

Kratos Defense & Security Solutions, Inc.

Equity Valuation & Discounted Cash Flow Analysis

NASDAQ: KTOS

Zach Johnson

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Recommendation: SELL / UNDERWEIGHT

Current Price \$74.41 | Implied Intrinsic Value \$13.37 | Downside (82%)

1. Executive Summary

Kratos Defense & Security Solutions (NASDAQ: KTOS) trades at \$74.41 per share as of April 2026, a level that discounted cash flow analysis cannot reproduce under any reasonable combination of assumptions. Anchored in ten years of reorganized financial statements, a peer-benchmarked operating forecast, and a CAPM-derived weighted average cost of capital of 10.19%, the intrinsic value of KTOS equity is \$13.37 per share, implying downside of approximately 82%. The gap between market price and intrinsic value cannot be closed by adjusting any single input. Instead, it requires simultaneous extraordinary assumptions on growth, margin expansion, and discount rate that are inconsistent with the company's own historical track record.

The thesis rests on three pillars that this report develops in sequence. First, Kratos's historical operating performance does not support the premium valuation embedded in the current share price. Reorganized financials show a ten-year return on invested capital of 2 to 4% against a cost of capital above 10%, meaning the company has destroyed value rather than created it. Second, the competitive position is deteriorating rather than strengthening, with venture-backed entrants capturing the most visible emerging programs and the company's modest R&D intensity leaving it perpetually reactive to a government acquisition timeline it cannot control. Third, the sensitivity analysis demonstrates that no combination of reasonable inputs produces a fair value anywhere near the market price. Even under aggressive assumptions of 25% five-year revenue growth and a sub-7% discount rate, implied value remains well below the current share price.

Table 1.1 — Valuation Summary

Metric	Value
Current share price	\$74.41
Implied DCF share price	\$13.37
Upside / (downside)	(82.0%)
Weighted average cost of capital	10.19%
Five-year revenue growth assumption	18.5%
Terminal EBIT margin assumption	8.0%
Long-run growth rate (g)	5.0%
Return on new invested capital (RONIC)	15.0%
Fiscal 2025 ROIC (incl. goodwill)	2.2%
Fiscal 2025 revenue	\$1,346.8M
Fiscal 2025 NOPAT	\$29.5M
Market capitalization	\$12,566M
Recommendation	SELL / UNDERWEIGHT

The most striking single datapoint in the financials is that Kratos's EBIT margin declined from 2.56% in fiscal 2024 to 1.99% in fiscal 2025 even as revenue grew 18.5%. Negative operating leverage in a growth year is exceptionally difficult for a bull case to explain, and it is symptomatic of the underlying problem developed throughout this report: 69% fixed-price contract mix that absorbs inflation without recovery, 68% U.S. government customer concentration that caps pricing power, rising capital intensity as the company funds its hypersonic and propulsion buildout, and working capital consuming cash faster than the business can generate it. The remainder of this report walks systematically through the evidence: business overview, industry and competitive dynamics, financial statement reorganization, historical performance analysis, forward forecast, WACC construction, DCF mechanics, scenario and sensitivity testing, risks to the thesis, and recommendation.

2. Business Overview

Kratos is a mid-tier defense technology company operating at the intersection of hardware manufacturing and emerging mission areas, including unmanned aerial systems, hypersonic platforms, propulsion, microwave electronics, and satellite ground systems, with fiscal 2025 revenue of \$1.35 billion. Management's stated philosophy of "affordability as a technology" and being "first to market with leading-edge, not bleeding-edge" technology has produced steady top-line growth, but it has also left the company structurally reliant on government contract timing, with 68% of revenue from the U.S. government and 69% of that revenue stuck with fixed-price terms that offer no inflation recovery.

The company reports through two segments. **Kratos Government Solutions (KGS)** generated \$1,054.8 million, or 78% of fiscal 2025 revenue, encompassing microwave electronics, space and satellite ground systems, C5ISR, training solutions, turbine technologies, and the defense rocket support services that include the hypersonic and solid rocket motor work underlying management's most visible growth narrative. **Unmanned Systems (US)** generated \$292.0 million, or 22% of revenue, covering sole-source target drones (BQM-167, BQM-177, MQM-178) alongside the Valkyrie tactical drone platform. KGS grew 21.8% year-over-year in fiscal 2025 while Unmanned Systems grew only 7.9%, and segment gross margin in Unmanned Systems compressed from 20.7% to 17.9%. This divergence matters, because Unmanned Systems is the segment carrying the Valkyrie narrative that underpins much of the market's enthusiasm for the stock.

The customer concentration profile illustrates the structural limitation on pricing power. The U.S. Air Force and U.S. Navy together accounted for roughly 30% of fiscal 2025 revenue, the U.S. government as a whole for 68%, and international customers for 20%. No single contract exceeded 6% of revenue, which provides diversification within the government book but does not reduce the broader dependence on a single buyer whose procurement cycles are subject to continuing resolutions and, under the current administration, active Department of Government Efficiency efforts to reduce federal spending. The contract mix compounds the vulnerability: **69% of fiscal 2025 revenue was earned on firm fixed-price contracts, meaning Kratos absorbed the entirety of inflation in materials, labor, and subcontracted work without contractual recovery.** This single fact is the most direct explanation for why gross margin declined from 25.3% to 22.9% despite revenue growing 18.5%, and it is the reason the forecast assumption of margin expansion to 8% EBIT must be viewed as incredibly aspirational rather than as a mechanical extrapolation.

