Idea Flow For The Buy Side

Knowing The Next Step To

Kratos (KTOS) Goes to $28 Before its Bought Out.

The Wolf is at the Door.

08.31.2023

Kratos (KTOS) Goes to $28 Before its Bought Out.

The Wolf is at the Door.

Preface.

This is a re-initiation piece. The first was done right before inflation created the Bear Market that crushed small-cap growth. Turning KTOS into the "boy who cried wolf " story because the Defense of Defense never appropriated the money for their next generation combat drones. But being "early" is over. That sort of wrong ended a quarter ago with the thesis still completely intact. KTOS gets to $28 on its own before being bought out by Northrop Grumman for $30+.

Christian Galatti…Phase IV Research…415.484.5860…christian@phase4research.com

Idea Flow For The Buy Side

Knowing The Next Step To

Kratos (KTOS) Goes to $28 Before its Bought Out.

The Wolf is at the Door.

Company Description.

$2B Space Defense & Drone Warfare company that trades almost 1m shares a day. Next generation Products and Services create accelerating YOY multi-segment top-line growth. Gross margins go up with the advent of cloud-based space services. Gross margins go up with commercialized drone volume now based on variable priced contracts. Going up now for all the right reasons because the wolf is at the door with a proof-of-concept buyout awaiting.

KTOS	**@ $16**
Target	**$28+**

- ∞ Website.
- ∞ Company Presentation.
- ∞ SEC Filings.

Modeling Notes.

- ∞ Hi end top-line forecast models' continuous bottom-line beats starting in Q3 (.09c/$252M consensus v estimated .12c/$259M.)
- ∞ Continuing Resolution Defense budget appropriations constrain 2024 book to bill to 1.1x1.
- ∞ Cloud based Space continually raises Services margins.
- ∞ Fixed to variable contract pricing continually improves Product margins.
- ∞ Commercial drone appropriations ramp in 2025 and enter global adoption in 2026 to counter Chinese swarms.
- ∞ Space Defense and Satellite Spatial Awareness ramps in 2025 and achieves global adoption in 2026.
- ∞ Commercial drone and hypersonic engine sales add to product revenue in 2024, become meaningful in 2025, and enter their own growth phase in 2026 (which ends up being the reason Northrop Grumman buys Kratos.)

Valuation Methodology.

- ∞ *Fair Value*: 20 x 2026 Non GAAP EPS = 20 x $1.42 = **$28**

- ∞ *Strategic*: 2x2026 Sales/2026 Shares x 1.2 Buyers Premium (From ORB/ATK Merger) = 2x $1.74B/137M x1.2 = **$30+**

