



Kratos Defense & Security

We Have Liftoff

Despite large expectations from investors, Kratos has continued to perform strongly and stick to its growth agenda. Kratos' growing role in hypersonics and drones will be the company in its overall growth beyond its current role in the industry. We initiate KTOS with a BUY rating and a 12-month price target of \$110.

Thesis Point 1

We believe Kratos has strong position in the defense sector through its interactions with larger companies, like GE Aerospace, where they have signed a formal teaming agreement. This is mentioned as part of its business strategy. They specialize in one of the fastest-growing defense spending categories- unmanned systems- which is expected to grow around 8-11% CAGR in the next decade. They are looking focus on this trend and continue to collaborate with other companies to drive growth.

Thesis Point 2

Kratos has a cost-effective model with strong long-term growth potential. They discuss affordability as a core part of their strategy and look to find the most efficient solutions. Even though they are considered a smaller player, with a market cap of around \$16 billion, they are well known for their ability to produce cost-effective defense strategies. On top of this, they are recognized as a leader in unmanned systems and continue to leverage this detail, especially with the XQ-58A Valkyrie. They continue to look for opportunities to continue to grow out of this smaller role through improved infrastructure plans and continued negotiations with giants within the defense industry.

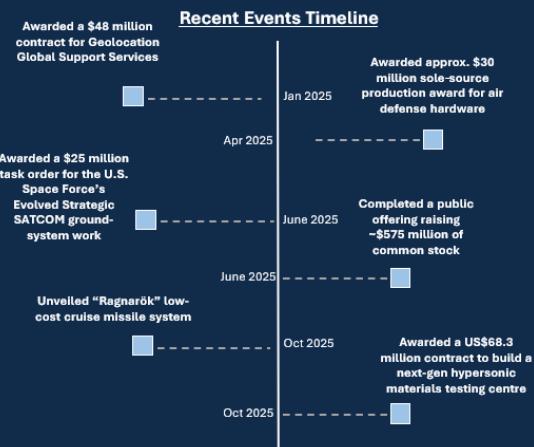
Company Overview

Kratos, ticker KTOS, is a defense company that specializes in unmanned systems, space and satellite communications, missile defense, hypersonic systems, and training solutions. They were founded in 1994 in California and focused on developing affordable defense that could help the US government. They are different from other defense contractors in that they look at cost-efficient technology and have a niche spot within the defense sector, along with being known for their ability to create cost-effective UAVs. They have a smaller market cap of around \$16 billion, compared to industry giant Lockheed Martin, whose market cap is around \$118 billion. Unlike larger defense contractors, Kratos targets niche programs where low-cost and quick deployment systems give it a competitive edge. They mainly gain revenue through contracts with the US Department of Defense. Their history of being involved with government contracts benefits them as the US defense budget for unmanned and autonomous systems is projected to rise 7.6-12.2%. This increasing demand makes the potential for growth promising for the company.

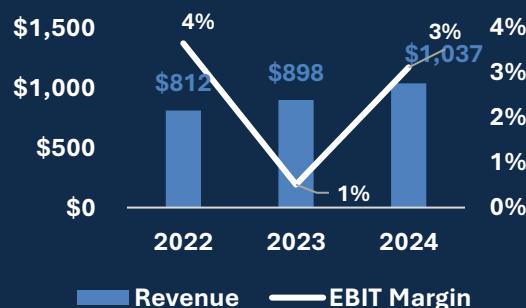


TICKER:	\$KTOS
RATING:	BUY
PRICE:	\$93.46
PRICE TARGET:	\$110.00
MARKET CAP:	\$15bn
52-W RANGE:	\$22 - \$113
P/E:	162x

1 Year Price History



EBIT Margin with Annual Revenue



Risk 1

Risks for this stock are dependent on the government and the industry in general. The United States is known for maintaining a strong military, but decreased spending can hurt this stock and decrease its price. A change in fiscal policies or government entities can be sudden and cause a negative change to this stock. Creating such high-stakes products also comes with high expectations, so mistakes can be costly. On top of this, while the majority party running Congress can be an advantage, it can also be a risk as Democrats trend towards less defense spending.

Risk 2

Dependency on winning contracts is also a large risk. As mentioned before, winning contracts can be a catalyst but also a risk. Not winning bids on contracts for long periods of time without government work can be detrimental. This means they must constantly stay competitive and keep up with government events to stay in the loop on the best way to win a contract. Again, this is a simple concept, but vital to stay on top of it.

