CRITICAL Q1 2018 UPDATE

Kratos Defense & Security Solutions, Inc.

| NASDAQ: KTOS |

INVESTMENT RESEARCH REPORT

"Target Locked: Ready To Fire Management"

RECOMMENDATION: *Strong Sell*

Full Legal Disclaimer

This research presentation expresses our research opinions. You should assume that as of the publication date of any presentation, report or letter, Spruce Point Capital Management LLC (possibly along with or through our members, partners, affiliates, employees, and/or consultants) along with our subscribers and clients has a short position in all stocks (and are long/short combinations of puts and calls on the stock) covered herein, including without limitation Kratos Defense & Security Solutions, Inc. ("KTOS"), and therefore stand to realize significant gains in the event that the price of its stock declines. Following publication of any presentation, report or letter, we intend to continue transacting in the securities covered therein, and we may be long, short, or neutral at any time hereafter regardless of our initial recommendation. All expressions of opinion are subject to change without notice, and Spruce Point Capital Management does not undertake to update this report or any information contained herein. Spruce Point Capital Management, subscribers and/or consultants shall have no obligation to inform any investor or viewer of this report about their historical, current, and future trading activities.

This research presentation expresses our research opinions, which we have based upon interpretation of certain facts and observations, all of which are based upon publicly available information, and all of which are set out in this research presentation. Any investment involves substantial risks, including complete loss of capital. Any forecasts or estimates are for illustrative purpose only and should not be taken as limitations of the maximum possible loss or gain. Any information contained in this report may include forward looking statements, expectations, pro forma analyses, estimates, and projections. You should assume these types of statements, expectations, pro forma analyses, estimates, and projections may turn out to be incorrect for reasons beyond Spruce Point Capital Management LLC's control. This is not investment or accounting advice nor should it be construed as such. Use of Spruce Point Capital Management LLC's research is at your own risk. You should do your own research and due diligence, with assistance from professional financial, legal and tax experts, before making any investment decision with respect to securities covered herein. All figures assumed to be in US Dollars, unless specified otherwise.

To the best of our ability and belief, as of the date hereof, all information contained herein is accurate and reliable and does not omit to state material facts necessary to make the statements herein not misleading, and all information has been obtained from public sources we believe to be accurate and reliable, and who are not insiders or connected persons of the stock covered herein or who may otherwise owe any fiduciary duty or duty of confidentiality to the issuer, or to any other person or entity that was breached by the transmission of information to Spruce Point Capital Management LLC. However, Spruce Point Capital Management LLC recognizes that there may be non-public information in the possession of KTOS or other insiders of KTOS that has not been publicly disclosed by KTOS. Therefore, such information contained herein is presented "as is," without warranty of any kind – whether express or implied. Spruce Point Capital Management LLC makes no other representations, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use.

This report's estimated fundamental value only represents a best efforts estimate of the potential fundamental valuation of a specific security, and is not expressed as, or implied as, assessments of the quality of a security, a summary of past performance, or an actionable investment strategy for an investor. This is not an offer to sell or a solicitation of an offer to buy any security, nor shall any security be offered or sold to any person, in any jurisdiction in which such offer would be unlawful under the securities laws of such jurisdiction. Spruce Point Capital Management LLC is not registered as an investment advisor, broker/dealer, or accounting firm.

Spruce Point Capital Management

Spruce Point Reiterates Strong Sell On Kratos, Downgrades View On Reduced Free Cash Flow

Based on recent Q1'2018 results, Spruce Point is incrementally more negative on Kratos (Nasdaq: KTOS), and continues to call for its CEO and CFO to resign immediately given mounting evidence of potentially deceptive free cash flow guidance and cash reporting. We see fair value at $3.15 to $6.30 per share (45% to 75% downside)

1) Adjusted For A Change In Accounting Principle, Which Was 4x Bigger Than Disclosed Less Than Three Months Ago, Kratos Q1 Revenues Missed Expectations By 6%

2) Kratos Operating Income Performance Was Aided By Unexplained Decline In Depreciation (Notably In Its Promoted Unmanned System (Drone)) Segment, Despite Ramp In Capex Spending

3) Kratos Q2'2018 Revenue Guidance of $140 to $150m Also Fell Short of Expectations for $154 million

4) In A Potentially Deceptive Manner, Kratos Reduced Its Normalized Free Cash Flow Guidance For 2018 By 36% to 58%

