contained in our Credit Agreement which, if not waived, would restrict our access to capital and could require us to pay down any then-existing debt under the Credit Agreement. Our lenders may not agree to extend additional or continuing credit under our Credit Agreement or waive restrictions on our access to capital. If adequate funds are not available or are not available on acceptable terms, we may not be able to take advantage of available opportunities, develop new products or otherwise respond to competitive pressures and our business, operating results or financial condition could be materially adversely affected.

Past acquisitions and future acquisitions could prove difficult to integrate, disrupt our business, dilute stockholder value and strain our resources.

We have in the past and may, in the future, acquire additional businesses that we believe could complement or expand our business or increase our customer base. Integrating the operations of acquired businesses successfully or otherwise realizing any of the anticipated benefits of acquisitions, including anticipated cost savings and additional revenue opportunities, involves a number of potential challenges. The failure to meet these integration challenges could seriously harm our financial condition and results of operations. Realizing the benefits of acquisitions depends in part on the integration of operations and personnel. These integration activities are complex and time-consuming, and we may encounter unexpected difficulties or incur unexpected costs, including:

- our inability to achieve the operating synergies anticipated in the acquisitions;
- diversion of management attention from ongoing business concerns to integration matters;
- difficulties in consolidating and rationalizing IT platforms and administrative infrastructures;
- complexities associated with managing the geographic separation of the combined businesses and consolidating multiple physical locations where management may determine consolidation is desirable;
- difficulties in integrating personnel from different corporate cultures while maintaining focus on providing consistent, high quality customer service;
- difficulties or delays in transitioning U.S. Government contracts pursuant to federal acquisition regulations;
-

challenges in demonstrating to customers of Kratos and to customers of acquired businesses that the acquisition will not result in adverse changes in customer service standards or business focus;

- possible cash flow interruption or loss of revenue as a result of change of ownership transitional matters; and
- inability to generate sufficient revenue to offset acquisition costs.

Acquired businesses may have liabilities or adverse operating issues that we fail to discover through due diligence prior to the acquisition, including cyber and other security vulnerabilities. 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 U.S. Government or other customers, we, 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 that are subject to potential impairment in the

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future that could harm our financial results. In addition, if we finance acquisitions by issuing debt or equity securities, our existing stockholders may be diluted, which could affect the market price of our stock. Acquisitions and/or the related equity financings could also impact our ability to utilize our NOL carryforwards. As a result, if we fail to properly evaluate acquisitions or investments, we may not achieve the anticipated benefits of any such acquisitions, and we may incur costs in excess of what we anticipate. Acquisitions frequently involve benefits related to integration of operations. The failure to successfully integrate the operations or to otherwise realize any of the anticipated benefits of the acquisition could seriously harm our financial condition and results of operations.

We also evaluate from time to time the potential disposition of assets or business that may no longer meet our growth, return and/or strategic objectives. Divestitures have inherent risks, including the possibility that any anticipated sale will be delayed or will not occur, the potential failure to realize the perceived strategic or financial merits of the divestment, difficulties in the separation of operations, services, information technology, products and personnel, unexpected costs associated with such separation, diversion of management's attention from other business concerns and potential post-closing claims for alleged breaches of related agreements, indemnification or other disputes. A failure to successfully complete a disposition or to otherwise realize any of the anticipated benefits of a disposition could seriously harm our financial condition and results of operations.

If we are unable to manage our growth, our business and financial results could suffer.

Sustaining our growth has placed significant demands on our management, as well as on our administrative, operational and financial resources. For us to continue to manage our growth, we must continue to improve our operational, financial and management information systems and expand, motivate and manage our workforce. Additionally, our future financial results depend in part on our ability to profitably manage our growth on a combined basis with the businesses we have acquired and those we may acquire in the future. If we are unable to manage our growth while maintaining our quality of service and profit margins, or if new systems that we implement to assist in managing our growth do not produce the expected benefits, our business, prospects, financial condition or operating results could be adversely affected.

The loss of any member of our senior management could impair our relationships with U.S. Government customers and disrupt the management of our business.

We believe that the success of our business and our ability to operate profitably depends on the continued contributions of the members of our senior management. We rely on our senior management to generate business and execute programs successfully. In addition, the relationships and reputation that many members of our senior management team have established and maintain with U.S. Government personnel contribute to our ability to maintain strong customer relationships and to identify new business opportunities. The loss of any member of our senior management could impair our ability to identify and secure new contracts, to maintain good customer relations and to otherwise manage our business.

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

The growth of our business and revenue depends in large part upon our ability to attract and retain sufficient numbers of highly qualified individuals who have advanced technical and/or engineering skills. These employees are in great demand and are likely to remain a limited resource in the foreseeable future. In addition, certain U.S. Government contracts require us, and some of our employees, to maintain national security clearances. Obtaining and maintaining national security clearances for employees involves a lengthy process, and it is difficult to identify, recruit and retain employees who already hold national security clearances. Further, some of our contracts contain provisions requiring us to staff an engagement with personnel that the customer considers key to our successful performance under the contract. In the event we are unable to provide these key personnel or acceptable substitutions, the customer may terminate the contract. As a result, if we are unable to recruit and retain a sufficient number of qualified employees, we may lose revenue and our ability to maintain and grow our business could be limited.

Moreover, in a tight labor market our direct labor costs could increase or we may be required to engage large numbers of subcontractor personnel, which could cause our profit margins to suffer. Conversely, if we maintain or increase our staffing levels in anticipation of one or more projects and the projects are delayed, reduced or terminated, we may underutilize the additional personnel, which would increase our general and administrative expenses, reduce our earnings and possibly harm our results of operations.

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We are subject to the requirements of the National Industrial Security Program Operating Manual for our facility security clearance, which is a prerequisite to our ability to perform on classified contracts for the U.S. Government.
A facility security clearance is required for a company to perform on classified contracts for the DoD and certain other agencies of the U.S. Government. Security clearances are subject to regulations and requirements including the National Industrial Security Program Operating Manual ("NISPOM"), which specifies the requirements for the protection of classified information released or disclosed in connection with classified U.S. Government contracts. We require certain facility and personnel security clearances to perform our classified U.S. Government related business. As such, we must comply with the requirements of the NISPOM and any other applicable U.S. Government industrial security regulations. If we were to violate the terms and requirements of the NISPOM or any other applicable U.S. Government industrial security regulations (which apply to us under the terms of classified contracts), any of our cleared facilities could lose its facility security clearance. We cannot be certain that we will be able to maintain our facility security clearances. If for some reason one or more of our facility security clearances is invalidated or terminated, we would not be able to continue to perform on classified contracts at that facility and would not be able to enter into new classified contracts, which could adversely affect our revenues. Failure to comply with the NISPOM or other security requirements may subject us to civil or criminal penalties, loss of access to classified information, loss of a U.S. Government contract, or potentially debarment as a government contractor.
We may be unable to realize any benefit from our cost reduction and restructuring efforts and our profitability may be hurt or our business otherwise might be adversely affected.
We have engaged in cost reduction and restructuring activities in the past, including recent restructuring actions in our modular systems business and our divestiture of the Public Safety & Security business, and we may engage in other cost reduction restructuring activities in the future. These types of cost reduction and restructuring activities are complex. If we do not successfully manage our current cost reduction and restructuring activities, or any other cost reduction and restructuring activities that we may take in the future, any expected efficiencies and benefits might be delayed or not realized, and our operations and business could be disrupted. In addition, the costs associated with implementing cost reduction and restructuring activities might exceed expectations, which could result in additional future charges.
Risks Related to Our International Operations
Revenues derived from our international business could be subject to global economic downturn and hardship.

Our international business represents 19% of our total revenue for the year ended December 30, 2018, which may be impacted by changes in foreign national priorities and government budgets and may be further impacted by global economic conditions and fluctuations in foreign currency exchange rates. Continued international economic uncertainty and reductions in consumer spending may result in reductions in our revenue. In particular, recent events have caused increased attention on U.S. defense sales to the Kingdom of Saudi Arabia ("KSA"). Although we currently do not expect to be prevented from doing business in KSA, which represents nearly 8% of our sales (which are through FMS), if government action impairs our ability to fulfill our contractual obligations or otherwise to continue to do business in KSA, it could have an adverse effect on our financial results.
Additionally, disruptions in international credit markets may materially limit consumer credit availability and restrict credit availability of our customers. Any reduction in international sales of our solutions resulting from reductions in consumer spending or continued disruption in the availability of credit to retailers or consumers, could materially and adversely affect our business, results of operations and financial condition.

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Our international business exposes us to additional risks.

Our operations outside of the U.S. are subject to risks that are inherent in conducting business under non-U.S. laws, regulations and customs, including those related to:

- foreign currency exchange rate fluctuations, potentially reducing the U.S. dollars we receive for sales denominated in foreign currency;
- the possibility that unfriendly nations or groups could boycott our solutions;
- political conditions in the markets in which we operate;
- potential increased costs associated with overlapping tax structures;
- import-export control;
- the ability to obtain required U.S. government agency issued export licenses to ship our product overseas;
- more limited protection for intellectual property rights in some countries;
- difficulties and costs associated with staffing and managing foreign operations;
- unexpected changes in regulatory requirements;
- the difficulties of compliance with a wide variety of foreign laws and regulations;
- longer accounts receivable cycles in certain foreign countries, whether due to cultural differences, exchange rate fluctuation or other factors;
- technology transfer restrictions;
- changes to our distribution networks; and
- our employees.

