

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

Form 10-Q

May 06, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 27, 2011

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

Commission file number 0-27231

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

(Exact name of Registrant as specified in its charter)

Delaware

13-3818604

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(State or other jurisdiction of
incorporation or organization)

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

4820 Eastgate Mall

San Diego, CA 92121

(858) 812-7300

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

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of April 29, 2011 23,870,467 shares of the registrant's common stock were outstanding.

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FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED March 27, 2011

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in millions, except par value and number of shares)

(Unaudited)

	December 26, 2010	March 27, 2011
Assets		
Current assets:		
Cash and cash equivalents	\$ 10.8	\$ 45.5
Restricted cash	8.5	112.3
Accounts receivable, net	125.8	161.8
Inventoried costs	25.9	72.4
Prepaid expenses	7.1	9.9
Other current assets	6.1	11.8
Total current assets	184.2	413.7
Property, plant and equipment, net	28.4	58.1
Goodwill	226.4	368.7
Intangible assets, net	89.1	122.8
Other assets	8.0	20.1
Total assets	\$ 536.1	\$ 983.4
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 45.6	\$ 57.5
Accrued expenses	21.4	37.0
Accrued compensation	21.7	36.6
Billings in excess of costs and earnings on uncompleted contracts	17.2	16.4
Other current liabilities	12.5	23.6
Total current liabilities	118.4	171.1
Long-term debt, net of current portion	225.0	516.5
Other long-term liabilities	22.8	47.9
Total liabilities	366.2	735.5
Commitments and contingencies		
Stockholders' equity:		

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Preferred stock, 5,000,000 shares authorized Series B Convertible Preferred Stock, \$.001 par value, 10,000 shares outstanding at December 26, 2010 and 0 shares outstanding at March 27, 2011 (liquidation preference \$5.0 million at December 26, 2010) (see note 5)

Common stock, \$.001 par value, 195,000,000 shares authorized; 18,616,023 and 23,828,726 shares issued and outstanding at December 26, 2010 and March 27, 2011, respectively

Additional paid-in capital	553.5	618.1
Accumulated deficit	(383.6)	(387.1)
Total Kratos Defense & Security Solutions, Inc. stockholders' equity	169.9	231.0
Noncontrolling interest		16.9
Total stockholders' equity	169.9	247.9
Total liabilities and stockholders' equity	\$ 536.1	\$ 983.4

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

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in millions, except per share amounts)

(Unaudited)

	Three months ended	
	March 28, 2010	March 27, 2011
Service revenues	\$ 64.6	\$ 79.8
Product sales	4.1	43.0
Total revenues	68.7	122.8
Cost of service revenue	49.9	60.3
Cost of product sales	3.5	35.1
Total costs	53.4	95.4
Gross profit	15.3	27.4
Selling, general and administrative expenses	11.1	19.6
Merger and acquisition expenses and other		5.8
Research and development expenses	0.6	0.6
Operating income from continuing operations	3.6	1.4
Other income (expense):		
Interest expense, net	(3.9)	(6.7)
Other income	0.2	0.3
Total other expense, net	(3.7)	(6.4)
Loss from continuing operations before income taxes	(0.1)	(5.0)
Provision (benefit) for income taxes from continuing operations	0.3	(1.2)
Loss from continuing operations	(0.4)	(3.8)
Net income from discontinued operations	0.6	0.3
Net income (loss)	\$ 0.2	\$ (3.5)
Basic income (loss) per common share:		
Loss from continuing operations	\$ (0.02)	\$ (0.18)
Net income from discontinued operations	0.04	0.01
Net income (loss) per common share:	\$ 0.02	\$ (0.17)
Diluted income (loss) per common share:		
Loss from continuing operations	\$ (0.02)	\$ (0.18)
Net income from discontinued operations	0.04	0.01
Net income (loss) per common share:	\$ 0.02	\$ (0.17)
Weighted average common shares outstanding:		
Basic	15.9	21.3
Diluted	15.9	21.3