5) New Anomalies In Kratos Financials Call Into Question The Accuracy of Its Cash Balances

6) Kratos Trades At An Irrational 163x Free Cash Flow Estimates Despite Revenue Disappointments, A New High In DSO, And Evidence That Suggests Management Is Using Deceptive Free Cash Flow Forecasts

7) Kratos Would Be Worthless If Given An Industry Free Cash Flow Multiple. Giving Them The Benefit of The Doubt, It Is Very Easy To Justify 45% to 75% Downside Risk

Kratos Q1 Result In A Large Revenue Miss Pro Forma For Revenue Accounting Change

Spruce Point Capital Management

Pay very close attention to Kratos results for Q1'2018 which benefited from the adoption of ASU 2014-09 relating to revenue recognition. In Kratos' 10-K Annual Report filed in Feb 2018, it said it did not expect the accounting change to be material, yet given footnote disclosure in the recently filed 10-Q, the impact was very material – 4x larger to revenues. Instead of a fractional miss to revenue expectations, Kratos missed expectations by approximately 6%. Kratos also offered Q2'18 revenue guidance of $140 to $150m vs. $154m – suggesting further disappointment

Kratos on New Revenue Accounting Change (2017 10-K, F-17, Feb 28, 2018): *"Based upon an assessment of material active contracts as of December 31, 2017, the Company has determined that the impact on the results of operations and cash flows upon adoption are not material. The Company also does not expect the impact in the periods after adoption to be material…..The Company expects the cumulative effect of adopting ASU 2014-09 to **result in an increase in revenue of less than $2 million and an increase in operating income of less than $2 million**. These changes principally reflect the impact of converting contracts applying the units-of-delivery under the old revenue guidance to the cost-to-cost method of accounting. The cumulative effect of adoption of the new revenue guidance will be recognized as an increase in contract assets, a reduction in inventoried costs, an increase in contract liabilities and a net decrease in accumulated deficit as of January 1, 2018."*

$ in mm	Q1'2018 As Reported	Actual Change In Accounting Principle ASU 2014-09 (ASC 606)	Pro Forma Q1'2018	Adjusted Expectation (1)	Surprise / (Disappoint)
Revenues	$143.0	($7.7)	$135.3	$143.3	(6%)
Gross Profit % gross margin	$40.8 28.5%	($3.5)	$37.3 27.5%	28.0%	(0.5%)
Operating Income (EBIT)	$7.0	($3.5)	$3.5	$1.0	350% (2)

1) We adjust the Street's expectation for the $2m disclosed impact of the adoption when the 10-K was filed 2/28/18 (which assumes analysts correctly modeled for the change), except for gross margin which Kratos did not provide an estimate related to the impact
2) On the next slide, we will illustrate how EBIT appears overstated by an unexplained decline in depreciation and amortization. Also, R&D fell $0.8m YoY

Source: Kratos 10-Q, p. 8 and Wall St. Consensus Estimates

Spruce Point Capital Management

Operating Margin Improvement By Questionable Depreciation Decline

Kratos is touting its significant improvement in operating income, and specifically its improved performance in its hyped Unmanned Systems (US or drone) business. However, digging beneath the surface we find an unexplained decline in depreciation and amortization year-over-year. (1) The biggest percentage decline of 50% was in Unmanned Systems segment. This result makes little sense given that Capex is now running higher than depreciation, and the majority of the Capex is focused on growing the Unmanned System business. The result is unlikely to be explained by the divestiture of PSS which carried very little depreciation and amortization expense.