These risks, individually or in the aggregate, could have an adverse effect on our results of operations and financial condition. For example, we are subject to compliance with the Foreign Corrupt Practices Act and similar anti-bribery laws, which generally prohibit companies and their intermediaries from making improper payments to foreign government officials for the purpose of obtaining or retaining business. While our employees and agents are required to comply with these laws, we cannot be sure that our internal policies and procedures will always protect us from violations of these laws, despite our commitment to legal compliance and corporate ethics. The occurrence or allegation of these types of risks may adversely affect our business, performance, prospects, value, financial condition, and results of operations. In addition, our international contracts may include industrial cooperation agreements requiring specific in-country purchases, investments, manufacturing agreements or other financial obligations, known as offset obligations, and provide for penalties if we fail to meet such requirements. In addition, due to the nature of our products, we must obtain licenses and authorizations from various U.S. government agencies before selling our products outside of the U.S. Our ability to obtain these licenses and authorizations timely or at all is subject to risks and uncertainties, including changing U.S. government policies or laws or delays in Congressional action due to geopolitical and other factors. The impact of these factors is difficult to predict, but one or more of them could adversely affect our financial position, results of operations, or cash flows.

Violations of the International Traffic in Arms Regulations (“ITAR”) or other applicable trade compliance regulations could result in significant sanctions including fines, more onerous compliance requirements and debarments from export privileges or loss of authorizations needed to conduct aspects of our international business. A violation of ITAR or other applicable trade regulations could have a materially adverse effect on our business, financial condition and results of operations.

Risks Related to Our Outstanding Indebtedness

We have substantial indebtedness, which could adversely affect our cash flow, financial condition and business.

As of December 30, 2018, we had approximately $294.2 million of total indebtedness outstanding, which includes $5.8 million of unamortized debt issuance costs. As a result of this indebtedness, our interest payment obligations are significant. The degree to which we are leveraged could have adverse effects on our business, including the following:

- it may limit our flexibility in planning for, or reacting to, changes in our business and the industries in which we operate;

- it may require us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures and other general corporate purposes;
- it may restrict us from making strategic acquisitions or exploiting business opportunities;
- it may place us at a competitive disadvantage compared to our competitors that have less debt;

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- it may limit our ability to borrow additional funds;
- it may prevent us from raising the funds necessary to repurchase our outstanding 6.5% Notes (as defined below) tendered to us if there is a change of control, which would constitute a default under the Indenture (as defined below) governing our 6.5% Notes and under our Credit Agreement; and
- it may decrease our ability to compete effectively or operate successfully under adverse economic and industry conditions.

Our level of indebtedness increases the risk that we may default on our debt obligations. We may be unable to generate sufficient cash flow to pay the interest on our debt. If we are unable to service our indebtedness, we will be forced to adopt an alternative strategy that may include actions such as reducing capital expenditures, reducing internal investments in research and development efforts, selling assets, restructuring or refinancing our indebtedness or seeking additional equity capital. These alternative strategies may not be affected on satisfactory terms, if at all, and they may not yield sufficient funds to make required payments on our indebtedness.

If, for any reason, we are unable to meet our debt service and repayment obligations, we would be in default under the terms of the agreements governing our debt, which would allow our creditors at that time to declare certain outstanding indebtedness to be due and payable, which would in turn trigger cross acceleration or cross default rights between the relevant agreements. In addition, the holders of our 6.5% Notes could foreclose against the assets securing the 6.5% Notes and we could be forced into bankruptcy or liquidation and/or our lenders could compel us to apply all of our available cash to repay our borrowings or they could prevent us from making payments on our indebtedness. If the amounts outstanding under any of our indebtedness were to be accelerated, our assets may not be sufficient to repay in full the money owed to the lenders or to our other debt holders.

We and our subsidiaries may incur more debt, which may increase the risks associated with our leverage, including our ability to service our indebtedness.

The agreements governing our debt permit us, under some circumstances, to incur certain additional indebtedness or obligations. To the extent that we incur additional indebtedness or such other obligations, the risks associated with our leverage described above, including our possible inability to service our debt, would increase.

Changes in our credit ratings or macroeconomic conditions may affect our liquidity, increasing borrowing costs and limiting our financing options.

Macroeconomic conditions, such as increased volatility or disruption in the credit markets, could adversely affect our ability to refinance existing debt or obtain additional financing at terms satisfactory to us, thereby affecting our resources to support operations or to fund new initiatives. In addition, if our credit ratings are lowered, borrowing costs for future long-term debt or short-term credit facilities may increase and our financing options, including our access to the unsecured credit market, could be limited. We may also be subject to restrictive covenants that would reduce our flexibility.

A portion of our business is conducted through foreign subsidiaries, and the failure to generate sufficient cash flow from these subsidiaries, or otherwise repatriate or receive cash from these subsidiaries, could result in our inability to repay our indebtedness.

As of December 30, 2018, approximately 13% of our consolidated assets, based on book value, and 15% of our consolidated revenues for the year ended December 30, 2018, were held by foreign subsidiaries, which do not guarantee the 6.5% Notes. Our ability to meet our debt service obligations with cash from foreign subsidiaries will depend upon the results of operations of these subsidiaries and may be subject to legal, contractual or other restrictions and other business considerations. In addition, dividend and interest payments to us from the foreign subsidiaries may be subject to foreign withholding taxes, which would reduce the amount of funds we receive from such foreign subsidiaries. Therefore, to the extent that we must use cash generated in foreign jurisdictions to make principal or interest payments on our debt, there may be a cost associated with repatriating the cash to the U.S. Dividends and other distributions from our foreign subsidiaries may also be subject to fluctuations in currency exchange rates and legal and other restrictions on repatriation, which could further reduce the amount of funds we receive from such foreign subsidiaries.

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The agreements governing our debt impose significant operating and financial restrictions on us and our subsidiaries that may prevent us and our subsidiaries from pursuing certain business opportunities and restrict our ability to operate our business.

The Indenture and the Credit Agreement subject us, and our subsidiaries, to several financial and other restrictive covenants, including limitations on liens or indebtedness, payment of dividends, transactions with affiliates, and mergers, sales or other dispositions of our assets.

Our Credit Agreement also requires us to comply with specified financial ratios, including a borrowing base availability and minimum fixed charge coverage ratio which is required to be maintained if borrowing levels, as defined, under the Credit Agreement, occur under the line of credit. Many factors, including events beyond our control, may affect our ability to comply with these covenants and financial ratios. We cannot be sure we will meet our debt-related obligations or that lenders will waive any failure to meet those obligations. Any failure to meet those debt-related obligations could result in an event of default under our other indebtedness and the acceleration of such indebtedness.

The restrictions contained in the Indenture and in our Credit Agreement could also limit our ability to plan for or react to market conditions, meet capital needs or otherwise restrict our activities or business plans and adversely affect our ability to finance operations, enter into acquisitions or to engage in other business activities that would be in the Company’s interest.

Changes in the method for determining LIBOR and the potential replacement of LIBOR may affect interest rates on our credit facilities and interest rate swaps.

LIBOR, the London interbank offered rate, is the basic rate of interest used in lending between banks on the London interbank market and is widely used as a reference for setting the interest rate on loans globally. Interest rates under our Credit Agreement are based partly on the LIBOR rate. On July 27, 2017, the United Kingdom’s Financial Conduct Authority, which regulates LIBOR, announced that it intends to phase out LIBOR by the end of 2021. It is unclear if at that time LIBOR will cease to exist or if new methods of calculating LIBOR will be established such that it continues to exist after 2021. If the method for calculation of LIBOR changes, if LIBOR is no longer available or if lenders have increased costs due to changes in LIBOR, we may suffer from potential increases in interest rates on our borrowings under the Credit Agreement. Further, we may need to renegotiate our credit facilities or any other borrowings that utilize LIBOR as a factor in determining the interest rate to replace LIBOR with the new standard that is established.

Risks Related to Our Intellectual Property

We may be unable to protect our intellectual property rights.

We rely on a combination of patents, trademarks, copyrights, trade secrets and nondisclosure agreements to protect our proprietary intellectual property. Our efforts to protect our intellectual property and proprietary rights may not be sufficient. We cannot be sure that our pending patent applications will result in the issuance of patents to us, that patents issued to or licensed by us in the past or in the future will not be challenged or circumvented by competitors or that these patents will remain valid or sufficiently broad to preclude our competitors from introducing technologies similar to those covered by our patents and patent applications. In addition, our ability to enforce and protect our intellectual property rights may be limited in certain countries outside the U.S., which could make it easier for competitors to capture market position in such countries by utilizing technologies that are similar to those developed or licensed by us. Competitors also may harm our sales by designing products that mirror the capabilities of our products or technology without infringing on our intellectual property rights. If we do not obtain sufficient protection for our intellectual property, or if we are unable to effectively enforce our intellectual property rights, our competitiveness could be impaired, which would limit our growth and future revenue.

We may be harmed by intellectual property infringement claims.

We may become subject to claims from our employees or third parties who assert that software and other forms of intellectual property that we use in delivering services and solutions to our customers infringe upon intellectual property rights of such employees or third parties. Our employees develop some of the software and other forms of intellectual property that we use to provide our services and solutions to our customers, but we also license technology from other vendors. If our employees, vendors, or other third parties assert claims that we or our customers are infringing on their intellectual property rights, we could incur substantial costs to defend those claims. If any such infringement claims were ultimately successful, we 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 our employees, vendors, or other third parties, or redesign our products and services that rely on the challenged software or technology.

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Disclosure of trade secrets could cause harm to our business.

We attempt to protect our trade secrets by entering into confidentiality and intellectual property assignment agreements with third parties, our employees and consultants. However, these agreements can be breached and, if they are, there may not be an adequate remedy available to us. In addition, others may independently discover our trade secrets and proprietary information, and in such cases we could not assert any trade secret rights against such party. Enforcing a claim that a party illegally obtained and is using our trade secret is difficult, expensive and time consuming, and the outcome is unpredictable. If we are unable to protect our intellectual property, our competitors could market services or products similar to our services and products, which could reduce demand for our offerings. Any litigation to enforce our intellectual property rights, protect our 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.