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

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

	Three months ended March 28, 2010	Three months ended March 27, 2011
Operating activities:		
Net income (loss)	\$ 0.2	\$ (3.5)
Less: Income from discontinued operations	0.6	0.3
Loss from continuing operations	(0.4)	(3.8)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities from continuing operations:		
Depreciation and amortization	1.9	4.8
Stock-based compensation	0.4	0.6
Mark to market on swaps	(0.2)	(0.3)
Deferred income taxes		0.3
Change in accrual for unused office space	(0.4)	
Amortization of deferred financing costs	2.3	0.4
Provision for doubtful accounts	0.1	
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	(15.1)	3.0
Inventoried costs	(0.4)	1.3
Prepaid expenses and other assets	(5.7)	0.9
Accounts payable	0.3	3.1
Accrued expenses	(0.6)	(9.0)
Accrued compensation	3.0	2.0
Billings in excess of costs and earnings on uncompleted contracts	14.2	(4.3)
Income tax receivable and payable		(2.2)
Other liabilities	(0.1)	
Net cash used in operating activities from continuing operations	(0.7)	(3.2)
Investing activities:		
Cash paid for acquisitions, net of cash acquired		(224.1)
Increase in restricted cash		(101.1)
Other, net	(0.3)	(0.5)
Net cash used in investing activities from continuing operations	(0.3)	(325.7)
Financing activities:		
Proceeds from the issuance of long-term debt		314.0
Proceeds from the issuance of common stock		61.5
Borrowings under credit facility	57.9	
Repayments under credit facility	(58.8)	
Debt issuance costs	(1.9)	(13.0)

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Other	0.6	1.2
Net cash provided by (used in) financing activities from continuing operations	(2.2)	363.7
Net cash flows of continuing operations	(3.2)	34.8
Net operating cash flows of discontinued operations	(0.4)	(0.1)
Net increase in cash and cash equivalents	(3.6)	34.7
Cash and cash equivalents at beginning of period	9.9	10.8
Cash and cash equivalents at end of period	\$ 6.3	\$ 45.5

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

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

(a) Basis of Presentation

The information as of and for the three months ended March 27, 2011 and March 28, 2010 is unaudited. The condensed consolidated balance sheet as of December 26, 2010 was derived from the Company's audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company's financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the U.S. (GAAP). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company's audited annual consolidated financial statements for the fiscal year ended December 26, 2010, included in the Company's Annual Report on Form 10-K, filed with the U.S. Securities and Exchange Commission on March 2, 2011 (the Form 10-K). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(b) Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries for which all inter-company transactions have been eliminated in consolidation. The Company and its subsidiaries are collectively referred to herein as the Company.

(c) Fiscal Year

The Company has a 52/53 week fiscal year ending on the last Sunday of the year, with interim fiscal periods ending on the last Sunday of the last month of each calendar quarter. The three months ended March 28, 2010 and March 27, 2011 consisted of 13 week periods. There are 52 calendar weeks in the fiscal years ending on December 26, 2010 and December 25, 2011.

(d) Cash and Cash Equivalents

The Company's cash equivalents consist of its highly liquid investments with an original maturity of three months or less when purchased by the Company.