$ in mm	2015	2016	2017	3m 2017	3m 2018	YoY Change	LTM 3/31/18
Kratos Gov't (KGS)	$18.2	$14.9	$14.3	$3.7	$3.6	(2.7%)	$14.2
PSS (divested)	$0.6	$0.5	$0.4	--	--	--	--
Unmanned Systems (US)	$6.7	$7.4	$7.8	$1.8	$0.9	(50.0%)	$6.9
Total Depreciation and Amort.	$25.5	$22.8	$22.5	$5.5	$4.5	(18.2%)	$21.5
Less: Amortization Expense	$13.0	$10.5	$10.4	$2.6	$1.7	(34.6%)	$9.5
Total Depreciation Expense	**$12.5**	**$12.3**	**$12.1**	**$2.9**	**$2.8**	(3.4%)	**$12.0**
				Why is D&A expense falling with capex > D&A			
Capex by Segment							
Unmanned Systems (US)	N/A	N/A	$13.2	N/A	$4.5	N/A	N/A
KGS/Other	N/A	N/A	$13.3	N/A	$2.2	N/A	N/A
Total Capex	**$11.3**	**$9.2**	**$26.5**	**$5.1**	**$6.7**	N/A	**$28.1**
Total Capex / Depreciation	0.90x	0.75x	2.19x	1.76x	2.39x	N/A	2.34x
US Capex / Total Capex	N/A	N/A	49.8%	N/A	67.2%	N/A	N/A
US Capex / Depreciation	N/A	N/A	1.69x	N/A	5.00x	N/A	N/A

Source: Kratos Annual Report and 10-Q

1) Kratos fails to disclose on its conference call or 10-Q why depreciation and amortization declined YoY

Spruce Point Capital Management

Downgrading Kratos On Reduction in Continuing Free Cash Flow Guidance

Pay very close attention to Kratos new guidance disclosure. Kratos added one sentence that discloses that cash flow forecasts include $7m of working capital proceeds from the sale of its Public Safety and Security business. This is a non-recurring source of cash flow and should not be factored into the forward valuation of its share price. On a continuing basis, Kratos continuing free cash flow guidance is a meager $5 to $12m

New disclosure last week in Kratos Q1'18 Press Release: *"Kratos is also affirming its full year 2018 financial guidance of positive cash flow generation from operations of $35 to $45 million, including the expected collection of net working capital proceeds of the PSS business retained by Kratos."*

The disclosure was absent from Kratos prior Q4'17 press release when 2018 guidance was offered

Kratos Adjusted 2018E Free Cash Flow From Continuing Operations

$ in mm	Last Quarter Feb 28, 2018	This Quarter May 10, 2018
Cash from Operations	$35 to $45	$35 to $45
Less: Capex	($23) to ($26)	($23) to ($26)
Kratos Promoted Free Cash Flow	**$12 to $19**	**$12 to $19**
Less: Cash Working Capital From Sale of the PSS Business	--	($7)
Continuing Free Cash Flow From Ops. ***Reduction in Guidance***	**--**	**$5 to $12** **-36% to -58%**

Source: Kratos Earnings Press Releases, Spruce Point Adjustments

CFO Potentially Misleading Kratos Investors And Analysts About The PSS Sale Impact?

The CFO of Kratos explicitly stated last quarter that guidance excluded results of PSS. Furthermore, when asked directly by an analyst and given the opportunity to provide clarity about the working capital assumptions behind the forecast, she still failed to mention that the cash flow guidance included $7m from the PSS divestiture. We believe this is a material omission.

CFO Lund on Q4'17 Call (Feb 2018): *"Accordingly today we are providing initial guidance for the first quarter and full-year 2018 reflecting PSS as a discontinued operation. Kratos' PSS business was forecast to achieve full-year 2018 revenues and adjusted EBITDA before corporate overhead of approximately $140 to $159 and $9 million to $12 million respectively. PSS generated full-year 2017 revenues and adjusted EBITDA excluding the allocated corporate overhead cost of $149 million and $6.9 million respectively. As the result of the pending sale Kratos' Q1 2018 and full-year financial guidance provided today excludes PSS as those all other financial information covered."*

Analyst Herbert Q4'17 Call (Feb 2018): *"Eric and Deanna, I really appreciate all the detail. I just wonder Deanna really I mean the guidance calls very significant improvement in cash from operations and free cash flow for the full-year. I know you went through some of this, but how will you characterize maybe the risk to that 40 million in cash from operations at the midpoint for 2018? And maybe just a little more detail on specifically, what you assume working capital and some of the other key pieces to provide?"*

CFO Lund Response To Herbert Fails To Address PSS: *"So some of the rest are there is some flight milestones that need to occur on some of the Unmanned programs which just doing part arrange time to get on to certain ranges that Ken delayed that milestones so that's one of the risks some of the other ones we don't really see as risky because they are just really hitting certain performance metrics that are in our control which obviously that the flights on range time those are not totally in our control. From a working capital requirement prospective we do expect some use in working capital as we continue to grow the business but that some of that is offset in the cash flow guidance that we given with some of that milestone that we do expect and to collect. Some of these milestones are milestones we had expected in the second half of '17 and they have moved into '18 to some of them we do expect to see some in the first half of '18."*