Risks Related to Regulatory, Environmental and Legal Issues

Our failure to comply with complex procurement laws and regulations could cause us to lose business and subject us to a variety of penalties.

We must comply with laws and regulations relating to the formation, administration and performance of U.S. Government contracts, which affect how we do business with our customers, prime contractors, subcontractors and vendors and may impose added costs on us. New regulations or procurement requirements (including, for example regulations regarding counterfeit and corrupt parts, supply chain diligence and cyber security) or changes to current requirements could increase our costs and risk of non-compliance. Our role as a contractor to agencies and departments of the U.S. Government results in our being routinely subject to investigations and reviews relating to compliance with various laws and regulations, including those associated with organizational conflicts of interest, procurement integrity, bid integrity and claim presentation, among others. These investigations may be conducted without our knowledge. Adverse findings in these investigations or reviews can lead to criminal, civil or administrative proceedings, and we could face 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 U.S. Government agencies. In addition, we could suffer serious harm to our reputation and competitive position if allegations of impropriety were made against us, whether or not true. If our reputation or relationship with U.S. Government agencies were impaired, or if the U.S. Government otherwise ceased doing business with us or significantly decreased the amount of business it does with us, our revenue and operating profit would decline.

Our contracts and administrative processes and systems are subject to audits and cost adjustments by the U.S. Government, which could reduce our revenue, disrupt our business or otherwise adversely affect our results of operations.

U.S. Government agencies, including the Defense Contract Audit Agency (“DCAA”), routinely audit and investigate government contracts and government contractors’ administrative processes and systems. These agencies review our performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. They also review the adequacy of our compliance with government standards for our accounting and management of internal control systems, including our: control environment and overall accounting system; general IT system; budget and planning system; purchasing system; material management and accounting system; compensation system; labor system; indirect and other direct costs system;billing system; and estimating system used for pricing on government contracts. Both contractors and the U.S. Government agencies conducting these audits and reviews have come under increased scrutiny. The current audits and reviews have become more rigorous, and the standards to which contractors are being held are being more strictly interpreted, increasing the likelihood of an audit or review resulting in an adverse outcome. During the course of its current audits, the DCAA is closely examining and questioning several of our established and disclosed practices that it had previously audited and accepted, increasing the uncertainty as to the ultimate conclusion that will be reached.

A finding of significant control deficiencies in our system audits or other reviews can result in decremented billing rates to our U.S. Government customers until the control deficiencies are corrected and our corrections are accepted by Defense Contract Management Agency (“DCMA”). Government audits and reviews may conclude that our practices are not consistent with applicable laws and regulations and result in adjustments to contract costs and mandatory customer refunds. Such adjustments can be applied retroactively, which could result in significant customer refunds. Our receipt of adverse audit findings or the failure to obtain an “approved” determination of our various accounting and management internal control systems, including our changes to indirect cost and direct labor estimating systems, from the responsible U.S. Government agency could significantly and adversely affect our business, including our ability to bid on new contracts and our competitive position in the bidding process. A determination of non-compliance with applicable contracting and procurement laws, regulations and standards could also result in the U.S. Government imposing penalties and sanctions against us, including withholding of payments, suspension of payments and increased government scrutiny that could delay or adversely affect our ability to invoice and receive timely payment on contracts, perform contracts or compete for contracts with the U.S. Government.

We have submitted incurred cost claims through 2017. The actual indirect cost audits by the DCAA have been completed for our subsidiaries for fiscal 2016. Although we have recorded contract revenues subsequent to fiscal 2016 based upon costs that we believe will be approved upon final audit or review, we do not know the outcome of any ongoing or future audits or reviews and, if future adjustments exceed our estimates, our profitability would be adversely affected.

Our employees or others acting on our behalf may engage in misconduct or other improper activities, which could cause us to lose contracts or cause us to incur costs.

We are exposed to the risk that employee fraud or other misconduct from our employees or others acting on our behalf could occur. Misconduct by employees or others could include intentional failures to comply with U.S. Government procurement regulations, engaging in unauthorized activities or falsifying time records. Misconduct by our employees or others acting on our behalf could also involve the improper use of our customers' sensitive or classified information, which could result in regulatory sanctions against us, serious harm to our reputation, a loss of contracts and a reduction in revenues, or cause us to incur costs to respond to any related governmental inquiries. It is not always possible to deter misconduct, and the precautions we take to prevent and detect this activity may not be effective in controlling unknown or unmanaged risks or losses, which could cause us to lose contracts or cause a reduction in revenues. In addition, alleged or actual misconduct by employees or others acting on our behalf could result in investigations or prosecutions of persons engaged in the subject activities, which could result in unanticipated consequences or expenses and management distraction for us regardless of whether we are alleged to have any responsibility.

We have in the past experienced and may in the future experience such misconduct, despite our various compliance programs. Misconduct or improper actions by our employees, agents, subcontractors, suppliers, business partners and/or joint ventures could subject us to administrative, civil or criminal investigations and enforcement actions; monetary and non-monetary penalties; liabilities; and the loss of privileges and other sanctions, including suspension and debarment, which could negatively impact our reputation and ability to conduct business and could have a material adverse effect on our financial position, results of operations and/or cash flows.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud.

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our operating results could be misstated, our reputation may be harmed and the trading price of our stock could be negatively affected. Our management has concluded that there are no material weaknesses in our internal controls over financial reporting as of December 30, 2018. However, although we continue to devote substantial time and resources to the documentation and testing of our controls, there can be no assurance that our controls over financial processes and reporting will be effective in the future or that material weaknesses or significant deficiencies in our 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 our operating results, cause us to fail to meet our reporting obligations or result in material misstatements in our consolidated financial statements or other public disclosures. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock.

We are subject to environmental laws and potential exposure to environmental liabilities. This may affect our ability to develop, sell or rent our property or to borrow money where such property is required to be used as collateral.

We use hazardous materials common to the industries in which we operate. We are required to follow federal, state and local environmental laws and regulations regarding the handling, storage and disposal of these materials, including the Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act, the Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”), and the Toxic Substances Control Act. We could be subject to fines, suspensions of production, alteration of our manufacturing processes or interruption or cessation of our operations if we fail to comply with present or future laws or regulations related to the use, storage, handling, discharge or disposal of toxic, volatile or otherwise hazardous chemicals used in our manufacturing processes. These regulations could require us to acquire expensive remediation equipment or to incur significant other expenses to comply with environmental regulations. Our failure to control the handling, use, storage or disposal of, or adequately restrict the discharge of, hazardous substances could subject us to liabilities and production delays, which could cause us to miss our customers’ delivery schedules, thereby reducing our sales for

a given period. We may also have to pay regulatory fines, penalties or other costs (including remediation costs), which could materially reduce our profits and adversely affect our financial condition. Permits are required for our operations, and these permits are subject to renewal, modification and, in some cases, revocation.
In addition, under environmental laws, ordinances or regulations, a current or previous owner or operator of property may be liable for the costs of removal or remediation of some kinds of petroleum products or other hazardous substances on, under, or in its property, adjacent or nearby property, or offsite disposal locations, without regard to whether the owner or operator knew of, or caused, the presence of the contaminants, and regardless of whether the practices that resulted in the contamination were legal at the time they occurred. We have incurred, and may incur in the future, liabilities under CERCLA and other environmental laws at our current or former facilities, adjacent or nearby properties or offsite disposal locations. The costs associated with future cleanup activities that we may be required to conduct or finance may be material. The presence of, or failure to remediate properly, hazardous substances may adversely affect the ability to sell or rent the property or to borrow funds using the property as collateral. Additionally, we may become subject to claims by third parties based on damages, including personal injury and property damage, and costs resulting from the disposal or release of hazardous substances into the environment.

Regulations related to “conflict minerals” may cause us to incur additional expenses and could limit the supply and increase the cost of certain metals used in manufacturing our products.

We are subject to regulations requiring disclosures of specified minerals, known as conflict minerals, that are necessary to the functionality or production of products manufactured or contracted to be manufactured by public companies. The rule requires companies to perform due diligence, disclose and report whether or not such minerals originate from the Democratic Republic of the Congo or an adjoining country. The rule can affect sourcing at competitive prices and availability in sufficient quantities of certain minerals used in the manufacture of our products, including tantalum, tin, gold and tungsten. The number of suppliers who provide conflict-free minerals is limited. In addition, there are costs associated with complying with the disclosure requirements, such as costs related to determining the source of certain minerals used in our products, as well as costs of changes to products, processes, or sources of supply as a consequence of such verification activities. Since our supply chain is complex, we are not always able to sufficiently verify the origins of the relevant minerals used in our products through the due diligence procedures we implemented, which may harm our reputation. In addition, we may encounter challenges to satisfy those customers who require that all of the components of our products be certified as conflict-free, which could place us at a competitive disadvantage if we are unable to do so.

Litigation may distract us from operating our business, and adverse judgments or settlements could adversely affect our financial results and operations.
Litigation that may be brought by or against us could cause us to incur significant expenditures and distract our management from the operation of our business. Furthermore, there can be no assurance that we would prevail in such litigation or resolve such litigation on terms favorable to us, which may adversely affect our financial results and operations. See Note 14 of the Notes to Consolidated Financial Statements contained within this Annual Report for a further discussion of our legal proceedings.