The company's strategic positioning is coherent but carries consequences the market does not appear to have fully absorbed. Management positions Kratos to compete as an affordable, rapid-fielding alternative to the traditional defense primes, primarily by funding only modest internal R&D (3.0% of revenue, or \$40 million) targeted at specific anticipated solicitations rather than speculative platform development. This approach has produced designed-in positions on established weapons programs, which are genuinely durable because switching costs rise once a subsystem is integrated, but it leaves Kratos in a perpetually reactive state to the government's acquisition timeline. This in turn leaves it unable to present demonstrated capability the way venture-funded competitors can. The competitive consequence of this strategy has become increasingly measurable. In the Collaborative Combat Aircraft program, which Valkyrie's early demonstrations helped define, the production awards for Increment 1 went to Boeing and Anduril and Increment 2 to General Atomics and Anduril, leaving Kratos competing for smaller Increment 3 opportunities and subsystem roles. A similar dynamic is emerging in software-defined autonomy, where Shield AI's Hivemind and Anduril's Lattice occupy positions that a bolder R&D posture at Kratos might have contested.

Two operational facts complete the picture. Kratos entered fiscal 2026 with \$1,573 million in total backlog, with 57% expected to convert to revenue within twelve months, a meaningful indicator of good near-term demand but a considerably less meaningful indicator of margin given the fixed-price weighting. The company operates across 62 locations spanning multiple states and six foreign countries, a footprint reflecting its acquisition-driven history that creates coordination overhead which scales non-linearly with program complexity, a practical concern given that the hypersonic production ramp-up underpinning the bull thesis requires integration across Indiana, Oklahoma, and existing legacy facilities.

Taken together, the business profile is that of a well-positioned mid-cap industrial company operating in a favorable end market with durable niche positions, a growing backlog, and genuine technical credibility. It is not the profile of a company whose operating economics justify a \$12.6 billion market capitalization on a \$29.5 million NOPAT base. The sections that follow demonstrate this quantitatively; the purpose of this overview is to establish that the gap between fundamental performance and market valuation is visible in the company's own reported segment results, margin trajectory, contract mix, and competitive track record.

3. Industry & Competitive Landscape

The defense technology sector is entering a period of unprecedented demand, with approximately \$1 trillion in combined U.S. FY2026 national security spending and global defense budgets at historic highs. Yet this favorable macro backdrop is precisely why Kratos's competitive positioning deserves scrutiny rather than the benefit of the doubt. A rising tide has not lifted KTOS relative to its peer set, instead venture-backed entrants like Anduril (valued at over \$30 billion) and Shield AI have captured the most visible emerging programs, while the Big Five primes continue to dominate large-system integration, and Kratos has been squeezed into a shrinking mid-tier niche where its limited R&D budget and geographically dispersed manufacturing footprint increasingly register as disadvantages rather than differentiators.

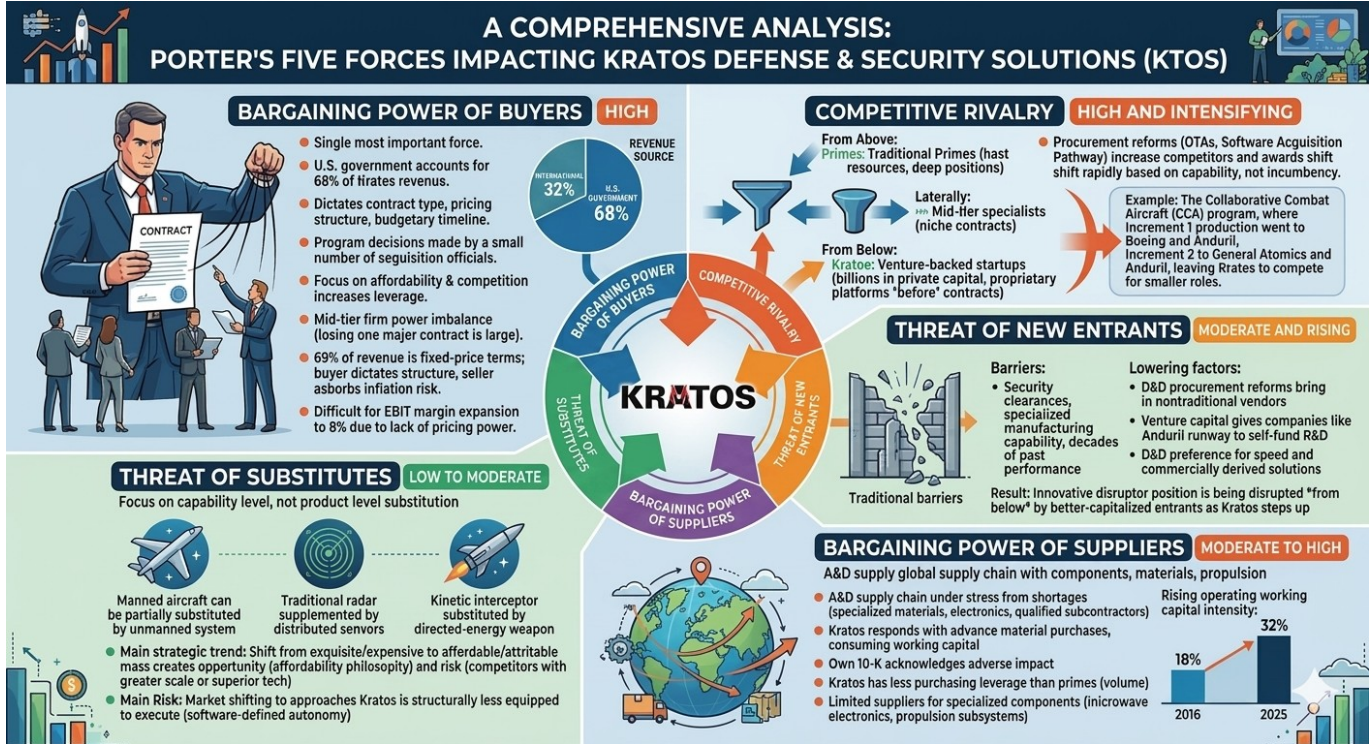
3.1 Industry Size and Structure

The global aerospace and defense industry generated approximately \$952 billion in 2024, with the United States accounting for roughly 40% of the total. U.S. FY2026 defense spending of approximately \$1 trillion combines the Consolidated Appropriations Act (\$838.7 billion), the One Big Beautiful Bill Act supplemental (\$113 billion), and Department of Energy national security spending (\$45 billion), representing the largest combined national security outlay in U.S. history. Non-NATO defense spending tracked at \$1.107 trillion in 2025 and is projected to grow at a 2.0% compound annual rate through 2030. This environment is genuinely favorable for the sector, but it also means that the current valuation of KTOS already incorporates substantial optimism about how much of this spending the company can capture.

