KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 424B3
December 04, 2008

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PROPOSED MERGER YOUR VOTE IS VERY IMPORTANT

Kratos Defense & Security Solutions, Inc., or Kratos, and Digital Fusion, Inc., or Digital Fusion, have entered into a merger agreement pursuant to which a wholly owned subsidiary of Kratos will merge with and into Digital Fusion, with Digital Fusion continuing as a wholly owned subsidiary of Kratos. Kratos and Digital Fusion believe that the proposed merger will allow Kratos and Digital Fusion to be better positioned to compete in the rapidly evolving defense and security solutions industry.

Immediately prior to the effective time of the merger, each share of Digital Fusion common stock will be converted into the right to receive 1.7933 shares of Kratos common stock. The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger. Upon completion of the merger, Digital Fusion's former stockholders will own approximately 16% of the then outstanding shares of Kratos common stock, based on the number of shares of Kratos and Digital Fusion common stock expected to be outstanding immediately prior to the closing of the merger. The value of the merger consideration to be received in exchange for each share of Digital Fusion common stock will fluctuate with the market price of Kratos common stock.

Based on the closing sale price for Kratos common stock on November 21, 2008, the last trading day before public announcement of the merger, the 1.7933 exchange ratio represented approximately $2.44 in value for each share of Digital Fusion common stock. Based on the closing sale price for Kratos common stock on December 2, 2008, the latest practicable date before the printing of this joint proxy statement/prospectus, the 1.7933 exchange ratio represented approximately $2.19 in value for each share of Digital Fusion common stock.

The merger cannot be completed unless Kratos stockholders approve the issuance of the shares of Kratos common stock in the merger and Digital Fusion stockholders adopt the merger agreement and approve the merger. A special meeting of the stockholders of Kratos will be held at Kratos' offices, 4810 Eastgate Mall, San Diego, California on December 22, 2008 at 10:00 a.m. local time, at which the stockholders of Kratos will be asked to consider and vote upon a proposal to approve the issuance of Kratos common stock in connection with the proposed merger. A special meeting of the stockholders of Digital Fusion will be held at Embassy Suites, 800 Monroe Street, Huntsville, Alabama on December 22, 2008 at 9:30 a.m. local time, at which the stockholders of Digital Fusion will be asked to consider and vote upon a proposal to adopt the merger agreement and approve the merger. Holders of approximately 34% of the outstanding shares of Digital Fusion common stock have entered into stockholder agreements with Kratos, pursuant to which they have agreed to vote their shares in favor of the merger.

Kratos common stock is listed on the Nasdaq Global Select Market under the symbol "KTOS." Digital Fusion common stock trades on the Pink Sheets under the symbol "DIGF.PK." We urge you to obtain current market quotations for the shares of Kratos and Digital Fusion.

After careful consideration, each of the Kratos and Digital Fusion boards of directors has approved the merger agreement and the merger and has determined that it is advisable to enter into the merger. Each of the boards of directors of Kratos and Digital Fusion recommends that its stockholders vote "FOR" the proposals described in the accompanying proxy statement/prospectus.

Your vote is very important. Whether or not you plan to attend your respective company's meeting of stockholders, please submit your proxy as soon as possible to make sure that your shares are represented at that meeting. Information about these meetings, the merger and the other business to be considered by stockholders is contained in this proxy statement/prospectus. We urge you to read this proxy statement/prospectus carefully. You should also carefully consider the risk factors beginning on page 18.

Eric M. DeMarco *Chief Executive Officer and President* Kratos Defense & Security Solutions, Inc.	Gary Ryan *Chief Executive Officer* Digital Fusion, Inc.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the securities to be issued in connection with the merger or determined if this proxy statement/prospectus is accurate or complete. Any representation to the contrary is a criminal offense.

This proxy statement/prospectus is dated December 4, 2008, and is first being mailed to stockholders of Kratos and Digital Fusion on or about December 5, 2008.

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS TO BE HELD ON MONDAY, DECEMBER 22, 2008

To the Stockholders of Kratos Defense & Security Solutions, Inc.:

A special meeting of stockholders of Kratos Defense & Security Solutions, Inc. ("Kratos") will be held at the offices of Kratos, 4810 Eastgate Mall, San Diego, California, on Monday, December 22, 2008 at 10:00 a.m. local time, for the following purposes:

1. To approve the issuance of 32,900,534 shares of Kratos common stock pursuant to the Agreement and Plan of Merger, dated as of November 21, 2008, by and among Kratos Defense & Security Solutions, Inc., Dakota Merger Sub, Inc., and Digital Fusion, Inc., as the same may be amended from time to time.

2. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

The accompanying proxy statement/prospectus further describes the matters to be considered at the meeting. A copy of the Agreement and Plan of Merger referenced above has been included as *Annex A* to the proxy statement/prospectus.

The Kratos board of directors has set November 25, 2008 as the record date for the special meeting. Only holders of record of Kratos common stock at the close of business on November 25, 2008 will be entitled to notice of and to vote at the special meeting and any adjournments or postponements thereof. Any stockholder entitled to attend and vote at the meeting is entitled to appoint a proxy to attend and vote on such stockholder's behalf at the special meeting and any adjournments and postponements thereof. Such proxy need not be a holder of Kratos common stock. **To ensure your representation at the special meeting, please complete and return the enclosed proxy card or submit your proxy by telephone or through the Internet**. Please vote promptly whether or not you expect to attend the special meeting. Submitting a proxy now will not prevent you from being able to vote at the special meeting by attending in person and casting a vote.

The Kratos board of directors unanimously recommends that you vote FOR the proposal to approve the issuance of Kratos common stock in the merger.

By Order of the Kratos Board of Directors,

Eric M. DeMarco
President and Chief Executive Officer
San Diego, CA
December 4, 2008

PLEASE VOTE YOUR SHARES PROMPTLY. YOU CAN FIND INSTRUCTIONS FOR VOTING ON THE ENCLOSED PROXY CARD. IF YOU HAVE QUESTIONS ABOUT THE PROPOSALS OR ABOUT VOTING YOUR SHARES, PLEASE CALL KRATOS' PROXY SOLICITOR, GEORGESON INC., AT 1-800-561-4162.

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS TO BE HELD ON MONDAY, DECEMBER 22, 2008

To the Stockholders of Digital Fusion, Inc.:

A special meeting of stockholders of Digital Fusion, Inc. will be held at Embassy Suites, 800 Monroe Street, Huntsville, Alabama, on Monday, December 22, 2008 at 9:30 a.m. local time, for the following purposes:

1. To adopt and approve the Agreement and Plan of Merger, dated as of November 21, 2008, by and among Kratos Defense & Security Solutions, Inc., Dakota Merger Sub, Inc., and Digital Fusion, Inc., as the same may be amended from time to time.

2. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

The accompanying proxy statement/prospectus further describes the matters to be considered at the special meeting. A copy of the Agreement and Plan of Merger referenced above has been included as *Annex A* to this proxy statement/prospectus.

The Digital Fusion board of directors has set December 2, 2008 as the record date for the special meeting. Only holders of record of shares of Digital Fusion common stock at the close of business on December 2, 2008 will be entitled to notice of and to vote at the special meeting and any adjournments or postponements thereof. **To ensure your representation at the special meeting, please complete and return the enclosed proxy card or submit your proxy by telephone or through the Internet**. Please vote promptly whether or not you expect to attend the special meeting. Submitting a proxy now will not prevent you from being able to vote at the special meeting by attending in person and casting a vote.

The board of directors of Digital Fusion recommends that you vote FOR the proposal to adopt and approve the merger agreement.

By Order of the Digital Fusion Board of Directors,

Gary Ryan
Chief Executive Officer
December 4, 2008

PLEASE VOTE YOUR SHARES PROMPTLY. YOU CAN FIND INSTRUCTIONS FOR VOTING ON THE ENCLOSED PROXY CARD. IF YOU HAVE QUESTIONS ABOUT THE PROPOSALS OR ABOUT VOTING YOUR SHARES, PLEASE CALL DIGITAL FUSION'S CORPORATE SECRETARY AT (256) 327-8100 OR VIA EMAIL AT JBRABSTON@DIGITALFUSION.COM.

ADDITIONAL INFORMATION

This joint proxy statement/prospectus incorporates important business and financial information about Kratos Defense & Security Solutions, Inc. that is not included in or being delivered with this joint proxy statement/prospectus. The incorporated information that is not included in or being delivered with this joint proxy statement/prospectus is available to you without charge upon your written or oral request. You can obtain any document that is incorporated by reference in this proxy statement/prospectus, excluding all exhibits that have not been specifically incorporated by reference, on the investor relations page of Kratos' website at *http://www.kratosdefense.com* or by requesting it in writing or by telephone from Kratos at the following address or telephone number:

4810 Eastgate Mall
San Diego, CA 92121
(858) 812-7300
Attn.: Corporate Secretary
Website: *www.kratosdefense.com*

If you would like to request any documents, please do so by December 15, 2008 in order to receive them before the special meeting. See "Where You Can Find More Information."

You should rely only on the information contained or incorporated by reference in this joint proxy statement/prospectus and the registration statement of which this joint proxy statement/prospectus is a part to vote on the proposals being presented at the special meetings. No one has been authorized to provide you with information that is different from what is contained in this document or in the incorporated documents.

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QUESTIONS AND ANSWERS ABOUT THE MERGER

The following questions and answers briefly address some commonly asked questions about the Kratos and Digital Fusion meetings. They may not include all the information that is important to holders of stock of Kratos and Digital Fusion. We urge stockholders to read carefully this entire proxy statement/prospectus, including the annexes and the other documents referred to herein.

Q:

Why am I receiving these materials?

A:

We are sending you these materials to help you decide how to vote your shares of Kratos or Digital Fusion common stock with respect to their proposed merger. The merger cannot be completed unless Kratos stockholders approve the issuance of Kratos common stock and Digital Fusion stockholders adopt and approve the merger agreement. Each of Kratos and Digital Fusion is holding its meeting of stockholders to vote on the proposals necessary to complete the merger. Information about these meetings, the merger and the other business to be considered by holders of stock is contained in this proxy statement/prospectus.

We are delivering this document to you as both a joint proxy statement of Kratos and Digital Fusion and a prospectus of Kratos. It is a joint proxy statement because each of our boards of directors is soliciting proxies from its stockholders. It is a prospectus because Kratos will exchange shares of its common stock for shares of Digital Fusion in the merger.

Q:

What will stockholders receive in the merger?

A:

In the proposed merger, holders of Digital Fusion common stock will receive 1.7933 shares of Kratos common stock for each share of Digital Fusion common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing.

The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger.

Q:

When do Kratos and Digital Fusion expect to complete the merger?

A:

Kratos and Digital Fusion expect to complete the merger after all conditions to the merger in the merger agreement are satisfied or waived, including after stockholder approvals are received at their respective stockholder meetings. Kratos and Digital Fusion currently expect to complete the merger during late 2008 or early 2009. However, it is possible that factors outside of either company's control could require Kratos and Digital Fusion to complete the merger at a later time or not to complete it at all.

Q:

How do the boards of directors of Kratos and Digital Fusion recommend that I vote?

A:

The Kratos board of directors unanimously recommends that holders of Kratos common stock vote FOR the proposal to approve the issuance of Kratos common stock in the merger.

The Digital Fusion board of directors unanimously recommends that Digital Fusion stockholders vote FOR the proposal to approve the merger and adopt the merger agreement.

Q:

What do I need to do now?

A:

After carefully reading and considering the information contained in this proxy statement/prospectus, please vote your shares as soon as possible so that your shares will be represented at your respective company's meeting. Please follow the instructions set forth on the proxy card or on the voting instruction form provided by the record holder if your shares are held in the name of your broker or other nominee.

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Q: **How do I vote?**

A: You may vote before your company's meeting in one of the following ways:

- use the toll-free number shown on your proxy card;
- visit the website shown on your proxy card to vote via the Internet;
- complete, sign, date and return the enclosed proxy card in the enclosed postage-paid envelope; or
- cast your vote in person at your company's meeting.

If your shares are held in "street name" through a broker, bank or other nominee, that institution will send you separate instructions describing the procedure for voting your shares. "Street name" stockholders who wish to vote at the meeting will need to obtain a proxy form from the institution that holds their shares.

Q: **When and where are the Kratos and Digital Fusion meetings of stockholders?**

A: The special meeting of Kratos stockholders will be held at the offices of Kratos, 4810 Eastgate Mall, San Diego, California, on December 22, 2008 at 10:00 a.m. local time. All stockholders as of the record date, or their duly appointed proxies, may attend the meeting.

The special meeting of Digital Fusion stockholders will be held at Embassy Suites, 800 Monroe Street, Huntsville, Alabama, on December 22, 2008 at 9:30 a.m. local time. All stockholders as of the record date, or their duly appointed proxies, may attend the meeting.

Q: **If my shares are held in "street name" by a broker or other nominee, will my broker or nominee vote my shares for me?**

A: Your broker or other nominee does not have authority to vote on the proposals described in this proxy statement/prospectus. Your broker or other nominee will vote your shares held by it in "street name" with respect to these matters ONLY if you provide instructions to it on how to vote. You should follow the directions your broker or other nominee provides.

Q: **What constitutes a quorum?**

Stockholders who hold a majority in voting power of the Kratos common stock issued and outstanding as of the close of business on the record date and who are entitled to vote at the special meeting must be present or represented by proxy in order to constitute a quorum to conduct business at the Kratos special meeting.

Stockholders who hold a majority in voting power of the Digital Fusion common stock issued and outstanding as of the close of business on the record date and who are entitled to vote at the special meeting must be present or represented by proxy in order to constitute a quorum to conduct business at the Digital Fusion special meeting.

Q: **What vote is required to approve each proposal?**

A: For Kratos stockholders, the affirmative vote of a majority of the total votes represented in person or by proxy at the special meeting is required to approve the proposal to approve the issuance of Kratos common stock in the merger.

For Digital Fusion stockholders, the affirmative vote of a majority of the outstanding shares of Digital Fusion common stock entitled to vote at the meeting is required to approve the merger agreement.

Q:

What if I do not vote on the matters relating to the merger?

A:

If you are a Kratos stockholder and you fail to vote or fail to instruct your broker or other nominee how to vote on the proposal to issue shares of common stock in the merger, it will have no effect on the vote for the proposal. If you respond with an "abstain" vote, your proxy will have the same effect as a vote against the proposal. If you submit a proxy but do not indicate how you want to vote on the proposal, your proxy will be counted as a vote in favor of the proposal in accordance with the recommendation of the Kratos board of directors.

If you are a Digital Fusion stockholder and you fail to vote or fail to instruct your broker or other nominee how to vote on the proposal to adopt and approve the merger agreement, it will have the same effect as a vote against the merger. If you respond with an "abstain" vote on the proposal, your proxy will have the same effect as a vote against the proposal. If you respond but do not indicate how you want to vote on the merger, your proxy will be counted as a vote in favor of the merger.

Q:

What if I hold shares in both Kratos and Digital Fusion?

A.

If you are a stockholder of both Kratos and Digital Fusion, you will receive two separate packages of proxy materials. A vote as a Kratos stockholder approving the issuance of Kratos common stock will not constitute a vote as a Digital Fusion stockholder for the merger, or vice versa. Therefore, please sign, date and return all proxy cards that you receive, whether from Kratos or Digital Fusion, or vote as both a Kratos and Digital Fusion stockholder by telephone or via the Internet.

Q:

May I change my vote after I have delivered my proxy or voting instruction card?

A:

Yes. You may change your vote at any time before your proxy is voted at the applicable meeting. You may do this in one of four ways:

- by sending a notice of revocation to the corporate secretary of Kratos or Digital Fusion, as applicable;
- by sending a completed proxy card bearing a later date than your original proxy card;
- by logging onto the Internet website specified on your proxy card in the same manner you would to submit your proxy electronically or by calling the telephone number specified on your proxy card, in each case if you are eligible to do so, and following the instructions on the proxy card; or
- by attending the applicable meeting and voting in person. Your attendance alone will not revoke any proxy.

If you choose any of the first three methods, you must take the described action no later than the beginning of the applicable meeting. If your shares are held in an account at a broker or other nominee, you should contact your broker or other nominee to change your vote.

Q:

What are the material United States federal income tax consequences of the merger?

A:

Kratos and Digital Fusion intend for the merger to qualify as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended, which we refer to as the Code, for United States federal income tax purposes. Accordingly, a holder of Digital Fusion common stock generally will not recognize any gain or loss for U.S. federal income tax purposes upon the exchange of the holder's shares of Digital Fusion common stock for shares of Kratos common stock pursuant to the merger, except that a Digital Fusion stockholder will recognize a gain or loss with respect to any cash received in lieu of a fractional share of Kratos common stock.

Q: **Do I have appraisal rights?**

A: The holders of Kratos common stock will not be entitled to exercise any appraisal rights in connection with the merger. Pursuant to Section 262 of the Delaware General Corporation Law, or DGCL, the holders of Digital Fusion common stock are entitled to appraisal rights if they do not vote in favor of the merger and otherwise comply with the requirements of the DGCL. Digital Fusion stockholders who dissent from the merger and exercise their appraisal rights will recognize gain or loss with respect to cash received in exchange for their Digital Fusion common stock.

Q: **Should I send in my stock certificates now?**

A: No. Please do not send your stock certificates with your proxy card.

If you are a holder of Digital Fusion common stock, you will receive written instructions from the exchange agent after the merger is completed on how to exchange your stock certificates for Kratos common stock. Kratos stockholders will not be exchanging their stock certificates in connection with the merger. Accordingly, Kratos stockholders holding stock certificates should keep their stock certificates both now and after the merger is completed.

Q: **What if I hold Digital Fusion and Kratos stock options or warrants?**

A: Kratos stock options and other equity-based awards, including restricted stock units, will remain outstanding and will not be affected by the merger.

Kratos will assume outstanding options and warrants to purchase shares of Digital Fusion common stock in the merger. Each outstanding option and warrant to acquire Digital Fusion common stock will be converted automatically at the effective time of the merger into an option or warrant to acquire Kratos common stock, and will continue to be governed by the terms of the relevant Digital Fusion stock plan and/or related agreements under which it was granted, except that the number of shares of Kratos common stock for which each option or warrant is exercisable and the exercise price of each option or warrant will be adjusted based on the exchange ratio in the merger.

Q: **Who should I contact if I have any questions about the merger, the proxy materials or voting power?**

A: If you have any questions about the merger or if you need assistance in submitting your proxy or voting your shares or need additional copies of the proxy statement/prospectus or the enclosed proxy card, you should contact the company in which you hold shares.

If you are a Kratos stockholder, you should contact Georgeson Inc., the proxy solicitation agent for Kratos, at 1-800-561-4162. If you are a Digital Fusion stockholder, you should contact Jamie Brabston, Corporate Secretary, at (256) 327-8100 or via email at jbrabston@digitalfusion.com. If your shares are held in a stock brokerage account or by a bank or other nominee, you should call your broker or other nominee for additional information.

SUMMARY

This summary highlights selected information contained in this joint proxy statement/prospectus, referred to as this proxy statement/prospectus, and does not contain all the information that may be important to you. Kratos and Digital Fusion urge you to read carefully this proxy statement/prospectus in its entirety, including the annexes. Unless stated otherwise, all references in this proxy statement/prospectus to Kratos refer to Kratos Defense & Security Solutions, Inc., a Delaware corporation, all references to Digital Fusion refer to Digital Fusion, Inc., a Delaware corporation, all references to Merger Sub refer to Dakota Merger Sub, Inc., a Delaware corporation, and all references to the merger agreement refer to the Agreement and Plan of Merger, dated as of November 21, 2008, by and among Kratos, Merger Sub, and Digital Fusion, a copy of which is attached as Annex A to this proxy statement/prospectus.

The Parties

Kratos

Kratos Defense & Security Solutions, Inc.
4810 Eastgate Mall
San Diego, CA 92121
(858) 812-7300

Kratos is an innovative provider of mission critical engineering, IT services and warfighter solutions. Kratos performs work primarily for the U.S. government and government agencies, but also performs work for state and local agencies and commercial customers. As a result of its market focus, Kratos is organized into two primary operating segments, the Kratos Government Solutions, or KGS, segment and the Public Safety and Security, or PSS, segment. The principle services of Kratos include, but are not limited to, Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance, or C5ISR; weapon systems life cycle support and extension; military range operations and technical services; missile, rocket and weapons systems test and evaluation; mission launch services; public safety; security and surveillance systems; advanced network engineering and IT services; and critical infrastructure design and integration services. Kratos offers its customers a range of solutions and technical expertise to support their mission-critical needs by leveraging skills across Kratos' core service areas.

Founded in 1994, Kratos is headquartered in San Diego and has offices in California, Washington D.C. and several other locations in the U.S.

For more information regarding Kratos, visit *www.kratosdefense.com*. The information on Kratos' website is not a part of this proxy statement/prospectus.

Digital Fusion

Digital Fusion, Inc.
5030 Bradford Drive
Building 1, Suite 210
Huntsville, AL 35805
(256) 327-8103

Digital Fusion is an information technology, research and engineering, and acquisition and business support services company that helps its customers make the most of technology to meet their business needs. Digital Fusion's IT Services business unit provides solutions to both government and commercial customers, focused in the following areas: Business Process Automation, Application Development and Data Management, Application Security, Web Portals and Digital Dashboards, System Integration, and IT Support. Digital Fusion's Research and Engineering Services business unit supports a variety of customers with state-of-the-art solutions that include: Systems Development and Engineering; Applied

Aerodynamics/ Computational Fluid Dynamics; Missile Engineering; Thermal-Structural Modeling; Program, Data and Financial Management Support; Modeling and Simulation; Control System Design and Analysis; Mechanical Design and Analysis; Optical Systems Design, Development and Test; Hardware-in-the-Loop Testing; and Test and Evaluation. Digital Fusion's Acquisition and Business Support Services business unit provides solutions focused on the following areas: Budget Integration and Analysis; Accounting Operations; Travel Management; SAP Expertise; Business System Development, Evaluation and Operation; Assessing Best Business Practices and Tools; Contracts Management and Administration; Purchasing Expertise; Procurement Documentation Generation and Evaluation; Price and Cost Analysis; Earned Value Management and Policy Evaluation and Support.

Founded in 1995, Digital Fusion is incorporated in Delaware. Its main office is located in Huntsville, Alabama and it has satellite offices in Texas and Washington, D.C.

For additional information regarding Digital Fusion, visit *www.digitalfusion.com*. The information on Digital Fusion's website is not a part of this proxy statement/prospectus.

Merger Sub

Dakota Merger Sub, Inc., or Merger Sub, a wholly-owned subsidiary of Kratos, is a Delaware corporation formed on November 13, 2008 for the sole purpose of effecting the merger. Upon completion of the merger, Merger Sub will merge with and into Digital Fusion, and Digital Fusion will become a wholly-owned subsidiary of Kratos.

The Merger

Each of the boards of directors of Kratos and Digital Fusion has approved the strategic merger of Kratos and Digital Fusion. Kratos and Digital Fusion have entered into an Agreement and Plan of Merger pursuant to which Digital Fusion will merge with a newly formed, wholly-owned subsidiary of Kratos, with Digital Fusion surviving the merger as a wholly-owned subsidiary of Kratos. In the proposed merger, Digital Fusion stockholders will receive 1.7933 shares of Kratos common stock for each share of Digital Fusion common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing. The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger.

A copy of the merger agreement is attached as *Annex A* to this proxy statement/prospectus. Kratos and Digital Fusion encourage you to read the entire merger agreement carefully because it is the principal document governing the merger. For more information on the merger agreement, see "The Merger Agreement and Related Agreements" beginning on page 81.

The merger is expected to be completed during late 2008 or early 2009, subject to the satisfaction or waiver of the closing conditions. For a discussion of the timing of the merger, see "The Merger Agreement and Related Agreements Closing and Effective Time of the Merger" beginning on page 82.

Merger Consideration

Each share of Digital Fusion common stock, par value $0.01 per share, issued and outstanding immediately prior to the completion of the merger, will be converted into the right to receive 1.7933 shares of Kratos common stock, for an aggregate of approximately 21.1 million shares, assuming no exercise or conversion of outstanding options. Kratos will not issue any fractional shares in the merger. Instead, Digital Fusion stockholders will receive cash (without interest) in lieu of such fractional share, after aggregating all fractional shares of Kratos common stock issuable to that holder, determined by multiplying such fraction by the average closing price of Kratos common stock for the five trading days immediately prior to the closing date.

For a more complete description of the merger consideration, see "The Merger Agreement and Related Agreements Terms of the Merger" beginning on page 81.

Treatment of Stock Options and Warrants

Kratos will assume outstanding options and warrants to purchase shares of Digital Fusion common stock in the merger. Each outstanding option and warrant to acquire Digital Fusion common stock will be converted automatically at the effective time of the merger into an option or warrant to acquire Kratos common stock, and will continue to be governed by the terms of the relevant Digital Fusion stock plan and/or related agreements under which it was granted, except that the number of shares of Kratos common stock for which each option or warrant is exercisable and the exercise price of each option or warrant will be adjusted based on the exchange ratio in the merger. For a more complete discussion of the treatment of Digital Fusion options and other stock-based awards, see "The Merger Agreement and Related Agreements Treatment of Digital Fusion Stock Options" beginning on page 81 and "The Merger Agreement and Related Agreements Treatment of Digital Fusion Warrants" beginning on page 82.

Directors and Executive Management Following the Merger

The directors and executive management of Kratos will remain unchanged at the effective time of the merger. At the effective time of the merger, the directors and officers of Merger Sub will become the directors and officers of Digital Fusion until each is replaced by his or her successor.

For a more complete discussion of the directors and management of Kratos, see "The Merger Composition of Kratos Board of Directors" beginning on page 74.

Recommendation of the Kratos Board of Directors

After careful consideration, the Kratos board of directors unanimously recommends that holders of Kratos common stock vote **FOR** the issuance of Kratos common stock in connection with the merger.

For a more complete description of Kratos' reasons for the merger and the recommendations of the Kratos board of directors, see "The Merger The Kratos Board of Directors' Recommendations and Reasons for the Merger" beginning on page 56.

Recommendation of the Digital Fusion Board of Directors

After careful consideration, the Digital Fusion board of directors unanimously recommends that holders of Digital Fusion common stock vote **FOR** the adoption of the merger agreement and approval of the merger.

For a more complete description of Digital Fusion's reasons for the merger and the recommendation of the Digital Fusion board of directors, see "The Merger The Digital Fusion Board of Directors' Recommendation and Reasons for the Merger" beginning on page 57.

Opinions of Financial Advisors

Kratos Financial Advisor

In connection with the transaction, Kratos' board of directors received a written opinion from Imperial Capital, LLC, or Imperial Capital, Kratos' financial advisor, as to the fairness, from a financial point of view and as of the date of its opinion, of the exchange ratio in the transaction to Kratos. The full text of Imperial Capital's written opinion, dated November 19, 2008, is attached to this proxy statement as *Annex C*. Holders of Kratos common stock are encouraged to read this opinion carefully in its entirety for a description of the assumptions made, procedures followed, matters considered and limitations on the review undertaken. **Imperial Capital's opinion was provided to Kratos' board of directors in connection with, and for the purposes of, its evaluation of the exchange ratio in the transaction from a financial point of view, does not address the merits of the underlying decision by Kratos to engage in the transaction or the relative merits of any alternatives discussed by Kratos' board of directors, does not constitute an opinion with respect to Kratos' underlying business decision to effect the transaction, any legal, tax or accounting issues concerning the transaction, or any terms of the transaction (other than the exchange ratio) and does not constitute a recommendation as to any action Kratos or any holder of Kratos common stock should take in connection with the transaction or any aspect thereof.**

For a more complete description of Imperial Capital's opinion, see "The Merger Opinion of Financial Advisor to the Kratos Board of Directors" beginning on page 59. See also *Annex C* to this proxy statement/prospectus.

Digital Fusion Financial Advisor

ISI Partners, LLC, or ISI, delivered an opinion to Digital Fusion's board of directors that, subject to and based upon the assumptions made, procedures followed, matters considered and limitations on its review undertaken, as of November 20, 2008, the exchange ratio in the merger agreement was fair from a financial point of view to Digital Fusion. The full text of ISI's written opinion, dated November 20, 2008, is attached as *Annex D* to this proxy statement/prospectus. Holders of shares of Digital Fusion common stock are urged to read the opinion carefully and in its entirety. ISI's opinion does not and shall not constitute a recommendation to any holders of shares of Digital Fusion common stock as to how they should vote in connection with the merger. This summary of ISI's opinion contained in this proxy statement/prospectus is qualified in its entirety by reference to the full text of the opinion.

For a more complete description of the ISI opinion, see "The Merger Opinion of Financial Advisor to the Digital Fusion Board of Directors" beginning on page 67. See also *Annex D* to this proxy statement/prospectus.

Interests of Digital Fusion Directors and Executive Officers in the Merger

When you consider the unanimous recommendation of Digital Fusion's board of directors that Digital Fusion stockholders approve the merger agreement and the merger, you should be aware that some Digital Fusion officers and directors may have interests in the transaction that may be different from, or in addition, to their interests as stockholders of Digital Fusion.

For a further discussion of interests of directors and executive officers in the merger, see "The Merger Interests of Digital Fusion Directors and Executive Officers in the Merger" beginning on page 74.

Material United States Federal Income Tax Consequences of the Merger

Kratos and Digital Fusion intend for the merger to qualify as a reorganization within the meaning of Section 368(a) of the Code for U.S. federal income tax purposes. Accordingly, Digital Fusion stockholders generally will not recognize gain or loss for U.S. federal income tax purposes upon the receipt of Kratos common stock in the merger, except that a Digital Fusion stockholder will recognize gain or loss with respect to any cash received in lieu of a fractional share of Kratos common stock. Digital Fusion stockholders who exercise their appraisal rights will recognize gain or loss with respect to cash received in exchange for their Digital Fusion common stock.

Tax matters are very complicated and the tax consequences of the merger to you, if you are a Digital Fusion stockholder, will depend upon the facts of your situation. In addition, you may be subject to state, local or foreign tax laws that are not addressed in this proxy statement/prospectus. You are urged to consult with your own tax advisors for a full understanding of the tax consequences of the merger to you.

For a more complete description of the material U.S. federal income tax consequences of the merger, see "The Merger Material United States Federal Income Tax Consequences" beginning on page 78.

Accounting Treatment of the Merger

The merger will be accounted for as an acquisition by Kratos of Digital Fusion under the purchase method of accounting according to U.S. generally accepted accounting principles.

Regulatory Matters

The parties are not aware of any governmental or regulatory approvals required in order to complete the transaction.

Appraisal Rights

Kratos stockholders have no appraisal rights with respect to the merger under Section 262 of the Delaware General Corporation Law, or DGCL.

Under the DGCL, holders of Digital Fusion common stock who do not vote for the adoption of the merger agreement have the right to seek appraisal and receive cash for the fair value of their shares, but only if they comply with all requirements of the DGCL and at least one stockholder who properly exercised appraisal rights litigates an appraisal proceeding in the Delaware Court of Chancery to obtain the appraisal. See "The Merger Appraisal Rights" on page 77, "Appraisal Rights" beginning on page 194 and *Annex E* to this proxy statement/prospectus.

Conditions to Completion of the Merger

Kratos and Digital Fusion expect to complete the merger after all the conditions to the merger in the merger agreement are satisfied or waived, including after the receipt of stockholder approvals at their respective stockholder meetings. In addition to obtaining such stockholder approvals, each of the other closing conditions set forth in the merger agreement must be satisfied. Kratos and Digital Fusion currently expect to complete the merger during late 2008 or early 2009. However, it is possible that factors outside of either company's control could cause the merger to be competed at a later time or not at all.

The merger agreement provides that certain of these conditions may be waived, in whole or in part, by Kratos or Digital Fusion, to the extent legally allowed. Neither Kratos nor Digital Fusion currently expects to waive any material condition to the completion of the merger. If either Kratos or Digital Fusion determines to waive any condition to the merger that would result in a material and adverse change in the terms of the merger to Kratos or Digital Fusion stockholders (including any change in the tax consequences of the transaction to Digital Fusion stockholders), proxies would be resolicited from the Kratos or Digital Fusion stockholders, as applicable.

For a more complete discussion of the conditions to the merger, see "The Merger Agreement and Related Agreements Conditions to Completion of the Merger" beginning on page 90.

No Solicitation of Other Offers

The merger agreement contains restrictions on the ability of Digital Fusion to solicit or engage in discussions or negotiations with a third party with respect to a proposal to acquire Digital Fusion's equity or assets. Notwithstanding these restrictions, the merger agreement provides that under specified circumstances, if Digital Fusion receives an unsolicited bona fide proposal from a third party to acquire a significant interest in it that its board of directors determines in good faith is reasonably likely to lead to a proposal that is superior to the merger, Digital Fusion may furnish nonpublic information to that third party and engage in negotiations regarding an acquisition proposal with that third party.

For a discussion of the prohibition on solicitation of acquisition proposals from third parties, see "The Merger Agreement and Related Agreements Non-Solicitation; Change in Recommendations" beginning on page 89.

Termination

Kratos and Digital Fusion may mutually agree at any time prior to the completion of the merger (including after stockholder approval) to terminate the merger agreement and abandon the merger. In addition, the agreement may be terminated by either Kratos or Digital Fusion under certain circumstances or upon the occurrence of certain events.

See "The Merger Agreement and Related Agreements Termination" beginning on page 92.