Natural disasters or severe weather conditions could disrupt our business and result in loss of revenue or higher expenses.
Our business depends on maintaining operations at our facilities and being able to operate at our customer facilities and project locations. A serious, prolonged interruption or damage due to power outage, telecommunications outage, terrorist attack, earthquake, hurricane, fire, flood or other natural disaster, or other interruption could have a material adverse effect on our business and financial results. While we insure against certain business interruption risks, such insurance may not adequately compensate us for any losses incurred as a result of natural or other disasters.

Risks Related to Our Common Stock

Some of our contracts with the U.S. Government are classified, which may limit investor insight into portions of our business.

We derive a portion of our revenues from programs with the U.S. Government that are subject to security restrictions (classified programs) that preclude the dissemination of information that is classified for national security purposes. We are limited in our ability to provide details about these classified programs, their risks or any disputes or claims relating to such programs. As a result, investors and others might have less insight into our classified programs than our other businesses and, therefore, less ability to fully evaluate the risks related to our classified business.

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The market price of our common stock may be volatile.

The price of our stock has been in the past, and will continue to be, subject to fluctuations as a result of a number of factors, most of which we cannot control, including: failure of our operating results to meet market or analysts' expectations; general fluctuations in the stock market; actual or anticipated fluctuations in our operating results based on reduced and/or delayed government spending or the threat thereof; fluctuations in the stock prices of companies in our industry; changes in earnings estimated by securities analysts or our ability to meet those estimates; rumors or dissemination of false information; litigation and government inquiries; political and/or military events associated with current worldwide conflicts; and domestic and foreign economic conditions. Such volatility has had a significant effect on the market prices of many companies' securities for reasons unrelated to their operating performance and, in the past, has led to securities class action litigation. Securities litigation against us could result in substantial costs and a diversion of our management's attention and resources, which could have an adverse effect on our business.

Your percentage of ownership in us may be diluted in the future.

As with any publicly traded company, your percentage ownership in us may be diluted in the future because of equity issuances for acquisitions, capital market transactions or otherwise, including equity awards that we expect will be granted to our directors, officers and employees.

Future sales of our common stock could cause the market price for our common stock to decline.

We cannot predict the effect, if any, that market sales of shares of our common stock or the availability of shares of our common stock for sale will have on the market price of our common stock prevailing from time to time. Sales of substantial amounts of shares of our common stock in the public market, or the perception that those sales will occur, could cause the market price of our common stock to decline or be depressed.

In the future, we may issue our securities if we need to raise capital in connection with a capital expenditure, working capital requirement or acquisition. The amount of shares of our common stock issued in connection with a capital expenditure, working capital requirement or acquisition could constitute a material portion of our then-outstanding shares of common stock. Any perceived excess in the supply of our shares in the market could negatively impact our share price and any issuance of additional securities in connection with investments or acquisitions may result in additional dilution to you.

We do not expect to pay any cash dividends for the foreseeable future.

We have not declared any cash dividends since becoming a public company. We currently intend to retain any future earnings to finance the growth and development of the business and, therefore, we do not anticipate that we will pay any cash dividends on shares of our common stock in the foreseeable future. In addition, our ability to pay dividends is restricted by both the Indenture and the Credit Agreement. Any determination to pay dividends in the future will be at the discretion of our board of directors and will be dependent upon our future financial condition, results of operations and capital requirements, general business conditions and other relevant factors as determined by our board of directors. See "Dividend Policy."

Certain provisions in our amended and restated certificate of incorporation and second amended and restated bylaws, as amended, and of Delaware law, may prevent or delay an acquisition of our Company, which could decrease the trading price of our common stock.

Our amended and restated certificate of incorporation, our second amended and restated bylaws, as amended, and Delaware law contain provisions that are intended to deter coercive takeover practices and inadequate takeover bids by making such practices or bids unacceptably expensive to the raider and to encourage prospective acquirers to negotiate with our board of directors rather than to attempt a hostile takeover. These provisions include, among others:

- the inability of our stockholders to call a special meeting;
- rules regarding how stockholders may present proposals or nominate directors for election at stockholder meetings;
- the right of our board of directors to issue preferred stock without stockholder approval;

- a super-majority requirement to amend our certificate of incorporation or bylaws; and
- the ability of our directors, and not stockholders, to fill vacancies on our board of directors.

Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock.

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We believe these provisions may help protect our stockholders from coercive or otherwise unfair takeover tactics by requiring potential acquirers to negotiate with our board of directors and by providing our board of directors with more time to assess any acquisition proposal. These provisions are not intended to make our Company immune from takeovers. In addition, although we believe these provisions collectively provide for an opportunity to receive higher bids by requiring potential acquirers to negotiate with our board, they would apply even if the offer may be considered beneficial by some stockholders. These provisions may also frustrate or prevent any attempts by our stockholders to replace or remove our current management team by making it more difficult for stockholders to replace members of our board, which is responsible for appointing the members of our management.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

At December 30, 2018, we owned or leased approximately 1.5 million square feet of floor space at 42 separate locations, primarily in the U.S., for manufacturing, warehousing, research and development, administration and various other uses. At December 30, 2018, we leased to third parties 141,451 square feet of our leased facilities, and had vacant floor space of 20,000 square feet. We continually evaluate our current and future space capacity in relation to current and projected future staffing levels. We maintain our properties in good operating condition and believe that the productive capacity of our properties is adequate to meet current contractual requirements and those for the foreseeable future.

We have major operations at the following locations:

Kratos Government Solutions: Huntsville, AL; San Diego, CA; Colorado Springs, CO; Orlando, FL; Baltimore and Lanham, MD; Dallastown, PA; and Alexandria and Chantilly, VA. Locations outside the U.S. include France, Israel, Norway, and the United Kingdom.

Unmanned Systems: Roseville and Sacramento, CA; Fort Walton Beach, FL, and Oklahoma City, OK.

Corporate and other locations: San Diego, CA.

The following is a summary of our floor space at December 30, 2018:

Square feet (in thousands)	Owned	Leased	Total
Kratos Government Solutions	417	807	1,224
Unmanned Systems	20	234	254
Corporate (includes San Diego, operations of KGS and US segments)	—	26	26
Total	437	1,067	1,504

See Note 5 of the Notes to Consolidated Financial Statements contained within this Annual Report for information regarding commitments under leases.

Item 3. Legal Proceedings.

See Note 14 of the Notes to Consolidated Financial Statements contained within this Annual Report for a further discussion of our legal proceedings.

Item 4. Mine Safety Disclosures.

None.

PART II

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Item 5. Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market Information

Our common stock is listed on the NASDAQ Global Select Market and is traded under the symbol "KTOS".

Holders of Record

On February 22, 2019, there were 356 shareholders of record of our common stock.

Dividend Policy

We have not declared any cash dividends since becoming a public company. We currently intend 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, our ability to pay dividends is restricted by both the Indenture and the Credit Agreement, each as discussed in the section entitled "Liquidity and Capital Resources" in Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 4 of the Notes to Consolidated Financial Statements contained within this Annual Report. Any future determination to pay cash dividends will be at the discretion of our board of directors and will be dependent upon our future financial condition, results of operations and capital requirements, general business conditions and other relevant factors as determined by our board of directors.

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Performance Graph

The following performance graph and related information shall not be deemed “soliciting material” or to be “filed” with the SEC, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933, as amended (the “Securities Act”), or the Exchange Act of 1934 as amended (the “Exchange Act”), except to the extent that we specifically incorporate it by reference into such filing.

The following performance graph presents a comparison of the five year cumulative stockholder return on our common stock against the cumulative total return of a broad equity market index, the Russell 2000 Stock Index, and two customized peer groups consisting of the companies listed below, for the period commencing December 31, 2013 and ending December 31, 2018. The performance graph assumes an initial investment of $100 in our common stock and in each of the Russell 2000 Stock Index and the peer groups, and further assumes that all dividends were reinvested and all returns are market-cap weighted. The historical information set forth below is not necessarily indicative of future stock price performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Kratos Defense & Security Solutions, Inc., the Russell 2000 Index,

Old Peer Group (1), and New Peer Group (2)

*$100 invested on 12/31/13 in stock or index, including reinvestment of dividends.

Fiscal year ending December 31.

(1) The companies included in the Company’s Old Peer Group are: AAR Corp., Aerojet Rocketdyne Holdings, Inc., AeroVironment Inc., Arotech Corp., Comtech Telecommunications Corp., CPI Aerostructures Inc., Ducommun Inc., Frequency Electronics Inc., and Sparton Corp.

(2) The companies included in the Company’s New Peer Group are: AAR Corp., Aerojet Rocketdyne Holdings, Inc., AeroVironment Inc., Arotech Corp., Comtech Telecommunications Corp., CPI Aerostructures Inc., Ducommun Inc., Frequency Electronics Inc., and Mercury Systems Inc.

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Recent Sales of Unregistered Securities; Use of Proceeds
None.
Purchases of Equity Securities by the Issuer and Affiliated Purchasers
None.

Item 6. Selected Financial Data.