08.31.2023

Christian Galatti…Phase IV Research…415.484.5860…christian@phase4research.com

Kratos (KTOS)	2021	2022	Q1.2023	Q2.2023	Q3.2023	Q4.2023	2023	Q1.2024	Q2.2024	Q3.2024	Q4.2024	2024	2025	2026
Government Service	214.50	320.00	90.20	102.20	110.00	105.00	407.40	99.22	112.42	126.50	120.75	458.89	550.67	688.34
Unmanned Service	4.90	5.20	1.40	1.50	1.50	1.50	5.90	1.50	1.50	2.00	2.00	7.00	8.75	10.50
Total Service Revenue	219.40	325.20	91.60	103.70	111.50	106.50	413.30	100.72	113.92	128.50	122.75	465.89	559.42	698.84
Government Product	365.10	356.60	93.60	102.60	95.00	98.00	389.20	102.96	112.86	109.25	112.70	437.77	503.44	604.12
Unmanned Product	227.00	216.50	46.60	50.60	52.00	52.00	201.20	53.59	58.19	59.80	59.80	231.38	289.23	433.84
Total Product Revenue	592.10	573.10	140.20	153.20	147.00	150.00	590.40	156.55	171.05	169.05	172.50	669.15	792.66	1,037.96
Total Revenue	**811.50**	**898.30**	**231.80**	**256.90**	**258.50**	**256.50**	**1,003.70**	**257.27**	**284.97**	**297.55**	**295.25**	**1,135.04**	**1,352.08**	**1,736.80**
Service Costs	156.20	239.00	68.20	80.00	82.51	78.28	308.99	73.53	82.59	92.52	87.77	336.40	397.19	489.18
Products costs	430.20	433.30	104.20	113.00	108.78	110.25	436.23	114.28	124.87	122.56	125.06	486.77	570.72	726.57
Total Costs	**586.40**	**672.30**	**172.40**	**193.00**	**191.29**	**188.53**	**745.22**	**187.81**	**207.46**	**215.08**	**212.83**	**823.18**	**967.90**	**1,215.76**
Gross Profit	225.10	226.00	59.40	63.90	67.21	67.97	258.48	69.46	77.51	82.47	82.42	311.86	384.18	521.04
Gross Margin	28%	25%	26%	25%	26%	27%	26%	27%	27%	28%	28%	27%	28%	30%
SGA	150.50	169.60	44.80	44.40	46.53	46.17	181.90	46.31	51.29	53.56	53.15	204.31	270.42	347.36
Merger	1.80	7.50	0.90				0.90							
R/D	35.20	38.60	10.20	9.90	10.34	10.26	40.70	10.29	11.40	11.90	11.81	45.40	54.08	69.47
Depreciation	5.00	5.50	1.40	1.30	1.50	1.50	5.70	2.00	2.00	2.00	2.00	8.00	10.00	12.00
Amortization	4.70	7.40	1.60	1.60	1.50	1.50	6.20	2.00	2.00	2.00	2.00	8.00	10.00	12.00
Operating Income	27.90	(2.60)	0.50	6.70	7.34	8.54	23.08	8.86	10.82	13.01	13.47	46.16	72.63	132.25
Interest Expense	(23.40)	(17.70)	(5.30)	(5.10)	(5.10)	(5.10)	(20.60)	(5.00)	(5.00)	(5.00)	(5.00)	(20.00)	(20.00)	(20.00)
Other	(0.10)	(12.40)	(0.30)	0.20			(0.10)							
Tax Provision	(3.90)	(1.40)	(0.70)	(2.40)	(1.00)	(1.00)	(5.10)	(1.00)	(1.00)	(1.00)	(1.00)	(4.00)	(4.00)	(4.00)
Discontinued Operations	(2.10)	0.90		0.20			0.20							
Net	(1.60)	(33.20)	(5.80)	(0.40)	1.24	2.44	(2.52)	2.86	4.82	7.01	7.47	22.16	48.63	108.25
Non Controlling Interest	(0.40)	(3.70)	(1.20)	(2.30)	(1.00)	(1.00)	(5.50)	(2.00)	(2.00)	(2.00)	(2.00)	(8.00)	(10.00)	(12.00)
Net Income	(2.00)	(36.90)	(7.00)	(2.70)	0.24	1.44	(8.02)	0.86	2.82	5.01	5.47	14.16	38.63	96.25
Non GAAP Add														
D&A	9.70	12.90	3.00	2.90	3.00	3.00	11.90	4.00	4.00	4.00	4.00	16.00	20.00	24.00
Interest Expense	23.40	17.70	5.30	5.10	5.10	5.10	20.60	5.00	5.00	5.00	5.00	20.00	20.00	20.00
Stock Expense	25.80	26.30	6.60	6.00	7.00	8.00	27.60	8.00	8.50	9.00	9.50	35.00	40.00	50.00
Other	(11.40)	19.90	0.30	0.10	0.50	1.00	1.90	1.00	1.00	1.00	1.00	4.00	4.00	4.00
Total Non GAAP Add	**47.50**	**76.80**	**15.20**	**14.10**	**15.60**	**17.10**	**62.00**	**18.00**	**18.50**	**19.00**	**19.50**	**75.00**	**84.00**	**98.00**
Non GAAP Net Income	**45.50**	**39.90**	**8.20**	**11.40**	**15.84**	**18.54**	**53.98**	**18.86**	**21.32**	**24.01**	**24.97**	**89.16**	**122.63**	**194.25**
Non GAAP EPS	**0.36**	**0.31**	**0.06**	**0.09**	**0.12**	**0.14**	**0.42**	**0.14**	**0.16**	**0.18**	**0.19**	**0.68**	**0.92**	**1.42**
Diluted Share Count	128.00	126.70	128.10	129.10	129.50	130.00	129.18	130.50	131.00	131.50	132.00	131.25	134.00	137.00
Margins														
Service	29%	27%	26%	23%	26%	27%	25%	27%	28%	28%	29%	28%	29%	30%
Product	27%	24%	26%	26%	26%	27%	26%	27%	27%	28%	28%	27%	28%	30%
SGA	19%	19%	19%	17%	18%	18%	18%	18%	18%	18%	18%	18%	20%	20%
R/D	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%

Kratos (KTOS) Goes to $28 Before its Bought Out.