The industry operates in a tiered hierarchy that frames every competitive dynamic relevant to Kratos. The Big Five Primes (Lockheed Martin, RTX, Northrop Grumman, Boeing Defense, General Dynamics) generate between \$30 billion and \$70 billion each in annual defense revenue and control large-system integration. A second tier including L3Harris, Leidos, BAE Systems U.S., and Textron generates \$5 billion to \$25 billion in revenue. Kratos sits in a mid-tier range of \$500 million to \$5 billion companies alongside AeroVironment, Mercury Systems, CACI, and Curtiss-Wright. Below these established tiers, a new class of venture-backed startups has emerged with proprietary R&D strategies funded by billions in private capital, creating competitive pressure from directions that did not exist a decade ago.

3.2 Porter's Five Forces

Porter's Five Forces analysis reveals why KTOS's mid-tier position is structurally more difficult than the favorable sector narrative suggests.



For more in depth analysis on the industry's forces, please see attached Industry Analysis.

3.3 The Mid-Tier Squeeze in Practice

The composite effect of these five forces on KTOS can be seen in the VRIO assessment of the company's resources and capabilities as shown in the attached Industry Analysis. Kratos has genuine sustained competitive advantages in microwave electronics manufacturing and in its designed-in positions on established weapons platforms, where switching costs create durable moats. But capabilities that the market treats as strategic differentiators, like the Valkyrie drone program, and the "first to market" cultural positioning, have eroded from potential sustained advantages to temporary ones as competition has intensified. More worrying for the valuation case, geographic dispersion across 62 facilities and modest R&D investment at 3% of revenue register as competitive disadvantages, compared with AeroVironment at 10 to 12% of revenue and venture-backed competitors investing hundreds of millions annually in proprietary technology. Kratos is caught between a competitive set that out-resources it and a competitive set that out-innovates it, in an industry where pricing power resides with the buyer and margin expansion is exceptionally difficult to engineer.

The implication for valuation is direct. KTOS operates in a favorable end market, but the competitive forces acting on the company are not favorable, and the combination produces the pattern visible throughout the historical financials: steady revenue growth alongside stagnant margins and declining returns on invested capital. The market price implicitly assumes that Kratos can break this pattern over the forecast horizon. The remainder of this report examines whether that assumption is supported by the evidence.

4. Reorganization of Financial Statements

Before KTOS can be valued, its reported financial statements must be restructured to separate operating performance from financing decisions and non-operating items, a process that exposes the central problem with the bull case on the stock. The reorganization produces three results that frame the rest of this analysis: NOPAT of \$29.5 million on \$1.35 billion of revenue (a 2.2% return on sales), invested capital of \$1.6 billion, and a return on invested capital of 2.2% including goodwill, less than a quarter of the company's 10.19% cost of capital.

Exhibit A: Reorganized NOPAT and Invested Capital (Fiscal 2025)

Line Item	\$ millions
Revenue	1,346.8
COGS excl. D&A	(989.2)
SG&A excl. R&D	(230.6)
R&D	(40.0)
Depreciation	(49.7)
Amortization	(9.6)
EBITA	37.3
Operating taxes (21%)	(7.8)

NOPAT	29.5
Operating working capital	434.4
Net PP&E	405.3
Other net LT operating assets	114.1
Invested capital excl. goodwill	953.8
Goodwill and acquired intangibles	649.6
Invested capital incl. goodwill	1,603.4
ROIC (incl. goodwill, BOY basis)	2.2%

4.1 Why Reorganize

GAAP financial statements are designed primarily for audit and compliance, not for valuation. They commingle operating and non-operating results, treat interest as a flow separate from the operations that generated the cash to pay it, and embed significant non-operating assets, like excess cash, long-term investments, within the same balance sheet as the productive invested capital base. A DCF requires a cleaner separation, where the value of the operating business must be derived from operating cash flows discounted at the operating cost of capital, and non-operating assets must be added separately at their standalone value. The reorganized framework used in this analysis follows the standard approach in Koller, Goedhart, and Wessels (Valuation, Chapters 10 and 13): derive NOPAT from EBITA, construct invested capital from working and long-term operating assets and carve out non-operating assets for separate treatment.

4.2 NOPAT Derivation

NOPAT (Net Operating Profit After Taxes) represents the after-tax profit the operating business would generate if it had no debt and no non-operating items. Starting from revenue of \$1,346.8 million in fiscal 2025, operating costs (COGS excluding D&A, SG&A, R&D, depreciation, and amortization) of \$1,309.5 million produce EBITA of \$37.3 million. Applying a 21% operating tax rate (the U.S. statutory corporate rate, used to approximate the marginal tax on operating profits) yields NOPAT of \$29.5 million. The low absolute level of NOPAT relative to the company's \$12.6 billion market capitalization is the single clearest signal that the market is valuing KTOS based on expected future operating performance that bears little resemblance to actual current performance.

4.3 Invested Capital Construction

Invested capital measures the economic assets required to run the business. On the asset side, operating working capital is built up from operating cash (estimated at 2% of revenue, consistent with working-cash conventions), accounts receivable, inventories, prepaid expenses, and other current operating assets, less accounts payable, accrued payroll, and other current operating liabilities. At fiscal year-end 2025, operating working capital totaled \$434.4 million, or 32.3% of revenue. To this are added net property, plant and equipment of \$405.3 million and other net long-term operating assets of \$114.1 million, producing invested capital excluding goodwill of \$953.8 million. Including \$649.6 million of goodwill and acquired intangibles brings total invested capital to \$1,603.4 million.