The following selected consolidated financial data should be read in conjunction with our Consolidated Financial Statements and related notes thereto and with Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained within this Annual Report. Our historical results are not necessarily indicative of operating results to be expected in the future.
Amounts in millions except per share amounts

	December 30, 2018	December 31, 2017	December 25, 2016	December 27, 2015	December 28, 2014
Consolidated Statements of Operations Data:					
Revenues	$ 618.0	$ 603.3	$ 541.9	$ 512.5	$ 566.6
Gross profit	169.7	157.6	120.5	124.2	141.5
Operating income (loss)	30.5	(12.0)	(18.0)	(9.6)	6.8
Provision (benefit) for income taxes	4.6	(10.2)	5.8	(13.8)	3.9
Income (loss) from continuing operations	4.1	(46.9)	(57.6)	(35.8)	(74.3)
Income (loss) from discontinued operations	(7.6)	4.2	(2.9)	55.6	(3.7)
Net income (loss)	$ (3.5)	$ (42.7)	$ (60.5)	$ 19.8	$ (78.0)
Income (loss) from continuing operations per common share:					
Basic	$ 0.04	$ (0.52)	$ (0.94)	$ (0.61)	$ (1.29)
Diluted	$ 0.04	$ (0.52)	$ (0.94)	$ (0.61)	$ (1.29)
Income (loss) from discontinued operations per common share:					
Basic	$ (0.07)	$ 0.04	$ (0.05)	$ 0.95	$ (0.06)
Diluted	$ (0.07)	$ 0.04	$ (0.05)	$ 0.95	$ (0.06)
Net income (loss) per common share:					
Basic	$ (0.03)	$ (0.48)	$ (0.99)	$ 0.34	$ (1.35)
Diluted	$ (0.03)	$ (0.48)	$ (0.99)	$ 0.34	$ (1.35)
Weighted average shares:					
Basic	103.8	89.5	61.3	58.7	57.6
Diluted	106.1	89.5	61.3	58.7	57.6

	December 30, 2018	December 31, 2017	December 25, 2016	December 27, 2015	December 28, 2014
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 182.7	$ 130.5	$ 70.2	$ 30.4	$ 36.1
Working capital	330.0	282.5	176.5	148.0	147.1
Total assets	1,010.1	1,024.0	948.6	903.3	1,131.2
Short-term debt	—	0.8	1.0	1.0	1.0
Long-term debt	294.2	293.5	431.0	444.1	655.4
Total stockholders' equity	$ 519.3	$ 511.5	$ 276.4	$ 254.2	$ 224.3

We incurred acquisition-related expenses of $0.2 million for fiscal 2014. The 2014 Consolidated Statement of Operations Data includes a loss on extinguishment of debt of $39.1 million related to the refinance of the $625.0 million 10% Senior Secured Notes due in 2017 (the "10% Notes") with the $625.0 million 7.00% Senior Secured Notes due in 2019 (the

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“7% Notes”). The 2014 Consolidated Balance Sheet Data reflects the refinancing of the 10% Notes with the 7% Notes. The net proceeds of the 7% Notes was $618.5 million after an original issue discount of $6.5 million. We utilized the net proceeds from the 7% Notes, a $41.0 million draw on the Credit Agreement, as well as cash from operations to extinguish the 10% Notes.

The 2015 Consolidated Statement of Operations Data includes an $80.8 million gain on the disposal of discontinued operations before taxes and a loss of $3.4 million on extinguishment of debt. The 2015 Consolidated Balance Sheet Data includes repayment of $41.0 million outstanding on our Credit Agreement and the repurchase of $175.0 million of our 7% Notes at par.

The 2016 Consolidated Balance Sheet Data includes our equity offering of 13.4 million shares of common stock, which generated net proceeds of $76.2 million and our use of $14.1 million of the net proceeds from the offering to buy back and redeem approximately $14.5 million of our 7% Notes. The 2016 Consolidated Statement of Operations Data and Consolidated Balance Sheet Data were impacted by an $18.7 million loss accrual recorded in 2016 on the LCASD cost share contract, which is expected to be incurred by us over the period of performance of the contract, and was incurred in order to retain the intellectual property rights for the new LCASD platform.

The 2017 Consolidated Statement of Operations Data and Consolidated Balance Sheet Data includes a $24.2 million impairment of the carrying value of the goodwill of our DRSS reporting unit within our KGS segment and a $17.3 million loss on extinguishment of debt related to the refinancing of the remaining $372.8 million outstanding balance of the 7% Notes. The 2017 Consolidated Balance Sheet Data also includes our equity offerings of approximately 28.0 million shares of common stock, which generated net proceeds of $269.1 million and our use of $64.0 million of the net proceeds from the offering to buy back and redeem approximately $62.7 million of our 7% Notes. The 2017 Consolidated Balance Sheet Data also reflects the refinancing of the remaining $372.8 million of our 7% Notes with $300.0 million of 6.5% Notes. We incurred debt issuance costs of $6.6 million associated with the new 6.5% Notes. We utilized the net proceeds from the 6.5% Notes, along with cash of $89.7 million to extinguish the 7% Notes.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

In addition to historical information, the following discussion contains forward-looking statements that are subject to risks and uncertainties. Our actual results may differ substantially from those expressed in or implied by any forward-looking statements herein due to a number of factors, including but not limited to the risks and uncertainties described in this Item 7, in Item 1A “Risk Factors” and elsewhere in this Annual Report. These forward-looking statements reflect our views and assumptions only as of the date such forward-looking statements are made. Except as required by law, we assume no responsibility for updating any forward-looking statements, whether as a result of new information, future events or otherwise.

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 Annual Report and other reports and filings made with the SEC.

Overview

Kratos is a government contractor at the forefront of the DoD’s recapitalization of strategic weapon systems to address peer and near peer threats and its related Rapid Innovation Initiatives. Kratos is a leading technology, intellectual property, proprietary product and system company focused on the U.S. and its allies’ national security. Kratos is a recognized industry leader in the rapid development, demonstration and fielding of high technology systems and products at an affordable cost. Kratos’ primary focus areas are unmanned systems, space and satellite communications, microwave electronics, cyber security/warfare, training systems, missile defense, C5ISR and training systems. We believe that our technology, intellectual property, proprietary products and designed-in positions on our customers' programs, platforms and systems, and our ability to rapidly develop, demonstrate and field affordable leading technology systems gives us a competitive advantage and creates a high barrier to entry into our markets. Our work force is primarily technically oriented and highly skilled with a significant number of employees holding national security clearances. Our entire organization is focused on executing our strategy of becoming the leading technology and intellectual property based company in our industry.

Our primary end customers are U.S. Government agencies, including the DoD, intelligence agencies, and other national and homeland security related agencies. We also conduct business with local, state and foreign governments and domestic and international commercial customers. In fiscal 2018, 2017 and 2016, we generated 72%, 75% and 73%, respectively, of our total revenues from contracts with the U.S. Government (including all branches of the U.S. military and including FMS), either as a prime contractor or a subcontractor. We believe our stable customer base, strong customer relationships, intellectual property, specialized and differentiated products, broad array of contract vehicles, “designed in” positions on strategic national security platforms, our targeted investments in strategic growth areas, large employee base possessing specialized skills, security clearances, specialized manufacturing facilities and equipment, extensive list of past performance qualifications, and significant management and operational capabilities position us for success.

We were incorporated in the state of New York on December 19, 1994 and began operations in March 1995. We reincorporated in the state of Delaware in 1998.

Industry Background

The federal budget and debt ceiling are expected to continue to be the subject of considerable debate, which could have a significant impact on defense spending broadly and the Company’s programs in particular.

The budget environment, including budget caps mandated by the BCA for fiscal years 2020 and 2021, and uncertainty surrounding the debt ceiling and the appropriations process, remain significant short and long-term risks. Considerable uncertainty exists regarding how future budget and program decisions will unfold, including the defense spending priorities of the Administration and Congress, what challenges budget reductions (required by the BCA and otherwise) will present for the defense industry and whether annual appropriations bills for all agencies will be enacted for FY 2020. If annual appropriations bills are not timely enacted for FY 2020 or beyond, the U.S. Government may again operate under a continuing resolution, restricting new contract or program starts, presenting resource allocation challenges and placing limitations on some planned program budgets, and we may face another government shutdown of unknown duration. If a prolonged government shutdown of the DoD were to occur, it could result in program cancellations, disruptions and/or stop work orders and could limit the U.S. Government’s ability to effectively progress programs and to make timely payments, and our ability to perform on our U.S. Government contracts and successfully compete for new work.

We believe continued budget pressures would have serious negative consequences for the security of our country, the defense industrial base, including the Company and the customers, employees, suppliers, investors, and communities that rely on companies in the defense industrial base. It is likely budget and program decisions made in this environment would have long-term implications for our Company and the entire defense industry.

Additionally, funding for certain programs in which we participate may be reduced, delayed or cancelled, and budget cuts globally could adversely affect the viability of our subcontractors and suppliers, and our employee base. While we believe that our business is well-positioned in areas that the DoD and other customers have indicated are areas of focus for future defense spending, the long-term impact of the BCA, other defense spending cuts, challenges in the appropriations process, the debt ceiling and the ongoing fiscal debates remain uncertain.

Significant delays or reductions in appropriations; long-term funding under a continuing resolution; an extended debt ceiling breach or government shutdown; and/or future budget and program decisions, among other items, may negatively impact our business and programs and could have a material adverse effect on our financial position, results of operations and/or cash flows.

Current Reporting Segments

We operate in two reportable segments. The KGS reportable segment is comprised of an aggregation of KGS operating segments, including microwave electronic products, satellite communications, training systems, modular systems, and defense and rocket support services. The US reportable segment consists of our unmanned aerial, unmanned ground and unmanned seaborne system businesses. Our KGS and US segments provide products, solutions and services for mission critical national security programs. KGS and US customers primarily include national security related agencies, the DoD, intelligence agencies and classified agencies, and to a lesser degree, international government agencies and domestic and international commercial customers. We organize our business segments based primarily on the nature of the products, solutions and services offered. For additional information regarding our reportable segments, see Note 13 of the Notes to Consolidated Financial Statements. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Discontinued Operations

On June 11, 2018, we completed the sale of all the issued and outstanding capital stock of PSS to Buyer for a purchase price of $69 million in cash, subject to a closing net working capital adjustment.