Termination Fees and Expenses

Digital Fusion is required to pay a termination fee of $1,344,000 to Kratos in the event the merger agreement is terminated by Digital Fusion in connection with the entry into an agreement for a superior proposal. In addition, Digital Fusion is required to pay Kratos the termination fee if Kratos terminates the merger agreement under certain conditions or in the event that Digital Fusion terminates the Merger Agreement and either enters into or consummates a takeover proposal, other than with Kratos, within 12 months of such termination under certain circumstances.

This termination fee could discourage other companies from seeking to acquire or merge with either Digital Fusion or Kratos. See "The Merger Agreement and Related Agreements Termination Fees and Expenses" and " Effect of Termination," beginning on page 93.

Stockholder Agreements

In order to induce Kratos to enter into the merger agreement, several Digital Fusion stockholders entered into stockholder agreements and irrevocable proxies with Kratos pursuant to which, among other things, each of these stockholders agreed, solely in its capacity as a stockholder, to vote all of its shares of Digital Fusion capital stock and other Digital Fusion securities in favor of the merger and the adoption of the merger agreement, against any action or agreement that would result in a breach of the merger agreement by Digital Fusion, and against any other action which, directly or indirectly, would reasonably be expected to prevent or materially delay the consummation of the merger or the transactions contemplated by the merger agreement. These Digital Fusion stockholders also granted Kratos an irrevocable proxy to their respective Digital Fusion capital stock and securities in accordance with the stockholder agreement.

As of November 21, 2008, the stockholders of Digital Fusion that entered into stockholder agreements owned in the aggregate 3,999,567 shares of Digital Fusion stock, representing approximately 34% of the outstanding Digital Fusion stock.

See "The Merger Agreement and Related Agreements Stockholder Agreements" beginning on page 94.

Comparison of the Rights of Kratos and Digital Fusion Stockholders

The rights of Digital Fusion stockholders as Kratos stockholders after the merger will be governed by Kratos' certificate of incorporation and bylaws, each as amended, and the laws of the State of Delaware. Those rights differ from the rights of Digital Fusion stockholders under Digital Fusion's certificate of incorporation and bylaws.

See "Comparison of Rights of Kratos and Digital Fusion Stockholders" beginning on page 191.

Voting by Digital Fusion Directors and Executive Officers

On December 2, 2008, the record date set by the Digital Fusion board of directors, directors and executive officers of Digital Fusion and their affiliates owned and were entitled to vote 3,999,567 shares of Digital Fusion common stock, or approximately 34% of the shares of Digital Fusion common stock outstanding on that date. All Digital Fusion directors and executive officers have executed stockholder agreements agreeing to vote in favor of the merger.

SELECTED HISTORICAL FINANCIAL DATA OF KRATOS

The selected consolidated financial data below is derived from Kratos' audited consolidated financial statements as of and for each of the five years ended December 31, 2003 through 2007 contained in Kratos' annual reports on Form 10-K for the years ended December 31, 2003, 2004, 2005, 2006 and 2007, except for the financial data as of and for the nine months ended September 28, 2008, which is derived from Kratos' unaudited condensed consolidated financial statements contained in Kratos' quarterly report on Form 10-Q for the period ended September 28, 2008 and presented elsewhere in this proxy statement/prospectus. The information is only a summary and should be read in conjunction with Kratos' consolidated financial statements, accompanying notes, "Certain Information Relating to Kratos Management's Discussion and Analysis of Financial Condition and Results of Operations of Kratos," "Certain Information Relating to Kratos Description of Business," included elsewhere in this proxy statement/prospectus.

	Year ended December 31,					Nine months ended September 28,
	2003	2004	2005	2006	2007	2008
	(in millions, except per share amounts)					
Consolidated Statement of Operations Data:						
Revenues	$ 43.4	$116.9	$152.3	$153.1	$193.6	$ 222.0
Operating costs and expenses:						
Costs of revenues	22.2	87.9	115.7	124.2	162.0	178.6
Selling, general and administrative expenses	18.0	28.9	35.5	38.5	39.5	37.7
Research and development						1.0
Stock option investigation and related fees					14.0	(1.0)
Estimated cost for settlement of securities litigation					4.9	
Loss (recovery) of unauthorized issuance of stock options	5.7				(3.4)	(0.6)
Contingent acquisition consideration and restatement fees		13.9	(2.1)	0.1		
Impairment, restructuring fees and adjustments to the liability for unused office space	0.1			21.8	1.2	(0.3)
Total operating costs and expenses	46.0	130.7	149.1	184.6	218.2	215.4
Operating income (loss)	(2.6)	(13.8)	3.2	(31.5)	(24.6)	6.6
Other (income) expense:						
Interest income (expense), net	0.9	0.2	0.1	(0.7)	(1.2)	(7.5)
Impairment of investments in unconsolidated subsidiaries		(2.9)			(1.8)	
Other income and (expense), net	(0.1)	(0.1)	0.2	(0.2)	0.7	0.8
Total other (income) expense	0.8	(2.8)	0.3	(0.9)	(2.3)	(6.7)
Income (loss) from continuing operations before income taxes	(1.8)	(16.6)	3.5	(32.4)	(26.9)	(0.1)
Provision (benefit) for income taxes from continuing operations	(1.0)	(8.4)	(0.1)	13.8	1.3	1.4
Income (loss) from continuing operations	(0.8)	(8.2)	3.6	(46.2)	(28.2)	(1.5)
Income (loss) from discontinued operations	2.7	23.2	(2.0)	(11.7)	(12.6)	0.2
Net income (loss)	$ 1.9	$ 15.0	$ 1.6	$ (57.9)	$ (40.8)	$ (1.3)
Basic earnings (loss) per common share:						
Continuing operations	$(0.01)	$ (0.12)	$ 0.05	$ (0.63)	$ (0.38)	$ (0.02)

Discontinued operations	0.04	0.34	(0.03)	(0.16)	(0.17)	0.00
Net income (loss)	$ 0.03	$ 0.22	$ 0.02	$ (0.79)	$ (0.55)	$ (0.01)
Diluted earnings (loss) per common share:						
Continuing operations	$ (0.01)	$ (0.12)	$ 0.05	$ (0.63)	$ (0.38)	$ (0.02)
Discontinued operations	0.04	0.34	(0.03)	(0.16)	(0.17)	0.00
Net income (loss)	$ 0.03	$ 0.22	$ 0.02	$ (0.79)	$ (0.55)	$ (0.01)
Weighted average common shares outstanding:						
Basic	68.4	67.7	74.0	73.5	74.0	88.0
Diluted	68.4	67.7	75.0	73.5	74.0	88.0

	December 31,					September 28,
	2003	2004	2005	2006	2007	2008
	(in millions)					
Consolidated Balance Sheet Data:						
Cash and cash equivalents	$ 75.8	$ 58.0	$ 7.7	$ 5.4	$ 8.6	$ 2.5
Working capital	132.5	98.6	67.4	(3.8)	23.4	32.2
Goodwill	5.5	57.1	94.4	129.9	194.5	237.3
Other intangible assets	1.9	6.4	7.4	13.4	19.9	25.0
Total assets	279.3	330.7	342.0	337.7	335.3	382.8
Total debt	0.7	1.9	0.7	51.4	76.7	83.8
Stockholders' equity	191.9	219.6	229.7	187.1	167.2	220.0

SELECTED HISTORICAL FINANCIAL DATA OF DIGITAL FUSION

The selected consolidated financial data below is derived from Digital Fusion's audited consolidated financial statements for each of the five years ended December 31, 2003 through 2007, except for financial data for the 38 weeks ended September 18, 2008, which is derived from Digital Fusion's unaudited condensed combined financial statements presented elsewhere in this proxy statement/prospectus. This information is only a summary and should be read in conjunction with Digital Fusion's consolidated financial statements, accompanying notes and "Certain Information Relating to Digital Fusion Management's Discussion and Analysis of Financial Condition and Results of Operations of Digital Fusion" included elsewhere in this proxy statement/prospectus.

	Year Ended December 31,					Nine months ended September 19, 2008
	2003	2004	2005	2006	2007	
	(All amounts except per share data in millions)					
Consolidated Statements of Operations Data:						
Revenues	$ 6.4	$ 6.8	$20.9	$34.4	$47.5	$ 44.7
Gross profit	1.5	0.8	3.5	5.1	7.1	6.3
Selling, general and administrative	1.7	1.7	2.7	4.9	6.2	4.5
Operating income (loss)	(0.2)	(0.9)	0.8	0.0	0.9	1.8
Provision (benefit) for income taxes	(0.0)	0.0	0.0	2.5	0.9	0.3
Net income (loss)	$ (0.4)	$ (1.0)	$ 0.0	$ 1.3	$ 1.6	$ 1.4
Net income (loss) per common share:						
Basic	$0.06	$(0.13)	$0.00	$0.11	$0.14	$ 0.12
Diluted	$0.06	$(0.13)	$0.00	$0.09	$0.12	$ 0.10
Weighted average shares:						
Basic	7.2	8.0	10.9	11.4	11.6	11.7
Diluted	7.2	8.0	13.0	14.0	13.6	13.6

	As of December 31,					Nine months ended September 19, 2008
	2003	2004	2005	2006	2007	
	(All amounts in millions)					
Consolidated Balance Sheet Data:						
Cash and cash equivalents	$0.4	$ 0.3	$ 0.0	$ 0.0	$ 0.0	$ 1.0
Working capital	0.5	(0.3)	(0.2)	1.0	3.1	6.0
Total assets	4.6	5.4	13.7	17.0	21.0	23.3
Short-term debt	0.1	0.6	3.0	2.7	1.8	
Long-term debt	1.3	0.1	1.7	1.5	0.0	
Total stockholders' equity	2.3	3.4	5.7	8.6	12.3	14.9

Certain amounts in the selected consolidated financial data above have been reclassified to conform to the 2007 presentation. See Note 1 of Notes to Consolidated Financial Statements of Digital Fusion.

SELECTED UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL DATA

The following summary unaudited pro forma condensed combined financial information is designed to show how the merger of Kratos and Digital Fusion might have affected historical financial statements if the merger had been completed at an earlier time and was prepared based on the historical financial results reported by Kratos, including Haverstick Consulting, Inc., SYS Technologies, and Digital Fusion. The unaudited pro forma condensed combined balance sheet gives effect to the merger as if it had occurred on September 28, 2008. The unaudited pro forma condensed combined income statements for the nine months ended September 28, 2008 and the year ended December 31, 2007, give effect to the merger as if the merger had become effective at January 1, 2007. The unaudited pro forma condensed combined financial statements assume the merger is completed on or before December 28, 2008. The merger will be accounted for under the purchase method of accounting in accordance with Statement of Financial Accounting Standards No. 141, "Business Combinations" with Kratos treated as the acquiring entity.

If the merger is consummated on or after December 29, 2008, the merger will be accounted for under Statement of Financial Accounting Standards (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R would require that the purchase price be determined based on Kratos's closing stock price on the date the merger is consummated, and that contingent assets and liabilities be recorded at fair value. Further, SFAS 141R would require that merger-related transaction costs and exit and termination costs be recorded to expense as incurred rather than capitalized as part of goodwill.

The following should be read in connection with "Unaudited Pro Forma Condensed Combined Financial Statements" beginning on page 150 of this proxy statement/prospectus and the Kratos, Haverstick and Digital Fusion audited consolidated financial statements beginning on pages FI-1, FII-1, and FIII-1, respectively. The pro forma condensed combined financial data is presented for illustrative purposes only and is not necessarily indicative of the financial condition or results of operations of future periods or the financial condition or results of operations that actually would have been realized had the entities been a single company during these periods.

	Year ended December 31, 2007	Period ended September 28, 2008
	(In millions, except per share amounts)	
Statements of Operations Data:		
Revenues	$ 414.3	$ 303.2
Operating income (loss)	(20.7)	7.7
Loss from continuing operations	(34.7)	(1.1)
Loss per common share from continuing operations:		
Basic	$ (0.27)	$ (0.01)
Diluted	$ (0.27)	$ (0.01)
Weighted average common shares outstanding:		
Basic	130.0	130.1
Diluted	130.0	130.1

	As of September 28, 2008
Balance Sheet Data:	
Cash and cash equivalents	$ 1.2
Property and equipment, net	8.1
Goodwill	266.2
Intangible assets, net	33.3
Total assets	430.8
Long-term debt, net of current portion	76.4
Accumulated deficit	(281.3)
Total stockholders' equity	256.4

EQUIVALENT AND COMPARATIVE PER SHARE INFORMATION

The tables below reflect:

- the historical net loss from continuing operations, book value per share and cash dividends per share of Kratos common stock and the historical net income from continuing operations, book value per share and cash dividends per share of Digital Fusion common stock;

- the unaudited pro forma combined Kratos, including Haverstick Consulting, Inc. and SYS Technologies, and Digital Fusion net loss from continuing operations after giving effect to the merger on a purchase basis if the merger had been consummated on January 1, 2007; book value per share, and cash dividends after giving effect to the merger on a purchase basis if the merger had been consummated on September 28, 2008; and

- the unaudited pro forma combined per Digital Fusion equivalent share data net loss from continuing operations, book value per share and cash dividends per share calculated by multiplying the unaudited pro forma combined data by the exchange ratio of 1.7933, which is the Kratos share which would be received for each share of Digital Fusion common stock pursuant to the merger agreement.

The following tables should be read in conjunction with the historical audited consolidated financial statements and accompanying notes of each of Kratos, Digital Fusion and Haverstick which are included elsewhere in this proxy statement/prospectus.

The unaudited pro forma data are presented for illustrative purposes only and are not necessarily indicative of actual or future financial position or results of operation that would have been realized if the proposed mergers had been completed as of the date indicated or will be realized upon completion of the proposed mergers. See the section entitled "Unaudited Pro Forma Condensed Combined Financial Information" beginning on page 150 of this proxy statement/prospectus.

	As of and for the year ended December 31, 2007	As of and for the nine month period ended September 28, 2008
Kratos Historical		
Basic loss per share	$ (0.38)	$ (0.02)
Diluted loss per share	(0.38)	(0.02)
Book value per share	2.26	2.50
Cash dividends per share		
Digital Fusion Historical		
Basic income per share	$ 0.14	$ 0.12
Diluted income per share	0.12	0.10
Book value per share	0.90	1.10
Cash dividends per share		
Unaudited Pro Forma Combined		
Basic loss per share	$ (0.27)	$ (0.01)
Diluted loss per share	(0.27)	(0.01)
Book value per common share		1.97
Cash dividends per share		
Unaudited Pro Forma Combined Digital Fusion Equivalents		
Basic loss per share	$ (0.48)	$ (0.02)
Diluted loss per share	(0.48)	(0.02)
Book value per common share		3.52

Cash dividends per share

The above tables show only historical comparisons. Because the market prices of Kratos and Digital Fusion common stock will likely fluctuate prior to the merge, these comparisons may not provide meaningful information to Kratos stockholders in determining whether to approve the issuance of shares of Kratos common stock in the merger or to Digital Fusion stockholders in determining whether to adopt the merger agreement and approve the merger. Kratos and Digital Fusion stockholders are encouraged to obtain current market quotations for Kratos and Digital Fusion common stock and to review carefully the other information contained in this joint proxy statement/prospectus in considering whether to approve the respective proposals before them.

The following table presents:

- the last reported sale price of a share of Kratos common stock, as reported on The NASDAQ Global Select Market;
- the last reported sale price of a share of Digital Fusion common stock, as reported on the Pink Sheets; and
- the pro forma equivalent per share value of Digital Fusion common stock based on the exchange ratio (i.e. 1.7933 shares of Kratos common stock for each outstanding share of Digital Fusion common stock) and the closing price of Kratos common stock;

in each case, on November 21, 2008, the last full trading day prior to the public announcement of the proposed merger, and on December 2, 2008, the last practicable trading day prior to the date of this joint proxy statement/prospectus.

Date	**Kratos Common Stock**	**Digital Fusion Common Stock**	**Equivalent Price per Share**
November 21, 2008	$ 1.36	$ 1.65	$ 2.44
December 2, 2008	$ 1.22	$ 1.80	$ 2.19

No cash dividends have been paid on either Kratos or Digital Fusion common stock during the two most recent financial years, and neither company intends to pay cash dividends on its common stock in the immediate future.

RISK FACTORS

In addition to the other information contained in this joint proxy statement/prospectus, you should carefully consider the following risk factors in deciding how to vote on the merger. In addition, you should read and consider the risks associated with each of the businesses of Kratos and Digital Fusion because these risks will also relate to Kratos following completion of the merger.

Risks Related to the Merger

The failure to successfully integrate Digital Fusion's business and operations in the expected time frame may adversely affect the combined company's future results.

Kratos believes that the merger with Digital Fusion will result in certain benefits including cost synergies and operational efficiencies. To realize the anticipated benefits, Kratos will be required to devote significant management attention and resources to integrating the two companies. The merger involves the integration of two companies that have previously operated independently with principal offices in two distinct locations. Due to legal restrictions, at present Kratos and Digital Fusion are able to conduct only limited planning regarding the integration of the two companies. The actual integration may result in additional and unforeseen expenses or delays. If Kratos is not able to successfully integrate Digital Fusion's business and operations, or if there are delays in combining the businesses, the anticipated benefits of the merger may not be realized fully or at all or may take longer to realize than expected. In addition, certain small business contracts could be at risk due to the merger as a result of recent changes to the rules governing the treatment of small business contracts after an acquisition. Failure to realize the full benefits of the merger could adversely affect Kratos' business, financial results, financial condition and stock price following the merger.

Because the market price of Kratos common stock will fluctuate, Digital Fusion stockholders cannot be sure of the market value of the Kratos common stock that they will receive.

When we complete the merger, each share of Digital Fusion common stock will be converted into the right to receive 1.7933 shares of Kratos common stock. The exchange ratio is fixed and will not be adjusted for changes in the market price of either Kratos common stock or Digital Fusion common stock. The merger agreement does not provide for any price-based termination right for either party. Accordingly, the market value of the shares of Kratos common stock that Kratos issues and Digital Fusion stockholders will be entitled to receive when the parties complete the merger will depend on the market value of shares of Kratos common stock at the time that the parties complete the merger and could vary significantly from the market value on the date of this proxy statement/prospectus or the date of the Kratos special meeting and the Digital Fusion special meeting. The market value of Kratos common stock will continue to fluctuate after the completion of the merger. For example, during the third calendar quarter of 2008, the sales price of Kratos common stock ranged from a low of $1.33 to a high of $2.14, as reported on the Nasdaq Global Select Market. See "Market Price of and Dividends on Kratos' Common Equity and Related Stockholder Matters" on page 104.

These variations could result from changes in the business, operations or prospects of Kratos or Digital Fusion prior to or following the merger, market assessments as to whether and when the merger will be consummated, regulatory considerations, general market and economic conditions and other factors both within and beyond the control of Kratos or Digital Fusion.

The issuance of shares of Kratos common stock to Digital Fusion stockholders in the merger will substantially dilute the interest in Kratos held by Kratos stockholders prior to the merger.

If the merger is completed, Kratos will issue up to approximately 32.9 million shares of Kratos common stock in connection with the merger, including common stock issuable pursuant to outstanding Digital Fusion options and warrants assumed by Kratos. Based on the number of shares of Kratos and Digital Fusion common stock outstanding on the Kratos and Digital Fusion record dates, Digital Fusion stockholders before the merger will own, in the aggregate, approximately 20% of the shares of Kratos common stock outstanding immediately after the merger on a fully diluted basis. The issuance of shares of Kratos common stock to Digital Fusion stockholders in the merger will cause a significant reduction in the relative percentage interest of current Kratos stockholders in the earnings, voting rights, liquidation value and book and market value of Kratos.

Uncertainty about the merger and diversion of management could harm Kratos and Digital Fusion, whether or not the merger is completed.

In response to the announcement of the merger, existing or prospective customers of Kratos or Digital Fusion may delay or defer their procurement or other decisions concerning Kratos or Digital Fusion, or they may seek to change their existing business relationship. In addition, as a result of the merger, current and prospective employees could experience uncertainty about their future with Kratos or Digital Fusion, and either organization could lose key employees as a result. In addition to retention, these uncertainties may also impair each company's ability to recruit or motivate key personnel. Completion of the merger will also require a significant amount of time and attention from management. The diversion of management attention away from ongoing operations could adversely affect ongoing operations and business relationships.

Failure to complete the merger could adversely affect Kratos' and Digital Fusion's stock prices and their future business and financial results.

Completion of the merger is conditioned upon, among other things, the receipt of approval of the Kratos and Digital Fusion stockholders. There is no assurance that the parties will receive the necessary approvals or satisfy the other conditions to the completion of the merger. Failure to complete the proposed merger would prevent Kratos and Digital Fusion from realizing the anticipated benefits of the merger. Each company will also remain liable for significant transaction costs, including legal, accounting and financial advisory fees. In addition, the market price of each company's common stock may reflect various market assumptions as to whether the merger will occur. Consequently, the failure to complete the merger could result in a significant change in the market price of the common stock of Kratos and Digital Fusion.

The combined company will incur significant transaction and merger-related costs in connection with the merger.

Kratos and Digital Fusion expect to incur significant costs associated with completing the merger and combining the operations of the two companies. The exact magnitude of these costs is not yet known. In addition, there may be unanticipated costs associated with the integration. Although Kratos and Digital Fusion expect that the elimination of duplicative costs and other efficiencies may offset incremental transaction and merger-related costs over time, these benefits may not be achieved in the near term or at all.

Because Digital Fusion's executive officers have interests in seeing the merger completed that are different than those of Digital Fusion's other stockholders, these persons may have conflicts of interest in recommending that Digital Fusion stockholders vote to adopt and approve the merger agreement.

Certain of Digital Fusion's directors and executive officers have interests in the merger that are different from, or are in addition to, the interests of Digital Fusion stockholders generally. This difference of interests stems from the equity and equity-linked securities held by such persons, the retention agreements covering Digital Fusion's executive officers under which such officers are entitled to severance payments and other benefits if their employment is terminated following the merger, and the Kratos obligation under the merger agreement to indemnify Digital Fusion's directors and officers following the merger. These and other material interests of the directors and executive officers of

Digital Fusion in the merger that are different than those of the other Digital Fusion stockholders are described under "The Merger Interests of Digital Fusion Directors and Executive Officers in the Merger" beginning on page 74.

The merger agreement contains provisions that could discourage a potential alternative acquirer that might be willing to pay more to acquire Digital Fusion.

The merger agreement contains "no shop" provisions that restrict Digital Fusion's ability to solicit or facilitate proposals regarding a merger or similar transaction with another party. Further, there are only limited exceptions to Digital Fusion's agreement that its board of directors will not withdraw or adversely qualify its recommendation regarding the merger agreement. Under certain circumstances, Digital Fusion's board of directors is permitted to terminate the merger agreement in response to an unsolicited third party proposal to acquire Digital Fusion, which Digital Fusion's board of directors determines to be more favorable than the merger with Kratos. However, if Digital Fusion or Kratos terminates the merger agreement because Digital Fusion has received an acquisition proposal that is deemed more favorable by its board of directors, Kratos will be entitled to collect a $1,344,000 termination fee from Digital Fusion. We describe these provisions under "The Merger Agreement and Related Agreements Termination" beginning on page 92 and " Termination Fees and Expenses" beginning on page 93.

These provisions could discourage a potential third party acquirer from considering or proposing an alternative acquisition, even if it were prepared to pay consideration with a higher value than that proposed to be paid in the merger, or might result in a potential third party acquirer proposing to pay a lower per share price than it might otherwise have proposed to pay because of the added expense of the termination fee.

Resales of shares of Kratos common stock following the merger and additional obligations to issue shares of Kratos common stock may cause the market price of Kratos common stock to decrease.

As of November 25, 2008, Kratos had 105,292,730 shares of common stock outstanding and approximately 8,452,378 shares of common stock subject to outstanding options and other rights to purchase or acquire its shares. Kratos currently expects that it will issue up to approximately 32.9 million shares of common stock in connection with the merger, including common stock issuable in connection with assumed options and warrants. The issuance of these new shares of Kratos common stock and the sale of additional shares of Kratos common stock that may become eligible for sale in the public market from time to time upon exercise of options and other equity-linked securities could have the effect of depressing the market price for shares of Kratos common stock.

Future results of the combined company may differ materially from the unaudited pro forma financial statements presented in this proxy statement/prospectus.

The future results of Kratos may be materially different from those shown in the unaudited pro forma financial statements presented in this proxy statement/prospectus which show only a combination of the historical results of Kratos and Digital Fusion. Kratos expects to incur significant costs associated with completing the merger and combining the operations of the two companies and the exact magnitude of these costs is not yet known. Furthermore, these costs may decrease the capital that Kratos could use for income-earning investments in the future.

The trading price of shares of Kratos common stock after the merger may be affected by factors different from those affecting the price of shares of Kratos common stock or shares of Digital Fusion common stock before the merger.

When the merger is completed, holders of Digital Fusion common stock will become holders of Kratos common stock. The results of operations of Kratos and the trading price of Kratos common stock after the merger may be affected by factors different from those currently affecting Kratos' or Digital Fusion's results of operations and trading prices.

Risks Related to Kratos

Kratos' business could be adversely affected by changes in the contracting or fiscal policies of the federal government and governmental entities.

Kratos derives a significant portion of its revenue from contracts with the U.S. federal government and government agencies and subcontracts under federal government prime contracts, and the success of Kratos' business and growth of its business will continue to depend on its successful procurement of government contracts either directly or through prime contractors. Accordingly, changes in government contracting policies or government budgetary constraints could directly affect Kratos' financial performance. Among the factors that could adversely affect Kratos' business are:

- changes in fiscal policies or decreases in available government funding, including budgetary constraints affecting federal government spending generally, or specific departments or agencies in particular;
- the adoption of new laws or regulations or changes to existing laws or regulations;
- changes in political or social attitudes with respect to security and defense issues;
- changes in federal government programs or requirements, including the increased use of small business providers;
- changes in or delays related to government restrictions on the export of defense articles and services;
- potential delays or changes in the government appropriations process; and
- delays in the payment of invoices by government payment offices.

These and other factors could cause governments and government agencies, or prime contractors that use Kratos as a subcontractor, to reduce their purchases under existing contracts, to exercise their rights to terminate contracts at-will or to abstain from exercising options to renew contracts, any of which could have an adverse effect on Kratos' business, financial condition and results of operations. Many of Kratos' government customers are subject to stringent budgetary constraints. The award of additional contracts from government agencies could be adversely affected by spending reductions or budget cutbacks at these agencies.

Kratos derives a substantial amount of its revenues from the sale of its solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in Kratos' revenues and earnings.

Government contracts frequently include provisions that are not standard in private commercial transactions and are subject to laws and regulations that give the federal government rights and remedies not typically found in commercial contracts, including provisions permitting the federal government to:

- terminate Kratos' existing contracts;
- reduce potential future income from existing contracts;

modify some of the terms and conditions in existing contracts;

- suspend or permanently prohibit Kratos from doing business with the federal government or with any specific government agency;
- impose fines and penalties;
- subject Kratos to criminal prosecution;
- suspend work under existing multiple year contracts and related task orders if the necessary funds are not appropriated by Congress;
- decline to exercise an option to extend an existing multiple year contract; and
- claim rights in technologies and systems invented, developed or produced by Kratos.

In addition, government contracts are frequently awarded only after formal competitive bidding processes, which have been and may continue to be protracted and typically impose provisions that permit cancellation in the event that necessary funds are unavailable to the public agency. Competitive procurements impose substantial costs and managerial time and effort in order to prepare bids and proposals for contracts that may not be awarded to Kratos. In many cases, unsuccessful bidders for government agency contracts are provided the opportunity to formally protest certain contract awards through various agencies, administrative and judicial channels. The protest process may substantially delay a successful bidder's contract performance, result in cancellation of the contract award entirely and distract management. Kratos may not be awarded contracts for which it bid, and substantial delays or cancellation of purchases may follow its successful bids as a result of such protests.

Certain of Kratos' government contracts also contain "organizational conflict of interest" clauses that could limit its ability to compete for certain related follow-on contracts. For example, when Kratos works on the design of a particular solution, it may be precluded from competing for the contract to install that solution. While Kratos actively monitors its contracts to avoid these conflicts, it may not be able to avoid all organizational conflict of interest issues.

Kratos faces intense competition from many competitors that have greater resources than it does, which could result in price reductions, reduced profitability or loss of market share.

Kratos operates in highly competitive markets and generally encounters intense competition to win contracts from many other firms, including mid-tier federal contractors with specialized capabilities and large defense and IT services providers. Competition in its markets may increase as a result of a number of factors, such as the entrance of new or larger competitors, including those formed through alliances or consolidation. These competitors may have greater financial, technical, marketing and public relations resources, larger client bases and greater brand or name recognition than Kratos does. These competitors could, among other things:

- divert sales from Kratos by winning very large-scale government contracts, a risk that is enhanced by the recent trend in government procurement practices to bundle services into larger contracts;
- force Kratos to charge lower prices; or
- adversely affect Kratos' relationships with current clients, including its ability to continue to win competitively awarded engagements in which it is the incumbent.

If Kratos loses business to its competitors or is forced to lower its prices, its revenue and operating profits could decline. In addition, it may face competition from its subcontractors who, from time-to-time, seek to obtain prime contractor status on contracts for which they currently serve as a subcontractor to Kratos. If one or more of its current subcontractors are awarded prime contractor status on such contracts in the future, it could divert sales from Kratos or could force Kratos to charge lower prices, which could cause its margins to suffer.

Recent acquisitions and potential future acquisitions could prove difficult to integrate, disrupt Kratos' business, dilute stockholder value and strain its resources.

Kratos has completed several acquisitions of complementary businesses in recent years, including its December 2007 acquisition of Haverstick Consulting, Inc. and June 2008 acquisition of SYS. The success of these acquisitions will depend in part on the success in integrating the operations, technologies and personnel of Haverstick and SYS into Kratos. The failure to successfully integrate the operations of the two companies or otherwise to realize any of the anticipated benefits of the acquisition could seriously harm Kratos' results of operations.

Kratos continually evaluates opportunities to acquire new businesses as part of its ongoing strategy and may in the future acquire additional companies that it believes could complement or expand its business or increase its customer base. As more fully described elsewhere in this proxy statement/prospectus, on November 21, 2008, Kratos entered into a merger agreement with Digital Fusion. Acquisitions, including the proposed acquisition of Digital Fusion, involve numerous risks, including:

- difficulties in integrating operations, technologies, accounting and personnel;
- difficulties in supporting and transitioning customers of acquired companies;
- difficulties or delays in transitioning federal government contracts pursuant to federal acquisition regulations;
- diversion of financial and management resources from existing operations;
- potential loss of key employees;
- federal acquisition regulations may require Kratos to enter into government novation agreements, a potentially time-consuming process;
- notifying and obtaining approval from agencies from which import and export licenses have been issued; and
- inability to generate sufficient revenue to offset acquisition costs.

Acquired companies may have liabilities or adverse operating issues that Kratos fails to discover through due diligence prior to the acquisition. In particular, to the extent that prior owners of any acquired businesses or properties failed to comply with or otherwise violated applicable laws or regulations, or failed to fulfill their contractual obligations to the federal government or other clients, Kratos, as the successor owner, may be financially responsible for these violations and failures and may suffer reputational harm or otherwise be adversely affected. Acquisitions also frequently result in the recording of goodwill and other intangible assets which are subject to potential impairments in the future that could harm Kratos' financial results. In addition, if Kratos finances acquisitions by issuing convertible debt or equity securities its existing stockholders may be diluted, which could affect the market price of its stock. If Kratos fails to properly evaluate acquisitions or investments, it may not achieve the anticipated benefits of any such acquisitions and may incur costs in excess of what it anticipates.

Kratos has agreed to indemnify acquirers of its divested operations against specified losses in connection with the sale of these operations, and any demands for indemnification may result in expenses it does not anticipate and distract the attention of its management from its continuing businesses.

Kratos agreed to indemnify acquirers of its divested operations against specified losses in connection with their sale and generally retain responsibility for various legal liabilities that accrued prior to closing. Kratos also made representations and warranties to these acquirers about the condition of the divested businesses and agreed to working capital adjustment provisions that could obligate it to make substantial payments to some of these acquirers. If any acquirer makes an indemnification claim because it has suffered a loss or a third party has commenced an action against the divested business, or if Kratos is required to make payments in settlement of working capital adjustments, Kratos may incur substantial expenses resolving such claims or defending against the third party action, which would harm its operating results. Kratos' ability to defend itself may be impaired because its former employees are now employees of the acquirer or other companies. These indemnity claims may require management to devote a substantial amount of time to resolving the claim and may divert management attention from responsibilities related to the daily ongoing concerns of the business. In addition, Kratos may be required to expend substantial resources trying to determine which party has responsibility for the claim, even if it is ultimately found to be not responsible.

Kratos' financial results may vary significantly from quarter to quarter.

Kratos expects its revenue and operating results to vary from quarter to quarter. Reductions in revenue in a particular quarter could lead to lower profitability in that quarter because a relatively large amount of its expenses are fixed in the short-term. It may incur significant operating expenses during the start-up and early stages of large contracts and may not be able to recognize corresponding revenue in that same quarter. It may also incur additional expenses when contracts expire, are terminated or are not renewed.

In addition, payments due to Kratos from federal government agencies may be delayed due to billing cycles or as a result of failures of government budgets to gain congressional and administration approval in a timely manner. The federal government's fiscal year ends September 30. If a federal budget for the next federal fiscal year has not been approved by that date in each year, Kratos' clients may have to suspend engagements that Kratos is working on until a budget has been approved. Any such suspensions may reduce Kratos' revenue in the fourth quarter of that year or the first quarter of the subsequent year. The federal government's fiscal year end can also trigger increased purchase requests from clients for equipment and materials. Any increased purchase requests Kratos receives as a result of the federal government's fiscal year end would serve to increase its third or fourth quarter revenue, but will generally decrease profit margins for that quarter, as these activities generally are not as profitable as Kratos' typical offerings.