The Company had restricted cash accounts of approximately \$8.5 million at December 26, 2010, which were required to collateralize a credit card program, a seller escrow account related to the acquisition of Gichner Holdings, Inc. (Gichner), and a deposit relating to the run out of a now terminated self-insured workers compensation program. As of March 27, 2011, the Company had restricted cash of \$112.3 million. The increase in restricted cash was primarily a result of the terms of the \$285.0 million in aggregate principal amount of 10% Senior Secured Notes due 2017 (the Stage I Notes) that the Company issued through its wholly-owned subsidiary, Acquisition Co. Lanza Parent (the Stage I Issuer), on March 25, 2011, in an unregistered offering pursuant to Rule 144A and Regulation S under the Securities Act of 1993, as amended (the Securities Act), to finance the acquisition of Herley Industries, Inc. (Herley). The Stage I Notes were guaranteed only by the assets of the Stage I Issuer and not by the assets of the Company. Pursuant to the terms of the indenture governing the Stage I Notes, approximately \$314.0 million in cash proceeds from the offering together with cash contributions of \$45.0 million from the Company were required to be deposited in an account of the Stage I Issuer. These proceeds were used to provide collateral for the Stage I Notes, finance the acquisition of all of the outstanding shares of common stock of Herley (see Note 2), and pay related fees and expenses. These proceeds could only be used for these purposes and could not be transferred to the Company for general corporate purposes until the acquisition of Herley was complete and as such were restricted. On April 4, 2011, after the acquisition of Herley was complete, the Stage I Issuer was merged with and into the Company, all assets and liabilities of the Stage I Issuer became assets and liabilities of the Company and the previously restricted proceeds became unrestricted.

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(e) Accounting Policies

There have been no changes in the Company's significant accounting policies for the three months ended March 27, 2011 as compared to the significant accounting policies described in the Form 10-K.

(f) Concentrations and Uncertainties

The Company maintains cash balances at various financial institutions and such balances commonly exceed the \$250,000 insured amount by the Federal Deposit Insurance Corporation. The Company has not experienced any losses in such accounts and management believes that the Company is not exposed to any significant credit risk with respect to such cash and cash equivalents.

Financial instruments, which subject the Company to potential concentrations of credit risk, consist principally of the Company's billed and unbilled accounts receivable. The Company's accounts receivable result from sales to customers within the federal government, state and local agencies and with commercial customers in various industries. The Company performs ongoing credit evaluations of its commercial customers. Credit is extended based on evaluation of the customer's financial condition and collateral is not required. Accounts receivable are recorded at the invoiced amount and do not bear interest. See Note 12 for a discussion of the Company's significant customers.

The Company has outstanding 10% Senior Secured Notes with an aggregate principal amount of \$510.0 million which is due on June 1, 2017. The Company pays interest at the rate of 10% per annum semi-annually, in arrears, on June 1 and December 1 of each year. As of March 27, 2011, the principal amount of \$510.0 million is outstanding under these notes. In addition, the Company has \$32.6 million available under its existing revolving credit agreement. See Note 9 for a complete description of the Company's debt.

The Company intends to fund its cash requirements with cash on hand, cash flows from operating activities and borrowings under its existing revolving credit facility, and management believes these sources of liquidity should be sufficient to meet the Company's cash needs for at least the next 12 months. The Company's quarterly and annual operating results have fluctuated in the past and may vary in the future due to a variety of factors, many of which are external to its control. If the conditions in its industry deteriorate or its customers cancel or postpone projects or if the Company is unable to sufficiently increase its revenues or further reduce its expenses, the Company may experience, in the future, a significant long-term negative impact to its financial results and cash flows from operations. In such a situation, the Company could fall out of compliance with its financial and other covenants which, if not waived, could limit its liquidity and capital resources.

(g) Reclassifications

Certain amounts in the March 28, 2010 condensed consolidated statement of operations have been reclassified to conform to the March 27, 2011 presentation.

Note 2. Acquisitions

Herley Industries, Inc.