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We currently expect to receive approximately $70 million of aggregate net cash proceeds from the Transaction, after taking into account amounts to be paid by us pursuant to a negotiated transaction services agreement between us and the Buyer, receipt of approximately $7.0 million in net working capital retained by the Company, and associated transaction fees and expenses, excluding the impact of the final settlement and determination of the closing net working capital adjustment. We are currently in a dispute with the Buyer regarding the closing net working capital adjustment. The amount in dispute is approximately $8 million. We currently expect that the net working capital retained by the Company will be collected by the first half of 2019 once certain legacy projects are completed and the project close-out process has been completed. The Company currently expects to recognize a net break-even on the sale of the Public Safety & Security business once the aggregate net proceeds described above have been collected excluding the impact of the final settlement and determination of the closing net working capital adjustment. Any changes or adjustments to the expected net proceeds will be reflected in future periods.

For additional information regarding discontinued operations, see Note 8 of the Notes to Consolidated Financial Statements contained within this Annual Report.

Key Financial Statement Concepts

As of December 30, 2018, we consider the following factors to be important in understanding our financial statements.

KGS' and US' business with the U.S. Government and prime contractors is generally performed under fixed-price, cost reimbursable, or time and materials contracts. Cost reimbursable contracts for the U.S. 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 time and materials contracts, we are 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. Effective January 1, 2018, we adopted the requirements of ASC 606, utilizing the modified retrospective method as discussed in Note 1 of the Notes to Consolidated Financial Statements contained within this Annual Report

The reported results for 2018 reflect the application of ASC 606 guidance while the reported results for periods prior to January 1, 2018 were prepared under the guidance of Financial Accounting Standards Board ("FASB") ASC 605, Revenue Recognition ("ASC 605"). The adoption of ASC 606 represents a change in accounting principle. In accordance with ASC 606, revenue is recognized when a customer obtains control of promised services and products. The amount of revenue recognized reflects the consideration that we expect to be entitled to receive in exchange for these services and products.

Prior to the adoption of ASC 606, we recognized the majority of our revenues using the percentage-of-completion method of accounting. Based on the nature of products provided or services performed, revenue was recorded as costs were incurred (the "percentage-of-completion cost-to-cost method") or as units were delivered (the "percentage-of-completion units-of-delivery method"). For the majority of contracts, the customer obtains control or receives benefits as work is performed on the contract. As a result, under ASC 606 revenue is recognized over a period of time utilizing the percentage-of-completion cost-to-cost method. This change generally results in an acceleration of revenue for contracts that were historically accounted for using the percentage-of-completion units-of-delivery method as revenues are now recognized earlier in the performance period as costs are incurred rather than as the products are delivered.

We consider the following factors when determining if collection of a receivable is reasonably assured: comprehensive collection history; results of our communications with customers; the current financial position of the customer; and the relevant economic conditions in the customer's country. If we have had no prior experience with the customer, we may review 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 our customers were to deteriorate and adversely affect their financial ability to make payments, additional allowances would be required. Additionally, on certain contracts whereby we perform services for a prime/general contractor, a specified percentage of the invoiced trade accounts receivable may be retained by the customer until we complete the project. We periodically review all retainages for collectability and record allowances for doubtful accounts when deemed appropriate, based on our assessment of the associated risks.

We monitor our policies and procedures with respect to our contracts on a regular basis to ensure consistent application under similar terms and conditions as well as compliance with all applicable government regulations. In addition, costs incurred and allocated to contracts with the U.S. Government are routinely audited by the DCAA.

We manage and assess the performance of our businesses based on our performance on individual contracts and programs obtained generally from government organizations with consideration given to our “Critical Accounting Principles and Estimates” discussed below. Due to the Federal Acquisition Regulation rules that govern our business, most types of costs are allowable, and we do not focus on individual cost groupings (such as cost of sales or general and administrative costs) as much as we do on total contract costs, which are a key factor in determining contract operating income. As a result, in evaluating our operating performance, we look primarily at changes in sales and service revenues and operating income, including the effects of significant changes in operating income. Changes in contract estimates are reviewed 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 in accordance with accounting principles generally accepted in the U.S. ("GAAP"). Significant management judgments and estimates, including the estimated costs to complete the project, which determine the project's percentage 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 our revenue for any period if management makes different judgments or utilizes different estimates.

Results of Operations

Comparison of Results for the Year Ended December 30, 2018 to the Year Ended December 31, 2017

Revenues. Revenues by reportable segment for the years ended December 30, 2018 and December 31, 2017 are as follows (in millions):

	2018	2017	$ Change	% Change
Kratos Government Solutions				
Service revenues	$200.7	$197.8	$ 2.9	1.5 %
Product sales	284.4	283.8	0.6	0.2 %
Total Kratos Government Solutions	485.1	481.6	3.5	0.7 %
Unmanned Systems - product sales	132.9	121.7	11.2	9.2 %
Total revenues	$618.0	$603.3	$ 14.7	2.4 %
Total service revenues	$200.7	$197.8	$ 2.9	1.5 %
Total product sales	417.3	405.5	11.8	2.9 %
Total revenues	$618.0	$603.3	$ 14.7	2.4 %

Revenues increased $14.7 million to $618.0 million for the year ended December 30, 2018 from $603.3 million for the year ended December 31, 2017. The increase in revenues was the result of an increase of $3.5 million in our KGS segment revenues primarily resulting from an increase in Kratos' training solutions business of $22.0 million, a $6.0 million impact from the acceleration in revenue recognition resulting from the implementation of ASC 606, offset by a reduction of $17.1 million in our legacy government services revenues which have continued to be impacted by the commoditization experienced in the government services industry as well as the impact of contracts being awarded on an LPTA basis and by a reduction of $3.7 million in our C5ISR modular systems business, and a reduction of $3.7 million of other services related business. Increased revenues of $11.2 million in our US segment resulted from the approximately $24.0 million impact from the acceleration in revenue recognition resulting from the implementation of ASC 606 that was positively affected by recent contract awards for our aerial target products, with approximately $11.3 million attributable to the AFSAT Lot 14 award of approximately $27 million in 2018, which is recorded under the percentage-of-completion cost-to-cost method as compared to the percentage-of-completion units-of-delivery method under ASC 605. In addition, work performed to manufacture Firejet high performance unmanned aerial systems under the recent awards from the U.S. Army and the Swedish Defence Materiel Administration are both now also recognized using the percentage-of-completion cost-to-cost method method versus the percentage-of-completion units-of-delivery method under ASC 605. These increases were partially offset by reductions related to work completed under our initial contract with the DIUx and certain foreign governments.

Product sales increased $11.8 million to $417.3 million for the year ended December 30, 2018 from $405.5 million for the year ended December 31, 2017, primarily as a result of a $30.0 million impact from the acceleration in revenue recognition resulting from the implementation of ASC 606, that was positively affected by an increase in production activity in our US segment under the percentage-of-completion cost-to-cost method method versus the percentage-of-completion units-of-delivery method under ASC 605. As a percentage of total revenue, product sales were 67.5% for the year ended December 30, 2018, as compared to 67.2% for the year ended December 31, 2017. Service revenues increased by $2.9 million to $200.7 million for the year ended December 30, 2018, from $197.8 million for the year ended December 31, 2017.

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As described in our “Critical Accounting Principles and Estimates” below and in the Notes to Consolidated Financial Statements contained within this Annual Report, prior to the adoption of ASC 606, we recognized the majority of our revenues using the percentage-of-completion method of accounting. Based on the nature of products provided or services performed, revenue was recorded as costs were incurred (the “percentage-of-completion cost-to-cost method”) or as units were delivered (the “percentage-of-completion units-of-delivery method”). For the majority of contracts, the customer obtains control or receives benefits as work is performed on the contract. As a result, under ASC 606 revenue is recognized over a period of time utilizing the percentage-of-completion cost-to-cost method. This change generally results in an acceleration of revenue for contracts that were historically accounted for using the percentage-of-completion units-of-delivery method as revenues are now recognized earlier in the performance period as costs are incurred. When revenue is calculated using the percentage-of-completion method, total costs incurred to date are compared to total estimated 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 percentage of completion, 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 our 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 on 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 our Consolidated Financial Statements.

Cost of revenues. Cost of revenues increased to $448.3 million for the year ended December 30, 2018, from $445.7 million for the year ended December 31, 2017. The $2.6 million increase in cost of revenues was primarily a result of increased revenue discussed above.

Gross margin percentage increased to 27.5% for the year ended December 30, 2018, compared to 26.1% for the year ended December 31, 2017. Margins on services increased to 31.3% for the year ended December 30, 2018 from 29.9% for the year ended December 31, 2017, due primarily to a more favorable mix of revenues including the Company’s de-emphasis of lower margin opportunities. Margins on product sales increased for the year ended December 30, 2018, as compared to December 31, 2017 to 25.6% from 24.3%, respectively, primarily as a result of a change in the mix of products sold including the Company’s de-emphasis of lower margin opportunities. Margins in the KGS segment increased to 29.1% for the year ended December 30, 2018 from 27.5% for the year ended December 31, 2017, primarily due to a more favorable mix of products produced including the Company’s de-emphasis of lower margin opportunities. Margins in the US segment increased to 21.3% for the year ended December 30, 2018 from 20.5% for the year ended December 31, 2017, primarily due to a more favorable mix of products produced and shipped in the year ended December 30, 2018, the migration from development to production on certain platforms and the leverage on the overhead and manufacturing base due to the increase in production volumes and a de-emphasis of lower margin opportunities.