Additional factors that may cause Kratos' financial results to fluctuate from quarter to quarter include those addressed elsewhere in these Risk Factors and the following, among others:

- the terms of customer contracts that affect the timing of revenue recognition;
- variability in demand for its services and solutions;
- commencement, completion or termination of contracts during any particular quarter;
- timing of award or performance incentive fee notices;
- timing of significant bid and proposal costs;
- variable purchasing patterns under the GSA Schedule 70 Contracts, government wide acquisition contracts (GWACs), blanket purchase agreements and other indefinite delivery/indefinite quantity contracts;
- restrictions on and delays related to the export of defense articles and services;
- costs related to ongoing government inquiries;
- strategic decisions by it or its competitors, such as acquisitions, divestitures, spin-offs and joint ventures;
- strategic investments or changes in business strategy;

- changes in the extent to which it uses subcontractors;
- seasonal fluctuations in its staff utilization rates;
- changes in its effective tax rate, including changes in its judgment as to the necessity of the valuation allowance recorded against its deferred tax assets; and
- the length of sales cycles.

Significant fluctuations in Kratos' operating results for a particular quarter could cause Kratos to fall out of compliance with the financial covenants contained in its credit facility, which if not waived by the lender, could restrict its access to capital and cause it to take extreme measures to pay down its debt under the credit facility. In addition, fluctuations in its financial results could cause its stock price to decline.

If Kratos fails to establish and maintain important relationships with government entities and agencies and other government contractors, its ability to bid successfully for new business may be adversely affected.

To develop new business opportunities, Kratos primarily relies on establishing and maintaining relationships with various government entities and agencies. It may be unable to successfully maintain its relationships with government entities and agencies, and any failure to do so could materially adversely affect its ability to compete successfully for new business. In addition, it often acts as a subcontractor or in "teaming" arrangements in which it and other contractors bid together on particular contracts or programs for the federal government or government agencies. As a subcontractor or team member, it often lacks control over fulfillment of a contract, and poor performance on the contract could tarnish its reputation, even when it performs as required. Kratos expects to continue to depend on relationships with other contractors for a portion of its revenue in the foreseeable future. Moreover, its revenue and operating results could be materially adversely affected if any prime contractor or teammate chooses to offer a client services of the type that it provides or if any prime contractor or teammate teams with other companies to independently provide those services.

Kratos derives a significant portion of its revenues from a limited number of customers.

Kratos has derived, and believes that it will continue to derive, a significant portion of its revenues from a limited number of customers. To the extent that any significant customer uses less of Kratos' services or terminates its relationship with Kratos, Kratos' revenues could decline significantly. As a result, the loss of any significant client could seriously harm Kratos' business. For the nine month period ended September 28, 2008, two customers comprised approximately 66.5% and 50.4% of Kratos' federal business revenues and total revenues, respectively, and Kratos' five largest customers accounted for approximately 81.8% and 62.0% of its total federal business revenues and total revenues, respectively. None of Kratos' customers are obligated to purchase additional services from it. As a result, the volume of work that Kratos performs for a specific customer is likely to vary from period to period, and a significant client in one period may not use its services in a subsequent period.

Kratos' margins and operating results may suffer if it experiences unfavorable changes in the proportion of cost-plus-fee or fixed-price contracts in its total contract mix.

Although fixed-price contracts entail a greater risk of a reduced profit or financial loss on a contract compared to other types of contracts Kratos enters into, fixed-price contracts typically provide higher profit opportunities because Kratos may be able to benefit from cost savings. In contrast, cost-plus-fee contracts are subject to statutory limits on profit margins, and generally are the least profitable of Kratos' contract types. Kratos' federal government customers typically determine what type of contract it enters into. Cost-plus-fee and fixed-price contracts in its federal business accounted for approximately 39.5% and 35.3%, respectively, of its federal business revenues for the period ended

September 28, 2008. To the extent that Kratos enters into more cost-plus-fee or less fixed-price contracts in proportion to its total contract mix in the future, its margins and operating results may suffer.

Kratos' cash flow and profitability could be reduced if expenditures are incurred prior to the final receipt of a contract.

Kratos provides various professional services and sometimes procures equipment and materials on behalf of its federal government customers under various contractual arrangements. From time to time, in order to ensure that it satisfies its customers' delivery requirements and schedules, it may elect to initiate procurement in advance of receiving final authorization from the government customer or a prime contractor. If a government or prime contractor customers' requirements should change, if the government or the prime contractor should direct the anticipated procurement to a contractor other than Kratos, or if the equipment or materials become obsolete or require modification before Kratos is under contract for the procurement, Kratos' investment in the equipment or materials might be at risk. This could reduce anticipated earnings or result in a loss, negatively affecting Kratos' cash flow and profitability.

Loss of Kratos' GSA contracts or GWAC schedule contracts would impair its ability to attract new business.

Kratos is a prime contractor under several GSA contracts and GWAC schedule contracts. Kratos believes that its ability to provide services under these contracts will continue to be important to its business because of the multiple opportunities for new engagements each contract provides. If it were to lose its position as prime contractor on one or more of these contracts, it could lose substantial revenues and its operating results could suffer. GSA contracts and other GWACs typically have a one or two-year initial term, with multiple options exercisable at the government client's discretion to extend the contract for one or more years. Kratos' government clients may not continue to exercise the options remaining on its current contracts and its future clients may not exercise options on any future contracts.

Failure to properly manage projects may result in additional costs or claims.

Kratos' engagements often involve large scale, highly complex projects. The quality of Kratos' performance on such projects depends in large part upon its ability to manage its relationship with its customers and to effectively manage the project and deploy appropriate resources, including third-party contractors and its own personnel, in a timely manner. Any defects or errors or failure to meet clients' expectations could result in claims for substantial damages against it. Kratos' contracts generally limit its liability for damages arising from negligent acts, error, mistakes or omissions in rendering services to its clients. However, these contractual provisions may not protect Kratos from liability for damages in the event it is sued. In addition, in certain instances, Kratos guarantees customers that it will complete a project by a scheduled date. If the project experiences a performance problem, it may not be able to recover the additional costs it will incur, which could exceed revenues realized from a project. Finally, if it underestimates the resources or time it needs to complete a project with capped or fixed fees, its operating results could be seriously harmed.

The loss of any member of Kratos' senior management team could impair its relationships with federal government clients and disrupt the management of its business.

Kratos believes that the success of its business and its ability to operate profitably depends on the continued contributions of the members of its senior management team. Kratos relies on its senior management to generate business and execute programs successfully. In addition, the relationships and reputation that many members of its senior management team have established and maintain with federal government personnel contribute to its ability to maintain strong client relationships and to identify new business opportunities. The loss of any member of its senior management team could impair its ability to identify and secure new contracts, to maintain good client relations and to otherwise manage its business.

If Kratos fails to attract and retain skilled employees or employees with the necessary security clearances, it may not be able to perform under its contracts or win new business.

The growth of Kratos' business and revenue depends in large part upon its ability to attract and retain sufficient numbers of highly qualified individuals who have advanced information technology and/or engineering skills. These employees are in great demand and are likely to remain a limited resource in the foreseeable future. Certain federal government contracts require Kratos and some of its employees to maintain security clearances. Obtaining and maintaining security clearances for employees involves a lengthy process, and it is difficult to identify, recruit and retain employees who already hold security clearances. In addition, some of Kratos' contracts contain provisions requiring it to staff an engagement with personnel that the client considers key to Kratos' successful performance under the contract. In the event Kratos is unable to provide these key personnel or acceptable substitutions, the client may terminate the contract and Kratos may lose revenue.

If Kratos is unable to recruit and retain a sufficient number of qualified employees, its ability to maintain and grow its business could be limited. In a tight labor market, its direct labor costs could increase or it may be required to engage large numbers of subcontractor personnel, which could cause its profit margins to suffer. Conversely, if Kratos maintains or increases its staffing levels in anticipation of one or more projects and the projects are delayed, reduced or terminated, it may underutilize the additional personnel, which could increase its general and administrative expenses, reduce its earnings and harm its results of operations.

If Kratos' subcontractors fail to perform their contractual obligations, its performance and reputation as a prime contractor and its ability to obtain future business could suffer.

As a prime contractor, Kratos often relies upon other companies to perform work it is obligated to perform for its clients as subcontractors. As Kratos secures more work under its GWAC vehicles, it expects to require an increasing level of support from subcontractors that provide complementary and supplementary services to its offerings. Depending on labor market conditions, it may not be able to identify, hire and retain sufficient numbers of qualified employees to perform the task orders it expects to win. In such cases, it will need to rely on subcontracts with unrelated companies. Moreover, even in favorable labor market conditions, Kratos anticipates entering into more subcontracts in the future as it expands its work under its GWACs. It is responsible for the work performed by its subcontractors, even though in some cases it has limited involvement in that work.

If one or more of Kratos' subcontractors fails to satisfactorily perform the agreed-upon services on a timely basis or violates federal government contracting policies, laws or regulations, Kratos' ability to perform its obligations as a prime contractor or meet its clients' expectations may be compromised. In extreme cases, performance or other deficiencies on the part of its subcontractors could result in a client terminating its contract for default. A termination for default could expose Kratos to liability, including liability for the agency's costs of reprocurement, could damage Kratos' reputation and could hurt its ability to compete for future contracts.

Kratos' failure to comply with complex procurement laws and regulations could cause it to lose business and subject it to a variety of penalties.

Kratos must comply with laws and regulations relating to the formation, administration and performance of federal government contracts, which affect how it does business with its clients and may impose added costs on it. In addition, the federal government, including the Defense Contract Audit

Agency (DCAA), audits and reviews a contractor's performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. The DCAA also reviews a contractor's internal control systems and policies, including the contractor's purchasing, property, estimating, compensation and management information systems, and the contractor's compliance with such policies. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. Adverse findings in a DCAA audit could materially affect Kratos' competitive position and result in a substantial adjustment to its revenue and profit.

The commercial business arena in which Kratos operates has relatively low barriers to entry and increased competition could result in margin erosion, which would make profitability even more difficult to sustain.

Other than the technical skills required in Kratos' commercial business, the barriers to entry in this area are relatively low. Kratos does not have any intellectual property rights in this segment of its business to protect its methods and business start-up costs do not pose a significant barrier to entry. The success of Kratos' commercial business is dependent on its employees, customer relations and the successful performance of its services. If Kratos faces increased competition as a result of new entrants in its markets, it could experience reduced operating margins and loss of market share and brand recognition.

If Kratos' commercial customers do not invest in security systems and other new in-building technologies such as wireless local area networks and/or IP-based networks, its business will suffer.

Kratos intends to devote significant resources to developing its enterprise-based wireless local area networks (WLAN), but it may not achieve widespread market acceptance amongst the enterprises it identifies as potential customers. It is possible that some enterprises will determine that capital constraints and other factors outweigh their need for WLAN systems. A significant delay in the adoption of WLAN by enterprises could harm Kratos' business.

If Kratos experiences systems or service failure, its reputation could be harmed and its clients could assert claims against it for damages or refunds.

Kratos creates, implements and maintains IT solutions that are often critical to its clients' operations. Kratos has experienced, and may in the future experience, some systems and service failures, schedule or delivery delays and other problems in connection with its work. If it experiences these problems, it may:

- lose revenue due to adverse client reaction;
- be required to provide additional services to a client at no charge;
- receive negative publicity, which could damage its reputation and adversely affect its ability to attract or retain clients; and
- suffer claims for substantial damages.

In addition to any costs resulting from product or service warranties, contract performance or required corrective action, these failures may result in increased costs or loss of revenue if clients postpone subsequently scheduled work or cancel, or fail to renew, contracts.

While many of Kratos' contracts limit its liability for consequential damages that may arise from negligence in rendering services to its clients, these contractual provisions may not be legally sufficient to protect Kratos if it is sued. In addition, its errors and omissions and product liability insurance coverage may not be adequate, may not continue to be available on reasonable terms or in sufficient amounts to cover one or more large claims, or the insurer may disclaim coverage as to some types of future claims. The successful assertion of any large claim against Kratos could seriously harm its business. Even if not successful, these claims could result in significant legal and other costs, may be a distraction to Kratos' management and may harm its reputation.

Security breaches in sensitive federal government systems could result in the loss of clients and negative publicity.

Many of the systems Kratos develops, installs and maintains involve managing and protecting information involved in intelligence, national security and other sensitive or classified federal government functions. A security breach in one of these systems could cause serious harm to Kratos' business, damage its reputation and prevent it from being eligible for further work on sensitive or classified systems for federal government clients. It could incur losses from such a security breach that could exceed the policy limits under its errors and omissions and product liability insurance. Damage to Kratos' reputation or limitations on its eligibility for additional work resulting from a security breach in one of the systems it develops, installs and maintains could materially reduce its revenue.

Kratos' employees may engage in misconduct or other improper activities, which could cause it to lose contracts.

Kratos is exposed to the risk that employee fraud or other misconduct could occur. Misconduct by employees could include intentional failures to comply with federal government procurement regulations, engaging in unauthorized activities or falsifying time records. Employee misconduct could also involve the improper use of Kratos' clients' sensitive or classified information, which could result in regulatory sanctions against Kratos and serious harm to its reputation, and could result in a loss of contracts and a reduction in revenues. It is not always possible to deter employee misconduct, and the precautions Kratos takes to prevent and detect this activity may not be effective in controlling unknown or unmanaged risks or losses, which could cause it to lose contracts or lead to a reduction in revenues.

Kratos' business is dependent upon its ability to keep pace with the latest technological changes.

The market for Kratos' services is characterized by rapid change and technological improvements. Failure to respond in a timely and cost effective way to these technological developments would result in serious harm to Kratos' business and operating results. Kratos has derived, and expects to continue to derive, a substantial portion of its revenues from providing innovative engineering services and technical solutions that are based upon today's leading technologies and that are capable of adapting to future technologies. As a result, its success will depend, in part, on its ability to develop and market service offerings that respond in a timely manner to the technological advances of its customers, evolving industry standards and changing client preferences.

If Kratos is unable to manage its growth, its business could be adversely affected.

Sustaining Kratos' growth has placed significant demands on its management, as well as on its administrative, operational and financial resources. For Kratos to continue to manage its growth, it must continue to improve its operational, financial and management information systems and expand, motivate and manage its workforce. If it is unable to manage its growth while maintaining its quality of service and profit margins, or if new systems it implements to assist it in managing its growth do not produce the expected benefits, its business, prospects, financial condition or operating results could be adversely affected.

Kratos may be harmed by intellectual property infringement claims and its failure to protect its intellectual property could enable competitors to market products and services with similar features.

Kratos may become subject to claims from its employees or third parties who assert that software and other forms of intellectual property that it uses in delivering services and solutions to its clients infringe upon intellectual property rights of such employees or third parties. Kratos' employees develop some of the software and other forms of intellectual property that Kratos' uses to provide its services and solutions to its clients, but it also licenses technology from other vendors. If its employees, vendors, or other third parties assert claims that it or its clients are infringing on their intellectual property rights, Kratos could incur substantial costs to defend those claims. If any of these infringement claims are ultimately successful, it could be required to cease selling or using products or services that incorporate the challenged software or technology, obtain a license or additional licenses from its employees, vendors, or other third parties, or redesign its products and services that rely on the challenged software or technology.

Kratos attempts to protect its trade secrets by entering into confidentiality and intellectual property assignment agreements with third parties, its employees and consultants. However, these agreements can be breached and, if they are, there may not be an adequate remedy available. In addition, others may independently discover Kratos' trade secrets and proprietary information and in such cases Kratos could not assert any trade secret rights against such party. Enforcing a claim that a party illegally obtained and is using trade secret is difficult, expensive and time consuming, and the outcome is unpredictable. If Kratos is unable to protect its intellectual property, its competitors could market services or products similar to its services and products, which could reduce demand for its offerings. Any litigation to enforce Kratos' intellectual property rights, protect its trade secrets or determine the validity and scope of the proprietary rights of others could result in substantial costs and diversion of resources, with no assurance of success.

The matters relating to Kratos' internal review of its stock option granting practices and the restatement of its financial statements have exposed it to civil litigation claims, regulatory proceedings and government proceedings that could have a material adverse effect on it.

In the summer of 2006, Kratos' current executive management team, which has been in place since 2004, initiated an investigation of Kratos' past stock option granting practices, which is referred to as the Equity Award Review, in reaction to media reports regarding stock option granting practices of public companies. The Equity Award Review was conducted with oversight from the Kratos board of directors and assistance from Kratos' outside counsel. In February 2007, the board of directors appointed a Special Committee of the board to review the adequacy of the Equity Award Review and the recommendations of management regarding historical option granting practices, and to make recommendations and findings regarding those practices and individual conduct. The Special Committee was not charged with making, and did not make, any evaluation of the accounting determinations or tax adjustments. The Special Committee was comprised of a non-employee director who had not served on the Compensation Committee before 2005.

The Equity Award Review encompassed all grants of options to purchase shares of Kratos' common stock and other equity awards made from two months prior to Kratos' IPO in November 1999 through December 2006. Kratos also reviewed all option grants that were entered into its stock option database, Equity Edge, after its IPO with a grant date before November 1999, as well as other substantial grants issued prior to its IPO, consisting of more than 14,000 grants. Kratos further reviewed all option grants with a grant date that preceded an employee's date of hire. As part of the review, interviews of 18 current and former officers, directors, employees and attorneys were conducted, and more than 40 million pages of electronic and hard copy documents were searched for relevant information. The Special Committee also conducted its own separate review of the option granting practices during the tenure of current executive management team through additional interviews and document collection and review with the assistance of its own separate counsel and FTI Consulting.

The Equity Award Review established the absence of contemporaneous evidence supporting a substantial number of the previously-recorded option grants, substantially all of which were made in the period from 1998 through late 2003. During this period of time, in some instances, documents, data and interviews suggest that option grants were prepared or finalized days or, in some cases, weeks or months after the option grant date recorded in Kratos' books. The affected grants include options issued to certain newly-hired employees but dated prior to their employment start dates and options issued to non-employees, including advisors to the board of directors erroneously designated as employees. The Special Committee also concluded that certain former employees and former officers participated in making improper option grants, including the selection of grant dates with the benefit of hindsight and in the deferral of the recording of otherwise approved option grants.

In light of the Equity Award Review, the Audit Committee of Kratos' board of directors concluded that Kratos' prior financial statements for periods from 1998 through the interim financial statements for the period ended September 30, 2006, could no longer be relied upon and must be restated. Kratos' management determined that, from fiscal year 1998 through fiscal year 2005, Kratos had unrecorded non-cash equity-based compensation charges associated with its equity incentive plans. These charges are material to Kratos' financial statements for the years ended December 31, 1998 through 2005, the periods to which such charges would have related. Previously filed annual reports on Form 10-K and quarterly reports on Form 10-Q affected by the restatements have not been and will not be amended and should not be relied upon. Kratos' Annual Report on Form 10-K filed on September 11, 2007 superseded and replaced in their entirety all of Kratos' previously issued financial statements and related reports filed with the Securities and Exchange Commission.

Kratos' past stock option granting practices and the restatement of its prior financial statements have exposed and may continue to expose it to greater risks associated with litigation, regulatory proceedings and government inquiries and enforcement actions. As described in "Certain Information About Kratos' Business Legal Proceedings" on page 99, several derivative complaints have been filed in state and federal courts against Kratos' current directors, some of its former directors and some of its current and former executive officers pertaining to allegations relating to stock option grants. The SEC initiated an inquiry into Kratos' historical stock option granting practices and Kratos received a subpoena from the U.S. Attorney's Office for the Southern District of California for the production of documents relating to its historical stock option granting practices. On April 1, 2008, the SEC notified Kratos that it had completed its investigation and that it did not intend to recommend any enforcement action by the SEC against Kratos. Kratos is cooperating with the U.S. Attorney's Office for the Southern District of California, and expects to continue to do so.

The period of time necessary to resolve the U.S. Attorney's Office inquiry is uncertain, and Kratos cannot predict the outcome of the inquiry or whether it will face additional government inquiries, investigations or other actions related to its historical stock option grant practices. Subject to certain limitations, it is obligated to indemnify its current and former directors, officers and employees in connection with the investigation of its historical stock option practices, the pending DOJ and concluded SEC inquiries and any future government inquiries, investigations or actions. These inquiries could require Kratos to expend significant management time and incur significant legal and other expenses, and could result in civil and criminal actions seeking, among other things, injunctions against Kratos and the payment of significant fines and penalties by it, which could have a material adverse effect on its financial condition, business, results of operations and cash flow.

If a federal government investigation uncovers improper or illegal activities, including any potential improper or illegal activities related to Kratos' stock option review or related matters, Kratos may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with federal government agencies. In addition, it could suffer serious harm to its reputation and competitive position if allegations of impropriety were made against it, whether or not true. If its reputation or relationship with federal government agencies was impaired, or if the federal government otherwise ceased doing business with it or significantly decreased the amount of business it does with Kratos, Kratos' revenues and operating profit would decline.

If Kratos fails to maintain an effective system of internal controls, it may not be able to accurately report its financial results or prevent fraud.

Effective internal controls are necessary for Kratos to provide reliable financial reports. If it cannot provide reliable financial reports, its operating results could be misstated, its reputation may be harmed and the trading price of its stock could be negatively affected. Kratos' management has concluded that its disclosure controls and procedures were effective at the reasonable assurance level as of September 28, 2008. However, there can be no assurance that Kratos' controls over financial processes and reporting will be effective in the future or that additional material weaknesses or significant deficiencies in its internal controls will not be discovered in the future. Any failure to remediate any future material weaknesses or implement required new or improved controls, or difficulties encountered in their implementation, could harm Kratos' operating results, cause it to fail to meet its reporting obligations or result in material misstatements in its financial statements or other public disclosures. Inferior internal controls could also cause investors to lose confidence in its reported financial information, which could have a negative effect on the trading price of Kratos stock. In addition, from time to time Kratos acquires businesses which could have limited infrastructure and systems of internal controls. Performing assessments of internal controls, implementing necessary changes, and maintaining an effective internal controls process is costly and requires considerable management attention, particularly in the case of newly acquired entities.

Kratos may need additional capital in the future to fund the growth of its business and financing may not be available.

Kratos currently anticipates that its available capital resources, including its credit facility and operating cash flows, will be sufficient to meet its expected working capital and capital expenditure requirements for at least the next 12 months. However, such resources may not be sufficient to fund the long-term growth of its business or the expenses associated with the ongoing litigation, litigation settlements and government inquiries. In particular, Kratos may experience a negative operating cash flow due to billing milestones and project timelines in certain of its contracts.

Kratos may raise additional funds through public or private debt or equity financings if such financings become available on favorable terms or it may expand its credit facility to fund future acquisitions and for general corporate purposes. However, Kratos' lender may not agree to extend additional or continuing credit under that facility, particularly in light of the current challenges in the lending markets. Kratos could fall out of compliance with financial and other covenants contained in its credit facility which, if not waived, would restrict its access to capital and could require it to pay down its existing debt under the credit facility. Any new financing or offerings would likely dilute its stockholders' equity ownership. In addition, additional financing may not be available on terms favorable to Kratos, or at all. If adequate funds are not available or are not available on acceptable terms, Kratos may not be able to take advantage of unanticipated opportunities, develop new products or otherwise respond to competitive pressures. In any such case, Kratos' business, operating results or financial condition could be materially adversely affected.

Kratos' ability to make payments on its debt will be contingent on its future operating performance, which will depend on a number of factors that are outside of its control.

Kratos' debt service obligations are estimated to be approximately $11 million to $13 million in 2008, including approximately $2.6 million of principal repayments. This debt service may have an adverse impact on Kratos' earnings and cash flow, which could in turn negatively impact its stock price. It is also subject to interest rate risk due to its indebtedness at variable interest rates, based on a base rate or LIBOR plus an applicable margin. As a result, shifts in interest rates could have a material adverse effect on it.

Kratos' ability to make principal and interest payments on its debt is contingent on its future operating performance, which will depend on a number of factors, many of which are outside of its control. In addition, the degree to which it is leveraged could have other important negative consequences on Kratos, including the following:

- Kratos must dedicate a substantial portion of its cash flows from operations to the payment of its indebtedness, reducing the funds available for future working capital requirements, capital expenditures, acquisitions or other general corporate requirements;
- a significant portion of its borrowings are, and will continue to be, at variable rates of interest, which may result in higher interest expense in the event of increases in interest rates;
- it may be more vulnerable to a downturn in the industries in which it operates or a downturn in the economy in general;
- it may be limited in its flexibility to plan for, or react to, changes in its businesses and the industries in which it operates;
- it may be placed at a competitive disadvantage compared to its competitors that have less debt;
- it may determine that it is necessary to dispose of certain assets or one or more of its businesses to reduce its debt; and
- its ability to borrow additional funds in excess of its current financing may be limited.

Kratos may not generate sufficient cash flow from operations and future borrowings may not be available in amounts sufficient to enable it to pay its indebtedness or to fund its other liquidity needs. Moreover, it may need to refinance all or a portion of its indebtedness on or before maturity. In such a case, Kratos may not be able to refinance any of its indebtedness on commercially reasonable terms or at all. If it is unable to make scheduled debt payments or comply with the other provisions of its debt instruments, its various lenders may be permitted under certain circumstances to accelerate the maturity of the indebtedness owed to them and exercise other remedies provided for in those instruments and under applicable law.

Kratos is subject to restrictive debt covenants pursuant to its indebtedness, which may restrict its ability to finance its business and the violation of which could result in its lenders foreclosing on substantially all of its assets.

The covenants contained in Kratos' current credit agreements and any credit agreement governing future debt may significantly restrict its future operations. Furthermore, upon the occurrence of any event of default, its lenders could elect to declare all amounts outstanding under such agreements, together with accrued interest, to be immediately due and payable. If those lenders were to accelerate the payment of those amounts, Kratos' assets may not be sufficient to repay those amounts in full. Kratos' indebtedness contains covenants that, among other things, significantly restricts and, in some cases, effectively eliminates its ability and the ability of its subsidiaries to:

- incur additional debt;

- create or incur liens;
- secure performance bonds by letters of credit, thereby limiting the amount of work it may bid on or perform;
- pay dividends or make other equity distributions to its stockholders;
- make investments;
- sell assets;
- issue or become liable on a guarantee;
- create or acquire new subsidiaries;
- effect a merger or consolidation, or sell all or substantially all of its assets; and
- raise capital via equity securities.

In addition, Kratos must comply with certain financial covenants. In the event it fails to meet any of such covenants and is unable to cure such breach or otherwise renegotiate such covenants, its lenders would have significant rights to deny future access to liquidity and/or seize control of substantially all of its assets. The material financial covenants with which it must comply include a maximum first lien leverage ratio, a maximum total leverage ratio, a minimum liquidity ratio, a minimum fixed charge coverage ratio, and a minimum consolidated EBITDA.

Kratos may be required to prepay its indebtedness prior to its stated maturity, which may limit its ability to pursue business opportunities.

Pursuant to the terms of certain of Kratos' indebtedness, in certain instances Kratos is required to prepay outstanding indebtedness prior to its stated maturity date. Specifically, certain non-recurring cash inflows such as proceeds from asset sales, insurance recoveries, and equity offerings may have to be used to pay down indebtedness and may not be reborrowed. These prepayment provisions may limit Kratos' ability to utilize this cash flow to pursue business opportunities.

Kratos' stock price may be volatile, which may result in lawsuits against it and its officers and directors.

The stock market in general, and the stock prices of government services companies in particular, have experienced volatility that has often been unrelated to or disproportionate to the operating performance of those companies. The market price of Kratos' common stock has fluctuated in the past and is likely to fluctuate in the future. Factors which could have a significant impact on the market price of Kratos' common stock include, but are not limited to, the following:

- quarterly variations in operating results;
- announcements of new services by Kratos or its competitors;
- the gain or loss of significant customers;
- changes in analysts' earnings estimates;

rumors or dissemination of false information;

pricing pressures;

short selling of its common stock;

impact of litigation and ongoing government inquiries;

general conditions in the market;

- political and/or military events associated with current worldwide conflicts; and
- events affecting other companies that investors deem comparable to it.

Companies that have experienced volatility in the market price of their stock have frequently been the subjects of securities class action litigation. Kratos and certain of its current and former officers and directors have been named defendants in class action and derivative lawsuits. These matters and any other securities class action litigation and derivative lawsuits in which Kratos may be involved could result in substantial costs to Kratos and a diversion of its management's attention and resources, which could materially harm its financial condition and results of operations.

Kratos' charter documents and Delaware law may deter potential acquirers and may depress its stock price.

Certain provisions of Kratos' charter documents and Delaware law, as well as certain agreements Kratos has with its executives, could make it substantially more difficult for a third party to acquire control of Kratos. These provisions include those:

- authorizing the board of directors to issue preferred stock;
- prohibiting cumulative voting in the election of directors;
- prohibiting stockholder action by written consent;
- establishing advance notice requirements for nominations for election to Kratos' board of directors or for proposing matters that can be acted on by stockholders at meetings of its stockholders;
- Section 203 of the Delaware General Corporation Law, which prohibits Kratos from engaging in a business combination with an interested stockholder unless specific conditions are met; and
- entitling certain of Kratos' executives to receive payments in certain circumstances following a change in control.

Kratos also has a stockholder rights plan that may discourage certain types of transactions involving an actual or potential change in control and may limit its stockholders' ability to approve transactions that they deem to be in their best interests. As a result, these provisions may depress Kratos' stock price.

Kratos may incur goodwill impairment charges in its reporting entities which could harm its profitability.

A significant portion of Kratos' net assets come from goodwill and other intangible assets. In accordance with Statement of Financial Accounting Standards, or SFAS, No. 142, "Goodwill and Other Intangible Assets," Kratos periodically reviews the carrying values of its goodwill to determine whether such carrying values exceed the fair market value. Its acquired companies are subject to annual review for goodwill impairment. If impairment testing indicates that the carrying value of a reporting unit exceeds its fair value, the goodwill of the reporting unit is deemed impaired. Accordingly, an impairment charge would be recognized for that reporting unit in the period identified, which could reduce Kratos' profitability.

Risks Related to Digital Fusion

Revenues would decline if Digital Fusion's relationships with agencies of the federal government Digital were harmed.

Digital Fusion's largest customers are agencies of the federal government. If the federal government in general, or any significant government agency, uses less of its services or terminates its relationship with Digital Fusion, its revenues would decline substantially, and its business would be

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seriously harmed. During 2007, contracts with the federal government and contracts with prime contractors of the federal government accounted for approximately 98% of Digital Fusion's revenues. Digital Fusion believes that federal government contracts are likely to account for a greater portion of its revenues for the foreseeable future. The volume of work that it performs for a specific customer, however, is likely to vary from year to year, and a significant customer in one year may not use its services as extensively, or at all, in a subsequent year.

Digital Fusion's government contracts may be terminated prior to their completion, and if Digital Fusion does not replace them, its operating results may be harmed.

Digital Fusion derives some of its revenues from government contracts that typically are awarded through competitive processes and span a one year base period and one or more option years. The unexpected termination or non-renewal of one or more of Digital Fusion's significant contracts could result in significant revenue shortfalls. Digital Fusion's customers generally have the right not to exercise the option periods. In addition, its contracts typically contain provisions permitting an agency to terminate the contract on short notice, with or without cause.

Following termination, if the customer requires further services of the type provided in the contract, there is frequently a competitive re-bidding process. Digital Fusion may not win any particular re-bid or be able to successfully bid on new contracts to replace those that have been terminated. Even if Digital Fusion does win the re-bid, Digital Fusion may experience revenue shortfalls in periods where Digital Fusion anticipated revenues from the contract rather than its termination and subsequent re-bidding. These revenue shortfalls could harm operating results for those periods.

Digital Fusion's lack of long-term contracts with customers and its relatively fixed operating expenses expose it to greater risk of incurring losses.

Many customers retain Digital Fusion on an engagement-by-engagement basis, rather than under long-term contracts. Digital Fusion incurs costs based on its expectations of future revenues. Digital Fusion operating expenses are relatively fixed and cannot be reduced on short notice to compensate for unanticipated variations in the number or size of engagements in progress. These factors make it difficult for Digital Fusion to predict its revenues and operating results. If Digital Fusion fails to predict its revenues accurately, it may seriously harm its financial condition and results of operation.

A reduction in or the termination of Digital Fusion's services could lead to underutilization of its employees and could harm its operating results.

Digital Fusion's employee compensation expenses are relatively fixed. Therefore, if a customer defers, modifies or cancels an engagement or chooses not to retain Digital Fusion for additional phases of a project, its operating results will be harmed unless Digital Fusion can rapidly re-deploy its employees to other engagements in order to minimize underutilization.

Failing to maintain strong relationships with prime contractors could result in a decline in Digital Fusion's revenues.

Digital Fusion derived approximately 33% of its revenues during 2007 through its relationships with prime contractors, which, in turn, have contractual relationships with end-customers. Digital Fusion expects to continue to depend on these relationships for a material portion of its revenues in the foreseeable future. If any of these prime contractors eliminate or reduce their engagements with Digital Fusion, or have their engagements eliminated or reduced by their end-customers, Digital Fusion will lose a source of revenues, which, if not replaced, will adversely affect its operating results.