Evidence To Suggest Deficient Cash Controls, Potential Misrepresentation of Cash Balances

Kratos reported negative proceeds from the issuance of stock in its cash flow statement. <u>Kratos does not have an active share repurchase program, so it is unlikely this is an error in labeling</u>. Furthermore, in Note 6 to the equity accounts, it has a zero balance for Q1'18 stock issuance. <u>We conclude that at best deficient controls in Kratos cash management exist, and at worse cash is being misrepresented or inaccurately reported</u>.

Kratos Cash Flow Statement

	Three Months Ended	
	April 1, 2018	March 26, 2017
Financing activities:		
Extinguishment of long-term debt	—	(64.0)
Debt issuance costs	(0.1)	—
Proceeds from the issuance of common stock	(1.1)	81.9
Repayment of debt	(0.2)	(0.3)
Proceeds from exercise of restricted stock units, employee stock options, and employee stock purchase plan	1.8	0.8
Net cash provided by financing activities from continuing operations	0.4	18.4

Note 6. Stockholders' Equity

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

	For the Three Months Ended	
	April 1, 2018	March 26, 2017
Stockholders' equity at beginning of period	$ 511.5	$ 276.4
Impact from adoption of ASC 606 (Note 1)	(0.2)	—
Comprehensive loss:		
Net loss	(2.2)	(10.0)
Change in cumulative translation adjustment	(0.1)	0.1
Total comprehensive loss	(2.3)	(9.9)
Stock-based compensation	1.7	2.1
Issuance of common stock for cash	—	81.9
Issuance of common stock for employee stock purchase plan	1.8	1.4
Restricted stock units exchanged for taxes	—	(0.5)
Stockholders' equity at end of period	$ 512.5	$ 351.4

Source: Kratos Q1`18 10-Q

Spruce Point Capital Management

More Cash Anomalies: Negative Cash…

Negative cash balance at Public Safety and Security (PSS)?
Spruce Point has never seen a business with a mathematically impossible financial account.
We believe that PSS has likely over-drafted its accounts and has greater liabilities than liquid cash resources

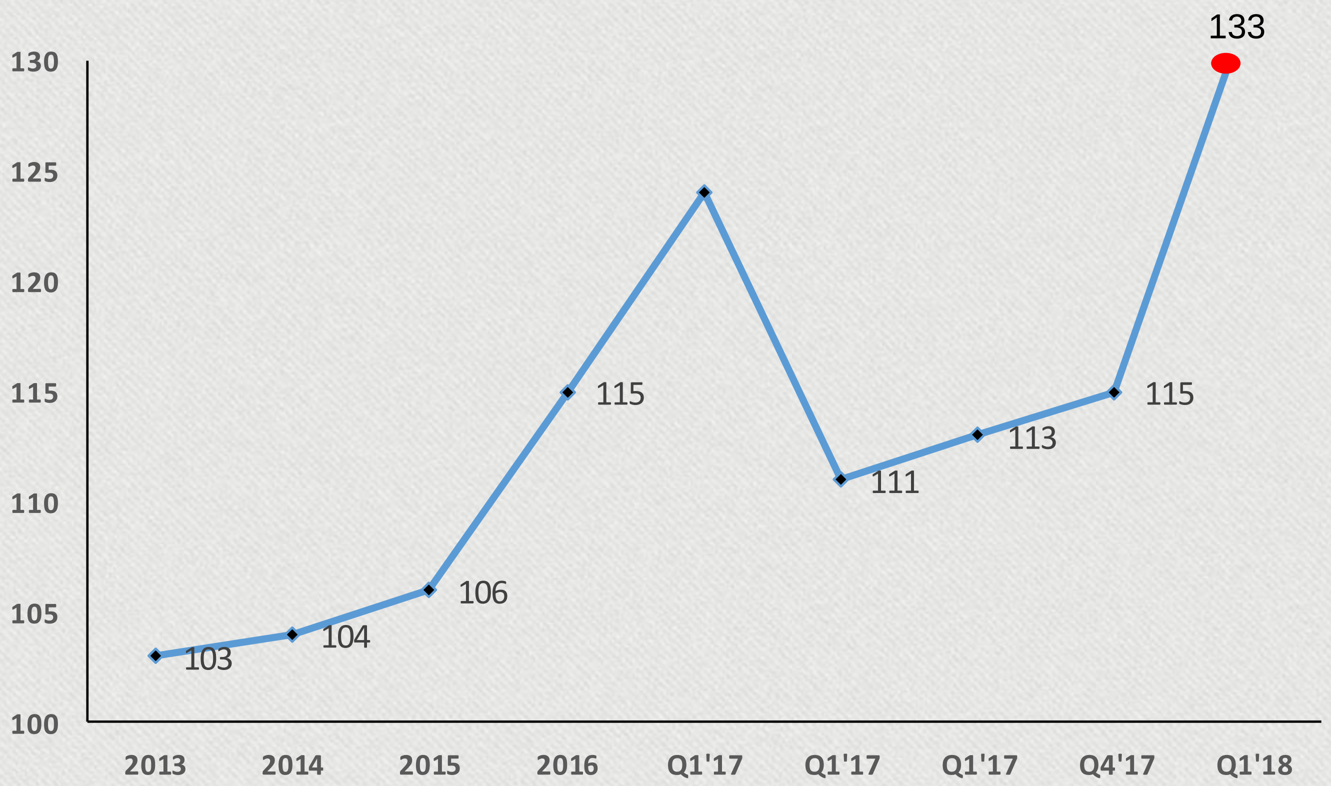
Assets and Liabilities of the Public Safety and Security (Discontinued) Business