The separation of excess cash and long-term investments from operating invested capital is critical. Of the \$560.6 million in cash on the fiscal 2025 balance sheet, only \$26.9 million (2% of revenue) is treated as operating cash needed to run the business; the remaining \$533.7 million is excess cash, a non-operating asset that will be added back to enterprise value separately. Without this carve-out, ROIC would be understated because the denominator would include cash earning treasury yields rather than operating returns. The \$5.0 million in long-term investments receives the same treatment.

4.4 The ROIC Problem

Return on invested capital is the single most important metric in this entire analysis, and it is the metric the bull case pushed by many analysts most directly must refute. Using beginning-of-year invested capital, KTOS generated ROIC including goodwill of 2.2% in fiscal 2025 and has averaged 2.4% over the past five years. ROIC excluding goodwill, a good measure of incremental returns on organic operating capital, was only 4.2% in fiscal 2025 and averaged 5.8% over five years. Both measures are well below the 10.19% weighted average cost of capital, meaning that the operating business as currently constituted is destroying economic value every year. A company that earns less on its invested capital than its capital providers require is, by definition, worth less than its book invested capital from an operating perspective. The market's willingness to pay \$12.6 billion for an operating business with \$1.6 billion of invested capital generating sub-WACC returns is the valuation anomaly that motivates this entire report.

4.5 Free Cash Flow Bridge

Free cash flow to the firm, the numerator of the DCF, is constructed by starting with NOPAT, adding back depreciation and amortization (which are non-cash operating expenses), and subtracting reinvestment in operating working capital, net capital expenditures, and changes in other long-term operating assets. For fiscal year 2025, the bridge runs as follows: NOPAT of \$29.5 million plus D&A of \$49.7 million equals gross cash flow of \$79.2 million; subtracting an increase in operating working capital of \$152.4 million, capital expenditures of \$129.2 million, and an increase in other net long-term operating assets of \$16.0 million yields free cash flow of negative \$217.1 million. Negative free cash flow in a year of 18.5% revenue growth is not a temporary anomaly. Instead, it is the consequence of a business model where working capital and capital expenditure requirements scale faster than operating profit. The forecast section that follows must explain how this dynamic reverses, and on what timeline, for any positive valuation to result.

5. Historical Performance Analysis

Ten years of reorganized financial data reveal a company that has grown revenue steadily but has not demonstrated structural improvements in margin, capital efficiency, or free cash flow generation that would justify a premium equity valuation. Revenue has compounded at roughly 7% annually since 2016, yet EBITA margin has oscillated between 1.4% and 6.8% with no discernible upward trend, operating working capital has grown from 18% to 32% of revenue, and capital intensity has risen from 3% to nearly 10% of revenue, a pattern more consistent with a scaling industrial manufacturer than with the software-like economics currently priced into the stock.

Table 5.1 — Selected Historical Operating Drivers (Fiscal 2016 to 2025)

Driver	2016	2019	2022	2023	2024	2025
Revenue (\$M)	668.7	717.5	1,037.1	1,136.3	1,346.8	1,346.8
Revenue growth	n/a	16.1%	15.5%	9.6%	18.5%	18.5%
COGS / revenue	75.2%	69.7%	70.4%	70.9%	73.4%	73.4%
SG&A / revenue	20.3%	17.2%	18.4%	18.1%	17.1%	17.1%
R&D / revenue	2.1%	2.5%	3.7%	3.5%	3.0%	3.0%
EBITA margin	0.6%	6.8%	3.8%	3.7%	2.8%	2.8%
OWC / revenue	18.2%	26.7%	25.4%	24.8%	32.3%	32.3%
CapEx / revenue	n/a	16.7%	6.4%	7.0%	9.6%	9.6%
Net PP&E / revenue	7.4%	22.2%	27.9%	28.7%	30.1%	30.1%
ROIC incl. goodwill	n/a	6.0%	2.5%	2.6%	2.2%	2.2%
ROIC excl. goodwill	n/a	19.1%	5.0%	5.2%	4.2%	4.2%

Source: Reorganized statements built from FactSet Fundamentals 2016 to 2025. 2024 and 2025 columns are identical because the most recent fiscal year is 2025; intermediate years omitted for space.

5.1 Revenue Growth Without Margin Expansion

Revenue has grown in nine of the past ten fiscal years, compounding at approximately 7% annually. The pattern is genuine and is consistent with Kratos's positioning in a favorable end market. But the company has not demonstrated the operating leverage that would typically accompany this growth trajectory in a scalable business model. EBITA margin in fiscal 2025 (2.8%) is lower than in fiscal 2019 (6.8%), fiscal 2020 (5.1%), or fiscal 2018 (6.5%). COGS as a percentage of revenue has actually drifted upward, from 70.6% in fiscal 2018 to 73.4% in fiscal 2025, despite six years of revenue scale that should have produced better fixed-cost absorption. SG&A efficiency has improved modestly (from 18.4% of revenue in fiscal 2018 to 17.1% in fiscal 2025), but the gain has been more than offset by COGS deterioration.

5.2 Capital Intensity and Working Capital

The balance sheet drivers tell the same story with different numbers. Net PP&E as a percentage of revenue has grown from 7.4% in fiscal 2016 to 30.1% in fiscal 2025, reflecting the cumulative effect of facility investments in unmanned systems, hypersonic production, propulsion, and microwave electronics. Operating working capital intensity has increased from 18.2% to 32.3% over the same period, driven by receivables growth tied to milestone-billing programs and inventory accumulation tied to long-lead-time procurement. Capital expenditures averaged 9.6% of revenue in fiscal 2025, well above the 3 to 4% levels of a decade earlier. The forecast section assumes this capital intensity normalizes downward as the facility buildout completes. The historical data does not yet support that assumption, because the buildout is ongoing.