The loss of a key executive could impair Digital Fusion's relationships with government customers and disrupt the management of its business.

Digital Fusion believes that its success depends on the continued contributions of the members of its senior management. Digital Fusion relies on senior management to generate business and execute programs successfully. In addition, the relationships and reputation that many members of its senior management team have established and maintain with government personnel contribute to its ability to maintain good customer relations and to identify new business opportunities. The loss of any member of its senior management could impair its ability to identify and secure new contracts, to maintain good customer relations, and otherwise to manage its business.

Digital Fusion may lose money on fixed-price contracts if Digital Fusion miscalculates the resources Digital Fusion need to complete the contract.

Unlike time and materials contracts, for which Digital Fusion are reimbursed based on its actual expenditures of resources, fixed-price contracts require Digital Fusion to price its contracts by predicting its expenditures in advance. If Digital Fusion miscalculates the resources it needs to complete fixed-price engagements, its operating results could be seriously harmed because Digital Fusion is not compensated for the higher costs.

Digital Fusion could lose revenues and customers and have exposure to liability if it fails to meet its customer expectations.

Digital Fusion creates, implements and maintains technology solutions that are often critical to its customers' operations. If Digital Fusion's technology solutions or other applications have significant defects or errors or fail to meet its customers' expectations, Digital Fusion may:

- lose revenues due to adverse customer reaction;
- be required to provide additional remediation services to a customer at no charge;
- receive negative publicity, which could damage its reputation and adversely affect its ability to attract or retain customers; or
- suffer claims for substantial damages against Digital Fusion, regardless of its responsibility for the failure.

While many of Digital Fusion's contracts limit its liability for damages that may arise from negligent acts, errors, mistakes or omissions in rendering services to its customers, Digital Fusion cannot be sure that these contractual provisions will protect it from liability for damages if Digital Fusion is sued. Furthermore, its general liability insurance coverage may not continue to be available on reasonable terms or in sufficient amounts to cover one or more large claims, or the insurer may disclaim coverage as to any future claim. The successful assertion of any large claim against it could seriously harm its business. Even if not successful, such claims could result in significant legal and other costs and may be a distraction to management.

Security breaches in sensitive government systems could result in the loss of customers and negative publicity.

Many of the systems Digital Fusion develops involve managing and protecting information involved in sensitive government functions. A security breach in one of these systems could cause serious harm to Digital Fusion's business, could result in negative publicity, and could prevent it from having further access to such critically sensitive systems or other similarly sensitive areas for other governmental customers. Losses that Digital Fusion could incur from such a security breach could exceed the policy limits that it has for "errors and omissions" or product liability insurance.

If Digital Fusion cannot obtain the necessary security clearances, Digital Fusion may not be able to perform classified work for the government and its revenues may suffer.

Government contracts require Digital Fusion, and some of its employees, to maintain security clearances. If Digital Fusion loses or is unable to obtain security clearances, the customer can terminate the contract or decide not to renew it upon its expiration. As a result, to the extent Digital Fusion cannot obtain the required security clearances for its employees working on a particular engagement, Digital Fusion may not derive the revenue anticipated from the engagement, which, if not replaced with revenue from other engagements, could seriously harm its operating results.

Audits of Digital Fusion's government contracts may result in a reduction in revenues Digital Fusion receives from those contracts or may result in civil or criminal penalties that could harm its reputation.

Federal government agencies routinely audit government contracts. These agencies review a contractor's performance on its contract, pricing practices, cost structure, and compliance with applicable laws, regulations and standards. An audit could result in a substantial adjustment to Digital Fusion's revenues because any costs found to be improperly allocated to a specific contract will not be reimbursed, while improper costs already reimbursed must be refunded. If a government audit uncovers improper or illegal activities, Digital Fusion may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with federal government agencies. In addition, Digital Fusion could suffer serious reputational harm if allegations of impropriety were made against it.

Digital Fusion may be liable for penalties under a variety of procurement rules and regulations, and changes in government regulations could slow its growth or reduce its profitability.

Digital Fusion must comply with and is affected by federal government regulations relating to the formation, administration, and performance of government contracts. These regulations affect how Digital Fusion does business with its customers and may impose added costs on its business. Any failure to comply with applicable laws and regulations could result in contract termination, price or fee reductions, or suspension or debarment from contracting with the federal government. Further, the federal government may reform its procurement practices or adopt new contracting methods relating to the GSA schedule or other government-wide contract vehicles. If Digital Fusion is unable to successfully adapt to those changes, its business could be seriously harmed.

Digital Fusion's failure to adequately protect its confidential information and proprietary rights may harm its competitive position.

While Digital Fusion's employees execute confidentiality agreements, it cannot guarantee that this will be adequate to deter misappropriation of its confidential information. In addition, Digital Fusion may not be able to detect unauthorized use of its intellectual property in order to take appropriate steps to enforce its rights. If third parties infringe or misappropriate its copyrights, trademarks, or other proprietary information, Digital Fusion's competitive position could be seriously harmed. In addition, other parties may assert infringement claims against Digital Fusion or claim that it has violated its intellectual property rights. Such claims, even if not true, could result in significant legal and other costs and may be a distraction to management.

Changes to federal government procurement rules and regulations could impact revenues.

While the government procurement changes of the mid-1990s generally benefited companies servicing the federal government (such as government agencies being able to award outsourcing contracts based on "best value" over lowest price), any future changes that sought to limit or reduce government outsourcing, perhaps, for example, bringing more technology systems work "in-house," could have a negative impact on Digital Fusion's revenues.

Continued involvement in Iraq, or other nations, could impact federal government spending on Digital Fusion's civilian and defense programs.

Although Digital Fusion's work focuses primarily on its customers' mission-critical programs, continued involvement in Iraq, or a war in another country, could change the federal government's spending priorities for domestic and military programs. Spending on its customers' programs could also be negatively impacted by Congress' unwillingness to pass the necessary appropriation bills required to pay for a war effort.

Digital Fusion's quarterly operating results may fluctuate significantly as a result of factors outside of Digital Fusion's control, which could cause the market price of its stock to decline.

Digital Fusion's revenue and operating results could vary significantly from quarter to quarter. In addition, Digital Fusion cannot predict with certainty its future revenue or results of operations. As a consequence, its operating results may fall below the expectations of securities analysts and investors, which could cause the price of its stock to decline. Factors that may affect its operating results include, but are not limited to:

- fluctuations in revenue earned on contracts;
- commencement, completion, or termination of contracts during any particular quarter;
- variable purchasing patterns under GSA schedule contracts, GWACs, and agency-specific indefinite delivery/indefinite quantity contracts;
- providing services under a share-in-savings or performance-based contract;
- additions and departures of key personnel;
- strategic decisions by Digital Fusion or its competitors, such as acquisitions, divestitures, spin-offs, joint ventures, strategic investments, or changes in business strategy;
- changes in policy or budgetary measures that adversely affect government contracts in general; and
- the seasonality of its business.

Reductions in revenue in a particular quarter could lead to lower profitability in that quarter because a relatively large amount of its expenses are fixed in the short-term. Digital Fusion may incur significant operating expenses during the start-up and early stages of large contracts and may not receive corresponding payments or revenue in that same quarter. Digital Fusion may also incur significant or unanticipated expenses when contracts expire or are terminated and not renewed. In addition, payments due to Digital Fusion from government agencies may be delayed due to billing cycles or as a result of failures of governmental budgets to gain Congressional and administration approval in a timely manner.

Digital Fusion's employees may engage in misconduct or other improper activities, which could harm its business.

Digital Fusion is exposed to the risk that employee fraud or other misconduct could occur. Misconduct by employees could include intentional failures to comply with federal government procurement regulations, engaging in unauthorized activities, seeking reimbursement for improper expenses, or falsifying time records. Employee misconduct could also involve the improper use of its customers' sensitive or classified information, which could result in regulatory sanctions against it and serious harm to its reputation. It is not always possible to deter employee misconduct, and the precautions Digital Fusion takes to prevent and detect this activity may not be effective in controlling unknown or unmanaged risks or losses, which could harm its business.

Digital Fusion has a limited operating history, which makes it difficult to evaluate its business.

Digital Fusion has been in operation since 1995 and many of its services have only been offered since 1997 or later. In 1999 and 2000, Digital Fusion acquired multiple companies. In 2000 and 2001, it sold off multiple divisions and under went significant restructurings. In 2001, 2004, and 2005, there was a significant change in management. As a result of the change in management and business units, prior operating history may not be representative of current operations, which makes it difficult to evaluate Digital Fusion and forecast future results.

Digital Fusion has experienced significant operating losses in the past. If it does not generate sufficient cash flow from operations or is unable to raise capital in sufficient amounts, it may be unable to continue to operate.

Historically, Digital Fusion has experienced significant losses in its operations; however, 2007 and 2006 were profitable years and losses are not expected in the foreseeable future. For the year ended December 28, 2007 and 2006, income from continuing operations was $1,592,000 and $1,257,000, respectively. Its expenses may increase as it seeks to grow its business and as business grows. Even though Digital Fusion has been profitable for two consecutive years, it may be unable to sustain profitability. It may not generate sufficient cash flow from operations or be able to raise capital in sufficient amounts to enable it to continue to operate. An inability to sustain profitability may also result in an impairment loss in the value of long-lived assets, such as goodwill, property and equipment, and other tangible and intangible assets. If it is unable to generate sufficient cash flow from operations or raise capital in sufficient amounts, Digital Fusion may be unable to continue as a going concern.

A loss of a significant customer could substantially decrease revenues.

Digital Fusion has several large customers and a termination by a major customer could substantially decrease revenues.

If revenues do not meet forecasted revenue, it may have an adverse effect on Digital Fusion's financial condition, and could cause material losses.

A large portion of the revenues derived from the consulting business is generally non-recurring in nature. There can be no assurance that Digital Fusion will obtain additional contracts for projects similar in scope to those previously obtained from any of its customers, that it will be able to retain existing customers or attract new customers, or that it will not remain largely dependent on a limited customer base, which may continue to account for a substantial portion of revenues. In addition, Digital Fusion is generally subject to delays in customer funding, lengthy customer review processes for awarding contracts, non-renewal, delay, termination, reduction or modification of contracts in the event of changes in customer policies or as a result of budgetary constraints, and increased or unexpected costs resulting in losses in the event of "fixed-price" contracts.

Digital Fusion may increase its operating expenses to increase the number of its sales, marketing and technical personnel to sell, provide, and support its products and services. It may not be able to adjust spending quickly enough to offset any unexpected revenue shortfall. It may have significant accounts receivable balances with customers that expose it to credit risks if such customers are unable to settle such obligations. If there is an unexpected shortfall in revenues in relation to expenses, or significant bad debt expense, there could be a material adverse effect on Digital Fusion's financial condition, and it could suffer material losses.

If Digital Fusion fails to adequately keep up with the rapidly changing, evolving information technology market, it may not be able to attain profitability.

The markets for some of Digital Fusion's services are rapidly changing and evolving, and therefore the ultimate level of demand for its services is subject to a high degree of uncertainty. Any significant decline in demand for programming and applications development and IT support and integration consulting services could materially adversely affect its business and prospects and it may not be able to attain profitability.

Digital Fusion's success is dependent on its ability to continually attract and retain new customers as well as to replace customers that do not renew their contracts. Achieving significant market acceptance will require substantial efforts and expenditures to create awareness of its services.

Digital Fusion may not have the resources to compete effectively with larger competitors, which could result in lost market share and decreased pricing.

Competition for the services that Digital Fusion provides is significant, and Digital Fusion expects that competition will continue to intensify due to the ease of entering that market. It may not have the financial resources, technical expertise, sales and marketing, or support capabilities to successfully meet this competition. If it is unable to compete successfully against such competitors, it will lose its market share. It competes against numerous large companies that have substantially greater market presence, longer operating histories, more significant customer bases, and greater financial, technical, facilities, marketing, capital, and other resources.

Digital Fusion's competitors may respond more quickly than Digital Fusion can to new or emerging technologies and changes in customer requirements. The competitors may also devote greater resources to the development, promotion, and sale of their products and services. They may develop services that are superior to or have greater market acceptance than Digital Fusion's. Competitors may also engage in more extensive research and development, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, and make more attractive offers to existing and potential employees and strategic partners.

New competitors, including large computer software, professional services, and other technology and telecommunications companies, may enter Digital Fusion's markets and rapidly acquire significant market share. As a result of increased competition and vertical and horizontal integration in the industry, Digital Fusion could encounter significant pricing pressures. These pricing pressures could result in significantly lower average selling prices for its services. It may not be able to offset the effects of any price reductions with an increase in the number of customers, higher revenue from services, cost reductions or otherwise. In addition, professional services businesses are likely to encounter consolidation in the near future, which could result in decreased pricing and other competition.

If Digital Fusion is unable to maintain efficient and uninterrupted operation of its computer systems, it could cause the loss of certain customers.

Some of Digital Fusion's business depends on the efficient and uninterrupted operation of its computer and communications hardware systems and infrastructure. Currently, most of its computer systems are located and maintained in its corporate headquarters in Huntsville, Alabama. While precautions have been taken against systems failure, interruptions could result from natural disasters, as well as power loss, telecommunications failure, and similar events. A disaster recovery plan is being implemented to avoid any major interruptions. Digital Fusion also leases telecommunications lines from local and regional carriers, whose service may be interrupted. Any damage or failure that interrupts or delays network operations could result in an unacceptable level of service to customers and their possible loss.

If Digital Fusion is unable to maintain the security integrity of its systems, it may result in a liability to Digital Fusion or a loss of customers.

Although measures have been taken to protect the integrity of Digital Fusion's infrastructure and the privacy of confidential information, it is potentially vulnerable to physical or electronic intrusions, computer viruses, or similar issues. If the security measures are circumvented the security of confidential information stored on the system could be jeopardized, proprietary information misappropriated, or operations interrupted. Digital Fusion may be required to make significant additional investments and take efforts to protect against or remedy security breaches. Security breaches that result in access to confidential information could damage its reputation and expose it to a risk of loss or liability.

The security services that are offered in connection with customers' use of the networks cannot guarantee complete protection from computer viruses, break-ins, and other disruptive problems. Although an attempt is made to limit contractually the liability in such instances, the occurrence of these problems may result in claims against Digital Fusion or liability on its part. These claims, regardless of their ultimate outcome, could result in costly litigation and could have a material adverse effect on its financial position and reputation and on its ability to attract and retain customers.

If Digital Fusion is unable to retain the services of key personnel, business operations may be disrupted.

The loss of existing personnel or the failure to recruit additional qualified technical, managerial, and sales personnel could disrupt business operations as well as increase expenses in connection with hiring replacement personnel. Digital Fusion depends on the performance of its executive officers and key employees, some of whom have not entered into employment agreements. The loss of these executives or key employees could disrupt business operations.

Digital Fusion may need additional capital and not be able to attain it, which could affect its ability to continue as a going concern.

Future capital uses and requirements will depend on numerous factors, including:

- extent to which solutions and services gain market acceptance;
- level of revenues from present and future solutions and services;
- expansion of operations;
- costs and timing of product and service developments, and sales and marketing activities;
- costs related to acquisitions of technology or businesses;
- competitive developments;
- costs related to downsizing and discontinuation or sale of business units;
- need for working capital;
- timing of accounts receivable collections; and
- timing of debt payments.

In order to continue to increase sales and marketing efforts, and continue to expand and enhance the solutions and services offered to present and future customers, Digital Fusion may require additional capital that may not be available on acceptable terms, or at all. In addition, if unforeseen difficulties arise in the course of these or other aspects of business, it may be required to spend funds that are greater than originally anticipated. Therefore, it will be required to raise additional capital through public or private equity or debt financings, collaborative relationships, bank facilities, or other arrangements. There can be no assurances that such additional capital will be available on acceptable terms, or at all. Any additional equity financing is expected to be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants and increased interest costs. Operations have been financed to date primarily through private sales of equity securities, proceeds from the initial public offering in May 1998, debt facilities, and cash flow from operations.

There can be no assurance that additional funding will be available to finance ongoing operations when needed or that adequate funds for operations, whether from financial markets, collaborative or other arrangements with corporate partners, or other sources, will be available when needed, or on acceptable terms. The inability to obtain sufficient funds may require Digital Fusion to delay, reduce, or eliminate some or all of its expansion programs, to limit the marketing of its products, or to license to third parties the rights to commercialize products or technologies that it would otherwise seek to develop and market.

The unpredictability of quarterly operating results may cause the price of Digital Fusion's common stock to fluctuate.

Revenues and operating results vary significantly from quarter-to-quarter due to a number of factors, many of which are beyond Digital Fusion's control. Investors should not rely on quarter-to-quarter comparisons of results of operations as an indication of future performance. It is possible that in some future periods, results of operations may be below the expectations of public market analysts and investors. In that event, the market price of its common stock may fall.

Factors that could cause quarterly results to fluctuate include:

- change in customer demand for products and services;
- timing of the expansion of operations;
- seasonality in revenues, principally during the summer and year-end holidays;
- the mix of products and services revenues from operating divisions;
- changes in pricing by competitors or Digital Fusion;
- introduction of new products or services by competitors or Digital Fusion;
- costs related to acquisitions of technology or businesses;
- recession or slow-down in economy; and
- termination of customer contracts.

Digital Fusion has limited intellectual property protection and may not be able to successfully protect proprietary information, which could result in lost sales and lost competitive advantage.

Digital Fusion relies on a combination of copyright and trademark laws, trade secrets laws, and license and nondisclosure agreements to protect its proprietary information, particularly the computer software applications that it has developed. It currently has one registered copyright and one patent application pending. It may be possible for unauthorized third parties to copy aspects of, or otherwise obtain and use, proprietary information without authorization. The majority of current contracts with customers contain provisions granting to the customer intellectual property rights to certain of Digital Fusion's work product, including the customized programming that is created for such customer. It is anticipated that contracts with future customers will contain similar provisions. Other existing agreements and future agreements may be silent as to the ownership of such rights. To the extent that the ownership of such intellectual property rights is expressly granted to a customer or is ambiguous, the ability to reuse or resell such rights may be limited.

Digital Fusion's policy is to execute confidentiality agreements with its employees and consultants upon the commencement of an employment or consulting relationship. These agreements generally require that all confidential information developed or made known to the individual during the course of the individual's relationship with Digital Fusion be kept confidential and not disclosed to third parties. These agreements also generally provide that inventions conceived by the individual in the course of rendering services to Digital Fusion shall be Digital Fusion's exclusive property. There can be no assurance that such agreements will not be breached, that there would be adequate remedies for any breach, or that trade secrets will not otherwise become known to or be independently developed by competitors, which may result in lost sales and lost competitive advantage.

If Digital Fusion fails to perform to customers' expectations it could result in claims against it which could reduce its earnings.

Digital Fusion's services involve development, implementation, and maintenance of computer systems and computer software that are critical to the operations of its customers' businesses. Failure or inability to meet a customer's expectations in the performance of its services could harm its business reputation or result in a claim for substantial damages, regardless of its responsibility for such failure or inability. In addition, in the course of performing services, Digital Fusion's personnel often gain access to technologies and content that includes confidential or proprietary customer information. Although policies have been implemented to prevent such customer information from being disclosed to unauthorized parties or used inappropriately, any such unauthorized disclosure or use could result in a claim for substantial damages. Digital Fusion attempts to limit contractually any damages that could arise from negligent acts, errors, mistakes, or omissions in rendering services and, although general liability insurance coverage is maintained, including coverage for errors and omissions, there can be no assurance that such coverage will continue to be available on reasonable terms or will be available in sufficient amounts to cover one or more large claims. The successful assertion of one or more large claims against Digital Fusion that are uninsured, exceed available insurance coverage, or result in changes to corporate insurance policies, including premium increases or the imposition of a large deductible or co-insurance requirements, would have a material adverse effect on the financial condition of Digital Fusion.

Large quantities of common stock sales by Digital Fusion's stockholders could cause its common stock price to decrease due to the lack of a liquid market for its common stock.

The market price of Digital Fusion's common stock could decline as a result of sales of a large number of shares of its common stock in the market or the perception that these sales may occur. These sales also might make it more difficult for it to sell equity securities in the future at a time and at a price that it deems appropriate.

Digital Fusion has holders of options and warrants that if exercised, could also have an adverse effect on the market price of its common stock.

Anti-Takeover Provisions

Provisions of Digital Fusion's Restated Certificate of Incorporation, its Amended and Restated By-laws, and Delaware law, could make it difficult for a third party to acquire it, even if doing so would be beneficial to its stockholders.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This proxy statement/prospectus includes forward-looking statements. These forward-looking statements relate to outlooks or expectations for earnings, revenues, expenses, asset quality or other future financial or business performance, strategies or expectations, or the impact of legal, regulatory or supervisory matters on business, results of operations or financial condition. Specifically, forward looking statements may include:

- statements relating to the benefits of the merger, including anticipated synergies and cost savings estimated to result from the merger;
- statements relating to future business prospects, revenue, income and financial condition; and
- statements preceded by, followed by or that include the words "estimate," "plan," "project," "forecast," "intend," "expect," "anticipate," "believe," "seek," "target" or similar expressions.

These statements reflect management judgments based on currently available information and involve a number of risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. However, actual results may differ materially from those in the forward-looking statements. Some factors that could cause actual results to differ include:

- either or both of the companies' respective stockholders may not approve the merger;
- the merger not close when expected or at all;
- the businesses may not be integrated successfully;
- expected cost savings from the merger may not be fully realized within the expected time frames or at all;
- revenues following the merger may be lower than expected;
- the effects of vigorous competition in the markets in which Kratos and Digital Fusion operate;
- the possibility of one or more of the markets in which Kratos and Digital Fusion compete being impacted by changes in political or other factors such as monetary policy, legal and regulatory changes or other external factors over which they have no control;
- changes in general economic and market conditions; and
- other risks referenced from time to time in filings with the SEC and those factors listed in this joint proxy statement/prospectus under "Risk Factors" beginning on page 18.

You are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this proxy statement/prospectus, or in the case of any other document, as of the date of that document. Except as required by law, neither Kratos nor Digital Fusion undertakes any obligation to publicly update or release any revisions to these forward-looking statements to reflect any events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Additional factors that could cause actual results to differ materially from those expressed in the forward-looking statements are discussed in this proxy statement/prospectus, including the section of this proxy statement/prospectus entitled "Risk Factors."

THE SPECIAL MEETING OF KRATOS STOCKHOLDERS

Date, Time and Place of the Special Meeting

These proxy materials are delivered in connection with the solicitation by the Kratos board of directors of proxies to be voted at the Kratos special meeting, which is to be held at the offices of Kratos at 4810 Eastgate Mall, San Diego, California on Monday, December 22, 2008 at 10:00 a.m. local time. On or about December 5, 2008, Kratos commenced mailing this proxy statement/prospectus and the enclosed form of proxy to its stockholders entitled to vote at the meeting.

Purpose of the Kratos Special Meeting

Kratos stockholders will be asked to vote on the following proposals:

1. To approve the issuance of Kratos common stock, par value $0.001 per share, pursuant to the Agreement and Plan of Merger, dated as of November 21, 2008, by and among Kratos Defense & Security Solutions, Inc., Dakota Merger Sub, Inc., and Digital Fusion, Inc., as the same may be amended from time to time.

2. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

It is a condition to completion of the merger that Kratos stockholders approve the issuance of shares of Kratos common stock in the merger. When the merger becomes effective, each share of Digital Fusion common stock outstanding immediately before the merger will be converted into the right to receive 1.7933 shares of Kratos common stock. Under Marketplace Rule 4350(i) promulgated by the Nasdaq Stock Market, a company listed on the Nasdaq Stock Market is required to obtain stockholder approval in connection with a merger with another company if the number of shares of common stock or securities convertible into common stock to be issued is in excess of 20% of the number of shares of common stock then outstanding. If the merger is completed, Kratos will issue up to approximately 32.9 million shares of Kratos common stock in connection with the merger, including common stock issuable pursuant to outstanding options, warrants and grants under the Digital Fusion deferred compensation plan, which will be assumed by Kratos. On an as converted basis, the aggregate number of shares of Kratos common stock to be issued and issuable in connection with the merger will exceed 20% of the shares of Kratos common stock outstanding on the record date for the Kratos special meeting, and for this reason Kratos must obtain the approval of Kratos stockholders for the issuance of these securities to Digital Fusion stockholders in the merger.

Board of Directors Recommendation

The Kratos board of directors has unanimously recommended that the Kratos stockholders vote "**FOR**" the proposal to approve the issuance of shares of Kratos common stock pursuant to the merger agreement. The approval of this proposal is required for completion of the merger.

Record Date and Voting Power

Only stockholders of record as of the close of business on November 25, 2008 (the official record date) will be entitled to notice of and to vote at the special meeting or at any subsequent meeting due to an adjournment of the original meeting. **Kratos is mailing this proxy statement and the accompanying proxy card on or about December 5, 2008 to all stockholders of record as of November 25, 2008.**

On the record date, Kratos had two classes of voting stock, common stock and preferred stock, of which 105,292,730 shares of common stock were issued and outstanding and 10,000 shares of Series B Convertible Preferred Stock were issued and outstanding. Each outstanding share of common stock entitles the holder to one vote and each outstanding share of Series B Convertible Preferred Stock entitles the holder to one hundred votes on all matters to be voted upon at the special meeting.

A complete list of stockholders entitled to vote at the Kratos special meeting will be available for examination by any Kratos stockholder at Kratos' headquarters, for purposes pertaining to the Kratos special meeting, during normal business hours for a period of ten days before the Kratos special meeting, and at the time and place of the Kratos special meeting.

Quorum and Votes Required

In order to carry on the business of the meeting, Kratos must have a quorum. A quorum requires the presence, in person or by proxy, of the holders of a majority of the votes entitled to be cast at the meeting.

The affirmative vote of a majority of the shares of Kratos common stock represented at a meeting in person or by proxy and entitled to vote at a meeting at which a quorum is present is required to approve the issuance of the Kratos common stock in the merger.

Abstentions, Broker Non-Votes and Incomplete Proxies

Brokers who hold shares of Kratos common stock in "street name" for a beneficial owner of those shares typically have the authority to vote in their discretion on routine proposals when they have not received instructions from beneficial owners. However, under the rules that govern brokers, brokers are not allowed to exercise their voting discretion with respect to the approval of matters that are "non-routine," such as approval of the issuance of shares of Kratos common stock pursuant to the merger agreement, without specific instructions from the beneficial owner. These non-voted shares are referred to as "broker non-votes." If your broker holds your Kratos common stock in "street name," your broker will vote your shares only if you provide instructions on how to vote by filling out the voter instruction form sent to you by your broker with this joint proxy statement/prospectus.

If you return a proxy card but fail to indicate your vote with respect to a proposal, an incomplete proxy, your shares will be voted in favor of the proposal in accordance with the recommendation of the board of directors.

Abstentions, incomplete proxies and "broker non-votes" will be counted as present and entitled to vote for purposes of determining whether a quorum is present at the meeting. Abstentions will have the same effect as a vote against and broker non-votes will have no effect on the outcome of the proposal for approval of the issuance of shares of Kratos common stock pursuant to the merger agreement.

Voting of Proxies

Giving a proxy means that a Kratos stockholder authorizes the persons named in the enclosed proxy card to vote its shares at the Kratos special meeting and any adjournment or postponement thereof in the manner it directs. A Kratos stockholder may vote by proxy or in person at the meeting. To vote by proxy, a Kratos stockholder may use one of the following methods if it is a registered holder (that is, it holds its stock in its own name):

- **Telephone voting,** by dialing the toll-free number and following the instructions on the proxy card;
- **Via the Internet,** by going to the web address *www.proxyvote.com* and following the instructions on the proxy card; or
- **Mail,** by completing and returning the proxy card in the enclosed envelope. The envelope requires no additional postage if mailed in the United States.

Kratos requests that its stockholders complete and sign the accompanying proxy and return it to Kratos as soon as possible in the enclosed postage-paid envelope. When the accompanying proxy is returned properly executed, the shares of Kratos stock represented by it will be voted at the Kratos special meeting in accordance with the instructions contained on the proxy card.

If any proxy is returned without indication as to how to vote, the Kratos stock represented by the proxy will be considered a vote in favor of all matters for consideration at the Kratos special meeting or at any adjournment or postponement thereof. Unless a stockholder checks the box on its proxy card to withhold discretionary authority, the proxy holders may use their discretion to vote on other matters relating to the Kratos special meeting.

If a Kratos stockholder's shares are held in "street name" by a broker or other nominee, the stockholder should check the voting form used by that firm to determine whether it may vote by telephone or the Internet.

Every stockholder's vote is important. Accordingly, each Kratos stockholder should sign, date and return the enclosed proxy card, or vote via the Internet or by telephone, whether or not it plans to attend the Kratos special meeting in person.

Revocability of Proxies and Changes to a Kratos Stockholder's Vote

A Kratos stockholder has the power to change its vote at any time before its shares are voted at the special meeting by:

- notifying Kratos' Corporate Secretary, Laura L. Siegal, in writing at 4810 Eastgate Mall, San Diego, CA 92121 that you are revoking your proxy;
- executing and delivering a later dated proxy card or submitting a later dated vote by telephone or in the internet; or
- voting in person at the special meeting.

However, if a Kratos stockholder has shares held through a brokerage firm, bank or other custodian, it may revoke its instructions only by informing the custodian in accordance with any procedures it has established.

Solicitation of Proxies

The solicitation of proxies from Kratos stockholders is made on behalf of the Kratos board of directors. Kratos and Digital Fusion will generally share equally the cost and expenses of printing and mailing this proxy statement/prospectus and all fees paid to the SEC. Kratos will pay the costs of soliciting and obtaining these proxies, including the cost of reimbursing brokers, banks and other financial institutions for forwarding proxy materials to their customers. Proxies may be solicited, without extra compensation, by Kratos officers and employees by mail, telephone, fax, personal interviews or other methods of communication. Kratos has engaged the firm of Georgeson Inc. to assist Kratos in the distribution and solicitation of proxies from Kratos stockholders and will pay Georgeson an estimated fee of $8,500 plus out-of-pocket expenses for its services. Digital Fusion will pay the costs of soliciting and obtaining its proxies and all other expenses related to the Digital Fusion special meeting.

Householding of Proxy Materials

As permitted by the Exchange Act, only one copy of this proxy statement/prospectus is being delivered to stockholders residing at the same address, unless Kratos stockholders have notified Kratos of their desire to receive multiple copies of the proxy statement/prospectus. Kratos will promptly deliver, upon oral or written request, a separate copy of this proxy statement/prospectus to any stockholder residing at an address to which only one copy was mailed. Requests for additional copies for this year or future years should be directed to: Kratos Defense & Security Solutions, Inc., Attention: Corporate Secretary, 4810 Eastgate Mall, San Diego, CA 92121.

All Kratos stockholders may view this proxy statement/prospectus on the internet at *www.kratosdefense.com*.

Attending the Meeting

Subject to space availability, all stockholders as of the record date, or their duly appointed proxies, may attend the meeting. Since seating is limited, admission to the meeting will be on a first-come, first-served basis. Registration and seating will begin at 9:00 a.m. local time.

If you are a registered stockholder (that is, if you hold your stock in certificate form), an admission ticket is enclosed with your proxy card. If you wish to attend the special meeting, please vote your proxy but keep the admission ticket and bring it with you to the special meeting.

If your shares are held in "street name" (that is, through a bank, broker or other holder of record) and you wish to attend the special meeting, you must bring a copy of a bank or brokerage statement reflecting your stock ownership as of the Kratos record date to the special meeting.

THE SPECIAL MEETING OF DIGITAL FUSION STOCKHOLDERS

Date, Time and Place of the Special Meeting

These proxy materials are delivered in connection with the solicitation by the Digital Fusion board of directors of proxies to be voted at the Digital Fusion special meeting, which is to be held at Embassy Suites, 800 Monroe Street, Huntsville, Alabama, on December 22, 2008 at 9:30 a.m. local time. On or about December 5, 2008, Digital Fusion commenced mailing this proxy statement/prospectus and the enclosed form of proxy to its stockholders entitled to vote at the meeting.

Purpose of the Digital Fusion Special Meeting

Digital Fusion stockholders will be asked to vote on the following proposals:

1. To adopt and approve the Agreement and Plan of Merger, dated November 21, 2008, by and among Kratos Defense Security Solutions, Inc., Dakota Merger Sub, Inc. and Digital Fusion.

2. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

Record Date and Voting Power

Only stockholders of record as of the close of business on December 2, 2008 (the official record date) will be entitled to notice of and to vote at the special meeting or at any subsequent meeting due to an adjournment of the original meeting. **Digital Fusion is mailing this proxy statement/prospectus and the accompanying proxy card on or about December 5, 2008 to all stockholders of record as of December 2, 2008**.

On the record date, December 2, 2008, Digital Fusion had one class of voting stock outstanding. On that date, 11,847,123 shares of Digital Fusion common stock were issued and outstanding. Each outstanding share of common stock entitles the holder to one vote on all matters to be voted upon at the special meeting.

A complete list of stockholders entitled to vote at the Digital Fusion special meeting will be available for examination by any Digital Fusion stockholder at Digital Fusion's headquarters, for purposes pertaining to the Digital Fusion special meeting, during normal business hours for a period of ten days before the Digital Fusion special meeting, and at the time and place of the Digital Fusion special meeting.

Quorum and Votes Required

In order to carry on the business of the meeting, Digital Fusion must have a quorum. A quorum requires the presence, in person or by proxy, of the holders of a majority of the votes entitled to be cast at the meeting. The affirmative vote of a majority of the outstanding shares of Digital Fusion common stock is required to adopt and approve the merger agreement.