On March 25, 2011 (the Acquisition Date), pursuant to an Agreement and Plan of Merger dated as of February 7, 2011 (the Herley Merger Agreement), by and among the Company, Lanza Acquisition Co. (Herley Merger Sub) and Herley, Herley Merger Sub acquired approximately 13.2 million shares of Herley common stock representing approximately 94% of the total outstanding shares of Herley common stock in a tender offer to purchase all of the outstanding shares of Herley common stock (the Offer). On March 30, 2011, following purchases in a subsequent offering period, Herley Merger Sub was merged with and into Herley, with Herley continuing as a wholly-owned subsidiary of the Company (the Herley Merger). The shares of Herley common stock were purchased at a price of \$19.00 per share. Accordingly, the Company paid approximately \$245.5 million in cash consideration as of March 27, 2011 and as of April 15, 2011 had paid total aggregate cash consideration of \$270.6 million in respect of the shares of Herley common stock and certain in-the-money options, which were exercised upon the change in control. In addition, upon completion of the merger, all unexercised options to purchase Herley common stock were assumed by the Company and converted into options to purchase Kratos common stock, entitling the holders thereof to receive 1.3495 shares of Kratos common stock for each share of Herley common stock underlying the options. The Company assumed each Herley Option in accordance with the terms (as in effect as of the date of the Herley Merger Agreement) of the applicable Herley equity plan and the option agreement pursuant to which such Herley Option was granted. The options will be exercisable for an aggregate of approximately 0.8 million shares of the Company's common stock. All options were fully vested upon the change in control and the fair value of the options assumed was \$1.4 million. The total aggregate consideration for the purchase of Herley was \$272.1 million. The fair value of the non-controlling interest related to Herley as of March 25, 2011 was \$16.9 million, which represents the market trading price of \$19.00 per share multiplied by the approximately 0.9 million shares that were not tendered as of March 25, 2011. In addition, the Company assumed change in control obligations of \$4.0 million related to the transaction, the majority of which will be paid in 2011, and combined transaction expenses of \$11.1 million.

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On February 11, 2011, the Company completed the sale of approximately 4.9 million shares of its common stock at a purchase price of \$13.25 per share in an underwritten public offering, and on March 25, 2011, the Stage I Issuer issued the Stage I Notes (see Note 1). The proceeds of the underwritten public offering and sale and issuance of the Stage I Notes were used to fund the acquisition of Herley. The Company received gross proceeds from the equity offering of approximately \$64.8 million and after deducting underwriting and other offering expenses received approximately \$61.1 million in net proceeds. The Stage I Notes were offered at a premium of 107%, for an effective interest rate of 8.5% and the gross proceeds were approximately \$314.0 million, which includes approximately \$20.0 million of issuance premium and \$9.0 million of accrued interest. The Company obtained the consent of the holders of a majority of the 10% Senior Secured Notes due 2017 issued by the Company on May 19, 2010 in the aggregate principal amount of \$225.0 million (as subsequently exchanged on August 11, 2010, the Existing Kratos Notes) and entered into a supplemental indenture to the indenture governing the Existing Kratos Notes (as supplemented, the Existing Kratos Indenture) in which such holders agreed to permit the Company to issue the Stage I Notes in an aggregate principal amount not to exceed \$285.0 million in connection with the acquisition of Herley and for general corporate purposes irrespective of whether such notes may be issued in compliance with the minimum consolidated fixed charge coverage ratio test contained in the limitation of incurrence of additional indebtedness covenant in the Existing Kratos Indenture. A consent fee of \$1.1 million was paid to all holders of the Existing Kratos Notes on April 1, 2011.

Herley is a leading provider of microwave technologies for use in command and control systems, flight instrumentation, weapons sensors, radar, communication systems, electronic warfare and electronic attack systems. Herley has served the defense industry for approximately 45 years by designing and manufacturing microwave devices for use in high-technology defense electronics applications. It has established relationships, experience and expertise in the military electronics, electronic warfare and electronic attack industry. Herley's products represent key components in the national security efforts of the U.S., as they are employed in mission-critical electronic warfare, electronic attack, electronic warfare threat and radar simulation, command and control network, and cyber warfare/cybersecurity applications. Herley is part of the Company's Kratos Government Solutions (KGS) segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by Herley's significant expertise in numerous established electronic attack and electronic warfare platforms, tactical missile systems, and strategic deterrence systems which complement the Company's existing business in manned and unmanned aircraft, missile systems and certain other programs.

The Herley transaction has been accounted for using the acquisition method of accounting which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the merger date. The following table summarizes the estimated fair values of major assets acquired and liabilities assumed (in millions):

Cash	\$	21.8
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