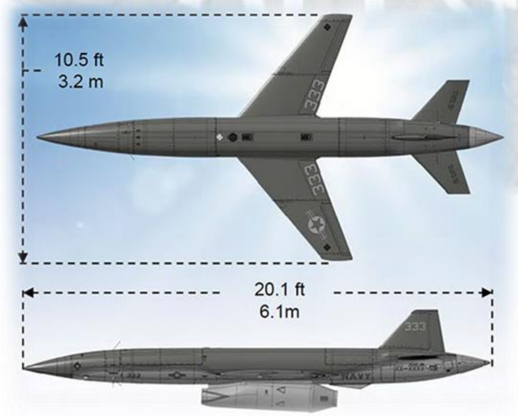
The Wolf is at the Door.

Story.

Kratos really is "the boy that cried wolf" story. War drones that were ready for commercialization years ago have never been appropriated by the Department of Defense. It's taken so long to modernize our Air Power that Kratos now has three catalysts instead of one as the commercialization of Space and Hypersonic Scramjet Engines enter the global adoption curve too. Where the thousands of new satellites going up will need Kratos' Spatial Awareness and ground-based cloud services to convert their data into dollars. The commercialization of Space will overlap with long overdue war drone orders to make Kratos' revenue accelerate through 2025/2026 to become the consistent growth stock that it has never been. KTOS will get to $28 on its own before it's bought out.

Catalyst #1: Unmanned Systems Accelerate Into Global Adoption (2025-2026.)

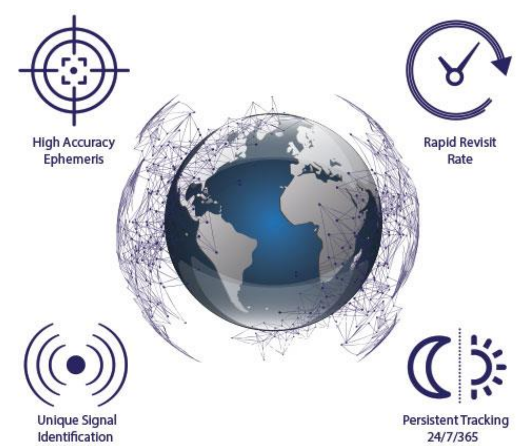
The Mako, a 20 foot fully armed fighter jet drone (see various images), has been commercially available since 2018. The mothership drone, the Valkyrie, is taking orders, *and has the facilities to ramp production immediately*. The swarming Gremlins were introduced four years ago, yet nothing has been done to upgrade our Air Power. Unmanned Systems revenue has waivered above $200M for years because we literally have had *no* Defense budget. The abuse of Continuing Resolutions stops in 2024 as their use becomes penalized. Meaning that Kratos war drones will enter the global adoption curve with five years of pent-up demand and a newly pugilistic China that's now a true Air Power threat. Unmanned Product revenue is expected to jump by 25% and 50% respectively to hit $430M+ revenue by 2026 with increasing margins as commercial volume is aided by variable priced contracts to achieve higher profitability.



Catalyst #2: Space Systems Accelerate Into Global Adoption (2025-2026.)

Commercial Space becomes a macro catalyst in 2025, pushing Kratos' Space System revenue at the same time the war drones are ramping. Creating such an overlap that 2025 signals Kratos' return to growth and with-it higher multiples tied to the top line (to achieve the 20x needed to attain $28+.)

Today every satellite launched needs Spatial Awareness to avoid the space junk. Tomorrow, they will need it to avoid the silent kill machines that will attack mission critical telecom constellations (see cover.) Space Systems are RF locators attached to cloud-based computing push Service margins higher and higher every quarter Space hits.



Christian Galatti…Phase IV Research…415.484.5860…christian@phase4research.com

Kratos (KTOS) Goes to $28 Before its Bought Out.

The Wolf is at the Door.

Story (continued.)