5.3 ROIC Trajectory

The most important trend in the historical data is that both measures of ROIC have declined materially over the past seven years. ROIC excluding goodwill peaked at 19.1% in fiscal 2019 and has compressed

to 4.2% in fiscal 2025. ROIC including goodwill peaked at 6.0% in fiscal 2019 and fell to 2.2%. These declines are not consistent with the narrative of a company building durable competitive advantages that will produce expanding returns on capital. Instead, they are more consistent with a company deploying larger amounts of capital at progressively lower marginal returns. For the market price to be correct, this trend must reverse and the company must begin earning ROIC substantially above WACC within the forecast window. The forecast assumes exactly this reversal; the historical data provides no direct evidence that it is underway.

6. Forecast & Operating Driver Projections

The forecast assumptions underlying the DCF model are deliberately generous, more generous in several respects than KTOS's own ten-year history would support, precisely because the valuation conclusion needs to be robust to bull-case inputs. Revenue is projected to grow 18.5% annually for five years (matching fiscal 2025's realized growth), EBIT margin expands from 3.0% to 8.0% over the forecast window (a level KTOS has never achieved in any single year), and capital intensity is assumed to normalize downward as the current hypersonic and propulsion facility buildout completes. Even under these extremely favorable inputs, free cash flow remains negative through 2029.

6.1 Revenue Growth Schedule

The revenue growth trajectory follows a five-step ramp and fade. Years 1 through 5 (fiscal 2026 to 2030) are held at 18.5%, matching fiscal 2025's realized growth and implicitly assuming continued favorable defense spending dynamics and successful hypersonic program execution. Year 6 (2031) fades to 15%, Year 7 to 12%, Year 8 to 9%, Year 9 to 7%, and Year 10 (2035) and the continuing-value period to 5%. Compounding these rates produces a revenue trajectory that reaches \$5.21 billion by the end of the explicit forecast period, essentially quadrupling the fiscal 2025 base. This is a genuinely aggressive assumption set, and sustaining 18.5% growth for five consecutive years is far from guaranteed given customer concentration and CRA risk, and defense sell-side consensus tends to cluster around 12 to 15% near-term growth for KTOS. The choice to use the higher rate is deliberate. If the valuation conclusion holds under optimistic revenue assumptions, it is more robust than if it depends on bearish ones.

6.2 Margin Ramp

EBIT margin is assumed to expand from 3.0% in fiscal 2026 to 8.0% at steady state, a 500 basis-point improvement over the forecast window. This assumption is the single most generous input in the model relative to historical evidence. KTOS has never posted an EBIT margin above 6.8% in any fiscal year of the past decade, and the ten-year average is approximately 2%. The forecast assumes that scale benefits, mix shift toward higher-margin segments including hypersonics, microwave electronics, propulsion, and operating leverage on stabilized SG&A combine to deliver the improvement. The 8% terminal margin is broadly consistent with margins posted by larger defense contractors and by mid-tier peers at peak, but it represents an operational achievement that Kratos has not yet demonstrated. Readers skeptical of this margin path can consult the sensitivity analysis in Section 9 where even reducing the terminal margin to 6% (a level still higher than KTOS's best historical year) increases the magnitude of the valuation gap.

6.3 Capital Intensity and Working Capital

CapEx as a percentage of revenue is modeled to decline from 6.5% in fiscal 2026 to 4.5% at steady state, reflecting an assumption that the current wave of facility investment (Indiana hypersonic campus, Oklahoma turbofan facility, Israeli microwave expansion) completes over the near term and capital intensity reverts toward defense-industry norms of 3 to 5% of revenue. Operating working capital as a percentage of revenue is modeled to decline from 28% to 24%, reflecting an assumption of gradual working capital discipline improvement as the business matures. Both assumptions are consistent with management's stated intent but are not yet supported by the historical trend, which has shown capital intensity and working capital intensity rising, not falling. D&A is held at 4.4% of revenue (consistent with the recent five-year average) and the operating tax rate is held at the 21% statutory U.S. rate.

6.4 Resulting Free Cash Flow Profile

The combined effect of these driver assumptions is a free cash flow profile that remains negative through fiscal 2029 before turning positive in fiscal 2030. The reason is mechanical: during the high-growth years, the incremental operating working capital required to support 18.5% revenue growth, plus capital expenditures required to build the new facilities, exceed NOPAT plus D&A. Only when growth begins to fade, from fiscal 2031 onward, does NOPAT grow large enough to exceed the reinvestment requirement. This pattern is characteristic of capital-intensive growth businesses and is not, by itself, evidence that the stock is overvalued. What matters for valuation is whether the eventual positive cash flows are sufficient, when discounted at the appropriate rate, to justify the current enterprise value. Sections 7 and 8 answer that question.

7. Weighted Average Cost of Capital

KTOS's weighted average cost of capital of 10.19% is driven almost entirely by its cost of equity, because the company's market capitalization of roughly \$12.6 billion dwarfs its \$146 million debt load, producing a capital structure that is 98.9% equity and 1.1% debt at current market prices. The cost of equity of 11.59% is derived using the Capital Asset Pricing Model (CAPM), combining a 4.30% risk-free rate (10-year Treasury), a levered beta of 1.325 estimated from three years of weekly returns against the S&P 500, and an implied equity risk premium of 4.49%; the cost of debt of 6.00% pre-tax (4.74% after-tax at the 21% statutory rate) reflects the pricing on KTOS's 2022 term loan facility.