Selling, general and administrative expenses (SG&A). SG&A decreased $7.5 million to $119.8 million for the year ended December 30, 2018, from $127.3 million for the year ended December 31, 2017. The decrease was primarily the result of cost reduction actions taken by the Company and the reduction of amortization of intangibles as a result of them being fully amortized in 2018. As a percentage of revenues, SG&A decreased to 19.4% for the year ended December 30, 2018 from 21.1% for the year ended December 31, 2017. Excluding amortization of intangibles of $5.9 million for the year ended December 30, 2018, and amortization of intangibles of $10.4 million for the year ended December 31, 2017, SG&A decreased as a percentage of revenues to 18.4% from 19.4% for the year ended December 30, 2018 and December 31, 2017, respectively.

Internal research and development (IR&D) expenses. IR&D expenses decreased to $15.6 million for the year ended December 30, 2018 from $17.8 million for the year ended December 31, 2017. As a percentage of revenues, IR&D

decreased to 2.5% of revenues for the year ended December 30, 2018 from 3.0% of revenues for the year ended December 31, 2017. IR&D expenditures are primarily related to investments we are making in coordination with our customers, with the objective of the Company owning the data package of a new system or platforms, or a “designed-in” position on our products on certain new long-term program opportunities.

Restructuring Expenses and Other. The expense of $3.8 million for the year ended December 30, 2018, was primarily due to a litigation settlement which has now been finalized, and related legal costs of approximately $2.8 million, and employee termination costs of approximately $1.0 million related to personnel reduction actions taken in 2018. The expense of $0.3 million for the year ended December 31, 2017, was related to employee termination costs associated with personnel reduction actions taken during the year.

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Impairment of goodwill. Impairment of goodwill includes a charge of $24.2 million for the year ended December 31, 2017 resulting from the annual impairment test of the carrying value of the goodwill balance of our DRSS reporting unit within the KGS segment. There was no impairment charge for the year ended December 30, 2018.

Other expense, net. Other expense, net, decreased to $21.8 million from $45.1 million for the years ended December 30, 2018 and December 31, 2017, respectively. The decrease in expense of $23.3 million was primarily related to a $17.3 million loss on the extinguishment of the 7% Notes in 2017, a reduction in net interest of $7.8 million to $20.8 million for the year ended December 30, 2018 from $28.6 million for the year ended December 31, 2017 as a result of the Company's refinancing of its 7% Notes in November 2017, which resulted in a reduced borrowing rate from 7.0% to 6.5% and a reduced outstanding principal balance from $431 million to $300 million, offset by foreign currency transaction losses for the year ended December 30, 2018 as compared to foreign currency transaction gains in the year ended December 31, 2017.

Provision (benefit) for income taxes from continuing operations. The benefit for income taxes from continuing operations changed to a provision of $4.6 million on income from continuing operations before income taxes of $8.7 million for the year ended December 30, 2018 from a benefit of $10.2 million on a loss of $57.1 million from continuing operations before income taxes for the year ended December 31, 2017. The tax provision for the year ended December 30, 2018 was primarily comprised of an increase in uncertain tax positions of $4.0 million, in addition to state and foreign taxes. The tax provision for the year ended December 31, 2017 was primarily comprised of foreign and state taxes offset by a $13.2 million deferred tax benefit as a result of enactment of the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act").

Effective January 1, 2018, the 2017 Tax Act requires the acceleration of revenue for tax purposes for certain types of revenue. The new rules require that we do not defer revenue on our unbilled accounts receivable later than the amounts are recognized in revenue for book purposes. This change impacts several accounting methods previously used by us and is expected to result in an acceleration of taxability of such revenue beginning in 2018 as compared with prior U.S. tax laws. Additionally, future interest deductions of the Company will be limited to 30% of tax adjusted EBITDA through 2021.

Income (loss) from discontinued operations. The loss from discontinued operations was $7.6 million for the year ended December 30, 2018, which includes a a loss of $6.7 million from operating activities through the completion of the Transaction and approximately $2.7 million of transaction-related expenses. The income from discontinued operations was $4.2 million from operating activities for the year ended December 31, 2017.

Comparison of Results for the Year Ended December 31, 2017 to the Year Ended December 25, 2016

Revenues. Revenues by reportable segment for the years ended December 31, 2017 and December 25, 2016 are as follows (in millions):

	2017	2016	$ Change	% Change
Kratos Government Solutions				
Service revenues	$197.8	$221.3	$(23.5)	(10.6)%
Product sales	283.8	244.8	39.0	15.9%
Total Kratos Government Solutions	481.6	466.1	15.5	3.3%
Unmanned Systems - product sales	121.7	75.8	45.9	60.6%
Total revenues	$603.3	$541.9	$61.4	11.3%
Total service revenues	$197.8	$221.3	$(23.5)	(10.6)%

Total product sales	405.5	320.6	84.9	26.5	%
Total revenues	$603.3	$541.9	$61.4	11.3	%

Revenues increased $61.4 million to $603.3 million for the year ended December 31, 2017 from $541.9 million for the year ended December 25, 2016. The increase in revenues was the result of increased revenues of $15.5 million in our KGS segment primarily resulting from increased shipments and work performed in our satellite communications business of approximately $14.1 million, our simulation and training systems business of approximately $16.1 million and our specialized ground equipment products business of $4.4 million. These increases were offset by a reduction in our government services business of approximately $19.2 million, which has been impacted by continued commoditization and price competiveness in the government services industry due to contract awards on a LPTA basis rather than on a best value basis. Increased revenues of $45.9 million in our US segment resulted from recent contract awards in unmanned combat aerial systems which includes the commencement in July 2017 of low rate initial production of our SSAT/177 aerial targets for the U.S. Navy, as well as an increase in shipments of other unmanned aerial target systems.

Product sales increased $84.9 million to $405.5 million for the year ended December 31, 2017 from $320.6 million for the year ended December 25, 2016, primarily as a result of the increase in product shipments due to the factors discussed above in our KGS and US segments. As a percentage of total revenue, product sales were 67.2% for the year ended December 31, 2017, as compared to 59.2% for the year ended December 25, 2016. Service revenues decreased by $23.5 million to $197.8 million for the year ended December 31, 2017, from $221.3 million for the year ended December 25, 2016, primarily due to the decline in our legacy government services business discussed previously.

Cost of revenues. Cost of revenues increased to $445.7 million for the year ended December 31, 2017, from $421.4 million for the year ended December 25, 2016. The $24.3 million increase in cost of revenues was primarily a result of increased revenue discussed above.

Gross margin percentage increased to 26.1% for the year ended December 31, 2017, compared to 22.2% for the year ended December 25, 2016. Margins on services increased to 29.9% for the year ended December 31, 2017 from 26.8% for the year ended December 25, 2016, due primarily to a more favorable mix of revenues and due to the impact of cost reduction actions that we took in 2016 in our modular systems business. Margins on product sales increased for the year ended December 31, 2017, as compared to December 25, 2016 to 24.3% from 19.1%, respectively, primarily as a result of a change in the mix of products sold, and the ramp in production in our US segment as we have commenced low rate initial production on our SSAT/177 program for the U.S. Navy. In addition, the 2016 gross profit and gross margin included an $18.7 million loss accrual recorded on the LCASD cost share contract incurred in order to retain the intellectual property rights for the new LCASD platform. Margins in the KGS segment increased to 27.5% for the year ended December 31, 2017 from 26.3% for the year ended December 25, 2016, primarily as a result of change in the mix of products sold. Margins in the US segment increased to 20.5% for the year ended December 31, 2017 from (2.9)% for the year ended December 25, 2016, which reflects the ramp in low rate initial production, the increase in revenues and the effect from the $18.7 million loss accrual recorded on the LCASD cost share contract during 2016.

Selling, general and administrative expenses (SG&A). SG&A increased $12.7 million to $127.3 million for the year ended December 31, 2017, from $114.6 million for the year ended December 25, 2016. The increase was primarily the result of the increase in revenues described previously. As a percentage of revenues, SG&A remained the same at 21.1% for fiscal 2017 and 21.1% for fiscal 2016. Excluding amortization of intangibles of $10.4 million for the year ended December 31, 2017, and amortization of intangibles of $10.5 million for the year ended December 25, 2016, SG&A increased slightly as a percentage of revenues to 19.4% from 19.2% for the year ended December 31, 2017 and December 25, 2016, respectively.

Internal research and development (IR&D) expenses. IR&D expenses increased to $17.8 million for the year ended December 31, 2017 from $13.9 million for the year ended December 25, 2016. As a percentage of revenues, IR&D increased to 3.0% of revenues for the year ended December 31, 2017 from 2.6% of revenues for the year ended December 25, 2016. IR&D expenditures are primarily related to investments we are making in conjunction with our customers and prospective customers, with the objectives of our products being the new platform for or “designed in” to certain new long term program opportunities and our owning certain intellectual property rights for products that support these programs primarily in our unmanned systems and microwave electronic businesses as well as technology upgrades and refresh activities that are necessary for the next generation of our existing product lines primarily in our satellite and space communications business.

Restructuring Expenses and Other. The expense of $0.3 million for the year ended December 31, 2017, was related to employee termination costs associated with personnel reduction actions taken during the year. The expense of $10.0 million for the year ended December 25, 2016, was due to a $9.2 million charge that was recorded in the Company's modular systems business as a result of the closure of one of its manufacturing facilities, as well as, the exit from certain lower margin product business lines and employee termination costs related to personnel reduction actions taken in the first quarter of 2016. The restructuring charge recorded in our modular systems business was comprised of $4.9 million related to fixed and intangible assets, of which $1.4 million was recorded in the fourth quarter of 2016 reflecting the write-down to estimated fair value of one of its facilities, $3.0 million related to exited product lines and $1.3 million related to excess facilities.