Abstentions, Broker Non-Votes and Incomplete Proxies

If you are a Digital Fusion stockholder and you fail to vote or fail to instruct your broker or other nominee how to vote on the merger agreement, your failure to vote or instruct your broker or other nominee how to vote will have the effect of a negative vote on the merger proposal. Similarly, if you "abstain" from voting, the shares represented by your proxy will be counted as present for purposes of determining whether a quorum exists, and your abstention will have the effect of a negative vote on the merger proposal. If you submit a proxy but do not indicate how you want your shares to be voted on the merger proposal, your proxy will be counted as present for purposes of determining whether a quorum exists and will be counted as voting in favor of the merger proposal.

Voting by Digital Fusion Directors and Executive Officers

On the Digital Fusion record date, directors and executive officers of Digital Fusion and their affiliates owned and were entitled to vote 3,999,567 shares of Digital Fusion common stock, or approximately 34% of the total voting power of the shares of Digital Fusion common stock outstanding on that date. All of Digital Fusion's directors and executive officers have executed voting agreements pursuant to which each has agreed to vote their shares of common stock in favor of the merger. In addition, Madison Run, an investor affiliated with one of Digital Fusion's directors, holds 22.3% of the total voting power of the shares of Digital Fusion, and it has agreed to vote its shares in favor of the merger.

Voting of Proxies

Giving a proxy means that a Digital Fusion stockholder authorizes the persons named in the enclosed proxy card to vote its shares at the Digital Fusion special meeting and any adjournment or postponement thereof in the manner it directs. A Digital Fusion stockholder may vote by proxy or in person at the meeting. To vote by proxy, a Digital Fusion stockholder may use one of the following methods if it is a registered holder (that is, it holds its stock in its own name):

- **Telephone voting,** by dialing the toll-free number 1-866-626-4508 and following the instructions on the proxy card;
- **Via the Internet,** by going to the web address *www.votestock.com* and following the instructions on the proxy card; or
- **Mail,** by completing and returning the proxy card in the enclosed envelope. The envelope requires no additional postage if mailed in the United States.

Digital Fusion requests that its stockholders complete and sign the accompanying proxy and return it to Digital Fusion as soon as possible in the enclosed postage-paid envelope. When the accompanying proxy is returned properly executed, the shares of Digital Fusion stock represented by it will be voted at the special meeting and any adjournment or postponement thereof in accordance with the instructions contained on the proxy card.

If any proxy is returned without indication as to how to vote, the Digital Fusion stock represented by the proxy will be considered a vote in favor of the adoption and approval of the merger agreement. Unless a Digital Fusion stockholder checks the box on its proxy card to withhold discretionary authority, the proxy holders may use their discretion to vote on other matters relating to the special meeting.

If a Digital Fusion stockholder's shares are held in "street name" by a broker or other nominee, the stockholder should check the voting form used by that firm to determine whether it may vote by telephone or the Internet.

Every stockholder's vote is important. Accordingly, each Digital Fusion stockholder should sign, date and return the enclosed proxy card, or vote via the Internet or by telephone, whether or not it plans to attend the Digital Fusion special meeting in person.

Revocability of Proxies and Changes to a Digital Fusion Stockholder's Vote

A Digital Fusion stockholder has the power to change its vote at any time before its shares are voted at the special meeting by:

- notifying Digital Fusion's Corporate Secretary, in writing at 5030 Bradford Drive, Building 1, Suite 210, Huntsville, Alabama 35805, that you are revoking your proxy;

executing and delivering a later dated proxy card or submitting a later dated vote by telephone or through the internet; or

voting in person at the special meeting.

However, if a Digital Fusion stockholder has shares held through a brokerage firm, bank or other custodian, it may revoke its instructions only by informing the custodian in accordance with any procedures it has established.

Solicitation of Proxies

The solicitation of proxies from Digital Fusion stockholders is made on behalf of the Digital Fusion board of directors. Kratos and Digital Fusion will generally share equally the cost and expenses of printing and mailing this proxy statement/prospectus and all fees paid to the SEC. Digital Fusion will pay the costs of soliciting and obtaining these proxies, including the cost of reimbursing brokers, banks and other financial institutions for forwarding proxy materials to their customers. Proxies may be solicited, without extra compensation, by Digital Fusion officers and employees by mail, telephone, fax, personal interviews or other methods of communication.

Attending the Meeting

Subject to space availability, all stockholders as of the record date, or their duly appointed proxies, may attend the meeting. Since seating is limited, admission to the meeting will be on a first-come, first-served basis. Registration and seating will begin at 9:00 a.m. local time.

If you are a registered stockholder (that is, if you hold your stock in certificate form), an admission ticket is enclosed with your proxy card. If you wish to attend the special meeting, please vote your proxy but keep the admission ticket and bring it with you to the special meeting.

If your shares are held in "street name" (that is, through a bank, broker or other holder of record) and you wish to attend the special meeting, you need to bring a copy of a bank or brokerage statement to the special meeting reflecting your stock ownership as of the Digital Fusion record date.

THE MERGER

The following is a discussion of the merger and the material terms of the merger agreement between Kratos and Digital Fusion. You are urged to read carefully the merger agreement in its entirety, a copy of which is attached as Annex A to this proxy statement/prospectus and incorporated by reference herein.

Background of the Merger

Digital Fusion received inquiries into its possible sale beginning in 2006. The Digital Fusion board of directors began discussing the need to engage an investment banking firm in April of 2006. The purpose of engaging an investment banking firm was to provide the Digital Fusion board of directors with an analysis of potential strategies and also to assist in determining the value of the company. In July of 2006, the Digital Fusion board of directors engaged the investment banker, ISI Partners, LLC, or ISI, and requested that ISI provide recommendations as to the financial structure and strategic future of Digital Fusion. ISI made a presentation to the Digital Fusion board on July 26, 2006, in which it evaluated several potential courses of action for the company. After an extensive and detailed review of Digital Fusion's strategy and financial projections, ISI recommended that Digital Fusion should deregister its stock under the Exchange Act and focus on building company value.

On August 29, 2006, the Digital Fusion board of directors again met with ISI and its legal counsel, Lanier, Ford, Shaver & Payne P.C., or LFSP, to discuss deregistration. Following an extensive review of ISI's recommendation and the advice of legal counsel, the Digital Fusion board approved the filing of a Form 15 with the SEC in order to deregister its stock.

Digital Fusion deregistered its stock by filing a Form 15 with the SEC on September 11, 2006. In October of 2006, the Digital Fusion board of directors formed a strategy committee, which would be responsible for shaping the future strategy of Digital Fusion.

On November 1, 2006, the President of Digital Fusion responded to an inquiry from a well-established government contractor regarding a possible sale of Digital Fusion. The Digital Fusion board of directors determined that a sale of the business at that time was premature, and the President informed the company that there was no interest in selling the company at that time.

On December 19, 2006, Digital Fusion's President asked ISI to respond to an unsolicited inquiry from an investment bank regarding the Digital Fusion board of directors' interest in selling Digital Fusion. ISI corresponded with the investment bank; however, it never replied.

In August of 2007, ISI received an inquiry from another interested party, regarding its interest in purchasing Digital Fusion. On August 28, 2007, Digital Fusion and the interested party executed a Non-Disclosure Agreement.

On September 17, 2007, Digital Fusion received a non-binding letter of intent from Kratos. The letter of intent was an offer to purchase Digital Fusion for consideration comprised of a mix of cash and stock. The Digital Fusion board of directors met and thoroughly reviewed the letter of intent from Kratos. They voted to reject the offer at that time because the terms and conditions were deemed unfavorable to Digital Fusion's stockholders and due to uncertainty related to the restatement of Kratos' financial statements and late SEC filings.

Negotiations between the financial advisors of both Digital Fusion and Kratos continued informally through the rest of September and October. On November 28, 2007, Kratos delivered a second non-binding letter of intent to Digital Fusion for $55,000,000 in cash. The Digital Fusion board of directors met on December 3, 2007, and thoroughly reviewed the offer. After discussion between the Digital Fusion board of directors, its financial advisor, and legal counsel, the Digital Fusion board of directors voted to approve the letter of intent, subject to certain changes. Kratos did not accept the counteroffer.

Despite the rejection of Digital Fusion's counteroffer, in February 2008, Digital Fusion's financial advisor contacted Kratos' chief executive officer to discuss Kratos' renewed interest in acquiring Digital Fusion once it had completed its acquisition of SYS. The two parties continued their discussions informally from May 2008 through July 2008.

On August 11, 2008, Digital Fusion's strategy committee met and discussed a third non-binding letter of intent from Kratos. The committee agreed to continue negotiations with Kratos on some of the terms of the letter of intent. The committee resolved that ISI, LFSP and Mr. Chris Brunhoeber, Chief Financial Officer, should continue negotiations.

On August 13, 2008, Digital Fusion's board of directors met and heard a presentation from ISI regarding the history of negotiations between Digital Fusion and Kratos and the industry and overall market dynamics. After a thorough review and discussion of the letter of intent, and discussions with LFSP, including a review of the board's fiduciary duties to the Digital Fusion stockholders, the board of directors voted unanimously to approve the non-binding letter of intent, including the provisions binding Digital Fusion to negotiate exclusively with Kratos until November 11, 2008. The board of directors also stated there were certain matters remaining to be negotiated, and thus the signed letter of intent was returned to Kratos with a cover letter from its President, which stated that resolution of five specific items was of prime importance.

On August 19, 2008, a teleconference was held between representatives of Kratos and Digital Fusion to discuss due diligence. Representatives of Kratos travelled to Huntsville, Alabama on August 26 to 27 to continue on-site due diligence, as well as to review Digital Fusion's capabilities. At that time, discussions related to transition and integration planning also began.

On September 3 to 5, certain of Digital Fusion's officers and directors traveled to San Diego, California to Kratos' corporate office to continue negotiations for a definitive agreement. At this time, Kratos executives presented capabilities briefings on each of their divisions, and answered some of Digital Fusion's due diligence questions. During these meetings, it became apparent that there were several transaction terms that would have to be amended to reach a satisfactory conclusion.

Negotiations over Digital Fusion's financials, waterfall analysis and its business opportunities continued throughout September. On September 24, 2008, Digital Fusion's board met to discuss the status of the transaction with Kratos. The Digital Fusion board of directors agreed that the strategy committee should meet and review the status of the transaction and make a recommendation to the board within 10 days of how to proceed.

On October 3, 2008, Digital Fusion received a revised letter of intent from Kratos. The revised letter of intent provided for an aggregate merger consideration of approximately 27.5 million shares of Kratos stock. The letter of intent provided for a stock-for-stock transaction that would have a fixed exchange ratio and a working capital adjustment. Digital Fusion's board met and voted unanimously to approve the non-binding letter of intent, including the provisions binding Digital Fusion to negotiate exclusively with Kratos until January 1, 2009.

On October 14-17, the President of Digital Fusion, its financial advisor and chief financial officer returned to San Diego to continue due diligence. Discussions were held with regard to Kratos' financial statements and forecasts, and other legal and due diligence issues.

On or about October 15, 2008, Kratos' counsel, Morrison & Foerster LLP, delivered to LFSP an initial draft of the merger agreement. From October 15, 2008 until the execution of the merger agreement, Kratos and Digital Fusion and representatives exchanged drafts of the merger agreement and held extensive negotiations relating to its terms and conditions.

The Chairman of the Digital Fusion board of directors traveled to Huntsville October 22 to 24 to work on due diligence issues with management.

On Tuesday, October 28, 2008, a conference call was held between, management of Digital Fusion and Kratos to discuss outstanding diligence issues as well as treatment of Digital Fusion's options, employee retention and lock-up and bleed-out guidelines.

On October 29, 2008, briefing slides were sent to members of the Digital Fusion board in preparation for a conference call the next day. ISI also sent the board of directors its valuation analysis on the small cap defense contractors.

On October 30-31, 2008, the Digital Fusion board of directors met along with LFSP and ISI to discuss the terms and conditions of the merger agreement, the recent activity of the stock markets, small and microcap markets, and the negative impact upon both the stock price of Digital Fusion and Kratos, and to discuss other due diligence items including Digital Fusion's financial forecast for 2009 and 2010. The discussions ended with an agreement that discussions would continue, and that Mr. DeMarco would personally come to Huntsville to address certain concerns.

On November 7, 2008, Digital Fusion received Kratos' proposed non-competition, stockholder and retention agreements. In the days that followed, further discussion of the exchange ratio, deal valuation and Kratos stock price occurred. As of November 7, 2008 Kratos' offer was a fixed exchange ratio of between 1.77 and 1.76 shares of Kratos stock for each share of Digital Fusion stock.

On November 10, 2008, Digital Fusion's board of directors met to discuss the Kratos transaction, including integration of the two companies, employee retention, and the fairness of the transaction with respect to Digital Fusion's stockholders. The Digital Fusion board of directors discussed the various issues that needed to be resolved before and during Kratos Chief Executive Officer Eric DeMarco's upcoming trip to Huntsville.

On November 19, 2008, Kratos' board of directors held a board meeting to consider approval of the merger agreement and the strategic acquisition of Digital Fusion. Also at such meeting, Imperial Capital reviewed with Kratos' board of directors Imperial Capital's financial analyses and delivered to Kratos' board of directors an oral opinion, which opinion was confirmed by delivery of a written opinion, dated November 19, 2008, to the effect that, as of that date and based on and subject to various assumptions, matters considered and limitations described in its opinion, the exchange ratio in the transaction was fair, from a financial point of view, to Kratos. The full text of the written opinion of Imperial Capital, which sets forth the assumptions made, procedures followed, matters considered and limitations on the review undertaken in connection with such opinion, is attached hereto as *Annex C*. Following discussion, the Kratos board of directors approved the merger agreement and the transactions contemplated by the merger agreement and resolved to recommend that the Kratos stockholders vote to approve the issuance of Kratos common stock in the merger.

On November 20, 2008, Digital Fusion's board of directors held a board meeting to consider approval of the merger agreement and the merger. Also at such meeting, ISI reviewed with Digital Fusion's board of directors its financial analyses and delivered to the board of directors an oral opinion, which opinion was confirmed by delivery of a written opinion, dated November 20, 2008, to the effect that, as of that date and based on and subject to various assumptions, matters considered and limitations described in its opinion, the exchange ratio in the transaction was fair, from a financial point of view, to the stockholders of Digital Fusion. The full text of the written opinion of ISI, which sets forth the assumptions made, procedures followed, matters considered and limitations on the review undertaken in connection with such opinion, is attached hereto as *Annex D*. Following discussion, the Digital Fusion board of directors approved the merger agreement and the transactions contemplated by the merger agreement and resolved to recommend that the Digital Fusion stockholders vote to approve and adopt the merger agreement and the merger. All directors were present for the meeting and voted to approve the transaction unanimously.

The Kratos Board of Directors' Recommendations and Reasons for the Merger

At a special meeting of the Kratos board of directors held on November 19, 2008, the Kratos board of directors:

- determined that the merger is advisable, fair to and in the best interests of Kratos and its stockholders;
- approved the merger agreement;
- directed that approval of the issuance of Kratos common stock pursuant to the merger agreement be submitted for consideration by Kratos stockholders at a Kratos special meeting; and
- resolved to recommend that the Kratos stockholders vote "FOR" approval of the proposal to issue Kratos common stock in the merger pursuant to the merger agreement.

In reaching its decision, the Kratos board of directors consulted with Kratos' management, as well as Kratos' financial advisor and outside legal counsel, and considered the short-term and long-term interests of Kratos and its stockholders. The Kratos board of directors considered that the merger could enhance stockholder value through, among other things, enabling Kratos, following the merger, to capitalize on the following strategic advantages and opportunities:

- The government market is an attractive market for continued expansion due to relative stability and steady cash flow generation;
- The merger would allow Kratos to access new customers, obtain additional contract vehicles and further grow its operations in Huntsville, Alabama to take advantage of BRAC realignment opportunities;
- The combined company, with greater scale, size, more past performance qualifications and a larger number of employees, especially those with security clearances, will be able to bid on larger and more contracts in the prime contract role;
- The merger will broaden the capabilities that Kratos can offer to its customers;
- The merger will allow Kratos to add approximately 300 hard-to-find employees with skill sets that are very marketable and in high demand; and
- The merger will assist Kratos in achieving its growth objectives and profitability targets.

The Kratos board of directors also considered a variety of other factors and risks concerning the merger, including the following:

- The information concerning the respective historic businesses of Kratos and Digital Fusion, financial results and prospects, including the result of Kratos due diligence review of Digital Fusion;
- The assessments of Kratos that Digital Fusion's business can effectively and efficiently be integrated;
- The financial presentation of Imperial Capital and its opinion dated November 19, 2008, to Kratos' board of directors as to the fairness, from a financial point of view and as of that date, of the exchange ratio in the transaction to Kratos, as more fully described below under " Opinion of Financial Advisor to the Kratos Board of Directors" beginning on page 59 and in

the written opinion of Imperial Capital attached as *Annex C* to this proxy statement/prospectus;

- The exchange ratio and the fact that the exchange ratio is fixed and will not fluctuate based upon changes in the Kratos stock price between signing and closing, reflecting the strategic purpose of the merger and consistent with market practices for a merger of this type;

- The expectation that Digital Fusion stockholders and option holders, immediately after completion of the merger, would hold approximately 20% of the outstanding shares of common stock of Kratos, on a fully diluted basis;

- The challenges and costs of combining the two businesses and the risks of completing the integration, which could harm the combined company's operating results and preclude the realization of anticipated synergies or benefits from the merger;

- The potential for diversion of management and employee attention from other strategic priorities and for increased employee attrition both before and after the closing of the merger agreement, and the potential effect on the business and relations of Kratos with customers and suppliers;

- The fees and expenses associated with completing the merger; and

- The risk that anticipated cost savings will not be achieved.

The foregoing discussion of the factors considered by the Kratos board of directors is not intended to be exhaustive but summarizes the material factors and risks considered by Kratos' board of directors in making its recommendation. In view of the wide variety of factors considered in connection with its evaluation of the merger and the complexity of these matters, the Kratos board of directors did not find it useful to, and did not attempt to, quantify, rank or otherwise assign relative weights to these factors. In considering the factors described above, individual members of the Kratos board of directors may have given different weight to different factors.

In addition, the Kratos board of directors did not undertake to make any specific determination as to whether any particular factor, or any aspect of any particular factor, was favorable or unfavorable to its ultimate determination, but rather conducted an overall analysis of the factors described above, including discussions with the Kratos management team and the Kratos outside legal and financial advisors. Based on the totality of the information presented, the Kratos board of directors determined that Kratos should proceed with the merger and the merger agreement, and recommends that the Kratos stockholders approve the Share Issuance.

The Digital Fusion Board of Directors' Recommendations and Reasons for the Merger

At a regular meeting of the Digital Fusion board of directors held on November 20, 2008, the board of directors voted unanimously to approve the merger agreement, the merger, and the other transactions contemplated by the merger agreement, to direct that the merger agreement and the merger be submitted to a vote of Digital Fusion's stockholders and to recommend that Digital Fusion's stockholders vote to adopt and approve the merger agreement and the merger. In reaching its decision to enter into the merger agreement, the Digital Fusion board of directors consulted with: senior management; outside legal counsel; its audit firm Anglin Reichman Snellgrove & Armstrong, P.C.; and its financial advisor ISI. Digital Fusion's board of directors also reviewed a significant amount of information and considered a number of factors, the most relevant of which include the following:

- That by combining complementary operations, the combined company would have better opportunities for future growth;

- The opportunity for Digital Fusion's stockholders to participate in a larger, more diversified organization and to benefit from the potential appreciation in the value of Kratos' common stock;

- Information concerning the business, earnings, operations, competitive position and prospects of Digital Fusion and Kratos both individually and on a combined basis;

- The trading volume and market liquidity of Kratos stock;

- The opportunity for Digital Fusion stockholders to receive a significant premium over the existing market price for shares of Digital Fusion's common stock prior to the announcement of the merger;

- Discussions with Digital Fusion senior management and legal and financial advisor regarding certain business, financial, legal and accounting aspects of the merger, the results of the legal and financial due diligence and a review of the terms and conditions of the merger;

- The opinion of ISI that, as of November 20, 2008, and subject to the assumptions and limitations set forth in the fairness opinion, the exchange ratio in the merger was fair, from a financial point of view, to the holders of Digital Fusion's common stock;

- The possibility, as alternatives to the merger, of seeking to raise additional equity or debt capital, or seeking to engage in a business combination with an organization other than Kratos;

- The likely impact of the merger on Digital Fusion's employees and customers;

- The interests that certain executive officers and directors of Digital Fusion have with respect to the merger, in addition to their interests as stockholders of Digital Fusion generally, as described in "The Merger Interests of Digital Fusion Directors and Executive Officers in the Merger," starting on page 74;

- The fact that the parties intend for the merger to qualify as a tax-free transaction for U.S. federal income tax purposes which would permit Digital Fusion's stockholders to receive Kratos common stock in a tax-free exchange; and

- The history of contacts with other potential strategic partners and the judgment of Digital Fusion's board of directors and management that it was unlikely that any other party would be a more attractive strategic partner or make a proposal more favorable to Digital Fusion and its stockholders than Kratos.

Digital Fusion's board of directors also considered a number of potentially negative factors in its deliberation concerning the merger. The negative factors considered by the board of directors included:

- The risk that the merger would not be completed in a timely manner or at all;

- The possible negative effects of the public announcement of the merger on Digital Fusion's relationships with customers, suppliers, and employees; and operating results;

- The fact that the Digital Fusion stockholders will not receive the full benefit of any future growth in the value of their equity that Digital Fusion may have achieved as an independent company, and the potential disadvantage of Digital Fusion stockholders in the event that Kratos does not perform as well in the future as Digital Fusion may have performed as an independent company;

The substantial management time, effort and expense that will be required to consummate the merger and integrate the operations of the two companies;

The possibility that certain provisions of the merger agreement, including, among others, the no solicitation and termination fee payment provisions of the merger agreement and the fact that certain officers of Digital Fusion executed stockholder voting agreements, would likely have the effect of discouraging other persons potentially interested in merging with or acquiring Digital Fusion from pursuing such an opportunity;

The impact of unfavorable credit market on Kratos' ability to raise additional capital; and

The other risks and uncertainties discussed above under "Risk Factors," beginning on page 18 of this proxy statement/prospectus including the various outstanding stockholder and stock option litigation matters involving Kratos, and the potential future impacts of those matters on the merger consideration being issued to the Digital Fusion stockholders.

The foregoing discussion of the information and factors considered by the board of directors of Digital Fusion is not intended to be exhaustive. In view of the wide variety of the material factors considered in connection with the evaluation of the merger and the complexity of these matters, the board of directors did not find it practicable to, and did not, quantify or otherwise attempt to assign any relative weight to the various factors considered. In addition, the board of directors did not undertake to make any specific determination as to whether any particular factor, or any aspect of any particular factor, was favorable or unfavorable to the ultimate determination of the Digital Fusion board of directors, but rather, the Digital Fusion board of directors conducted an overall analysis of the factors described above, including discussions with and questioning of Digital Fusion's senior management, and legal and financial advisors. In considering the factors described above, individual members of the board of directors of Digital Fusion board of directors may have given different weight to different factors.

Opinion of Financial Advisor to the Kratos Board of Directors

On November 19, 2008, at a meeting of Kratos' board of directors held to evaluate the proposed transaction, Imperial Capital delivered to Kratos' board of directors an oral opinion, confirmed by delivery of a written opinion, dated November 19, 2008, to the effect that, as of that date and based on and subject to various assumptions, matters considered and limitations described in its opinion, the exchange ratio in the transaction was fair, from a financial point of view, to Kratos.

The full text of Imperial Capital's opinion describes the assumptions made, procedures followed, matters considered and limitations on the review undertaken by Imperial Capital. This opinion is attached as *Annex C* and is incorporated into this proxy statement by reference. **Imperial Capital's opinion is directed only to the fairness, from a financial point of view, of the exchange ratio in the transaction to Kratos. The opinion does not address the merits of the underlying decision by Kratos to engage in the transaction or the relative merits of any alternatives discussed by Kratos' board of directors and does not constitute an opinion with respect to Kratos' underlying business decision to effect the transaction, any legal, tax or accounting issues concerning the transaction, or any terms of the transaction (other than the exchange ratio). The opinion does not constitute a recommendation as to any action Kratos or any holder of Kratos common stock should take in connection with the transaction or any aspect thereof. Holders of Kratos common stock are encouraged to read the opinion carefully in its entirety. The summary of Imperial Capital's opinion described below is qualified in its entirety by reference to the full text of its opinion.**

In arriving at its opinion, Imperial Capital, among other things:

Analyzed certain publicly available information of Kratos that it believed to be relevant to its analysis, including Kratos' annual report on Form 10-K for the fiscal year ending December 31, 2007 and quarterly reports on Form 10-Q for the quarters ending June 29, 2008 and September 28, 2008;

Analyzed certain publicly available information of Digital Fusion that it believed to be relevant to its analysis, including Digital Fusion's annual reports for the fiscal years ending December 30, 2006 and December 28, 2007 and quarterly earnings releases for the quarters ending June 27, 2008 and September 19, 2008 (Draft);

Reviewed certain internal financial forecasts and budgets prepared and provided by Kratos' and Digital Fusion's managements;

Met with and held discussions with certain members of Kratos' and Digital Fusion's managements to discuss their respective operations and future prospects;

Reviewed industry reports and publications;

Reviewed public information with respect to certain other public companies with business lines and financial profiles which it deemed to be relevant;

Reviewed the implied financial multiples and premiums paid in merger and acquisition transactions which it deemed to be relevant;

Reviewed current and historical market prices of Kratos common stock and Digital Fusion common stock, as well as the trading volume and public float of such common stock;

Reviewed a draft of the Merger Agreement, including material schedules and exhibits, dated November 17, 2008; and

Conducted such other financial studies, analyses and investigations and took into account such other matters as it deemed necessary, including its assessment of general economic and monetary conditions.

In giving its opinion, Imperial Capital relied upon the accuracy and completeness of the foregoing financial and other information and did not assume any responsibility for independent verification of such information or conduct or receive any independent valuation or appraisal of any assets of Kratos or Digital Fusion or any appraisal or estimate of liabilities of Kratos or Digital Fusion. With the consent of Kratos' board of directors, Imperial Capital assumed that all financial forecasts had been reasonably prepared on bases reflecting the best currently available estimates and judgments of management of Kratos and Digital Fusion as to the future financial performance of the companies. Imperial Capital also relied upon the assurances of management of both companies that they were unaware of any facts that would make the information or financial forecasts provided to it incomplete or misleading. It assumed no responsibility for, and expressed no view as to, such financial forecasts or the assumptions on which they are based. Imperial Capital's opinion was based upon financial, economic, market and other conditions as they existed and could be evaluated on the date of its opinion and did not address the fairness of the exchange ratio as of any other date. These conditions were and remain subject to extraordinary levels of volatility and uncertainty, and Imperial Capital expressed no view as to the impact of such volatility and uncertainty on Kratos, Digital Fusion or the contemplated benefits of the transaction.

At the direction of Kratos' board of directors, Imperial Capital was not asked to, and it did not, offer any opinion as to the terms, other than the exchange ratio to the extent expressly specified in Imperial Capital's opinion, of the Merger Agreement or any related documents or the form of the transaction or any related transaction. Imperial Capital expressed no opinion as to what the value of Kratos common stock would be when issued pursuant to the transaction or the prices at which Kratos common stock or Digital Fusion common stock will trade at any time. Imperial Capital expressed no opinion as to the fairness of the amount or nature of any compensation to be received by any officers, directors or employees of any parties to the transaction or any class of such persons. Imperial Capital assumed, with the consent of Kratos' board of directors that (i) the final executed form of the Merger Agreement would not differ in any material respect from the draft that Imperial Capital examined, (ii) the parties to the Merger Agreement would comply with all the material terms of the Merger Agreement, and (iii) the transaction would be consummated in accordance with the terms of the Merger Agreement without any adverse waiver or amendment of any material term or condition thereof. Imperial Capital also assumed that all governmental, regulatory or other consents and approvals necessary for the consummation of the transaction would be obtained without any material adverse effect on Digital Fusion, Kratos or the transaction. Except as described above, Kratos' board of directors imposed no other instructions or limitations on Imperial Capital with respect to the investigations made or the procedures followed by Imperial Capital in rendering its opinion. The issuance of Imperial Capital's opinion was approved by an authorized committee of Imperial Capital.

In connection with rendering its opinion to Kratos' board of directors, Imperial Capital performed a variety of financial and comparative analyses that are summarized below. The following summary is not a complete description of all analyses performed and factors considered by Imperial Capital in connection with its opinion. The preparation of a financial opinion is a complex process involving subjective judgments and is not necessarily susceptible to partial analysis or summary description. With respect to the selected public companies analysis and the selected transactions analysis summarized below, no company or transaction used as a comparison was either identical or directly comparable to Kratos, Digital Fusion or the proposed transaction. These analyses necessarily involve complex considerations and judgments concerning financial and operating characteristics and other factors that could affect the public trading or acquisition values of the companies concerned.

Imperial Capital believes that its analyses and the summary below must be considered as a whole and that selecting portions of its analyses and factors or focusing on information presented in tabular format, without considering all analyses and factors or the narrative description of the analyses, could create a misleading or incomplete view of the processes underlying Imperial Capital's analyses and opinion. Imperial Capital did not draw, in isolation, conclusions from or with regard to any one factor or method of analysis for purposes of its opinion, but rather arrived at its ultimate opinion based on the results of all analyses undertaken by it and assessed as a whole.

The estimates of the future performance of Kratos and Digital Fusion provided by management of Kratos and Digital Fusion in or underlying Imperial Capital's analyses are not necessarily indicative of future results or values, which may be significantly more or less favorable than those estimates. In performing its analyses, Imperial Capital considered industry performance, general business and economic conditions and other matters, many of which are beyond the control of Kratos and Digital Fusion. Estimates of the financial value of companies do not purport to be appraisals or necessarily reflect the prices at which companies actually may be sold.

The exchange ratio in the transaction was determined through negotiation between Kratos and Digital Fusion, and the decision by Kratos' board of directors to enter into the transaction was solely that of Kratos' board of directors. Imperial Capital's opinion and financial analyses were only one of many factors considered by Kratos' board of directors in its evaluation of the transaction and should not be viewed as determinative of the views of Kratos' board of directors or management with respect to the transaction or the exchange ratio.

The following is a brief summary of the material financial analyses performed by Imperial Capital and reviewed with Kratos' board of directors in connection with Imperial Capital's opinion relating to the proposed transaction. **The financial analyses summarized below include information presented in tabular format. In order to fully understand Imperial Capital's financial analyses, the tables must be read together with the text of each summary. The tables alone do not constitute a complete description of the financial analyses. Considering the data below without considering the full narrative description of the financial analyses, including the methodologies and assumptions underlying the analyses, could create a misleading or incomplete view of Imperial Capital's financial analyses.**

Contribution Analysis

Imperial Capital reviewed and compared each party's relative financial contribution to the pro forma combined entity. For each party, Imperial Capital considered the (i) pro forma equity ownership contemplated in the proposed transaction, (ii) pre-transaction market capitalization (computed using closing stock prices as of November 18, 2008), (iii) pre-transaction enterprise value, (iv) revenue for the latest twelve-month period ended September 2008, (v) gross profit for the latest twelve-month period ended September 2008, (vi) earnings before interest, taxes, depreciation and amortization, commonly referred to as "EBITDA," for the latest twelve-month period ended September 2008, (vii) estimated revenue for the 2008 fiscal year, (viii) estimated EBITDA for the 2008 fiscal year, (ix) estimated revenue for the 2009 fiscal year and (x) estimated EBITDA for the 2009 fiscal year. Financial data for Kratos and Digital Fusion were based on the most recent available filings with the Securities and Exchange Commission and on projections provided by Kratos' and Digital Fusion's managements. This analysis indicated the following relative financial contribution of each party to the pro forma combined entity:

	Digital Fusion	**Kratos**
Pro Forma Equity Ownership per Proposed Transaction	19.6%	80.4%
Pre-Transaction Market Capitalization	11.5%	88.5%
Pre-Transaction Enterprise Value	7.4%	92.6%
Latest Twelve-Month Period Ended September 2008 Revenue(1)	14.6%	85.4%
Latest Twelve-Month Period Ended September 2008 Gross Profit(1)	10.8%	89.2%
Latest Twelve-Month Period Ended September 2008 EBITDA(1)	22.9%	77.1%
2008 Estimated Revenue	15.1%	84.9%
2008 Estimated EBITDA	20.2%	79.8%
2009 Estimated Revenue	12.9%	87.1%
2009 Estimated EBITDA	16.5%	83.5%

(1) Kratos' and Digital Fusion's Latest Twelve-Month Period Ended September 28, 2008 and September 19, 2008, respectively.

Selected Companies Analysis

Imperial Capital reviewed and compared selected financial information for Kratos and Digital Fusion with corresponding financial information and multiples for the following companies Imperial Capital considered relevant to Kratos and Digital Fusion:

Medium Capitalizations ($200 million - $1 billion Enterprise Value)	**Small Capitalizations (< $200 million Enterprise Value)**
ICF International, Inc.	ATS Corporation
MAXIMUS, Inc.	Dynamics Research Corp.
NCI, Inc.	Paradigm Holdings Inc.
SRA International, Inc.	TechTeam Global, Inc.
Stanley, Inc.	VSE Corp.