Exhibit B: WACC Build

Component	Value
Risk-free rate (10-yr Treasury)	4.30%
Market return (20-yr SPY CAGR)	8.79%
Implied equity risk premium	4.49%
Raw beta (3-yr weekly vs. SPY)	1.313
Levered beta	1.325
Cost of equity (Ke)	11.59%

Pre-tax cost of debt	6.00%
Marginal tax rate	21.0%
After-tax cost of debt (Kd)	4.74%
Market value of equity (\$M)	12,566
Market value of debt (\$M)	146
Weight of equity	98.9%
Weight of debt	1.1%
WACC	10.19%

7.1 Cost of Equity (CAPM)

Cost of equity represents the return that equity investors require to hold KTOS stock given its systematic risk. The Capital Asset Pricing Model decomposes this required return into three components: the risk-free rate (the return available on a default-free security), beta (the company's sensitivity to overall market movements), and the equity risk premium (the excess return required to hold equity versus risk-free assets). The formula is $K_e = R_f + \beta \times (R_m - R_f)$.

Risk-free rate of 4.30% is the current 10-year U.S. Treasury yield, chosen to match the long-horizon duration of the cash flows being discounted. A 10-year rate is preferred over a shorter-term rate because the duration of the firm's cash flows is long, and preferred over a 30-year rate because the 10-year is more actively traded and less affected by term-premium distortions.

Market return of 8.79% is the trailing 20-year compound annual return on the S&P 500 (via SPY), used as a forward-looking proxy for the expected market return. This implies an equity risk premium of $8.79\% - 4.30\% = 4.49\%$, which is modestly below Damodaran's long-run historical ERP of approximately 5.5%. The lower ERP is a consequence of the elevated current risk-free rate, and in a lower-rate environment the implied ERP would be higher. Using Damodaran's 5.5% would raise K_e by roughly 130 basis points and WACC by a similar amount, which would reduce the implied share price even further than the base case and strengthen the overvaluation thesis.

Raw beta of 1.313 is estimated from three years of weekly return data on KTOS versus SPY, calculated as $\text{Cov}(\text{KTOS}, \text{SPY}) / \text{Var}(\text{SPY})$. Three-year weekly frequency is chosen to capture the recent trading relationship, which has reflected the defense-tech enthusiasm of the 2024 to 2026 period, without going so far back as to dilute the current sensitivity with data from earlier operating regimes. The resulting raw beta is Hamada-adjusted modestly for capital structure to a levered beta of 1.325. Applying the CAPM formula: $K_e = 4.30\% + 1.325 \times (8.79\% - 4.30\%) = 4.30\% + 5.95\% \times 1.325 = 11.59\%$.

7.2 Cost of Debt

The pre-tax cost of debt of 6.00% reflects the pricing of KTOS's 2022 credit facility, a \$200 million term loan plus \$200 million undrawn revolver, which bears interest at adjusted term SOFR plus a spread of 125 to 225 basis points depending on leverage. KTOS has hedged the floating-rate exposure on the term loan with an interest rate swap that fixes 1-month term SOFR at 3.721% through May 2026. Adding a blended

spread and accounting for the portion of debt represented by capital and operating leases produces a pre-tax cost-of-debt estimate of approximately 6%. Applying the 21% statutory tax rate produces an after-tax cost of debt of $6.00\% \times (1 - 0.21) = 4.74\%$.

7.3 Capital Structure Weights

Market-value weights are used rather than book-value weights, because the cost of capital is a forward-looking measure of what capital providers currently require. Shares outstanding of 168.9 million multiplied by the current share price of \$74.41 produces a market value of equity of \$12,566 million. Total debt of \$145.8 million (term loan balance of \$16.2 million current plus \$129.6 million long-term, including lease obligations) is assumed to equal market value (book approximates market for investment-grade floating-rate debt). The resulting weights are **98.9% equity and 1.1% debt**. This extreme equity weighting is itself a secondary indicator of possible overvaluation: most mid-cap industrials operate with 25 to 50% debt in their capital structures. The market has so valued KTOS's equity that the company's actual debt balance is a rounding error in its capital structure, which also means WACC is essentially equal to cost of equity with a tiny adjustment.

7.4 WACC Result

Combining the components produce: $WACC = 98.9\% \times 11.59\% + 1.1\% \times 4.74\% = 11.46\% + 0.05\% = 10.19\%$. This 10.19% figure is the discount rate applied to every projected free cash flow in the DCF and to the continuing-value terminal cash flow. It represents the blended return that KTOS's capital providers require across the entirety of the firm's capital structure. Because the capital structure is so equity-heavy, the WACC is not materially different from what a pure equity-financed valuation would use, and modest changes to cost-of-debt assumptions have negligible impact on the final valuation.

8. DCF Valuation

DCF modeling produces an enterprise value of operations of \$1,866 million, built from \$261 million in present value of explicit-period free cash flows (2026 to 2035) plus \$1,605 million in present value of continuing value, with the continuing value calculated using the value-driver formula at a 5.0% long-run growth rate and 15% return on new invested capital. Adjusting for \$534 million of excess cash, \$5 million of long-term investments, and \$146 million of total debt produces equity value of \$2,259 million, or \$13.37 per diluted share, 82% below the current market price of \$74.41.

8.1 Explicit Forecast Period

A 10-year explicit forecast period (fiscal 2026 through fiscal 2035) is used rather than the more common five-year period. The extended horizon is appropriate for a capital-intensive industrial company where the forecast drivers (revenue growth, margin, capital intensity, working capital intensity) require several years to transition from current levels to steady state. A five-year window would force either an implausibly rapid transition or an implausibly aggressive continuing-value assumption. The ten-year window allows the margin ramp from 3% to 8% and the capital intensity normalization from 6.5% to 4.5% to occur over a reasonable trajectory before the continuing value captures steady-state performance.