	April 1, 2018	December 31, 2017
Cash and cash equivalents	$ (0.7)	$ (0.9)
Accounts receivable, net and unbilled receivables, net	48.6	56.0
Inventoried costs	2.6	1.5
Other current assets	1.6	2.0
Current assets of discontinued operations	$ 52.1	$ 58.6
Property, plant and equipment, net	$ 3.0	$ 3.0
Goodwill	35.6	35.6
Other assets	0.2	0.2
Non-current assets of discontinued operations	$ 38.8	$ 38.8
Accounts payable	$ 9.4	$ 14.2
Accrued expenses	3.4	4.7
Accrued compensation	4.9	4.6
Billings in excess of cost and earnings on uncompleted contracts	4.5	4.3
Other current liabilities	1.0	1.4
Current liabilities of discontinued operations	$ 23.2	$ 29.2
Non-current liabilities of discontinued operations	$ 5.9	$ 6.0

Source: Note 3. Discontinued Operations, Kratos Q1`18 10-Q

DSO's To Fresh Highs

Kratos Days Sales Outstanding (DSO) spiked to a new high this quarter. We believe this is more evidence that cash flow remains strained and will disappoint investors.

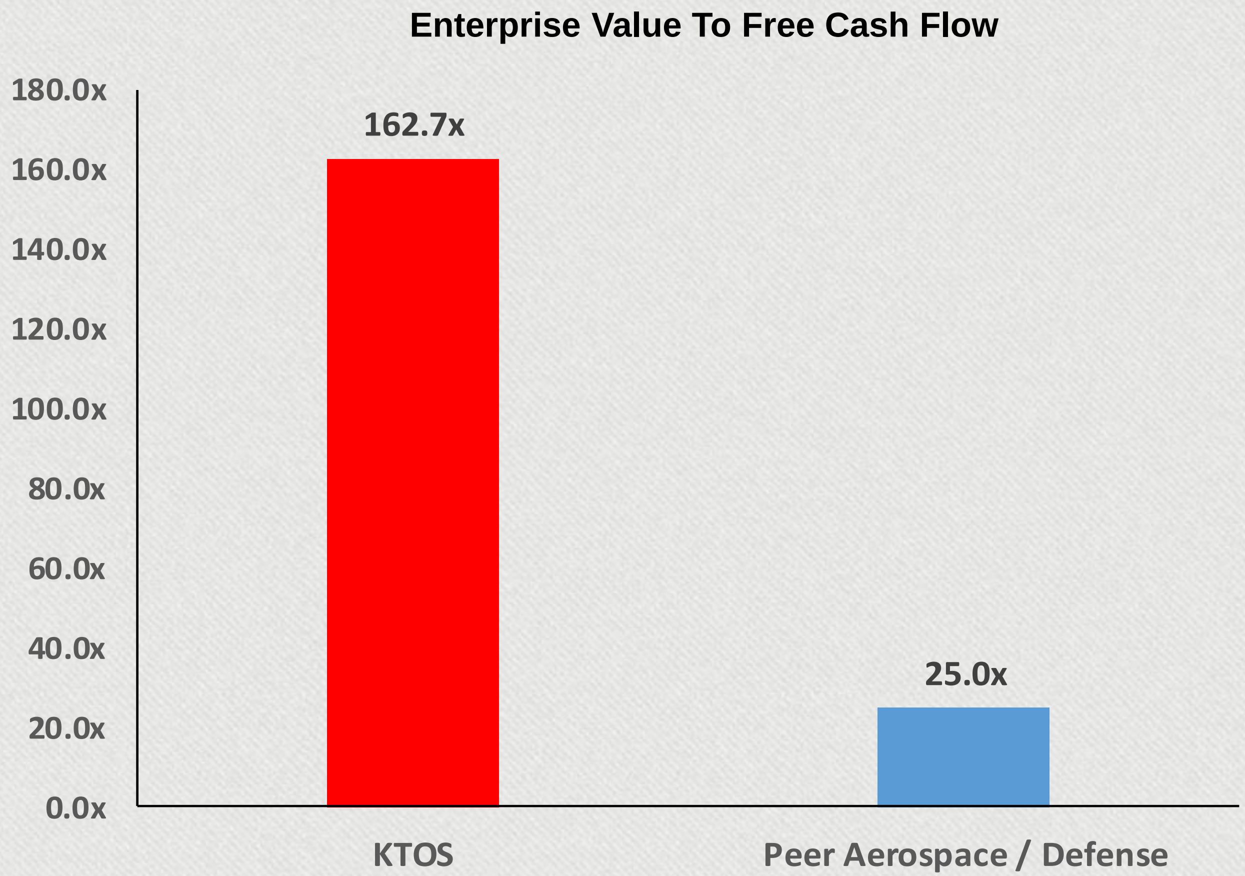


Source: Kratos conference calls and SEC filings

Spruce Point Capital Management

Kratos Valued Irrationally On Meager Continuing Free Cash Flow

Kratos $1.2 billion enterprise value relative to its $5 to $12 million of 2018E free cash flow this year makes little sense to us, especially in light of the fact that management appears to not be forthright about the guidance, and to have cash management control issues. Best-of-breed aerospace and defense peers with more consistent free cash flow that pay dividends and repurchases shares trade at an average of 25x and not 163x



Spruce Point
Capital Management

Easy To Estimate 45% – 75% Downside Risk