In its review of the selected companies, Imperial Capital considered, among other things, (i) market capitalization (computed using closing stock prices as of November 18, 2008), (ii) enterprise values, (iii) enterprise values as a multiple of revenue for the latest twelve-month period ended September 30, 2008 (with the exception of MAXIMUS, Inc., for which revenue for the twelve-month period ended June 30, 2008 was used), estimated revenue for the 2008 calendar year and estimated revenue for the 2009 calendar year and (iv) enterprise values as a multiple of EBITDA for the latest twelve-month period ended September 30, 2008 (with the exception of MAXIMUS, Inc., for which EBITDA for the twelve-month period ended June 30, 2008 was used), estimated EBITDA for the 2008 calendar year and estimated EBITDA for the 2009 calendar year. Financial data for the selected companies were based on the most recent available filings with the Securities and Exchange Commission and on the Institutional Brokers' Estimate System's and First Call estimates. Financial data for Kratos and Digital Fusion were based on the most recent available filings with the Securities and Exchange Commission and on forecasts provided by Kratos' and Digital Fusion's managements. This analysis indicated the following implied equity value per share ranges of Digital Fusion based on selected small capitalization company trading multiples applied to Digital Fusion's (a) revenue for the latest twelve-month period ended September 19, 2008, estimated revenue for the 2008 fiscal year and estimated revenue for the 2009 fiscal year and (b) EBITDA for the latest twelve-month period ended September 19, 2008, estimated EBITDA for the 2008 fiscal year and estimated EBITDA for the 2009 fiscal year:

	Implied Equity Value per Share		
Based on	**Low**	**Mid**	**High**
Latest Twelve-Month Period Ended September 19, 2008 Revenue	$1.13	$1.54	$1.92
2008 Estimated Revenue	$1.15	$1.57	$1.96
2009 Estimated Revenue	$0.96	$1.35	$1.72
Latest Twelve-Month Period Ended September 19, 2008 EBITDA	$2.03	$2.19	$2.36
2008 Estimated EBITDA	$1.61	$1.77	$1.92
2009 Estimated EBITDA	$1.20	$1.38	$1.54

This analysis also indicated the following implied equity value per share ranges of Digital Fusion based on selected medium capitalization company trading multiples applied to Digital Fusion's (i) revenue for the latest twelve-month period ended September 19, 2008, estimated revenue for the 2008 fiscal year and estimated revenue for the 2009 fiscal year and (ii) EBITDA for the latest twelve-month period ended September 19, 2008, estimated EBITDA for the 2008 fiscal year and estimated EBITDA for the 2009 fiscal year:

	Implied Equity Value per Share		
Based on	**Low**	**Mid**	**High**
Latest Twelve-Month Period Ended September 19, 2008 Revenue	$2.87	$3.21	$3.55
2008 Estimated Revenue	$2.86	$3.20	$3.54
2009 Estimated Revenue	$2.47	$2.80	$3.12
Latest Twelve-Month Period Ended September 19, 2008 EBITDA	$2.66	$2.82	$2.97
2008 Estimated EBITDA	$2.52	$2.67	$2.82
2009 Estimated EBITDA	$2.44	$2.59	$2.74

This analysis also indicated the following implied equity value per share ranges of Kratos based on selected medium capitalization company trading multiples applied to Kratos' pro forma (including Haverstick and SYS) (i) revenue for the latest twelve-month period ended September 28, 2008, estimated revenue for the 2008 fiscal year and estimated revenue for the 2009 fiscal year and (ii) EBITDA for the latest twelve-month period ended September 28, 2008, estimated EBITDA for the 2008 fiscal year and estimated EBITDA for the 2009 fiscal year:

	Implied Equity Value per Share		
Based on	**Low**	**Mid**	**High**
Latest Twelve-Month Period Ended September 28, 2008 Revenue	$1.54	$1.87	$2.20
2008 Estimated Revenue	$1.43	$1.76	$2.08
2009 Estimated Revenue	$1.47	$1.83	$2.18
Latest Twelve-Month Period Ended September 28, 2008 EBITDA	$0.45	$0.54	$0.62
2008 Estimated EBITDA	$0.58	$0.67	$0.76
2009 Estimated EBITDA	$0.89	$1.01	$1.13

Selected Transactions Analysis

Imperial Capital reviewed and compared selected financial information for Kratos and Digital Fusion with corresponding financial information for the following selected transactions involving companies Imperial Capital considered relevant to Kratos and Digital Fusion that were announced in the last two years:

Date Announced	Target	Buyer
October 2008	SM&A	Odyssey Investment Partners LLC
September 2008	MAXIMUS, Inc., Certain Assets	Constellation Software, Inc.
August 2008	SI International, Inc.	Serco, Inc.
August 2008	Emerging Technologies Group, Inc.	ManTech International Corp.
August 2008	Base One Technologies, Ltd.	Apptis, Inc.
July 2008	Oberon Associates, Inc.	Stanley, Inc.
July 2008	Kadix Systems LLC	Dynamics Research Corp.
June 2008	Digital Solutions, Inc.	Bart & Associates
June 2008	Project Performance Corporation	AEA Technology PLC
May 2008	Pomeroy IT Solutions, Inc.	Comvest Investment Partners
April 2008	G&B Solutions, Inc.	VSE Corp.
February 2008	SYS	Kratos Defense & Security Solutions, Inc.
January 2008	Jones & Stokes Associates, Inc.	ICF International, Inc.
January 2008	Sparta, Inc.	Cobham PLC
January 2008	iSYS LLC	WidePoint Corp.
December 2007	MTC Technologies, Inc.	BAE Systems, Inc.
December 2007	Integrated Combat Systems, Inc.	Orbit International
December 2007	RS Information Systems	Wyle, Inc.
November 2007	McDonald Bradley, Inc.	ManTech International Corp.
November 2007	Haverstick Consulting, Inc.	Kratos Defense & Security Solutions, Inc.
October 2007	PAC, Inc.	Quintegra Solutions, Ltd.
October 2007	Number Six Software, Inc.	ATS Corp.
October 2007	Dragon Development Corporation	CACI International
August 2007	Potomac Management Group	ATS Corp.
June 2007	Z-Tech Corp.	ICF International, Inc.
June 2007	Karta Technologies, Inc.	NCI, Inc.
June 2007	3H Technology LLC	Apogen Technologies, Inc.
June 2007	Constella Group LLC (Wachovia/Wakefield Group)	SRA International, Inc.
June 2007	D3 Technologies, Inc.	LMI Aerospace, Inc.
May 2007	Multimax, Inc.	Harris Corp.
May 2007	Wexford	CACI International
May 2007	New Vectors LLC	TechTeam Government Solutions, Inc.
May 2007	Logtec, Inc.	SI International, Inc.
May 2007	Dimensions International, Inc.	Honeywell International, Inc.
May 2007	Advanced Concepts, Inc.	L-1 Identity Solutions, Inc.
April 2007	SRS Technologies, Inc.	ManTech International Corp.
April 2007	Techrizon LLC	Stanley, Inc.
March 2007	ITS Corp.	QinetiQ Group PLC
January 2007	Analex Corp.	QinetiQ Group PLC
December 2006	QSS Group, Inc.	Perot Systems Corporation

In its review of the selected transactions, Imperial Capital considered, among other things, the enterprise value implied in each of the selected transactions as a multiple of revenue and EBITDA for the latest twelve-month period as of the date of announcement of the respective transaction. To the extent such data was not publicly available but the acquiring company disclosed forecasted revenue or EBITDA, Imperial Capital considered the enterprise value implied in the transaction as a multiple of such forecasted data. Imperial Capital then compared the multiples derived from the selected transactions with the corresponding multiples implied in the proposed transaction for Digital Fusion based on the exchange ratio. Multiples for the selected transactions were based on information from Securities and Exchange Commission filings, Capital IQ and company press releases. This analysis indicated the following implied equity value per share range of Digital Fusion based on selected merger and acquisition transaction multiples applied to Digital Fusion's revenue and EBITDA for the latest twelve-month period ended September 19, 2008:

	Implied Equity Value per Share		
Based on	**Low**	**Mid**	**High**
Latest Twelve-Month Period Ended September 19, 2008 Revenue	$ 3.68	$ 4.00	$ 4.33
Latest Twelve-Month Period Ended September 19, 2008 EBITDA	$ 2.83	$ 2.98	$ 3.13

This analysis indicated the following implied equity value per share range of Kratos based on selected transaction multiples applied to Kratos' pro forma (including Haverstick and SYS) revenue and EBITDA for the latest twelve-month period ended September 28, 2008:

	Implied Equity Value per Share		
Based on	**Low**	**Mid**	**High**
Latest Twelve-Month Period Ended September 30, 2008 Revenue	$ 2.33	$ 2.66	$ 2.99
Latest Twelve-Month Period Ended September 30, 2008 EBITDA	$ 0.54	$ 0.63	$ 0.71

Discounted Cash Flow Analysis

Imperial Capital performed a discounted cash flow analysis of Digital Fusion using forecasts for the period ranging from the beginning of fiscal year 2009 through the end of fiscal year 2012 (the "forecast period") provided by Kratos' management. Imperial Capital calculated the implied present values of free cash flows for Digital Fusion for the forecast period using discount rates ranging from 15.0% to 18.0%. Imperial Capital calculated the terminal values for Digital Fusion based on multiples of 6.0x to 10.0x applied to the 2012 free cash flow. The estimated terminal values were then discounted to implied present values using discount rates ranging from 15.0% to 18.0%. For range of discount rate and terminal value multiples, Imperial Capital added the implied present value of free cash flows to the implied present value of the terminal value to arrive at implied enterprise value for Digital Fusion. Imperial Capital then calculated the implied equity value of Digital Fusion as the implied enterprise value plus the $500,000 cash required as of closing. Implied equity value per share of Digital Fusion common stock was calculated using fully-diluted shares outstanding of Digital Fusion, as provided by the management of Digital Fusion. This analysis resulted in a range of implied equity values per share of Digital Fusion common stock of approximately $1.98 to $2.92.

Exchange Ratio Comparison

Imperial Capital calculated the average equity valuation per share of Kratos and Digital Fusion based on an equal weighting of the various valuation methodologies. The following represent the ranges calculated for Digital Fusion:

Method	Low	High
Selected Companies Analysis (Small Capitalization) Latest Twelve-Month Period Ended September 19, 2008 Revenue	$1.13	$1.92
Selected Companies Analysis (Small Capitalization) Latest Twelve-Month Period Ended September 19, 2008 EBITDA	$2.03	$2.36
Selected Companies Analysis (Small Capitalization) Estimated 2008 Revenue	$1.15	$1.96
Selected Companies Analysis (Small Capitalization) Estimated 2008 EBITDA	$1.61	$1.92
Selected Companies Analysis (Small Capitalization) Estimated 2009 Revenue	$0.96	$1.72
Selected Companies Analysis (Small Capitalization) Estimated 2009 EBITDA	$1.20	$1.54
Selected Companies Analysis (Medium Capitalization) Latest Twelve-Month Period Ended September 19, 2008 Revenue	$2.87	$3.55
Selected Companies Analysis (Medium Capitalization) Latest Twelve-Month Period Ended September 19, 2008 EBITDA	$2.66	$2.97
Selected Companies Analysis (Medium Capitalization) Estimated 2008 Revenue	$2.86	$3.54
Selected Companies Analysis (Medium Capitalization) Estimated 2008 EBITDA	$2.52	$2.82
Selected Companies Analysis (Medium Capitalization) Estimated 2009 Revenue	$2.47	$3.12
Selected Companies Analysis (Medium Capitalization) Estimated 2009 EBITDA	$2.44	$2.74
Selected Transaction Analysis Latest Twelve-Month Period Ended September 19, 2008 Revenue	$3.68	$4.33
Selected Transaction Analysis Latest Twelve-Month Period Ended September 19, 2008 EBITDA	$2.83	$3.13
Discounted Cash Flow Analysis	$1.98	$2.92
Average	$2.16	$2.70

And the ranges calculated for Kratos:

Method	Low	High
Selected Companies Analysis (Medium Capitalization) Latest Twelve-Month Period Ended September 28, 2008 Revenue	$1.54	$2.20
Selected Companies Analysis (Medium Capitalization) Latest Twelve-Month Period Ended September 28, 2008 EBITDA	$0.45	$0.62
Selected Companies Analysis (Medium Capitalization) Estimated 2008 Revenue	$1.43	$2.08
Selected Companies Analysis (Medium Capitalization) Estimated 2008 EBITDA	$0.58	$0.76
Selected Companies Analysis (Medium Capitalization) Estimated 2009 Revenue	$1.47	$2.18
Selected Companies Analysis (Medium Capitalization) Estimated 2009 EBITDA	$0.89	$1.13
Selected Transaction Analysis Estimated 2008 Revenue	$2.33	$2.99
Selected Transaction Analysis Estimated 2008 EBITDA	$0.54	$0.71
Average	$1.15	$1.58

Imperial Capital reviewed and compared the exchange ratio in the transaction with exchange ratios calculated using the average high and low ranges for Kratos and Digital Fusion, as well as Kratos' actual price per share, with the following results:

		Exchange Ratio
Exchange Ratio In The Transaction		1.7933
Digital Fusion Low/Kratos Actual	$2.16/$1.40	1.5421
Digital Fusion High/Kratos Actual	$2.70/$1.40	1.9311
Digital Fusion Low/Kratos Low	$2.16/$1.15	1.8703
Digital Fusion High/Kratos Low	$2.70/$1.15	2.3421
Digital Fusion Low/Kratos High	$2.16/$1.58	1.3632
Digital Fusion High/Kratos High	$2.70/$1.58	1.7071

Miscellaneous

Under the terms of its agreement with Imperial Capital, Kratos agreed to pay Imperial Capital an opinion fee of $350,000 due upon the delivery of a fairness opinion regardless of the conclusions reached therein. In addition, Kratos agreed to pay all fees, disbursements and out-of-pocket expenses incurred in connection with services to be rendered and to indemnify Imperial Capital and related parties against any liabilities arising out of or in connection with advice or services rendered or to be rendered pursuant to the engagement letter agreement. No portion of Imperial Capital's fee for the delivery of this fairness opinion is contingent upon the consummation of the transaction.

Kratos selected Imperial Capital as its financial advisor based on its experience with merger transactions and familiarity with Kratos. Imperial Capital is a full-service investment banking firm offering a wide range of advisory, finance and trading services. Imperial Capital acted as financial advisor to SYS in its acquisition by Kratos in June 2008. In the ordinary course of our business, Imperial Capital and its affiliates may actively trade the debt and equity securities of Kratos and Digital Fusion for Imperial Capital's own account and for the accounts of customers and, accordingly, may at any time hold a long or short position in such securities. In addition, certain Imperial Capital professionals actively involved in the issuance of this fairness opinion currently own securities in Kratos.

Opinion of Financial Advisor to the Digital Fusion Board of Directors

On November 20, 2008, at a meeting of Digital Fusion's board of directors held to evaluate the proposed merger, ISI delivered to the board of directors an oral opinion, confirmed by subsequent delivery of a written opinion, dated November 20, 2008, to the effect that, as of that date and based on and subject to various assumptions, matters considered and limitations described in its opinion, the exchange ratio in the merger was fair, from a financial point of view, to the holders of Digital Fusion common stock.

The full text of ISI's opinion describes the documents reviewed, matters considered and limitations on the review undertaken by ISI. This opinion is attached as *Annex D* and is incorporated into this proxy statement by reference. ISI's opinion is directed only to the fairness, from a financial point of view, of the exchange ratio in the merger to the holders of Digital Fusion common stock. The opinion does not address the merits of the underlying decision by Digital Fusion, which is also referred to as DFI below, to engage in the transaction or the relative merits of any alternatives discussed by Digital Fusion's board of directors and does not constitute an opinion with respect to Digital Fusion's underlying business decision to effect the transaction, any legal, tax or accounting issues concerning the transaction, or any terms of the transaction (other than the exchange ratio). The opinion does not constitute a recommendation as to any action Digital Fusion or any shareholder of Digital Fusion should take in connection with the transaction or any aspect thereof. Holders of Digital Fusion common stock are encouraged to read this opinion carefully in its entirety. The summary of ISI's opinion described below is qualified in its entirety by reference to the full text of its opinion.

In arriving at its opinion, ISI, among other things:

- Analyzed certain publicly available information of Digital Fusion that it believed to be relevant to its analysis, including Digital Fusion's annual reports for the years ending December 28, 2007 and December 31, 2006, and Digital Fusion's quarterly report for the nine months ended September 18, 2008;

- Analyzed certain publicly available information of Kratos that ISI believed to be relevant to its analysis, including the Kratos annual report on Form 10-K for the fiscal year ending December 31, 2007, and the Kratos quarterly reports on Form 10-Q for the quarters ending September 28, 2008, June 29, 2008 and March 30, 2008;

- Reviewed certain internal financial forecasts and budgets prepared and provided by the Digital Fusion and Kratos management including the Kratos pro forma model prepared by management;

- Met with and held discussions with certain members of the Digital Fusion and Kratos management to discuss the Digital Fusion and Kratos operations and future prospects;

- Reviewed certain industry reports and publications;

- Reviewed public information with respect to certain other public companies with business lines and financial profiles which ISI deemed to be relevant;

- Reviewed the implied financial multiples and premiums paid in merger and acquisition transactions which ISI deemed to be relevant;

- Reviewed current and historical market prices of Kratos and Digital Fusion common stock, as well as the trading volume and public float of such common stock;

- Reviewed the letter of intent and term sheet sent to Digital Fusion by Kratos dated October 3, 2008;

- Reviewed the draft merger agreement, including material schedules and exhibits, dated November 19, 2008; and

- Conducted such other financial studies, analyses and investigations and took into account such other matters as it deemed necessary, including its assessment of general economic and monetary conditions.

In connection with its review, ISI relied upon the accuracy and completeness of the foregoing financial and other information and did not assume any responsibility for independent verification of such information or conduct or receive independent valuations or appraisals of any assets of Digital Fusion or Kratos or any appraisal or estimate of liabilities of Digital Fusion or Kratos. ISI assumed that all financial forecasts had been reasonably prepared on bases reflecting the best currently available estimates and judgments of management of Digital Fusion and Kratos as to the future financial performance of the companies. ISI also relied upon the assurances of management of both companies that they were unaware of any facts that would make the information or financial forecasts provided to it incomplete or misleading. It assumed no responsibility for, and expressed no view, as to, such financial forecasts or the assumptions on which they are based. ISI's opinion was necessarily based on economic, market and other conditions as they existed and could be evaluated on the date of its opinion.

ISI was not asked to, and it did not, offer any opinion as to the terms, other than the exchange ratio to the extent expressly specified in ISI's opinion, of the merger agreement or any related documents or the form of the merger or any related transaction. ISI expressed no opinion as to what the value of Kratos common stock would be when issued pursuant to the transaction or the prices at which Kratos common stock will trade at any time. ISI expressed no opinion as to the fairness of the amount or nature of any compensation to be received by any officers, directors or employees of any parties to the transaction or any class of such persons. ISI assumed that (i) the final executed form of the merger agreement would not differ in any material respect from the draft that ISI examined, (ii) the parties to the merger Agreement would comply with all the material terms of the merger agreement, and (iii) the transaction would be consummated in accordance with the terms of the merger agreement without any adverse waiver or amendment of any material term or condition thereof. ISI also assumed that all governmental, regulatory or other consents and approvals necessary for the consummation of the transaction would be obtained without any material adverse effect on Kratos, Digital Fusion or the transaction. Except as described above, Digital Fusion's board imposed no other instructions or limitations on ISI with respect to the investigations made or the procedures followed by ISI in rendering its opinion.

In connection with rendering its opinion to Digital Fusion's board, ISI performed a variety of financial and comparative analyses that are summarized below. The following summary is not a complete description of all analyses performed and factors considered by ISI in connection with its opinion. The preparation of a financial opinion is a complex process involving subjective judgments and is not necessarily susceptible to partial analysis or summary description. With respect to the selected public companies analysis and the selected transactions analysis summarized below, no company or transaction used as a comparison was either identical or directly comparable to Digital Fusion, Kratos or the merger. These analyses necessarily involved complex considerations and judgments concerning financial and operating characteristics and other factors that could affect the public trading or acquisition values of the companies concerned.

ISI believes that its analyses and the summary below must be considered as a whole and that selecting portions of its analyses and factors or focusing on information presented in tabular format, without considering all analyses and factors or the narrative description of the analyses, could create a misleading or incomplete view of the processes underlying ISI's analyses and opinion. ISI did not draw, in isolation, conclusions from or with regard to any one factor or method of analysis for purposes of its opinion, but rather arrived at its ultimate opinion based on the results of all analyses undertaken by it and assessed as a whole.

The estimates of the future performance of Kratos and Digital Fusion provided by management of Kratos and Digital Fusion in or underlying ISI's analyses are not necessarily indicative of future results or values, which may be significantly more or less favorable than those estimates. In performing its analyses, ISI considered industry performance, general business and economic conditions and other matters, many of which are beyond the control of Kratos and Digital Fusion. Estimates of the financial value of companies do not purport to be appraisals or necessarily reflect the prices at which companies actually may be sold.

The exchange ratio in the transaction was determined through negotiation between Kratos and Digital Fusion, and the decision by Digital Fusion's board to enter into the merger was solely that of Digital Fusion's board. ISI's opinion and financial analyses were only one of many factors considered by Digital Fusion's board in its evaluation of the merger and should not be viewed as determinative of the views of Digital Fusion's board or management with respect to the merger of the exchange ratio.

The following is a brief summary of the material financial analyses performed by ISI and reviewed with Digital Fusion's board in connection with ISI's opinion relating to the proposed merger. The financial analyses summarized below include information presented in tabular format. In order to fully understand ISI's financial analyses, the tables must be read together with the text of each summary. The tables alone do not constitute a complete description of the financial analyses. Considering the data below without considering the full narrative description of the financial analyses, including the methodologies and assumptions underlying the analyses, could create a misleading or incomplete view of ISI's financial analyses.

Contribution Analysis

ISI reviewed and compared each party's relative financial contribution to the pro forma combined entity. For each party, ISI considered the (1) revenue, gross profit, and EBITDA for the latest twelve-month period ending September 30, 2008, and (2) revenue, gross profit and EBITDA, estimated for the 2008 and 2009 calendar years. Financial data for Kratos was based on the most recent available filings with the Securities and Exchange Commission and on projections provided by Kratos management. Financials for Digital Fusion were provided by Digital Fusion management. This analysis indicated the following relative financial contribution of each party to the pro forma combined entity:

	Kratos	Digital Fusion
Proforma Equity Ownership	78.1%	21.9%
Pre-Deal Equity Market Capitalization	89.5%	10.5%
LTM Revenue Sep-30-2008	83.3%	16.7%
2008 Estimated Revenue	83.8%	16.2%
2009 Estimated Revenue	83.8%	16.2%
LTM Gross Profit Ended Sep-30-2008	85.1%	14.9%
2008 Estimated Gross Profit	87.7%	12.3%
2009 Estimated Gross Profit	87.8%	12.2%
LTM EBITDA Sep-30-2008	71.9%	28.1%
2008 Estimated EBITDA	79.2%	20.8%
2009 Estimated EBITDA	80.4%	19.6%

Historical Trading Analysis

ISI reviewed general trading information concerning the stock prices of Digital Fusion and Kratos for the periods ended November 14, 2008. The table below summarizes the range of closing stock prices over the period:

	Share Price	
	Digital Fusion	Kratos
Recent Closing Price	$ 1.45	$ 1.38
5 Day Average	$ 1.49	$ 1.38
30 Day Average	$1.40	$1.47
60 Day Average	$1.58	$1.73
1 Year Average	$1.79	$1.86
1 Year High	$2.25	$2.36
1 Year Low	$1.10	$1.11

Historical Exchange Ratio Analysis

ISI analyzed the ratios of the daily closing prices of Digital Fusion common stock to those of Kratos common stock over the various periods and dates ending November 14, 2008. The table below sets forth the average of those exchange ratios for those periods or the exchange ratio for such dates and the premiums or discounts based on an implied exchange ratio of 1.7933 shares of Kratos stock for each share of Digital Fusion common stock:

	Exchange Ratio	Implied Premium
Recent Closing Price	1.0507	70.7%
5 Day Average	1.0797	66.1%
30 Day Average	0.9524	88.3%
60 Day Average	0.9133	96.4%
1 Year Average	0.9624	86.3%
1 Year High	0.9534	88.1%
1 Year Low	0.9910	81.0%

Premiums Paid Analysis

ISI analyzed premiums paid in selected mergers and acquisitions in the defense and information technology services industries. The period of the review was from January 1, 2006 through October 31, 2008 and covered transactions with transaction values between $30 million and $300 million. The information was obtained from Capital IQ, company filings and press releases. Based on the information obtained, and the closing prices of the Digital Fusion and Kratos shares on November 14, 2008, the implied equity values per share of Digital Fusion and Kratos are as follows:

	Implied Price/Share		
	1 Day Prior	1 Week Prior	1 Month Prior
Digital Fusion	$1.82	$1.86	$ 1.84
Kratos	$1.74	$1.77	$ 1.75

Selected Public Companies Analysis

ISI reviewed and compared selected financial information for Digital Fusion with corresponding financial information and multiples for the following publicly traded companies relevant to Digital Fusion:

Large Caps (>$1 billion)	Medium Caps ($200 million $1 billion)	Small Caps (<$200 million)
CACI International Inc.	DynCorp Intl., Inc.	ATS Corporation
ManTech International	ICF International, Inc.	Dynamics Research
SAIC, Inc	MAXIMUS, Inc.	SM&A.
NCI, Inc.	SI International, Inc.	TechTeam Global
Teledyne Technologies, Inc	Stanley, Inc.	VSE Corp.
	SRA International, Inc.	

For each of the selected public companies, ISI considered, among other things, (1) market capitalization (computed using closing stock prices as of November 14, 2008, (2) enterprise values, (3) enterprise values as a multiple of the latest twelve month period and estimated 2008 and 2009 revenue, and (4) enterprise values as a multiple of the latest twelve month period and estimated 2008 and 2009 earnings before interest, taxes, depreciation and amortization, commonly referred to as EBITDA. Financial data for the selected public companies were based on the most recent available filings with the Securities and Exchange Commission and on Capital IQ. Financial data for Digital Fusion and Kratos were based on the most recent available filings with the Securities and Exchange

Commission and on estimates provided by Digital Fusion's and Kratos' managements. This analysis indicated the following implied equity value per share ranges of Digital Fusion and Kratos, based on selected small-cap and mid-cap public company trading multiples, respectively:

	Implied Equity Value/Share		
	DFI		
	Low	Mean	High
TTM-Enterprise Value/Revenue	$ 0.93	$ 2.33	$ 4.19
Est. 2008 Enterprise Value/Revenue	$ 1.04	$ 2.60	$ 4.67
Est. 2009 Enterprise Value/Revenue	$ 1.23	$ 3.08	$ 4.92
LTM-Enterprise Value/EBITDA	$ 1.56	$ 2.45	$ 5.07
Est. 2008 Enterprise Value/EBITDA	$ 1.50	$ 2.77	$ 4.84
Est. 2009 Enterprise Value/EBITDA	$ 1.38	$ 2.23	$ 3.55

	Kratos		
	Low	Mean	High
TTM-Enterprise Value/Revenue	$ 0.67	$ 1.19	$ 2.74
Est. 2008 Enterprise Value/Revenue	$ 0.88	$ 1.18	$ 4.17
Est. 2009 Enterprise Value/Revenue	$ 1.15	$ 1.51	$ 4.34
LTM-Enterprise Value/EBITDA	$ 0.00	$ 0.48	$ 1.12
Est. 2008 Enterprise Value/EBITDA	$ 0.39	$ 1.03	$ 2.60
Est. 2009 Enterprise Value/EBITDA	$ 0.35	$ 1.16	$ 2.58

Selected Transaction Analysis

Using publicly available information, ISI reviewed selected transactions announced since January 2006 involving selected privately held and publicly traded companies that it believed were relatively comparable to Digital Fusion and Kratos. In its review of selected transactions, ISI considered the enterprise value implied in each of the selected transactions as a multiple of revenue and EBITDA for the latest 12 months as of the time of the respective transaction, to the extent such data were publicly available. ISI then compared the multiples derived from the selected transactions with the corresponding multiples implied in the merger for Digital Fusion based on the exchange ratio. Multiples for the selected transactions were based on information from Capital IQ, Securities and Exchange Commission filings and company press releases. This analysis indicated the following implied equity value per share range of Digital Fusion based on selected M&A transaction multiples applied to Digital Fusion's revenue and EBITDA:

	DFI			
	Implied Equity Value/Share			
	High	Mean	Median	Low
DFI TTM REVENUE	$7.43	$4.18	$ 4.18	$2.33
DFI TTM EBITDA	$5.85	$3.68	$ 3.40	$2.22
DFI 2008 EBITDA	$6.15	$3.85	$ 3.56	$2.35

This analysis indicated the following implied equity value per share range of Kratos based on selected transaction multiples applied to Kratos' revenue and EBITDA:

	Kratos			
	Implied Equity Value/Share			
	High	Mean	Median	Low
Kratos TTM REVENUE	$4.81	$2.22	$ 2.22	$0.67
Kratos TTM EBITDA	$1.52	$0.63	$ 0.52	$0.01
Kratos 2008 EBITDA	$2.74	$1.35	$ 1.17	$0.37

Discounted Cash Flow Analysis

ISI performed a discounted cash flow analysis of Digital Fusion using projections and financial information for the period ranging from the beginning of fiscal year 2009 through the end of fiscal year 2013 (the "projection period") provided by Digital Fusion's management. ISI calculated the implied present values of free cash flows for Digital Fusion for the projection period using discount rates ranging from 16.0% to 18.0% based on the weighted average cost of capital. ISI calculated the terminal values for Digital Fusion based on multiples of 6.0x to 8.0x and perpetuity growth rates of 3% to 4%. The estimated terminal values were then discounted to implied present values using discount rates ranging from 16.0% to 18.0% based on the weighted average cost of capital. For each combination of discount rate and terminal value multiple, ISI added the implied present value of free cash flows to the implied present value of the terminal value to arrive at implied enterprise value for Digital Fusion. For each combination of discount rate and terminal value multiple, ISI then calculated the implied equity value of Digital Fusion as the implied enterprise value less the net debt as of November 14, 2008. Implied equity value per share of Digital Fusion common stock was calculated using fully-diluted shares outstanding of Digital Fusion as provided by management of Digital Fusion. This analysis resulted in a range of implied equity values per share of Digital Fusion common stock of approximately $2.84 to $3.07.

Exchange Ratio Comparison

ISI calculated the average equity valuation per share of Digital Fusion and Kratos based on an equal weighting of the various valuation methodologies. The following represents the ranges calculated for Digital Fusion:

Method	**Low**	**High**
Premiums Paid Analysis	$ 1.82	$ 1.86
Selected Public Companies Analysis TTM Revenue	$ 0.93	$ 4.19
Selected Public Companies Analysis TTM EBITDA	$ 1.56	$ 5.07
Selected Public Companies Analysis 2008 Est. Revenue	$ 1.04	$ 4.67
Selected Public Companies Analysis 2008 Est. EBITDA	$ 1.50	$ 4.84
Selected Public Companies Analysis 2009 Est. Revenue	$ 1.23	$ 4.92
Selected Public Companies Analysis 2009 Est. EBITDA	$ 1.38	$ 3.55
Comparable Transaction Analysis TTM Revenue	$ 2.33	$ 7.43
Comparable Transaction Analysis TTM EBITDA	$ 2.22	$ 5.85
Comparable Transaction Analysis 2008 EBITDA	$ 2.35	$ 6.15
Discounted Cash Flow Analysis	$ 2.84	$ 3.07
Average	$ 1.75	$ 4.69

The following represents the ranges calculated for Kratos:

Method	**Low**	**High**
Premiums Paid Analysis	$ 1.74	$ 1.77
Selected Public Companies Analysis TTM Revenue	$ 0.67	$ 2.74
Selected Public Companies Analysis TTM EBITDA	$ 0.00	$ 1.12
Selected Public Companies Analysis 2008 Est. Revenue	$ 0.88	$ 4.17
Selected Public Companies Analysis 2008 Est. EBITDA	$ 0.39	$ 2.60
Selected Public Companies Analysis 2009 Est. Revenue	$ 1.15	$ 4.34
Selected Public Companies Analysis 2009 Est. EBITDA	$ 0.35	$ 2.58
Comparable Transaction Analysis TTM Revenue	$ 0.67	$ 4.81
Comparable Transaction Analysis TTM EBITDA	$ 0.01	$ 1.52
Comparable Transaction Analysis 2008 EBITDA	$ 0.37	$ 2.74
Average	$ 0.62	$ 2.84

ISI reviewed and compared the exchange ratio in the transaction with with exchange ratios calculated using the high and low ranges for DFI and Kratos with the following results:

Exchange Ratio in the Transaction			**Exchange Ratio**
DFI Low/Kratos Low	$1.75	$0.62	2.802
DFI Low/Kratos High	$1.75	$2.84	0.615
DFI High/Kratos Low	$4.69	$0.62	7.530
DFI High/Kratos High	$4.69	$2.84	1.652
Proposed Exchange Ratio			1.7933

Under the terms of the agreement with ISI, Digital Fusion agreed to pay ISI a non-refundable monthly retainer of $10,000 per month, plus a success fee of 1.75% of the value of the transaction, plus an increasing percentage if the value of the transaction is in excess of $50 million. Twenty percent (20%) of the success fee will be paid to ISI in Kratos common stock. The number of shares of Kratos stock payable will be based upon the average of the closing price for Kratos stock for the 10 consecutive trading day period ending on or just prior to the "Closing Date" as such term is defined in the merger agreement. In addition, Digital Fusion agreed to pay all fees, disbursements and out-of-pocket expenses incurred by ISI in connection with its services in connection with the merger and to indemnify ISI and related parties against any liabilities arising out of or in connection with advice or services rendered or to be rendered pursuant to the engagement letter agreement.