Catalysts

Catalysts for this stock to move closer to our desired price include increased geopolitical tensions and alliances with countries involved in conflict. With the current Republican administration and majority party in control, they are comfortable with defense spending. These two events are a promising combination to push the growth of this stock close to or even beyond our target price. On top of this, increased innovation and the integration of AI into this industry create a promising outlook. Another major catalyst comes somewhat often; this is winning a contract over a competitor, which is simple yet vital.

Valuation

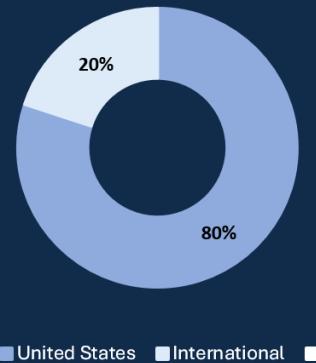
DCF Analysis (\$mm)						
	FY2025 12/31/2025	FY2026 12/31/2026	FY2027 12/31/2027	FY2028 12/30/2028	FY2029 12/30/2029	FY2030 12/31/2030
Revenue	1,270	1,430	1,593	1,755	1,913	2,063
<i>Revenue Growth</i>	12%	13%	11%	10%	9%	8%
United States	1,010	1,141	1,275	1,409	1,540	1,663
International	260	289	317	346	374	400
0.00	0	0	0	0	0	0
EBIT	39	500	440	355	246	113
<i>EBIT Margin</i>	3%	35%	28%	20%	13%	6%
Tax Expense	10	125	105	80	52	23
<i>Effective Tax Rate</i>	26%	25%	24%	23%	21%	20%
NOPAT	29.00	375.35	335.52	275.48	194.00	90.76
D&A	46	43	52	61	72	83
Capex	(65)	(71)	(80)	(88)	(96)	(103)
Changes in NWC	18	57	68	79	91	103
UFCF	122	433	399	346	271	173
PV of FCF	121	408	345	274	196	115

Our base case valuation assumes a 130x multiple, which appears extremely high, but aligns with consensus at this point. While this is a stretched multiple, it is justified by explosive growth within the past year and continued efforts towards expansion. We project EBIT margins to come back down towards the 10% range after skyrocketing past 30%.

Conclusion

We rate KTOS as a buy as we expect consistent growth even after its extremely strong performance this past year. Their continued efforts to provide cost-effective defense solutions and push to win vital contracts are the key to continued success. Our price target of \$110 implies around a 23% growth from the current price.

Revenue Segments

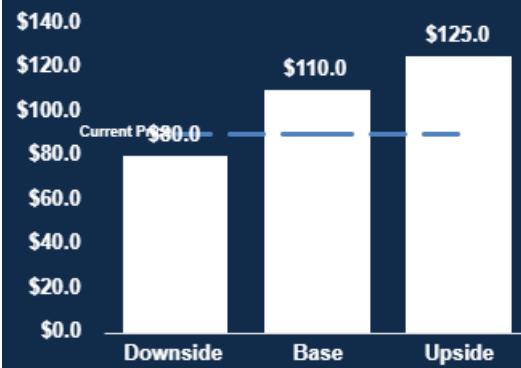


Terminal Value	
Exit Multiple Method	
2034 EBITDA	\$196
EV/EBITDA Exit Multiple	130.0x
Terminal Value	\$25,475
PV of Terminal Value	\$16,912
PV of Projection Period	\$1,459
PV of Terminal Value	\$16,912
Implied TEV	\$18,371
(-) Debt	\$289
(+) Cash	\$784
Implied Equity Value	\$18,865
Diluted Shares Outstanding	169
Implied Share Price	\$111.76
Upside/Downside	23.9%

