

VENTURE MANAGEMENT



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Kratos Defense & Security Solutions, Inc. (NasdaqGS: KTOS) announced that it has entered into a definitive agreement to merge with Digital Fusion, Inc. (DFI)

Huntsville, Alabama-based Digital Fusion, Inc. specializes in providing technical expertise in Aerosciences & Engineering Analysis; Sensor and Space Systems; Optics; System Engineering & Integration; Modeling & Simulation; and Advanced Design, Development & Prototyping for both government and commercial customers. DFI is a leading provider of modeling and simulation, information technology, research and engineering, acquisition and business support services, primarily to the United States government. DFI provides Kratos with new customers and an expanded contract vehicle portfolio, as well as broadening the range of service offerings to the existing Kratos customer base. Principal customers of DFI include the Army Aviation and Missile Research, Development and Engineering Center (AMRDEC), Army Space and Missile Defense Command/Army Forces Strategic Command (ARSTRAT), NASA Marshall Space Flight Center, and certain classified customers.

In its announcement of the transaction, Kratos said that:

"The combined company will provide the Department of Defense and other federal, state, and local government customers with an expanded portfolio of capabilities and qualifications for national defense, homeland security, and public safety and security, and further enhance Kratos' ability to capture a larger share of its target markets as a prime contractor."

"The addition of DFI's highly educated, uniquely qualified, and cleared employee base significantly enhances Kratos' qualifications to bid on an increasingly broad and diverse range of opportunities. Once the merger is completed and the transaction is closed, Kratos will have approximately 2,250 employees. Approximately 80% of Kratos' government employees hold national security clearances. DFI employs approximately 300 people."

"The merger with DFI is consistent with Kratos' stated strategy to combine organic growth with strategic transactions which enhance the company's presence in key BRAC recipient

locations, have outstanding management teams, and are immediately accretive to Kratos EBITDA valuation metrics."

Richard Selvaggio, Senior Vice President of Kratos' Weapons Systems division, said, "We are extremely excited to welcome DFI to the Kratos family in Huntsville. DFI's capabilities fully complement and enhance Kratos' current expertise in Systems Engineering; Lifecycle Weapon Support; Test & Evaluation; Modeling & Simulation; and High-Performance Computing. This combined force will further enable Kratos to establish a lead role in providing mission critical solutions through technical strength."

Digital Fusion CEO Gary Ryan stated: "I am very impressed with the Kratos management and culture. They are a rapidly growing company in the defense sector with significant high technology work which provides key synergies with the employees of Digital Fusion. With the significant defense presence in Huntsville, AL, Kratos provides the larger company umbrella of past experience needed for us to be able to compete for much larger contract awards. Furthermore, this transaction provides a much greater opportunity for liquidity for the Digital Fusion stockholders."

Kratos president and CEO Eric DeMarco stated: "We are focused on building a company, through both organic and acquired growth, that is a leading provider to the Department of Defense, and other federal, state, and local government agencies, as well as commercial customers. This merger with DFI, once complete, will provide Kratos with expanded customer relationships and additional contract vehicles, and will position Kratos to pursue larger prime contracts in areas that Kratos could not have previously pursued. Additionally, this transaction will result in Kratos having its largest employee presence in Huntsville, AL, which is a key BRAC recipient location, with Kratos' other major points of presence being in other BRAC locations, including the greater Washington D.C. area, San Diego, Hawaii, White Sands and Pt. Mugu."

DeMarco continued: "I am particularly excited about the contract work that DFI is doing in the areas of unmanned aerial vehicles, intelligence, surveillance and reconnaissance, sensor technologies, weapon systems, and modeling & simulation. DFI's core strengths in command and control systems, and air & missile defense are also extremely desirable and a solid match with Kratos."

DeMarco concluded: "We have been in discussions with DFI for over one year now, getting to know each others' cultures and capabilities, and exploring the possibility of a strategic relationship. The Kratos and DFI boards of directors believe that the combination of these two companies makes strategic sense to both DFI and Kratos shareholders, and all of the companies' stakeholders. Both companies agreed to a transaction structure and valuation that takes into consideration recent financial market dynamics, and we expect this transaction to be accretive to Kratos valuation metrics immediately upon closing."

Imperial Capital acted as exclusive financial advisor to Kratos and Morrison & Foerster LLP served as legal counsel. For DFI, ISI Partners, LLC was financial advisor and Lanier, Ford Shaver and Payne P.C. served as legal advisor.

Terms

On Nov. 24, 2008, Kratos Defense & Security Solutions, Inc. (NasdaqGS: KTOS) announced it had entered into a definitive agreement to merge with Digital Fusion, Inc. (DFI) in a stock-for-stock transaction.

Under the terms of the agreement, DFI will merge with a wholly-owned subsidiary of Kratos

and all of DFI's outstanding common shares will be converted into Kratos common shares. As a result of the transaction, Kratos will issue approximately 25.4 million shares of its common stock.

Under the agreement, which has been unanimously approved by both Boards of Directors, DFI stock will be converted into Kratos stock at a fixed exchange ratio of 1.7933 shares of Kratos common stock for each outstanding share of DFI stock. Upon closing, DFI shareholders will own approximately 20 percent, and current Kratos shareholders approximately 80 percent, of the combined company. Certain DFI shareholders and members of management have executed agreements obligating them to vote in favor of the merger and providing limitations on the selling of shares received in the merger for periods of time up to 270 days.

The transaction is subject to customary closing conditions, including approval of the transaction by DFI and Kratos shareholders, and is expected to close late this year or in the first quarter of 2009.

DFI employs approximately 300 people. The company had 2007 revenues of \$47.5 million, up from \$34.4 million in 2006. Operating cash flow in 2007 was \$2.5 million. The company had net income of \$1.6 million and \$1.25 million in 2007 and 2006, respectively, and cash flow generated from operations of \$2.5 million and \$1.9 million in 2007 and 2006, respectively.

DFI currently generates revenues from full and open competition contracts of approximately \$40 million annually, generating EBITDA of approximately 10 percent. DFI is expected to be debt free at transaction close, with a cash balance of approximately \$500,000, after all DFI related transaction costs have been paid. Accordingly, the transaction, in addition to being accretive to Kratos valuation metrics, is de-leveraging and improves Kratos' overall financial position.

Analysis: Kratos: Buying Into BRAC

The company, run by Titan Corp. alum Eric DeMarco, has gone from zero federal revenues in 2004 to a projected total exceeding \$300 million in 2008. It got there through a series of acquisitions of growing mid-sized federal contractors: (San Diego-based High Technology Solutions in 2004, Madison Research in 2006, Haverstick in 2007, and SYS Technologies earlier this year), along with a number of smaller deals.

A number of the company's deals have built its footprint in Huntsville, a city which is benefiting greatly from the Base Realignment and Closures (BRAC) process. DFI is the second company to be based in the Missile Defense Capital of the Free World (the other was Madison Research).

FGR offers analysis of M&A transactions involving government contractors. The analysis is written by Stuart McCutchan, president and CEO of InfoBase Publishers, Inc. online publisher of the market-leading Defense/Aerospace Competitive Intelligence Service (DACIS). Opinions expressed below are those of InfoBase. All rights reserved. For more on InfoBase Publishers, see www.dacis.com.

Digital Fusion, Inc. (DFI) 11/24/08
Madison Research Corp. (MRC) 8/11/06