Digital Fusion selected ISI as its financial advisor based on its experience with merger transactions and familiarity with the company. ISI is a financial advisory firm focusing on merger and acquisition and other advisory services to the defense and federal contract industries. Two directors of Digital Fusion, Jay Garner and Ronald Hite, are equity holders and members of the board of directors of ISI.

Composition of Kratos Board of Directors

The size and composition of the Kratos board of directors will not be affected by this transaction.

Interests of Digital Fusion Directors and Executive Officers in the Merger

In considering Digital Fusion's unanimous determination that the merger is fair and advisable and recommendation that Digital Fusion's stockholders vote "**FOR**" approval of the merger agreement, you should be aware that members of Digital Fusion's board of directors and members of Digital Fusion's management team have agreements or arrangements that provide them with interests in the merger that differ from and are in addition to those of other Digital Fusion stockholders. The Digital Fusion board of directors was aware of these agreements and arrangements during its deliberations of the merits of the merger and in determining to recommend to you that you vote "**FOR**" approval of the merger agreement.

As of November 21, 2008 directors and executive officers of Digital Fusion and their affiliates owned 3,999,567 shares of Digital Fusion common stock, which represented approximately 34% of the shares of Digital Fusion common stock then issued and outstanding. All of Digital Fusion's executive officers and directors have agreed with Kratos to vote their shares of Digital Fusion's common stock to approve the merger agreement. For more information see "Digital Fusion Stockholder Agreement" at *Annex B-1* through *B-3.*

Potential Change in Control or Severance Payments

From and after the effective time of the merger, each of Digital Fusion's executive officers listed in the chart below may become eligible to receive change of control or severance payments for a period of six months, based on the terms of their existing employment agreements, if they are terminated without cause or terminate their employment for any of the following reasons:

Their duties or responsibilities are modified in a way that is inconsistent with the terms of their agreement;

A material provision of the agreement is breached and the effects thereof are not remedied; or

The relocation of their employment by more than 40 miles from Huntsville, Alabama, for a period of time in excess of 180 days, provided only if such change, or relocation is effected without the employee's express written consent.

Name	Title	Approximate Amount of Severance Payment
Chris Brunhoeber	Chief Financial Officer	$ 75,000
Jamie Brabston	General Counsel, Vice President and Secretary	$ 75,000

In addition, the following directors and executive officers will receive bonuses in the following amounts in connection with the closing of the merger:

Name	Title	Amount of Bonus Payment
Gary Ryan	Chief Executive Officer and Director	$ 25,000
Chris Brunhoeber	Chief Financial Officer	$ 50,000
Jamie Brabston	General Counsel, Vice President and Secretary	$ 30,000
Dan Moore	Chairman of the Board of Directors	$ 45,000

Post-Merger Employment

Directors Daniel E. Moore, Gilbert F. Decker, Lt. Gen. (Ret.) Jay M. Garner, G. Stewart Hall, Lt. Gen. (Ret.) Ronald V. Hite, and Charles F. Lofty will no longer be directors of the surviving corporation after the merger. Executive officer and director Michael Wicks will continue to be employed by the surviving corporation and executive officer and director Gary Ryan will serve as a consultant. Executive officers Jamie Brabston and Chris Brunhoeber have entered into employment and retention agreements in connection with the merger and will become employees of the surviving corporation upon the closing of the merger.

Treatment of Digital Fusion Options and Other Equity-Based Awards

Digital Fusion and Kratos will take all actions necessary to provide that, effective as of the effective time of the merger, each outstanding stock option will be assumed by Kratos. Each stock option assumed by Kratos will continue to have, and be subject to, the same material terms and conditions of such option immediately prior to the merger, except that (i) each stock option will be exercisable for a number of shares of Kratos Stock equal to the product of the number of shares of Digital Fusion common stock that would be issuable upon exercise of the stock option outstanding immediately prior to the merger multiplied by the exchange ratio, rounded down to the nearest whole number of shares of Kratos stock, and (ii) the per share exercise price for the Kratos stock issuable upon exercise of such assumed stock option will be equal to the quotient determined by dividing the per share exercise price for such stock option outstanding immediately prior to the merger by the exchange ratio, rounded up to the nearest whole cent. Any restriction on the exercisability of such stock option will continue in full force and effect, and the term, exercisability, vesting schedule or other provisions of such stock option will remain unchanged except that in some cases (including for certain options held by directors and executive officers) the post-termination exercise period will be increased to two years. In addition, the vesting of certain options will be modified prior to closing to allow for accelerated vesting in connection with the closing of the merger. Consistent with the terms of the Digital Fusion option plans and the documents governing the outstanding options under the Digital Fusion option plans, the merger will not terminate any of the outstanding stock options.

Additional Interests

Directors Lt. Gen. (Ret.) Jay M. Garner and Lt. Gen. (Ret.) Ronald V. Hite each own one sixth ($^1/_6$) of ISI Partners, LLC, Digital Fusion's financial advisor. Thus, each of them will receive one sixth ($^1/_6$) of the payments made available to the members of ISI Partners, LLC as a result of the merger with Kratos.

Directors Lt. Gen. (Ret.) Jay M. Garner, Lt. Gen. (Ret.) Ronald v. Hite, G. Stewart Hall, Charles F. Lofty, Daniel E. Moore, and Gilbert F. Decker, each have restricted stock grants under DFI's Deferred Compensation Plan that will vest at the change of control. The number of restricted shares vested for each director is set forth below:

Lt. Gen. (Ret.) Jay M. Garner	115,000
Lt. Gen. (Ret.) Ronald V. Hite	115,000
G. Stewart Hall	115,000
Charles F. Lofty	20,000
Daniel E. Moore	75,000
Gilbert F. Decker	60,000

Directors and Officers of Digital Fusion after the Merger

The directors of Merger Sub will be the initial directors of Digital Fusion as the surviving corporation of the merger, and will serve until their successors have been duly elected or appointed and qualified, or until their earlier death, resignation or removal. The officers of Merger Sub will be the initial officers of Digital Fusion as the surviving corporation of the merger, subject to the authority of the board of directors of the surviving corporation, as provided by Delaware law and the bylaws of the surviving corporation.

Indemnification and Insurance

The merger agreement provides that for six years after the effective time of the merger and to the fullest extent permitted by law, Kratos will cause the surviving corporation to honor all rights to indemnification for acts or omissions prior to the effective time of the merger existing in favor of Digital Fusion directors or officers as provided in Digital Fusion's organizational documents. The merger agreement also provides that, prior to the effective time of the merger, Digital Fusion will purchase six-year "tail" officers' and directors' liability insurance policies on terms and conditions reasonably comparable to Digital Fusion's existing directors' and officers' liability insurance. If such "tail" policies are not purchased prior to the effective time, Digital Fusion shall purchase these "tail" policies or as much insurance coverage as can be obtained following the effective time for 150% or less of the annual premium paid by Digital Fusion for its existing insurance. Kratos and the surviving corporation are obligated to maintain such tail policies in full force and effect and continue to honor their respective obligations thereunder for the full term thereof.

Accounting Treatment

The merger will be accounted for as an acquisition of Digital Fusion by Kratos under the purchase method of accounting in accordance with U.S. generally accepted accounting principles. Under the purchase method of accounting, the assets and liabilities of the acquired company are, as of completion of the merger, recorded at their respective fair values and added to those of the acquirer, including an amount for goodwill representing the difference between the purchase price and the fair value of the identifiable net assets. Financial statements of Kratos issued after the merger will reflect only the operations of Digital Fusion after the merger and will not be restated retroactively to reflect the historical financial position or results of operations of Digital Fusion.

All unaudited pro forma condensed combined financial statements contained in this proxy statement/prospectus were prepared using the purchase method of accounting. The final allocation of the purchase price will be determined after the merger is completed and after completion of an analysis to determine the fair value of Digital Fusion's assets and liabilities. Accordingly, the final purchase accounting adjustments may be materially different from the unaudited pro forma adjustments. Any decrease in the fair value of the assets or increase in the fair value of the liabilities of Digital Fusion as compared to the unaudited pro forma information included in this proxy statement/prospectus will have the effect of increasing the amount of the purchase price allocable to goodwill.

If the merger is consummated on or after December 29, 2008, the merger will be accounted for under Statement of Financial Accounting Standards (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R would require that the purchase price be determined based on Kratos's closing stock price on the date the merger is consummated, and that contingent assets and liabilities be recorded at fair value. Further, SFAS 141R would require that merger-related transaction costs and exit and termination costs be recorded to expense as incurred rather than capitalized as part of goodwill.

Restrictions on Sales of Shares of Kratos Common Stock Received in the Merger

Kratos shares of common stock issued in the merger will not be subject to any restrictions on transfer arising under the Securities Act or the Exchange Act, except for Kratos shares issued to any Digital Fusion stockholder who may be deemed to be an "affiliate" of Kratos after completion of the merger. Former Digital Fusion stockholders who were affiliates of Digital Fusion at the time of the Digital Fusion special meeting and who are not affiliates of Kratos after the completion of the merger may sell their Kratos shares at any time. Former Digital Fusion stockholders who are or become affiliates of Kratos after completion of the merger will remain or be subject to the volume and sale limitations of Rule 144 under the Securities Act until they are no longer affiliates of Kratos. This proxy statement/prospectus does not cover resales of Kratos common stock received by any person upon completion of the merger, and no person is authorized to make any use of this proxy statement/prospectus in connection with any resale.

Regulatory Approvals Required for the Merger

The parties are not aware of any governmental or regulatory approvals required in order to complete the transaction.

Appraisal Rights

Kratos Stockholders

Pursuant to Section 262 of the Delaware General Corporation Law, or DGCL, Kratos stockholders are not entitled to exercise dissenters' rights or appraisal rights or to demand payment for their shares of Kratos common stock under applicable law as a result of the merger.

Digital Fusion Stockholders

Under the DGCL, holders of Digital Fusion common stock who do not vote for the adoption of the merger agreement have the right to seek appraisal and receive cash for the fair value of their shares as determined by the Delaware Court of Chancery if the merger is completed, but only if they comply with all requirements of Delaware law, which are summarized in this proxy statement/prospectus in "Appraisal Rights" beginning on page 194, and if at least one stockholder who properly exercised appraisal rights litigates an appraisal proceeding in the Court of Chancery to obtain the appraisal. This appraisal amount could be more than, the same as, or less than the amount a Digital Fusion stockholder would otherwise be entitled to receive under the terms of the merger agreement. Any holder of Digital Fusion common stock intending to exercise his appraisal rights, among other things, must submit a written demand for appraisal to Digital Fusion prior to the vote on the adoption of the merger agreement and must not vote or otherwise submit a proxy in favor of adoption of the merger agreement. Failure to follow exactly the procedures specified under Delaware law will result in the loss of appraisal rights. Because of the complexity of the Delaware law relating to appraisal rights, if you are considering exercising your appraisal rights, Digital Fusion encourages you to seek the advice of your own legal counsel.

Listing of Kratos Common Stock on the Nasdaq Global Select Market

Kratos has agreed that prior to the completion of the merger, it will cause the shares of Kratos common stock to be issued in the merger to be approved for listing on the Nasdaq Global Select Market. Such approval is a condition to the completion of the merger.

Material United States Federal Income Tax Consequences

General

The following general discussion summarizes the material U.S. federal income tax consequences of the merger to Kratos, Merger Sub, Digital Fusion and to holders of common stock of Digital Fusion who are "United States persons" and who hold their Digital Fusion common stock as a capital asset within the meaning of Section 1221 of the Code. For U.S. federal income tax purposes, a "United States person" is:

- a United States citizen or resident of the United States;
- a corporation (including, for this purpose, any entity treated as a corporation for U.S. federal income tax purposes) created or organized in the United States or under the laws of the United States, or any state within the United States;
- an estate whose income is includible in gross income for U.S. federal income tax purposes regardless of its source; or
- a trust, whose administration is subject to the primary supervision of a United States court and that has one or more U.S. persons who have the authority to control all substantial decisions of the trust.

The term "non-United States person" means a person or holder other than a "United States person."

This section does not discuss all of the U.S. federal income tax considerations that may be relevant to a particular stockholder in light of his or her individual circumstances or to stockholders subject to special treatment under the federal income tax laws, including, without limitation:

- brokers or dealers;
- stockholders who are subject to the alternative minimum tax provisions of the Code;

- tax-exempt organizations;
- stockholders who are "non-United States persons";
- U.S. expatriates;
- stockholders that have a functional currency other than the United States dollar;
- banks, mutual funds, financial institutions or insurance companies;
- stockholders who acquired Digital Fusion common stock in connection with stock option or stock purchase plans or in other compensatory transactions;
- stockholders who hold Digital Fusion common stock as part of an integrated investment, including a straddle, hedge, or other risk reduction strategy, or as part of a conversion transaction or constructive sale;
- stockholders who acquired their shares through Digital Fusion's 401(k) plan, deferred compensation plan or other retirement plan; or
- stockholders whose Digital Fusion common stock is "qualified small-business stock" for purposes of Section 1202 of the Code.

If a partnership (including, for this purpose, any entity treated as a partnership for U.S. federal income tax purposes) is a beneficial owner of Digital Fusion common stock, the U.S. federal income tax consequences to a partner in the partnership will generally depend on the status of the partner and the activities of the partnership. A holder of Digital Fusion common stock that is a partnership, and the partners in such partnership, should consult their own tax advisors regarding the U.S. federal income tax consequences of the merger.

This discussion is based upon the Code, regulations, judicial authority, rulings and decisions in effect as of the date of this proxy statement/prospectus, all of which are subject to change, possibly with retroactive effect. This summary does not address the tax consequences of the merger under state, local and foreign laws or under U.S. federal tax law other than income tax law.

The discussion set forth below is not intended to be, nor should it be construed to be, legal or tax advice to any particular stockholder. Digital Fusion stockholders are strongly urged to consult their tax advisors as to the specific tax consequences to them of the merger, including any applicable federal, state, local and foreign tax consequences.

In connection with this proxy statement/prospectus, Morrison & Foerster LLP will issue an opinion, of even date herewith, that the merger will constitute a reorganization within the meaning of Section 368(a) of the Code. The opinion of counsel will be based on then-existing law and be based in part upon representations, made as of the date hereof, by Kratos and Digital Fusion, which counsel will assume to be true, correct and complete. If the representations are inaccurate, the opinion of counsel could be adversely affected. No ruling has been nor will be sought from the Internal Revenue Service as to the U.S. federal income tax consequences of the merger, and neither the opinion of counsel nor the following summary is binding on the Internal Revenue Service or the courts.

Assuming the merger will be completed as described in the merger agreement and this proxy statement/prospectus and the merger will constitute a "reorganization" within the meaning of Section 368(a) of the Code, the material U.S. federal income tax consequences of the merger are as follows:

Digital Fusion stockholders will not recognize any gain or loss upon the receipt of Kratos common stock in exchange for Digital Fusion common stock in connection with the merger, except to the extent of cash received in lieu of a fractional share of Kratos common stock, as discussed below.

Cash payments received by a Digital Fusion stockholder for a fractional share of Kratos common stock will be treated as if such fractional share had been issued in connection with the merger and then redeemed by Kratos for cash. Digital Fusion stockholders generally should recognize capital gain or loss with respect to such cash payment measured by the difference between the amount of cash received and the tax basis in such fractional share.

The aggregate tax basis of the Kratos common stock received by a Digital Fusion stockholder in connection with the merger will be the same as the aggregate tax basis of the Digital Fusion common stock surrendered in exchange for Kratos common stock, reduced by any amount allocable to a fractional share of Kratos common stock for which cash is received.

The holding period of the Kratos common stock received by a Digital Fusion stockholder in connection with the merger will include the holding period of the Digital Fusion common stock surrendered in connection with the merger.

Digital Fusion stockholders who dissent from the merger and exercise their appraisal rights will recognize capital gain or loss measured by the difference between the amount of cash received and the tax basis of shares of Digital Fusion common stock surrendered, provided the cash payment is not treated as a dividend distribution for tax purposes. The payment should not be treated as a dividend distribution if the Digital Fusion stockholder owns no Kratos stock (either actually or constructively) after receiving the payment.

Any capital gain or loss from the foregoing will be long-term capital gain or loss if the relevant shares of Digital Fusion common stock have been held for more than twelve months.

Kratos, Merger Sub and Digital Fusion will not recognize gain or loss as a result of the merger.

Backup Withholding

If you are a non-corporate holder of Digital Fusion common stock you may be subject to information reporting and 28% backup withholding on any cash payments received in lieu of a fractional share interest in Kratos common stock or received in exchange for Digital Fusion common stock. You will not be subject to backup withholding, however, if you:

- furnish a correct taxpayer identification number and certify that you are not subject to backup withholding on the substitute Form W-9 or successor form included in the letter of transmittal to be delivered to you following the completion of the merger (or the appropriate Form W-8, as applicable); or

- are otherwise exempt from backup withholding.

Any amounts withheld under the backup withholding rules will be allowed as a refund or credit against your U.S. federal income tax liability, provided you furnish the required information to the Internal Revenue Service.

Tax Return Reporting Requirements

If you receive Kratos common stock as a result of the merger, you will be required to retain records pertaining to the merger, and you may be required to file with your U.S. federal income tax return for the year in which the merger takes place a statement setting forth certain facts relating to the merger as provided in Treasury Regulations Section 1.368-3.

The preceding discussion does not purport to be a complete analysis or discussion of all potential tax effects relevant to the merger. Digital Fusion stockholders are urged to consult their own tax advisers as to the specific consequences of the merger to them, including tax return reporting requirements, the applicability and effect of federal, state, local, foreign and other tax laws and the effects of any proposed changes in the tax laws.

THE MERGER AGREEMENT AND RELATED AGREEMENTS

The following discussion summarizes material provisions of the Agreement and Plan of Merger, which we refer to as the merger agreement, a copy of which is attached as Annex A to this proxy statement/prospectus and is incorporated by reference herein. The rights and obligations of the parties are governed by the express terms and conditions of the merger agreement and not by this summary. This summary is not complete and is qualified in its entirety by reference to the complete text of the merger agreement. We urge you to read the merger agreement carefully in its entirety, as well as this proxy statement/prospectus, before making any decisions regarding the merger.

The representations and warranties described below and included in the merger agreement were made by Kratos and Digital Fusion to each other as of specific dates. The assertions embodied in those representations and warranties were made solely for purposes of the merger agreement and may be subject to important qualifications and limitations agreed to by Kratos and Digital Fusion in connection with negotiating its terms, including, but not limited to, the qualifications and limitations listed in the disclosure schedules to the merger agreement. Moreover, the representations and warranties may be subject to a contractual standard of materiality that may be different from what may be viewed as material to stockholders, or may have been used for the purpose of allocating risk between Kratos and Digital Fusion rather than establishing matters as facts. The merger agreement is described in this proxy statement/prospectus and included as Annex A only to provide you with information regarding its terms and conditions, and not to provide any other factual information regarding Kratos, Digital Fusion or their respective businesses. Accordingly, you should not rely on the representations and warranties in the merger agreement as characterizations of the actual state of facts about Kratos or Digital Fusion, and you should read the information provided elsewhere in this proxy statement/prospectus, and in the documents which are incorporated by reference as exhibits to the registration statement of which this proxy statement/prospectus is a part, for information regarding Kratos and Digital Fusion and their respective businesses. See "Where You Can Find More Information" beginning on page 197 of this proxy statement/prospectus.

Terms of the Merger

Each of the Kratos board of directors and Digital Fusion board of directors has approved the merger agreement, which provides for the merger of Merger Sub with and into Digital Fusion. Digital Fusion will be the surviving corporation in the merger and will remain a subsidiary of Kratos. Each share of Digital Fusion common stock, par value $0.01 per share, issued and outstanding immediately prior to the completion of the merger, will be converted into the right to receive 1.7933 shares of Kratos common stock, for an aggregate of approximately 21.1 million shares.

Kratos will not issue any fractional shares in the merger. Instead, Digital Fusion stockholders will receive cash (without interest) in lieu of such fractional share, after aggregating all fractional shares of Kratos common stock issuable to that holder, determined by multiplying such fraction by the average closing price of Kratos common stock for the five trading days immediately prior to the closing date.

Treatment of Digital Fusion Stock Options

Each outstanding option to acquire Digital Fusion common stock will be converted automatically at the effective time of the merger into an option to acquire Kratos common stock and will continue to be governed by the terms of the relevant Digital Fusion stock plan and related grant agreements under which it was granted, which will remain in effect, except that:

- each converted stock option will be exercisable for a number of shares of Kratos common stock equal to the product of the number of shares of Digital Fusion common stock previously subject to the Digital Fusion stock option and 1.7933, rounded down to the next whole share; and the per share exercise price for the Kratos common stock issuable upon exercise of each converted stock option will be equal to (i) exercise price for each share of Digital Fusion common stock previously subject to the stock option immediately prior to completion of the merger, divided by (ii) 1.7933, rounded up to the nearest whole cent.

Treatment of Digital Fusion Warrants

Each outstanding warrant to purchase Digital Fusion common stock will be converted automatically at the effective time of the merger into a warrant to purchase Kratos common stock and will continue to be governed by the terms of the relevant Digital Fusion warrant agreement, except that:

the number of shares of Kratos common stock subject to each such warrant will be equal to the product of the number of shares of Digital Fusion common stock previously subject to the Digital Fusion warrant and 1.7933, rounded down to the next whole share; and

the per share exercise price for the Kratos common stock issuable upon exercise of such warrant will be equal to (i) the exercise price for each share of Digital Fusion common stock previously subject to the warrant immediately prior to completion of the merger, divided by (ii) 1.7933, rounded up to the nearest whole cent.

Closing and Effective Time of the Merger

The closing of the merger will occur no later than the second business day after the conditions to completion of the merger have been satisfied or waived, unless the parties agree otherwise in writing. The merger will become effective upon the filing of a certificate of merger with the Secretary of State of the State of Delaware. The parties expect the merger will be completed in late 2008 or early 2009.

Directors and Executive Management Following the Merger

Kratos President and Chief Executive Officer Eric DeMarco will serve as President and Chief Executive Officer of the combined company. The board of directors of Kratos will remain unchanged following the merger.

Conversion of Shares; Exchange of Certificates

After the effective time, each certificate that previously represented shares of Digital Fusion common stock will represent only the right to receive the applicable merger consideration as described above, including cash for any fractional shares of Kratos common stock. The conversion of Digital Fusion common stock into the right to receive the merger consideration will occur automatically upon completion of the merger. Prior to the completion of the merger, Kratos will appoint an exchange agent for the purpose of exchanging certificates and uncertificated shares of Digital Fusion common stock. Promptly after the effective time of the merger, the exchange agent will mail transmittal materials to each holder of record of Digital Fusion shares of common stock. This mailing will contain instructions for surrendering common stock certificates and uncertificated shares to the exchange agent in exchange for the merger consideration.

Each holder of a share of Digital Fusion common stock that has been converted into a right to receive the applicable merger consideration (including cash for fractional shares) will receive the applicable merger consideration upon surrender to the exchange agent of the applicable Digital Fusion common stock certificate or uncertificated shares, together with a letter of transmittal covering such shares and such other documents as Kratos or the exchange agent may reasonably require. Holders of Digital Fusion common stock should not send in their Digital Fusion stock certificates until they receive, complete and submit a signed letter of transmittal sent by the exchange agent with instructions for the surrender of Digital Fusion stock certificates.

After completion of the merger, there will be no further transfers on the stock transfer books of Digital Fusion except as required to settle trades executed prior to completion of the merger.

Withholding

The exchange agent will be entitled to deduct and withhold from the cash in lieu of fractional shares payable to any Digital Fusion stockholder the amounts it is required to deduct and withhold under any federal, state, local or foreign tax law. If the exchange agent withholds any amounts, they will be treated as having been paid to the stockholders from whom they were withheld.

Termination of Exchange Fund

Six months after the completion of the merger, Kratos may require the exchange agent to deliver to Kratos all cash and shares of Kratos common stock remaining in the exchange fund. Thereafter, Digital Fusion stockholders must look only to Kratos for payment of the merger consideration on their shares of Digital Fusion common stock.

Transfers of Ownership and Lost Stock Certificates

Kratos will only issue the merger consideration, cash in lieu of a fractional share and any dividends or distributions on Kratos common stock that may be applicable in a name other than the name in which a surrendered Digital Fusion stock certificate is registered if the certificate is properly endorsed or otherwise in proper form and any applicable stock transfer taxes have been paid. If a certificate for Digital Fusion common stock has been lost, stolen or destroyed, the exchange agent will issue the consideration properly payable under the merger agreement upon receipt of appropriate evidence as to that theft, loss or destruction and customary identification.

No Liability

Digital Fusion and Kratos are not liable to holders of shares of Digital Fusion common stock for any amount delivered to a public official under applicable abandoned property, escheat or similar laws.

Distributions with Respect to Unexchanged Shares

Holders of Digital Fusion common stock are not entitled to receive any dividends or other distributions on Kratos common stock until the merger is completed. After the merger is completed, holders of Digital Fusion common stock certificates will be entitled to dividends and other distributions declared or made after completion of the merger with respect to the number of whole shares of Kratos common stock to which they are entitled upon exchange of their Digital Fusion stock certificates, but they will not be paid any dividends or other distributions on Kratos common stock until they surrender their Digital Fusion stock certificates to the exchange agent in accordance with the exchange agent instructions.

Appraisal Rights

Shares of Digital Fusion common stock held by any Digital Fusion stockholder that properly demands payment for its shares in compliance with the appraisal rights under Section 262 of the DGCL will not be converted into the right to receive the merger consideration. Digital Fusion stockholders properly exercising appraisal rights will be entitled to payment as described under "Appraisal Rights" beginning on page 194. However, if any Digital Fusion stockholder fails to perfect or otherwise waives, withdraws or loses the right to receive payment under Section 262, then that stockholder will not be paid in accordance with Section 262 and the shares of common stock held by that stockholder will be exchangeable solely for the right to receive the merger consideration.

Reasonable Best Efforts; Other Agreements

Reasonable Best Efforts

Kratos and Digital Fusion have each agreed to use their reasonable best efforts to take all actions necessary, proper or advisable under the merger agreement and applicable laws, rules and regulations to complete the merger and the other transactions contemplated by the merger agreement as promptly as practicable. Notwithstanding the foregoing, (i) Kratos is not required to agree to or carry out any divestiture, sale, license or imposition of any material limitation on the ability of Kratos to conduct its business or to hold or exercise full ownership of the Digital Fusion shares, except in each case as would not involve any assets that are material to Kratos and its subsidiaries, taken as a whole and (ii) Digital Fusion shall not offer or pay any consideration, or make any agreement affecting the business, assets, properties or liabilities of Digital Fusion in order to obtain any consents, approvals or waivers, except with the prior written consent of Kratos.

Proxy Statement/Prospectus; Stockholders' Meetings

Kratos and Digital Fusion have agreed to cooperate in preparing and filing with the SEC this proxy statement/prospectus and the registration statement of which it forms a part. Each has agreed to use its reasonable best efforts to resolve any SEC comments relating to this proxy statement/prospectus and to have the registration statement of which it forms a part declared effective, and will cause this proxy statement/prospectus to be mailed to its respective stockholders as early as practicable after it is declared effective. Each has also agreed to hold a stockholders' meeting as promptly as possible after the registration statement is declared effective and in any event within 45 days of such declaration.

Other Agreements

The merger agreement contains certain other agreements, including agreements relating to access to information and cooperation between Kratos and Digital Fusion during the pre-closing period, public announcements and certain tax matters.

Representations and Warranties

The merger agreement contains customary representations and warranties of Digital Fusion, which are subject to materiality and knowledge qualifications in many respects and which expire at the effective time of the merger. These representations and warranties relate to, among other things:

- organization and qualification;
- capitalization;
- subsidiaries;
- corporate power and authority and board approval;
- absence of conflicts and required filings and consents;
- reports and financial statements;
- absence of certain changes or events;

litigation;

compliance with applicable laws;

- material contracts and defaults;
- tax matters;
- employee benefit plans, ERISA compliance and excess parachute payments;
- labor and employment matters;
- environmental matters;
- intellectual property;
- real property;
- insurance;
- title to and sufficiency of assets;
- matters related to business practices, relationships, products and services;
- related party transactions;
- matters related to government equipment and government contracting;
- certain business practices and international trade matters;
- brokers and finders; and
- takeover laws.

The merger agreement also contains customary representations and warranties of Kratos, which are subject to materiality and knowledge qualifications in many respects and which expire at the effective time of the merger. These representations and warranties relate to, among other things:

- organization and qualification;
- capitalization and authorized stock;
- corporate power and authority and board approval;

- absence of conflicts and required filings and consents;
- reports and financial statements;
- compliance with applicable laws;
- brokers and finders;
- ownership and activities of Merger Sub;
- litigation;
- certain business practices; and
- its credit facility.

Conduct of Business Before Completion of the Merger

Digital Fusion and Kratos have agreed to restrictions on their activities until the completion of the merger. In general, each of the parties has agreed to conduct its business in the ordinary course of business consistent with past practice and use its reasonable best efforts to preserve its current business organization and goodwill. In addition, Digital Fusion has agreed that it will keep available the services of its present officers, employees and independent contracts and preserve its business relationships.

Digital Fusion has also agreed that, except as expressly permitted by the merger agreement or with Kratos' prior written consent, it will not (and will not permit any of its subsidiaries to):

- amend or propose to amend the certificate of incorporation or bylaws;
- split, combine or reclassify its outstanding capital stock or issue or authorize the issuance of any other security;
- declare, set aside, make or pay any dividend or other distribution;
- create any subsidiary or alter its or any of its subsidiaries' corporate structure or ownership;
- enter into any agreement with respect to the voting of its capital stock or other securities held by it or any of its subsidiaries;
- issue, sell, pledge, dispose of, grant, encumber, or agree to issue, sell, pledge, dispose of, grant or encumber any shares of any class of capital stock, or any options, warrants or rights of any kind to acquire any shares of, its capital stock of any class or any debt or equity securities convertible into or exchangeable for such capital stock, except that it may issue shares upon exercise of stock options and warrants outstanding on the date of the agreement in accordance with their terms;
- issue any debt securities, incur, guarantee or otherwise become contingently liable with respect to any indebtedness for borrowed money, or enter into any arrangement having the economic effect of any of the foregoing;
- make any loans, advances or capital contributions to, or investments in, any person;
- redeem, purchase, acquire or offer to purchase or acquire any shares of its capital stock, or any options, warrants or rights to acquire any of its capital stock or any security convertible into or exchangeable for its capital stock;
- acquire or agree to acquire by merging or consolidating with, or by purchasing a substantial portion of the assets of or equity in, or by any other manner, any business or any corporation, limited liability company, partnership, association or other business organization or division thereof or otherwise acquire or agree to acquire any assets other than in the ordinary course of business consistent with past practice;
- authorize, make or agree to make any new capital expenditure or expenditures, or enter into any contract or arrangement that reasonably may result in payments by or liabilities in excess of $50,000 individually or $100,000 in the aggregate in any twelve (12) month period;
- sell, pledge, assign, dispose of, transfer, lease, securitize, or encumber any businesses, properties or assets, other than sales of inventory and other assets in the ordinary course of business and consistent with past practice;
- increase the compensation payable or to become payable (including bonus grants) or increase or accelerate the vesting of the benefits provided to its directors, officers or employees or other service providers, except for increases in the ordinary course of business and consistent with past practice in salaries or wages of its employees who are not directors or executive officers;
- grant any severance or termination pay or benefits to, or enter into any employment, severance, retention, change in control, consulting or termination agreement with, any director, officer or other employee or other service provider;

establish, adopt, enter into or amend any collective bargaining, bonus, profit-sharing, thrift, compensation, stock option, restricted stock, pension, retirement, deferred compensation, employment, termination, severance or other plan, agreement, trust, fund, policy or arrangement for the benefit of any director, officer or employee or other service providers;

pay or make, or agree to pay or make, any accrual or arrangement for payment of any pension, retirement allowance, or any other employee benefit;

announce, implement or effect any reduction in labor force, lay-off, early retirement program, severance program or other program or effort concerning the termination of employment of employees, other than routine employee terminations;

knowingly violate or knowingly fail to perform any obligation or duty imposed upon it by any applicable federal, state, local or foreign law, rule, regulation, guideline or ordinance, or under any order, settlement agreement or judgment;

make any change to accounting policies or procedures, other than actions required to be taken by GAAP;

prepare or file any tax return inconsistent with past practice or, on any tax return, take any position, make any election, or adopt any method inconsistent with positions taken, elections made or methods used in preparing or filing similar tax returns in prior periods;

make or change any express or deemed election related to taxes, change an annual accounting period, adopt or change any method of accounting, file an amended tax return, surrender any right to claim a refund of taxes, consent to any extension or waiver of the limitation period applicable to any tax proceedings, or take any other similar action relating to taxes if such election, change, adoption, amendment, surrender, consent or other action would have the effect of increasing its tax liability;

commence any litigation or proceedings with respect to taxes, settle or compromise any litigation or proceedings with respect to taxes, commence any other litigation or proceedings or settle or compromise any other material litigation or proceedings;

enter into a new line of business which is material to Digital Fusion or represents a category of revenue that is not discussed in its 2007 Annual Report;

open or close any facility or office;

pay, discharge or satisfy any claims, liabilities or obligations (whether or not absolute, accrued, asserted, contingent or otherwise), other than the payment, discharge or satisfaction, in the ordinary course of business consistent with past practice or in accordance with their terms, of liabilities adequately reflected or reserved against in, its most recent financial statements;

amend, modify or consent to the termination of any material contract, or amend, waive, modify or consent to the termination of its rights thereunder;

enter into, amend, modify, permit to lapse any rights under, or terminate (i) any agreements pursuant to which any other party is granted exclusive marketing or other exclusive rights of any type or scope with respect to any of its products or technology or which restricts Digital Fusion or, upon completion of the merger or any other transaction contemplated hereby, Kratos, from engaging or competing in any line of business or in any location, (ii) any agreement or contract with any customer, supplier, sales representative, agent or distributor, other than in the ordinary course of business and consistent with past practice, (iii) any agreement or contract with any other person pursuant to which Digital Fusion is the licensor or licensee of any intellectual property, (iv) any agreement or arrangement with affiliates or executive officers or directors of Digital Fusion, (v) any lease for real property or material operating lease, or (vi) any material rights or claims with respect to any confidentiality or standstill agreement to which Digital

Fusion is a party and which relates to a business combination or other similar extraordinary transaction;

terminate, cancel, amend or modify any insurance coverage policy which is not promptly replaced by a comparable amount of insurance coverage;

terminate or waive any right of any material value to Digital Fusion;

commence, waive, release, assign, settle or compromise any material claims, or any material litigation or arbitration;

take any action to (i) render inapplicable, or to exempt any third person from, the provisions of Section 203 of the DGCL, or any other state takeover or similar law or state law that purports to limit or restrict business combinations or the ability to acquire or vote shares or (ii) adopt or implement any stockholder rights agreement or plan;

take any action or omit to take any action that is intended or would reasonably be expected to result in any of the conditions to the merger not being satisfied; or

authorize, recommend, propose or announce an intention to do any of the foregoing, or enter into any contract, agreement, commitment or arrangement to do any of the foregoing.