Football Field Valuation Range



Risk vs. Reward DCF Cases



Income Statement (\$mm)	2024A	2025E	2026E	2027E	2028E	CAGR%
Revenue	10,588	11,220	11,902	12,616	13,338	8.0%
EBITDA	2,949	2,770	3,011	3,182	3,354	4.4%
EBIT	2,506	2,300	2,500	2,649	2,801	3.8%
NOPAT	582	1,016	1,248	1,585	1,744	44.2%
Margin & Growth Data	2024A	2025E	2026E	2027E	2028E	AVG%
EBITDA Margin	27.9%	24.7%	25.3%	25.2%	25.2%	25.6%
EBIT Margin	23.7%	20.5%	21.0%	21.0%	21.0%	21.4%
Revenue Growth	10.1%	6.0%	6.1%	6.0%	5.7%	6.8%
EBIT Growth	13.3%	-8.2%	8.7%	6.0%	5.7%	5.1%
Valuation Metrics	2024A	2025E	2026E	2027E	2028E	AVG%
P/FCF	15.4x	19.9x	17.7x	15.9x	14.3x	16.6x
EV/Sales	2.2x	2.1x	2.0x	1.9x	1.8x	2.0x
EV/EBITDA	8.0x	8.5x	7.8x	7.4x	7.0x	7.7x
FCF Yield	6.5%	5.0%	5.7%	6.3%	7.0%	6.1%
Comparable Companies \$mm						
Ticker	Mkt Cap	EV	P/E LTM	Revenue LTM	EBITDA LTM	
Deckers Outdoor Corporation (NYSE:DECK)	\$15,595	\$14,187	16.8x	\$5,125	\$1,288	
NIKE, Inc. (NYSE:NKE)	\$110,502	\$112,372	35.7x	\$46,309	\$4,477	
adidas AG (XTRA:ADS)	\$34,450	\$40,286	24.8x	\$28,349	\$2,691	
The Gap, Inc. (NYSE:GAP)	\$7,282	\$10,548	8.1x	\$15,161	\$1,667	
lululemon athletica	\$7,282	\$23,894	13.1x	\$10,750	\$2,977	
Ticker	LTM EV/EBITDA	Gross Margin	EBITDA Margin	EBIT Margin	Yr Rev	Growth Rate LF
Deckers Outdoor Corporation (NYSE:DECK)	11.0x	57.6%	25.1%	23.7%		15.5%
NIKE, Inc. (NYSE:NKE)	25.1x	42.7%	9.7%	8.0%		(9.8%)
adidas AG (XTRA:ADS)	15.0x	51.2%	9.5%	7.3%		11.0%
The Gap, Inc. (NYSE:GAP)	6.3x	41.4%	11.0%	7.7%		1.1%
lululemon athletica	8.0x	59.3%	27.7%	23.4%		9.4%
High	25.10x	59.3%	27.7%	23.7%		15.5%
75th Percentile	14.97x	57.6%	25.1%	23.4%		11.0%
Average	13.09x	50.4%	16.6%	14.0%		5.4%
Median	11.02x	51.2%	0.0%	8.0%		9.4%
25th Percentile	8.03x	42.7%	9.7%	7.7%		1.1%
Low	6.33x	41.4%	9.5%	7.3%		-9.8%
lululemon athletica						
Implied Enterprise Value (25th Percentile)					\$	23,894
Implied Enterprise Value (Median)					\$	32,801
Implied Enterprise Value (75th Percentile)					\$	44,574
Implied Share Price (25th Percentile)					\$	196.19
Implied Share Price (Median)					\$	270.51
Implied Share Price (75th Percentile)					\$	368.74
Weighted Average Cost of Capital (\$mm)						
Market Risk Premium	4.33%					
Beta	1.13					
Risk Free Rate	4.39%					
Cost of Equity	9.12%					
Weighted Average Cost of Debt	5.77%					
Tax Rate	25.00%					
Cost of Debt	0.08%					
Total Equity	\$15,229					
Total Debt	(\$494)					
Equity/Total Capitalization	98.14%					
Debt/Total Capitalization	1.86%					
WACC	9.20%					

Disclosures and Ratings: Bluegrass Capital Research does not hold any professional relationships with the securities mentioned in this report. Our ratings are defined as follows: **Buy** (expected to outperform the market), **Hold** (expected to perform in line with the market), and **Sell** (expected to underperform the market), typically over a 12-month horizon. This report is for educational and informational purposes only and should not be considered as financial advice.

Downside Case: Our downside case applies a 100x multiple. This could be a drought of contracts or changes in fiscal policy to be more frugal. Revenue growth slows to 5% by 2030 and yields an \$80 price target.

Upside Case: Our upside case applies a 160x multiple driven by massive contract deals and continued infrastructure growth and innovations. Revenue grows to 9% by 2030, yielding a \$120 price target.