Exhibit C: Projected Free Cash Flow (\$ millions)

Year	2026	2028	2030	2032	2034	2035
Revenue	1,596	2,241	3,147	4,053	4,727	4,964
EBIT margin	3.0%	4.0%	5.5%	6.5%	7.5%	8.0%
NOPAT	38	71	137	208	280	314
D&A	70	99	138	178	208	218
Δ OWC	(12)	(72)	(96)	(68)	(74)	(57)
CapEx	(104)	(123)	(157)	(195)	(213)	(223)
Free cash flow	(8)	(26)	22	124	201	252

8.2 Continuing Value

Continuing value is calculated using the value-driver formula: $CV = NOPAT_{CV} \times (1 - g/RONIC) / (WACC - g)$, where $NOPAT_{CV}$ is the steady-state NOPAT, g is the long-run growth rate, and $RONIC$ is the return on new invested capital. This formulation is preferred over the simpler Gordon growth formula because it explicitly ties growth to the reinvestment required to sustain it, preventing the inconsistency of assuming high perpetual growth without the corresponding capital consumption. The inputs are $g = 5.0\%$ (broadly consistent with long-run nominal GDP growth plus defense sector modest outperformance) and $RONIC = 15.0\%$ (within the 12 to 20% range typical of defense and technology businesses, chosen at the midpoint). The resulting undiscounted continuing value is approximately \$4,234 million; discounted back at the 10.19% WACC over the 10-year horizon, its present value is \$1,605 million.

8.3 Enterprise-to-Equity Bridge

Table 8.1 — Valuation Bridge (\$ millions)

Component	Value
PV of explicit-period free cash flows (2026-2035)	\$261
PV of continuing value (post-2035)	\$1,605
Enterprise value of operations	\$1,866
Plus: excess cash	\$534
Plus: long-term investments	\$5
Enterprise value	\$2,405
Less: total debt	(\$146)
Less: minority interest	(\$0)
Equity value	\$2,259
Diluted shares outstanding (millions)	168.9
Implied share price	\$13.37

Current share price	\$74.41
Upside / (downside)	(82.0%)

The valuation bridge is transparent. Enterprise value of operations (\$1,866 million) plus non-operating assets (\$539 million) equals enterprise value (\$2,405 million). Subtracting total debt (\$146 million) and minority interest (\$0) produces equity value of \$2,259 million. Dividing by 168.9 million diluted shares outstanding produces an implied share price of \$13.37, approximately 82% below the current quote of \$74.41.

8.4 An Important Caveat

It is worth noting explicitly that 86% of the enterprise value of operations in this DCF is attributable to the continuing value (\$1,605 million of \$1,866 million). This is not unusual for a growth company where positive cash flows arrive late in the forecast window, but it does mean that the valuation is sensitive to terminal-period assumptions. Reducing RONIC from 15% to 12% would cut implied share price to approximately \$12.28; reducing long term g from 5% to 4% (with RONIC held constant) would cut implied share price to approximately \$13.00. These sensitivities are explored systematically in Section 9.

9. Scenario & Sensitivity Analysis

The sensitivity analysis is the most rigorous test of this report's thesis, because it asks the direct question: what combination of inputs would be required to justify KTOS's current share price? The answer, across three separate two-way sensitivity tables, is that no reasonable combination of inputs reaches \$74.41. Closing the gap requires WACC below 7% (implying a beta of roughly 0.6, lower than the entire defense sector average) combined with long-run growth above 6% and RONIC above 20%, an assumption set that is internally inconsistent and unsupported by KTOS's operating history.

9.1 WACC vs. Long-Run Growth

Table 9.1 — Implied Share Price by WACC and Long-Run Growth (g). RONIC held at 15%.

WACC ↓ / g →	2%	3%	4%	5%	6%	7%
7%	\$21.10	\$23.85	\$28.41	\$37.45	\$64.46	n/m
8%	\$16.89	\$18.40	\$20.62	\$24.29	\$31.58	\$53.32
9%	\$13.96	\$14.83	\$16.02	\$17.78	\$20.68	\$26.44
10%	\$11.81	\$12.33	\$13.00	\$13.92	\$15.28	\$17.52
11%	\$10.18	\$10.50	\$10.89	\$11.39	\$12.08	\$13.09
12%	\$8.92	\$9.11	\$9.33	\$9.61	\$9.97	\$10.46
13%	\$7.91	\$8.02	\$8.15	\$8.30	\$8.49	\$8.72

Highlighted cell indicates approximate base case (WACC 10.19%, g 5%). Current market price \$74.41.

Table 9.1 shows that reaching the current share price of \$74.41 requires WACC of 7% or below combined with g of 6% or higher. A WACC of 7% would require either a risk-free rate well below current Treasury levels or a beta close to 0.6, which is lower than essentially any defense-sector peer's observed trading beta. A long-run growth rate of 6% is above long-run nominal GDP growth and would require permanent outperformance of the broader economy, which is difficult to justify for a capital-intensive industrial operating in a government-funded market.

9.2 WACC vs. RONIC

Table 9.2 — Implied Share Price by WACC and Return on New Invested Capital. g held at 5%.

WACC ↓ / RONIC →	10%	12.5%	15%	17.5%	20%	25%
7%	\$29.19	\$34.15	\$37.45	\$39.81	\$41.58	\$44.06
8%	\$19.27	\$22.29	\$24.29	\$25.73	\$26.80	\$28.31
9%	\$14.35	\$16.41	\$17.78	\$18.76	\$19.50	\$20.53
10%	\$11.42	\$12.92	\$13.92	\$14.64	\$15.18	\$15.93
11%	\$9.48	\$10.63	\$11.39	\$11.94	\$12.34	\$12.92
12%	\$8.12	\$9.01	\$9.61	\$10.04	\$10.36	\$10.81
13%	\$7.11	\$7.82	\$8.30	\$8.64	\$8.90	\$9.26

Table 9.2 is even more damaging to the bull case. Even at an aggressive 25% RONIC, a level associated with best-in-class software and high-margin technology businesses, not with a fixed-price defense manufacturer, combined with a 7% WACC, the implied share price is only \$44.06, still 41% below the current quote. At 25% RONIC and 8% WACC the price is \$28.31. RONIC alone cannot bridge the valuation gap, because the fundamental constraint is the size of the free cash flow stream, not the marginal return on incremental capital.