Only wishful thinking can justify Kratos' inflated valuation.

$ in millions, except per share amounts

Valuation	Low Price	High Price	Note
Price / Book Multiple **Stated Book Value** **Price Target** **% Downside**	1.0x $4.94 $4.94/sh *-58%*	1.5x $4.94 $7.27/sh *-37%*	Kratos' assets have historically traded between 0.7x to 1.4x. We could argue that Kratos should trade below book value because it still has not demonstrated positive free cash flow. Even giving Kratos the benefit of the doubt it can stop the cash bleed, and generate cash this year (despite evidence of potential cash and free cash flow misrepresentation), we apply a 1.0x – 1.5x range and estimate 37% to 58% downside risk
Multiple of Free Cash Flow **KTOS Continuing Free Cash Flow** **Enterprise Value** **Plus: Cash** **Less: Debt** **Dil. Shares** **Price Target** **% Downside**	25.0x $5.0 $125.0 $127.8 ($295.3) 105.7 ($0.40)/sh *-100%*	50.0x $12.0 $600.0 $127.8 ($295.3) 105.7 $4.09/sh *-64%*	We downgrade our free cash flow target to remove the non-continuing portion from the sale of the PSS business. If Kratos were valued at an industry peer multiple (commensurate with peers that generate consistent free cash flow, pay dividends and repurchase shares), Kratos stock would be worthless. Even giving them the benefit of a 2x industry multiple we estimate 65% downside

Downside based on $11.50/share.
Note: Analysis does not factor in federal tax loss carryforwards of $380.0 million (per Q1'18 conference call). The federal tax loss carryforwards will begin to expire in 2020 and state tax loss carryforwards will begin to expire in 2018 in certain states