Catalyst #3: Hypersonic Engines and Drone Turbines Become the Reason NOC Acquires KTOS.
The Street doesn't understand the importance of Kratos' emergence as a global leader in drone turbines and hypersonic scramjet engines. A segment that becomes meaningful in 2025 adds momentum in 2026 to become the reason Northrop Grumman buys out KTOS for $4B. Kratos is looking to become the Rolls Royce of drone turbines at the same time their hypersonic scramjet engines attain proof of concept. NOC will buy KTOS to immediately add synergies to their own Space Systems platform while capturing an entire tactical drone division. Further building out their portfolio after they acquired rocket and missile maker Orbital/ATK in 2018.

Conclusion.

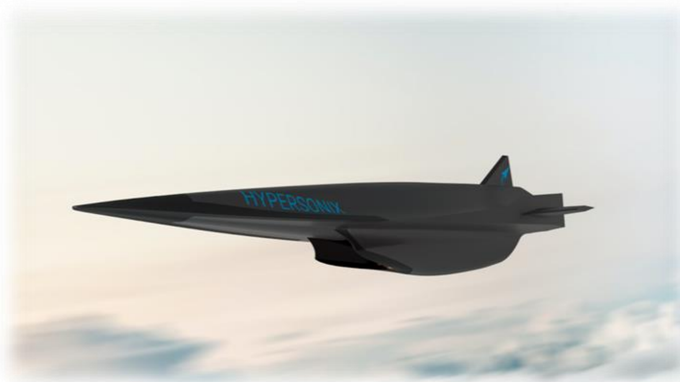
"The acquisition of Orbital ATK is an exciting strategic step as we continue to invest for profitable growth," Wesley G. Bush, Northrop's chairman and chief executive, said in a statement.

Under the terms of the deal announced on Monday, Northrop would pay $134.50 for each Orbital ATK share, a 22 percent premium to the closing price on Friday. Including the assumption of debt, the proposed transaction is valued at about $9.2 billion.

When Northrop bought ORB/ATK they did it for their rocket portfolio, they did it for their engine technology, and they bought it for growth. I was there when NOC bought ORB/ATK because I used to cover them all.

When Northrop buys KTOS they will do it for their drone portfolio, they will do it for their engine technology, and they will buy Kratos for growth. It's the exact same acquisition formula for the exact same price…2xSales with a 22 percent premium. Which puts KTOS at $4B.

Being "early" is over. That sort of wrong ended a quarter ago with the thesis still completely intact. KTOS gets to $28 on its own before being bought out by Northrop Grumman for $30+.



Idea Flow For The Buy Side

Knowing The Next Step To

Kratos (KTOS) Goes to $28 Before its Bought Out.

The Wolf is at the Door.

- Phase IV methodology is thematic – contrarian, producing top-down targets that are then vetted through a bottoms-up fundamental process. Phase IV analyzes Street consensus to find an edge, uses technical analysis to determine timing, then looks for an emerging catalyst that will drive the targeted name into adoption to produce exponential returns over a two-year period. A methodology that exploits maturation into the hype-adoption curve.
- Publications are weekly. Made in graphic arts, and sometimes the publications are meant to be art.
- Idea generation is made for financially trained professionals only. *Idea Flow for the Buy Side & Politics for the Buy Side.*
- Phase IV Research is institutionally compliant to over $1T in AUM. All research is taken from open public sources. Equity targets with exponential potential are found without the use of expert networks, internal surveys, or private company triangulation.
- I bought KTOS at $16 when I was early the last time.

Bio.
Born and raised in San Francisco. Went to UCLA. Graduated with honors in Political Theory. Started institutionally with Bear Stearns. Became the Director of Research for *The Shemano Group* which went under in the Great Recession. Created Phase IV at the beginning of 2010 to market a methodology of finding exponential returns to the Buy Side. Became a SMID Cap specialist with macro insights developed from inference and anomaly. First ideas in print were LVS @ $2 and BID @ $8. I've been finding the same pattern ever since.

Still in San Francisco.

Contact:
Christian Galatti
Idea Generator
Phase IV Research
415.946.1270 (Landline)
415.484.5860 (Google Voice/Mobile)
Site: www.phase4research.com (in development until late September.)
Email: christian@phase4research.com

08.31.2023