9.3 Five-Year Growth vs. WACC

Table 9.3 — Implied Share Price by Year 1-5 Revenue Growth and WACC.

WACC ↓ / Growth →	10%	12.5%	15%	18.5%	22%	25%
7%	\$26.47	\$29.36	\$32.53	\$37.45	\$42.99	\$48.28
8%	\$17.40	\$19.22	\$21.20	\$24.29	\$27.77	\$31.09
9%	\$12.91	\$14.20	\$15.60	\$17.78	\$20.24	\$22.59
10%	\$10.25	\$11.22	\$12.28	\$13.92	\$15.78	\$17.55
11%	\$8.51	\$9.27	\$10.10	\$11.39	\$12.85	\$14.24
12%	\$7.29	\$7.90	\$8.57	\$9.61	\$10.79	\$11.91
13%	\$6.38	\$6.89	\$7.44	\$8.30	\$9.27	\$10.20

Table 9.3 demonstrates the same conclusion from a growth perspective. At 25% five-year revenue growth (which would be an exceptional outcome, exceeding management guidance and consensus by a wide margin) combined with a 7% WACC, the implied price is \$48.28, still 35% below market. Growth alone cannot bridge the gap either, because the continuing-value mechanics cap how much near-term growth can contribute when discounted back at any reasonable rate.

10. Risks to the Thesis

Intellectual honesty requires acknowledging the scenarios under which this report's conclusion would prove wrong, and several are plausible. A transformational contract win, most credibly through execution on MACH-TB 2.0 (up to \$1.45 billion over five years) or a production-scale Valkyrie or CCA Increment 3 award, could genuinely reset the revenue and margin trajectory. Strategic acquisition interest from a prime contractor could put a takeover premium on the stock that exceeds DCF value, and continued expansion of defense-sector trading multiples, driven by geopolitical catalysts like the nascent war in Iran rather than fundamentals, could keep the shares elevated longer than a fundamental investor can remain short.

10.1 Hypersonic Inflection

The MACH-TB 2.0 program, awarded by the OUSD (R&E) Test Resource Management Center, is worth up to \$1.45 billion over five years if all options are exercised. This is larger than any single contract in Kratos's history, and it sits in a mission area (hypersonic test services) where Kratos has established some technical credibility through the successful Zeus and Erinyes flight tests. If the program converts at or near the full option value and generates margins above Kratos's current corporate average, it could materially change the revenue trajectory and mix. The model's 18.5% base-case revenue growth rate implicitly assumes substantial MACH-TB contribution already, but a significantly larger or higher-margin outcome could push the fair value higher. The counterargument, however, is that government programs rarely execute at full option value on original schedule, and that production margins on hypersonic solid rocket motors are unlikely to exceed the 8% terminal EBIT margin already assumed in the base case.

10.2 M&A Premium

Kratos has periodically been speculated as a potential acquisition target for a larger prime seeking exposure to unmanned systems, hypersonics, or propulsion. A strategic buyer could plausibly pay a premium above DCF value to capture synergies and sole-source positions. If a deal is announced, the market price would likely hold at or above the deal value regardless of intrinsic value. The base-case DCF does not and cannot price an M&A premium, and thus any investor shorting the stock on fundamental grounds takes on this optionality risk. The counterargument is that Kratos's current market cap of roughly \$12.6 billion is already larger than the historical M&A valuations paid for mid-tier defense companies, and that a prime would have difficulty justifying the premium over fundamental value to its own shareholders making this an unlikely course of action.

10.3 Multiple Expansion

Defense-sector trading multiples have expanded substantially over the past three years, driven by the Russia-Ukraine conflict, tensions with China, and broad geopolitical uncertainty. Anduril's private valuation above \$30 billion has reset investor expectations for defense technology valuations across the board. If this re-rating continues, KTOS could remain at elevated multiples for a sustained period even without fundamental improvement. The counterargument is that multiple expansion driven by sentiment rather than fundamentals is, by definition, reversible and fickle, and eventually converges toward fundamental value.

10.4 Timing Risk

The core risk of a fundamental overvaluation thesis is not that it will prove wrong in the stated direction, but rather that the timing of the correction is unknown. A stock can remain above its intrinsic value for extended periods, and any investor positioned against the stock must be able to sustain the position through. This risk is structural rather than analytical, and it does not change the conclusion that the stock is overvalued, but it does affect the practical implementation of the view.

11. Conclusion & Recommendation

The evidence assembled across this report, including historical ROIC of 2 to 4% against a 10.19% WACC, a ten-year track record of margin volatility without structural improvement, negative free cash flow in a growth year, competitive position deteriorating against both primes and venture-backed entrants, and a sensitivity table showing that no reasonable combination of inputs bridges the valuation gap, supports a SELL / UNDERWEIGHT recommendation with a 12-month price target range of \$25 to \$35. The thesis would not expect a correction to happen immediately, only that, over time, KTOS's equity value converges toward the cash flows it can plausibly generate.

The base-case DCF produces an implied share price of \$13.37, but an immediate correction of this magnitude is unlikely. The more realistic 12-month price target above reflects partial convergence toward intrinsic value, tempered by the timing and M&A risks identified in Section 10. The range is roughly 55 to 65% drawdown from current levels, which is consistent with how defense-sector corrections have historically played out, as the operating results (or lack thereof) catch up with the valuation.

Catalysts that would change the view include: (1) sustained EBIT margin above 8% for two or more consecutive quarters, indicating structural rather than cyclical margin expansion; (2) ROIC above WACC for a full fiscal year; (3) a transformational prime contract award at an annual run-rate exceeding \$500 million; or (4) successful acquisition-led entry into AI-enabled autonomy software at terms that do not dilute margins. Without one or more of these catalysts, the gap between operating fundamentals and market valuation is expected to narrow through equity price correction rather than through fundamental improvement.