Impairment of goodwill. Impairment of goodwill includes a charge of $24.2 million for the year ended December 31, 2017 resulting from the annual impairment test of the carrying value of the goodwill balance of our DRSS reporting unit within the KGS segment. The majority of this business includes our legacy government services business, which we deemphasized in 2010 and no longer consider a core business area. The expected future performance for the DRSS reporting unit has been adversely impacted by competitive pressures and commoditization resulting from lower priced technically acceptable awards rather than awards based on best value. Specifically, we lost two sizable five-year contract opportunities, which significantly impacted the expected future financial performance of the DRSS business.

Other expense, net. Other expense, net increased to $45.1 million from $33.8 million for the years ended December 31, 2017 and December 25, 2016, respectively. The increase in expense of $11.3 million was primarily related to a $17.3 million loss on the extinguishment of the 7% Notes in 2017, a reduction in net interest of $6.1 million to $28.6 million for the year ended December 31, 2017 from $34.7 million for the year ended December 25, 2016 as a result of the Company's repurchase and extinguishment of approximately $77.2 million of our 7% Notes since the fourth quarter of 2016.

Provision (benefit) for income taxes from continuing operations. The provision for income taxes from continuing operations changed to a benefit of $10.2 million on a loss from continuing operations before income taxes of $57.1 million for the year ended December 31, 2017 from an expense of $5.8 million on a loss of $51.8 million from continuing operations before income taxes for the year ended December 25, 2016. The tax benefit for the year ended December 31, 2017 was primarily comprised of foreign and state taxes offset by a tax benefit for the decrease of $13.2 million in the indefinite life deferred tax liability as a result of enactment of the 2017 Tax Act. Effective January 1, 2018, the 2017 Tax Act requires the acceleration of revenue for tax purposes for certain types of revenue. The new rules require that we do not defer revenue on our unbilled accounts receivable later than the amounts are recognized in revenue for book purposes. This change impacts several accounting methods previously used by us and is expected to result in an acceleration of taxability of such revenue beginning in 2018 as compared with prior U.S. tax laws. Additionally, future interest deductions of the company will be limited to 30% of tax adjusted EBITDA through 2021.

Income (loss) from discontinued operations. The income from discontinued operations was $4.2 million for the year ended December 31, 2017, and the loss from discontinued operations was $2.9 million for the year ended December 25, 2016.

Liquidity and Capital Resources

As of December 30, 2018, we had cash and cash equivalents of $182.7 million compared with cash and cash equivalents of $130.5 million as of December 31, 2017, which includes $12.0 million and $10.7 million, respectively, of cash and cash equivalents held by our foreign subsidiaries. We are not presently aware of any restrictions on the repatriation of these funds, however, earnings of these foreign subsidiaries are essentially considered permanently invested in these foreign subsidiaries. If these funds were needed to fund our operations or satisfy obligations in the U.S. they could be repatriated, and their repatriation into the U.S. may cause us to incur additional foreign withholding taxes. We do not currently intend to repatriate these earnings. Included in our cash and cash equivalents at December 30, 2018 are net proceeds of approximately $66 million we received as a result of our divestiture of our PSS business.

During 2017, we sold approximately 28.0 million shares of our common stock in underwritten public offerings, raising net proceeds of approximately $269.1 million, after deducting underwriting fees and other offering expenses.

On November 20, 2017, we issued and sold $300 million aggregate principal amount of 6.5% Notes in a private placement pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. The proceeds from the 6.5% Notes were used to redeem our existing 7% Senior Secured Notes due 2019 ("7% Notes") and to pay all fees and expenses, including premium and unpaid interest, if any, related thereto. We incurred debt issuance costs of $6.6 million associated with the new 6.5% Notes. We utilized the net proceeds from the sale of the 6.5% Notes, as well as cash from our recent equity offering to extinguish the outstanding 7% Notes.

The total reacquisition price of the 7% Notes was $385.2 million, including a $12.0 million call premium, and $0.3 million of accrued interest. During 2017, we decreased long term indebtedness by $135.5 million utilizing cash on hand and the proceeds from the 6.5% Notes, resulting in a loss on extinguishment of debt of $17.3 million during 2017.

Our total debt, including principal due on the 6.5% Notes, other term debt, and debt issuance costs of $5.8 million, decreased by $0.1 million to $294.2 million as of December 30, 2018 from $294.3 million as of December 31, 2017. The decrease in total debt was due to the principal payment required on our ten-year term loan with a bank in Israel, which was paid in full in 2018, offset partially by the amortization of deferred financing costs on our 6.5% Notes.

We use our operating cash flow to finance trade accounts receivable, fund necessary increases in inventory, which may include leaning forward to procure long-lead materials for certain of our unmanned systems programs at our customers' request, prior to receipt of customer contractual funding documents, fund capital expenditures, our IR&D investments, and our ongoing operations, service our debt and make strategic acquisitions. Financing trade accounts receivable is necessary because,

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on average, our customers do not pay us as quickly as we pay our vendors and employees for their goods and services since a number of our receivables are contractually billable and due to us only when certain contractual milestones are achieved, certain of which are not achieved until final shipment and acceptance of our products. Financing increases in inventory balances is necessary to fulfill shipment requirements to meet delivery schedules of our customers. Cash from continuing operations is primarily derived from our customer contracts in progress and associated changes in working capital components. Our days sales outstanding ("DSO") have increased to 140 days as of December 30, 2018 from 128 days as of December 31, 2017. Our DSOs can fluctuate from period to period, primarily as a result of certain contractual billing milestones that have not yet been attained, such as equipment shipments and deliveries on certain products, and for certain flight requirements that must be fulfilled on certain aerial target programs, or final billings which are not due until completion on certain of our large training systems deliveries, and therefore we are unable to contractually bill for amounts outstanding related to those milestones at this time. We are currently in dispute with an international customer in our US segment over approximately $11.2 million in unbilled receivables outstanding as of December 30, 2018. The dispute concerns the completion of flight requirements and contractual milestones.

A summary of our net cash provided by (used in) operating activities from continuing operations from our Consolidated Statements of Cash Flows is as follows (in millions):

	Year Ended		
	December 30, 2018	December 31, 2017	December 25, 2016
Net cash provided by (used in) operating activities from continuing operations	$18.1	$ (26.9)	$ (14.6)

Our cash provided by and used in operating activities was impacted by interest expense we paid related to our senior secured notes. We paid $20.5 million, $28.3 million, and $32.4 million in interest expense in 2018, 2017, and 2016, respectively. Cash provided by (used in) operating activities in 2018, 2017 and 2016 was also negatively impacted by discretionary investments we have made in internally funded research and development of $15.6 million in 2018, $17.8 million in 2017 and $13.9 million in 2016, contract development costs on new platforms in our US segment, and increased SG&A expenditures primarily related to business capture pursuits in the tactical unmanned aircraft systems initiatives, as well as changes in working capital accounts. The net use in working capital accounts for 2018 and 2017 includes approximately $3.6 and $7.7 million, respectively, of internal development product development investments that are non-capital expenditures we are making related to the LCASD or "Valkyrie". The increase in cash provided by operating activities in 2018 compared to 2017 reflects the increased operating income generated in 2018 as a result of the increase in revenues, a more favorable mix of revenues and the leverage on the Company's manufacturing overhead and administrative infrastructure.

Our cash provided by (used in) investing activities from continuing operations is summarized as follows (in millions):

	Year Ended		
	December 30, 2018	December 31, 2017	December 25, 2016
Investing activities:			
Cash paid for acquisitions, net of cash acquired	$(2.9)	$ —	$ (5.1)
Proceeds from sale of assets	66.0	0.7	—
Capital expenditures	(22.6)	(26.1)	(9.0)
Net cash provided by (used in) investing activities from continuing operations	$40.5	$ (25.4)	$ (14.1)

Net cash provided by investing activities from continuing operations for year ended December 30, 2018 was positively impacted by the approximately $66.0 million net proceeds, net of related transaction expenses, received from the Transaction. We currently expect to receive approximately $70 million of aggregate net cash proceeds from the Transaction, after taking into account amounts to be paid by us pursuant to a negotiated transaction services agreement between us and the Buyer, receipt of approximately $7.0 million in net working capital retained by us, and associated transaction fees and expenses, excluding the impact of the final settlement and determination of the closing net working capital adjustment. We are currently in a dispute with the Buyer regarding the closing net working capital adjustment. The amount in dispute is approximately $8.0 million. We currently expect that the net working capital retained by the Company will be collected in the first half of 2019 once certain legacy projects are completed and the project close-out process has been completed. These proceeds were partially offset by

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capital expenditures of $22.6 million, which consist of investments in machinery, computer hardware and software and improvement of our physical properties in order to maintain suitable conditions in which to conduct our business, capital expenditures of $13.2 million in our US segment to build Company-owned tactical aircraft and related equipment related to the LCASD and UTAP-22 or Mako platforms, as well as, capital expenditures of $2.9 million related to a previous strategic investment in a satellite signal monitoring, signal intelligence and location identification technology and product line to enhance our existing space and satellite communications business offering.

Net cash used in investing activities from continuing operations for 2017 and 2016 was primarily driven by capital expenditures, which reflects investments we made for certain machinery, test equipment, demonstration units and Company-owned aircraft in our unmanned aerial systems business, and to a lesser degree, investments we made in our microwave electronic products business, and our space and satellite communications business. The 2017 capital expenditures included approximately $13.2 million related to investments we are making in our US segment to build Company-owned tactical aircraft and related equipment related to the LCASD and UTAP-22 or Mako platforms. In addition, we used $5.1 million during the fourth quarter of 2016 to fund a strategic initial investment in a satellite signal monitoring, signal intelligence and location identification technology and product line to enhance our existing space and satellite communications bus