Kratos has agreed that, except as expressly permitted by the merger agreement or with Digital Fusion's prior written consent, it will not (and will not permit any of its subsidiaries to):

amend or propose to amend the certificate of incorporation or bylaws, except as required by law or the rules or regulations of Nasdaq or those changes that would not reasonably be expected to have a material adverse effect on Kratos;

sell, lease or encumber any properties or assets, other than sales of inventory and other assets in the ordinary course of business and consistent with past practice and other transactions that would not reasonably be expected to have a material adverse effect on Kratos; or

authorize, recommend, propose or announce an intention to do any of the foregoing, or enter into any contract, agreement, commitment or arrangement to do any of the foregoing.

Employee Matters

Following completion of the merger, Digital Fusion's existing employee benefit plans will remain in effect for the benefit of employees of Digital Fusion covered by such plans at the effective time of the merger, until such time as Kratos adopts new employee benefit plans for the benefit of the employees of Digital Fusion. To the extent Kratos adopts new benefit plans for Digital Fusion employees, Kratos has agreed to the extent commercially practicable to provide each such employee with (i) service credit for all limitations such as preexisting conditions, exclusions and waiting periods, to the extent such an employee would have received such credit under the prior Digital Fusion plan, (ii) credit for any co-payments and deductibles, and (iii) all service for purposes of vesting and benefit accruals (although not for benefit accruals under any defined benefit pension plan), subject to the consent of any applicable insurance carrier and to the extent commercially practicable. Notwithstanding the foregoing, Kratos may amend, modify or terminate any of the existing employee benefit plans of Digital Fusion or related contracts in accordance with their terms and applicable law.

Non-Solicitation; Change in Recommendation

In the merger agreement Digital Fusion has agreed that its board will recommend that Digital Fusion's stockholders adopt and approve the merger agreement and that it will not directly or indirectly:

- solicit, initiate or encourage the submission, making or announcement of any "takeover proposal" (as described below);
- participate in any discussions or negotiations, provide any information with respect to, or otherwise cooperate in any way or take any action to facilitate the making of any inquiry or proposal that is or could lead to a takeover proposal; or
- make or authorize any statement, recommendation or solicitation in respect of any takeover proposal.

In addition, Digital Fusion has agreed to immediately terminate any discussions with respect to any takeover proposal conducted prior to the entry into the merger agreement and request the return or destruction of previously provided confidential information with respect to any takeover proposal.

However, if Digital Fusion receives a bona fide takeover proposal prior to the time that the Digital Fusion stockholder vote approving the merger has been obtained, that does not result from the breach of the terms of the merger agreement or any confidentiality, standstill or similar agreement and Digital Fusion's board of directors determines in good faith, (i) after consultation with outside counsel and an independent financial advisor, that the takeover proposal is, or is reasonably likely to result in, a "superior proposal" (as described below), and (ii) after consultation with outside counsel, that failure to take the following actions would result in a breach of its fiduciary duties, then Digital Fusion may (after providing written notice to Kratos):

- furnish information about Digital Fusion to the person making the takeover proposal, subject to a confidentiality agreement no less restrictive than the confidentiality agreement entered into with Kratos, and providing that all information not previously provided to Kratos is provided to it; and
- participate in discussion or negotiations with the person making the takeover proposal.

As used in the merger agreement, "takeover proposal" means any inquiry, proposal or offer from any person relating to, or that is reasonably likely to lead to, directly or indirectly: (i) a merger, consolidation, tender offer, exchange offer, share exchange, joint venture, dissolution, recapitalization, liquidation, business combination or other similar transaction involving Digital Fusion or its subsidiaries; (ii) the acquisition by any person of any class of equity securities of Digital Fusion equal to or greater than 15% of the shares outstanding prior to such acquisition; (iii) the acquisition by any person of assets that constitute 15% or more of the net revenues, net income or assets of Digital Fusion, in each case other than the transactions contemplated by the merger agreement.

As used in the merger agreement, "superior proposal" means any unsolicited third party proposal to acquire all of the outstanding capital stock of Digital Fusion or all or substantially all of its assets, (i) for consideration that the Digital Fusion board of directors determines in its good faith judgment to be superior from a financial point of view on a present value basis to the Digital Fusion stockholders than the transactions contemplated by the merger agreement, based on the advice of an independent financial advisor, taking into account all the terms and conditions of such proposal, the merger agreement and any proposal by Kratos to amend the terms of the merger agreement, (ii) for which financing, to the extent required, is then fully committed, (iii) for which, in the good faith judgment of the board of directors, no regulatory approvals are required, including antitrust approvals, that would not reasonably be expected to be obtained without undue cost or delay and (iv) that, in the good faith judgment of the board of directors, is otherwise reasonably likely to be consummated, taking into account all legal, financial, regulatory and other aspects of the proposal and the person making the proposal.

The Digital Fusion board of directors has unanimously adopted a resolution recommending that the Digital Fusion stockholders adopt the merger agreement. Under the merger agreement, except as provided below, the Digital Fusion board of directors may not withdraw, modify or qualify, or propose to withdraw, modify or qualify its recommendation, or approve or recommend, or propose to approve or recommend any takeover proposal. Any of these actions is referred to as a "change in recommendation". In addition, the Digital Fusion board may not approve or cause or permit Digital Fusion to enter into any letter of intent or agreement relating to any takeover proposal.

The Digital Fusion board of directors may make a change of recommendation if prior to the time that the Digital Fusion stockholder vote approving the merger has been obtained, the board of directors receives an unsolicited takeover proposal that did not result from a breach of the terms of the merger agreement or any confidentiality, standstill or similar agreement that the Digital Fusion board of directors determines, in good faith after consultation with outside counsel, constitutes a superior proposal that is not withdrawn, and the board determines in good faith that the failure to do so would cause it to violate its fiduciary duties to the Digital Fusion stockholders. However, the board of directors may make a change of recommendation or terminate the merger agreement under these circumstances only if (i) it has complied with the non-solicitation and change of recommendation provisions of the merger agreement in all material respects, (ii) it has provided written notice to Kratos in accordance with the terms of the merger agreement, (iii) either Kratos does not modify the terms of the merger agreement within five business days after receipt of the written notice from Digital Fusion or the Digital Fusion board of directors determines in good faith after consultation with its financial advisor that any proposed modifications by Kratos do not cause the takeover proposal to cease being a superior proposal, and (iv) concurrently with and as a condition of such termination, Digital Fusion accepts the superior proposal and enters into an acquisition agreement with respect to the superior proposal, and pays Kratos a termination fee (as described further in "Termination Fee" below).

The merger agreement also provides that Digital Fusion must promptly, but in any event within 48 hours, notify Kratos of any takeover proposal received by it and provide Kratos with copies of all written material provided to it with respect to any takeover proposal. Digital Fusion must also keep Kratos fully informed of the status and terms of any such takeover proposal and provide Kratos with at least 48 hours prior written notice of any Digital Fusion board meeting at which the board of directors is expected to consider any takeover proposal or related inquiry, or consider providing information to any person in connection with a takeover proposal. Kratos may also request that Digital Fusion publicly reaffirm its recommendation upon ten business day written notice.

Conditions to Completion of the Merger

Each party's obligation to effect the merger is subject to the satisfaction or waiver of various conditions, which include the following:

- the adoption of the merger agreement by Digital Fusion stockholders;
- the approval of the issuance of shares of Kratos common stock by Kratos stockholders;
- the approval of the listing of the Kratos common stock to be issued in the merger on the Nasdaq Global Select Market;
- the effectiveness of the registration statement of which this proxy statement/prospectus is a part and the absence of any stop order or proceedings initiated for that purpose;
- the absence of any order, judgment, injunction or other decree issued by any court of competent jurisdiction making the merger illegal or otherwise preventing the consummation of the merger;

the receipt of any governmental authorizations, consents, orders and approvals as may be required in connection with the merger, subject to certain exceptions; or

the absence of any suit, action or proceeding by any governmental entity seeking to prohibit the consummation of the merger or any transaction contemplated by the merger agreement or that would otherwise have a material adverse effect on Digital Fusion or Kratos, provided that this condition is deemed satisfied if a court dismisses or denies a request for an injunction.

Each of Kratos and Digital Fusion's obligations to complete the merger is also separately subject to the satisfaction or waiver of the following conditions:

the truth and correctness of the other party's representations and warranties, subject to certain materiality standards provided in the merger agreement;

the performance by the other party of its obligations under the merger agreement in all material respects; and

there shall have been no material adverse effect on the other party.

In addition, Kratos' obligation to complete the merger is also separately subject to a number of conditions, including the following:

the absence of any instituted or pending proceeding by any governmental entity seeking to restrain or interfere with, or impose limitations on, Kratos' ownership or operation of Digital Fusion's business;

Digital Fusion shall have obtained all required consents from a any person or governmental entity whose consent or approval is required in connection with the merger;

the entry into certain non-competition agreements and employment and retention agreements by certain Digital Fusion employees;

Digital Fusion shall have at least $500,000 cash on hand and no interest bearing debt immediately prior the closing of the merger;

all security background checks and investigations required to satisfy the collateral requirements of Kratos' lenders shall have been satisfied;

Kratos shall have completed and shall be reasonably satisfied with all background checks and related investigations for certain Digital Fusion employees;

Digital Fusion shall have delivered resignation letters of its officers and directors to Kratos; and

Digital Fusion shall have delivered to Kratos documentation of a certain Digital Fusion contract option exercise, in a form reasonably acceptable to Kratos.

The merger agreement provides that certain of the conditions described above may be waived by Kratos or Digital Fusion. Neither Kratos nor Digital Fusion currently expects to waive any material condition to the completion of the merger.

The merger agreement defines a material adverse effect on each party as any fact, event, circumstance or effect that, individually or together with all other such facts, events, circumstances and effects, is, or could reasonably be expected to be, material and adverse to the business, condition (financial or otherwise), capitalization, assets, liabilities, or results of operations of that party, taken as a whole, or prevents or materially delays, or could reasonably be expected to prevent or materially delay, the ability of the party to perform its obligations under the merger agreement or to consummate the transactions contemplated by the merger agreement in accordance, other than: (i) changes after the date of the merger agreement in laws, rules or regulations of general applicability or interpretations thereof by a governmental entity, unless such changes disproportionately adversely affects the party as compared with other companies operating in its industries, (ii) general changes after the date hereof in economic conditions, securities markets in general in the United States or general changes in the industry in which the party operates generally, unless such changes disproportionately adversely affect the party as compared with other companies operating in its industries, (iii) failure to meet internal projections or forecasts or (iv) a change in the market price or trading volume of the party's common stock, in and of itself.

Termination

Generally, the merger agreement may be terminated and the merger may be abandoned at any time prior to the completion of the merger (including after stockholder approval) by mutual written consent of Kratos and Digital Fusion. The agreement may also be terminated by either Kratos or Digital Fusion if:

- the merger is not consummated on or before January 31, 2009, except that such right is not available to any party whose failure to comply with the merger agreement has been the cause of, or resulted in, such failure and provided that this date (the "outside date") may be extended to the earlier of May 30, 2009 or 60 days following the date the SEC notifies Kratos that the registration statement of which this proxy statement/prospectus is no longer subject to review and comments;

- a governmental entity issues an order, decree or ruling or takes any other nonappealable final action permanently restraining, enjoining or otherwise prohibiting the merger, except that such right is not available to any party whose failure to comply with the merger agreement has been the cause of, or resulted in, such action;

- the required Kratos or Digital Fusion stockholder vote has not been obtained at the applicable stockholder meeting, or any adjournment or postponement thereof, except that this right is not available to any party who is in material breach of its obligations under the merger agreement; or

- the other party breaches any of its agreements or representations in the merger agreement in such a way as would cause certain of the conditions to closing not to be satisfied, and such breach is either incurable or is not cured by the earlier of (i) 30 days following receipt of written notice of such breach or failure to perform or (ii) one business day prior to the outside date.

In addition, the merger agreement may be terminated by Kratos, and Digital Fusion will be required to pay the termination fee (as described below) to Kratos, if:

- the Digital Fusion board of directors effects a change of recommendation or resolves to do so;

- the Digital Fusion board of directors approves or recommends a takeover proposal or resolved to do so;

- a tender offer or exchange offer for Digital Fusion's shares is commenced (other than by Kratos) and the Digital Fusion board recommends that the Digital Fusion stockholders tender their shares in the offer or fails to recommend that its stockholders reject such tender or exchange; or

- Digital Fusion materially violates certain terms of the merger agreement related to non-solicitation, changes in recommendations, its board of directors' recommendation in favor of the merger and holding the stockholder meeting.

In addition, the merger agreement may be terminated by Digital Fusion prior to the time the Digital Fusion stockholder approval of the merger is obtained if Digital Fusion terminates in the agreement in connection with the entry into an agreement for a superior proposal in accordance with

the terms and conditions of the merger agreement with Kratos, as long as Digital Fusion has complied with all related notice and other provisions and pays Kratos the termination fee (as described below).

Termination Fee and Expenses

Digital Fusion is required to pay a termination fee of $1,344,000 (the "termination fee") to Kratos in the event the merger agreement is terminated by Digital Fusion in connection with the entry into an agreement for a superior proposal, as described above. In addition, Digital Fusion is required to pay Kratos the termination fee if Kratos terminates the merger agreement under the following conditions:

- the Digital Fusion board of directors effects a change of recommendation or resolves to do so;
- the Digital Fusion board of directors approves or recommends a takeover proposal or resolved to do so;
- a tender offer or exchange offer for Digital Fusion's shares is commenced (other than by Kratos) and the Digital Fusion board recommends that the Digital Fusion stockholders tender their shares in the offer or fails to recommend that its stockholders reject such tender or exchange; or
- Digital Fusion materially violates certain terms of the merger agreement related to non-solicitation, changes in recommendations, its board of directors' recommendation in favor of the merger and holding the stockholder meeting.

Digital Fusion is also required to pay the termination fee in the event that:

- it has knowledge of a takeover proposal;
- a takeover proposal has been made to Digital Fusion stockholders; or
- any person has announced an intention to make a takeover proposal;

and thereafter, the merger agreement is terminated (i) by either Digital Fusion or Kratos if the merger is not consummated by the outside date, (ii) by either Digital Fusion or Kratos if the required Digital Fusion vote has not been obtained at the stockholder meeting, or (iii) by Kratos if Digital Fusion breaches any of its agreements or representations in the merger agreement in such a way as would cause certain of the conditions to closing not to be satisfied, and within 12 months of such termination of the merger agreement, Digital Fusion either enters into or consummates a takeover proposal, other than with Kratos and Merger Sub.

Whether or not the merger is completed, all costs and expenses incurred in connection with the merger agreement and the transactions contemplated by the merger agreement will be paid by the party incurring those costs or expenses.

Effect of Termination

If the merger agreement is terminated as described in " Termination" above, the agreement will become void and there will be no liability or obligation of any party, except that (i) both parties will remain liable for any willful breach of the merger agreement, fraud or knowing misrepresentation, and (ii) designated provisions of the merger agreement, including certain provisions relating to confidential treatment of information and fees and expenses (including the termination fees described above) will survive termination.

Amendment, Waiver and Extension of the Merger Agreement

Subject to applicable law, the merger agreement may be amended by the parties in writing at any time. However, after approval by Kratos' and Digital Fusion's stockholders of the transactions

contemplated by the merger agreement, the merger agreement may not be amended in a manner that would require further approval by either party's stockholders unless the parties obtain such approval.

At any time prior to the completion of the merger, each of the parties may extend the time for performance of any of the obligations or other acts of the other party to the merger agreement, waive any inaccuracies in the representations and warranties of the other party or waive compliance by the other party with any agreement or condition in the merger agreement.

Stockholder Agreements

In order to induce Kratos to enter into the merger agreement, several Digital Fusion stockholders entered into stockholder agreements and irrevocable proxies with Kratos pursuant to which, among other things, each of these stockholders agreed, solely in its capacity as a stockholder, to vote all of its shares of Digital Fusion capital stock and other Digital Fusion securities in favor of the merger and the adoption of the merger agreement, against any action or agreement that would result in a breach of the merger agreement by Digital Fusion, and against any other action which, directly or indirectly, would reasonably be expected to prevent or materially delay the consummation of the merger or the transactions contemplated by the merger agreement. These Digital Fusion stockholders also granted Kratos an irrevocable proxy to their respective Digital Fusion capital stock and securities in accordance with the stockholder agreement. These Digital Fusion stockholders may vote their shares of Digital Fusion capital stock and securities on all other matters not referred to in such proxy. The forms of the stockholder agreements are attached to this joint proxy statement/prospectus as *Annexes B-1, B-2* and *B-3*.

As of November 21, 2008, the stockholders of Digital Fusion that entered into stockholder agreements owned in the aggregate 3,999,567 shares of Digital Fusion common stock then issued and outstanding, representing approximately 34% of the outstanding Digital Fusion stock.

Under these stockholder agreements executed by Digital Fusion stockholders, subject to certain exceptions, such stockholders also have agreed not to sell or transfer Digital Fusion capital stock and securities held by them, or any voting rights with respect thereto, until the completion of the merger. In addition, pursuant to the stockholder agreements and subject to certain exceptions, Digital Fusion stockholders that entered into stockholder agreements have further agreed not to directly or indirectly offer, sell or contract or grant any option to sell, or otherwise dispose of, pledge or transfer any shares of Kratos common stock acquired by them pursuant to the terms of the merger agreement without the prior written consent of Kratos until the 270th day following the closing date of the merger; provided, however, that, with the exception of Madison Run, each such Digital Fusion stockholder may under certain circumstances and subject to certain restrictions, without the prior written consent of Kratos, offer or sell a portion of such acquired shares of Kratos common stock after each of the 120th day and the 180th day following the closing date of the merger.

Nothing in the stockholder agreements limits or restricts any of the stockholders who are party to the agreements or any of their affiliates from (i) acting in its capacity as an officer, director or employee of Digital Fusion or (ii) voting in its sole discretion on any matter other than those referred to in the stockholder agreements.

The stockholder agreements and the obligations of the parties thereunder shall terminate immediately, without any further action being required, upon the earlier of the termination of the merger agreement according to its terms or the closing date of the merger; provided, however, that the lock-up restrictions on the shares of Kratos common stock described above shall survive the termination of the stockholder agreements.

CERTAIN INFORMATION ABOUT KRATOS' BUSINESS

Kratos was initially incorporated in the state of New York on December 19, 1994, commenced operations in March 1995 and was reincorporated in Delaware in 1997. Kratos is an innovative provider of mission critical engineering, IT services and warfighter solutions. Kratos works primarily for the U.S. government and government agencies, but it also performs work for state and local agencies and commercial customers. Kratos' principle services are related to, but are not limited to, Command, Control, Communications, Computing, Combat Systems Intelligence, Surveillance and Reconnaissance, which Kratos refers to as C5ISR, weapons systems lifecycle support and extension, military weapon range operations and technical services, missile and rocket and weapons system test and evaluation, mission launch services, public safety, security and surveillance systems, advanced network engineering and information technology services, advanced IT services, security and surveillance systems, and critical infrastructure design and integration services. Kratos offers its customers solutions and expertise to support their mission-critical needs by leveraging its skills across its core service areas.

Kratos derives a substantial portion of its revenue from contracts performed for federal government agencies, with the majority of its revenue currently generated from the delivery of mission-critical warfighter solutions, advanced engineering services, system integration and system sustainment services to defense and other non-DoD (Department of Defense) and civilian government agencies. Kratos believes its diversified and stable client base, strong client relationships, broad array of contracts, considerable employee base possessing government security clearances, extensive list of past performance qualifications, and significant management and operational capabilities position it for continued growth.

Description of Business

Kratos is well positioned to meet the rapidly evolving needs of federal government agencies for high-end engineering services, IT solutions and other technical operations because it possesses the following key business strengths and performance qualifications:

Significant and Highly Specialized Experience

Through the existing customer engagements and with the government-focused acquisitions it has completed over the past several years, Kratos has amassed significant and highly specialized experience in areas directly related to weapon systems life cycle extension and sustainment; missile, rocket and weapons test and evaluation; C5ISR; military range operations and technical services and other highly differentiated services and solutions. This collective experience, or 'past performance qualifications,' is a requirement of the majority of contract vehicles and customer engagements Kratos is involved in. Kratos believes this to be a significant barrier to entry and lends itself to advantageous positioning for long-term success.

In-Depth Understanding of Client Missions

Kratos has a history of providing mission-critical services and solutions to its clients, enabling it to develop an in-depth understanding of customer missions and technical needs. In addition, a significant number of Kratos employees are located at client sites, allowing for valuable strategic insight into clients' ongoing and future program requirements. Additionally, Kratos' in-depth understanding of its client missions, in conjunction with the strategic location of its employees, enables Kratos to offer technical solutions tailored to clients' specific requirements and consistent with their evolving mission objectives.

Diverse Base of Key Contract Vehicles

As a result of its business development focus on securing key contracts, Kratos is a preferred contractor on numerous multi-year government-wide acquisition contracts and multiple award contracts that provide Kratos with the opportunity to bid on hundreds of millions of dollars of business against a discrete number of other pre-qualified companies each year. These contracts include Seaport-e, GSA, Passive RFID EPC-1, PES, IT, LOG World, Mobis Millennia Lite, AMCOM Express, Consolidated Acquisition of Professional Services, referred to as CAPS, Support Services for Aviation, Air Defense and Missile Systems, Systems Engineering and Technical Assistance Contract, and Specialized Engineering, Development and Test Articles/Models. While the federal government is not obligated to make any awards under these vehicles, Kratos believes that holding preferred positions on these contract vehicles provides an advantage when seeking to expand the level of services it provides to clients.

Strategic Geographic Locations and BRAC

The federal government's Base Realignment and Closure, referred to as BRAC, Act of 2005 is the congressionally authorized process the Department of Defense has implemented to reorganize its base structure to more efficiently and effectively support U.S. armed forces, increase operational readiness and facilitate new ways of doing business. As a result of the DoD's BRAC transformation, Kratos has concentrated its business strategy on building a significant presence in key BRAC receiving locations where the federal government is relocating its personnel as well as related technical and professional services. As Kratos continues to entrench in these key locations, it expects this to be a significant competitive advantage.

Highly Skilled Employees and an Experienced Management Team

Kratos delivers its services through a highly skilled workforce of approximately 1,500 full-time, part-time and on-call employees in its on-going business. Kratos' senior managers have over 125 years of collective experience with federal government agencies, the U.S. military, and federal government contractors. Members of the Kratos management team have significant experience growing businesses organically, as well as through acquisitions.

The cumulative experience and differentiated expertise of Kratos' personnel in its core focus areas of C5ISR, weapons systems lifecycle extension and maintenance, missile and rocket test and evaluation, along with its sizable employee base with government security clearances, allows Kratos to qualify for and bid on larger projects in the prime contracting role.

Services and Solutions

Kratos provides a range of integrated engineering, war fighter, security and information technology services and solutions by leveraging its core service offerings: weapon systems life cycle support and extension; C5ISR; military range operations and technical services; missile and rocket test and evaluation; security systems integration; and advanced network engineering and IT services.

Weapon Systems Life Cycle Support and Extension

Kratos provides weapon systems life cycle support and extension services for the DoD and foreign governments. These services focus on maintaining, testing and repairing certain weapons systems for the war fighter.

C5ISR (Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance)

In the area of C5ISR, Kratos is involved in a wide range of services, including the installation, upgrade and maintenance of command, control, combat and surveillance systems for customers such as Joint Inter Agency Task Force-south and the Naval Undersea Warfare Center, which Kratos refers to as NUWC.

Military Range Operations and Technical Services

A key area of differentiation for Kratos is within the range and technical service areas. Kratos has resources strategically located at virtually all major range locations throughout the United States, including NAWC Pt. Mugu, Hawaii Pacific Missile Range, Fort Bliss, Texas, and White Sands Missile Range, New Mexico. The services of Kratos include aerial targets operations and maintenance, surface targets operations and maintenance, missile systems operations and maintenance, range operations planning and support, hazardous materials management, supply and logistics support, and manufacturing.

Missile and Rocket Test and Evaluation

Through the acquisition of Haverstick Consulting, Inc., Kratos acquired expertise in the area of missile and rocket test and evaluation services. This includes exclusive rights to the design and manufacture of the motor on the Oriole Rocket System and ancillary hardware for sounding rockets, suborbital research and target services. Additionally, this area of business develops and produces low-cost ballistic missile defense targets.

Security Systems Integration

Kratos has broad experience integrating security services and solutions across a number of network and communications platforms. In particular, the non-federal business of Kratos has long-standing experience and has developed significant customer relationships by providing best-in-class systems integration services on a variety of platforms including digital (IP) surveillance and security, building automation systems and controls, fire and life safety systems, access control and perimeter protection, and service and maintenance of the aforementioned systems.

Advanced Engineering & IT Services

Kratos offers a full lifecycle of network engineering services to clients from the initial analysis of the requirements and design of the network through implementation and testing of the solution, including the design of disaster recovery contingency plans. Kratos' network engineering capabilities include architecture development, design, implementation, configuration, and operation of Local Area Networks (LAN), Metropolitan Area Networks (MAN) and Wide Area Networks (WAN). Kratos has extensive experience providing the following network engineering services for federal government clients which allows it to rapidly identify potential bottlenecks, security threats and vulnerabilities, and address these potential issues with cost-effective solutions in design, architecture, testing system, integration, deployment, security assessments, recovery plans, and certification.

Kratos has comprehensive experience providing engineering services at any phase of a project lifecycle including program management, engineering design, systems engineering, C5I System INCO, operations and maintenance, integrated logistics, test and evaluation, security/building mapping, propulsion research and development, advanced telecommunications, and warfare systems training.

In addition to these services, Kratos also offers a range of IT services and solutions from conceptual network planning to system service and maintenance. Kratos has extensive experience building complex and secure networks for the federal government, and it possesses in-depth experience with network operations centers. Key services include network operations centers, help desks, system maintenance, system upgrades, configuration management, data warehousing, COTS selection and integration, and high performance computing.

Corporate Strategy

From a strategic perspective, the objective of Kratos is to aggressively grow its business as a leading provider of highly-differentiated services in its core areas of focus as noted above by delivering comprehensive, high-end engineering services, technical solutions and information technology services to federal government agencies while improving overall profitability. To achieve this objective, Kratos intends to:

Accelerate Internal Growth

Kratos is focused on accelerating its internal growth rate by capitalizing on its current contract base, expanding services provided to existing clients, expanding the client base and offering new, complementary services.

Pursue Strategic Acquisitions

Kratos intends to supplement its organic growth by identifying, acquiring and integrating businesses that meet its primary objective of providing enhanced capabilities in order to pursue a broader cross section of the DoD, DHS and other government markets, complement and broaden the existing client base and expand primary service offerings. The senior management team of Kratos brings significant acquisition experience.

On December 31, 2007, Kratos completed the acquisition of Haverstick Consulting, Inc., an Indianapolis, Indiana based privately-held provider of rocket and missile test and evaluation, weapons systems support, and professional services to the U.S. Army, U.S. Air Force, U.S. Navy, NASA, and other federal, state and local agencies. In addition, on February 20, 2008, Kratos entered into a definitive merger agreement with San Diego-based C5ISR and net-centric warfare solutions provider SYS in a stock-for-stock transaction. These acquisitions will significantly broaden the Kratos portfolio of customers, contract vehicles and past performance qualifications.

Customers

A representative list of Kratos' customers within the Kratos Government Solutions (KGS) segment during 2007 included the U.S. Air Force, U.S. Army, U.S. Navy, Missile Defense Agency, the Department of Homeland Security, NASA, FMS and the U.S. Southern Command. In the Kratos Public Safety and Security (PSS) segment, customers in 2007 included General Electric, Atlanta's Hartsfield-Jackson Airport, Lockheed Martin, the City of Houston, Texas, and the Toyota Center.

Employees

As of December 31, 2007, including the employees from the Haverstick Consulting acquisition, Kratos employed approximately 1,500 full-time, part-time and on-call employees. Kratos has one collective bargaining unit of approximately 22 employees which is represented by the International Association of Machinists & Aerospace Workers, AFL-CIO, White Sands Local Lodge 2515, Alamogordo, New Mexico.

Description of Properties

Kratos' principal executive offices for all business segments are located in approximately 93,000 square feet of office space in San Diego, California. The lease for such space expires in April 2010. Other corporate resource offices are located in the following locations: Washington, D.C.; Marietta, Georgia; Newport, Delaware; Houston, Texas; Huntsville, Alabama; Alexandria, Virginia; and Indianapolis, Indiana. Kratos also leases office space to provide local support services to its customers in various regions throughout the United States. The leases on these spaces expire at various times through August 2016. Kratos continually evaluates its current and future space capacity in relation to current and projected future staffing levels. Kratos believes that its existing facilities are suitable and adequate to meet its current business requirements.

Legal Proceedings

IPO Securities Litigation

Beginning in June 2001, Wireless Facilities, Inc. ("WFI") and certain of its officers and directors were named as defendants in several parallel class action stockholder complaints filed in the United States District Court for the Southern District of New York, now consolidated under the caption, In re Wireless Facilities, Inc. Initial Public Offering Securities Litigation, Case No. 01-CV-4779. In the amended complaint, the plaintiffs allege that Kratos, certain of its officers and directors, and the underwriters of its initial public offering ("IPO") violated section 11 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934 based on allegations that its registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of other public companies ("Issuers") that conducted IPOs of their common stock in the late 1990s and 2000 (the "IPO Cases").

In July 2002, certain defendants, including WFI, moved to dismiss the amended complaints. The court denied the motions to dismiss the Section 11 claims as to virtually all the defendants in the consolidated actions, including WFI. The court, however, dismissed the Section 10(b) claims against WFI. In addition, the named WFI officers and directors entered into tolling agreements and, pursuant to a court order dated October 9, 2002, were dismissed from the litigation without prejudice. In June 2004, the Issuers (including WFI) executed a settlement agreement with the plaintiffs that would, among other things, result in the dismissal with prejudice of all claims against the Issuers and their officers and directors and the assignment of certain potential Issuer claims to the plaintiffs. On February 15, 2005, the court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. On February 24, 2006, the court dismissed litigation filed against certain underwriters in connection with certain claims to be assigned under the settlement. On April 24, 2006, the court held a Final Fairness Hearing to determine whether to grant final approval of the settlement. While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The court directed that the litigation proceed within "focus cases" rather than in all of the approximately 300 cases that have been consolidated. Kratos' case is not one of these focus cases. On December 5, 2006, the Second Circuit Court of Appeals vacated the lower court's earlier decision certifying as class actions the six "focus cases." Thereafter, the District Court ordered a stay of all proceedings in all of the IPO Cases pending the outcome of plaintiffs' petition to the Second Circuit for rehearing en banc and resolution of the class certification issue. On April 6, 2007, the Second Circuit denied plaintiffs' rehearing petition, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. Accordingly, the settlement was terminated pursuant to stipulation and will not receive final approval.

Plaintiffs filed amended complaints in the six focus cases in August 2007. In September 2007, plaintiffs moved to certify the classes alleged in the focus cases and to appoint class representatives and class counsel in those cases. Certain focus case defendants filed motions to dismiss the claims against them in November 2007. The Court denied the motions to dismiss on March 26, 2008, except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. The class certification motion was withdrawn without prejudice on October 10, 2008. Due to the inherent uncertainties of litigation, the ultimate outcome of this matter is uncertain. In accordance with FASB No. 5, "Accounting for Contingencies," Kratos believes any contingent liability related to this claim is not probable or estimable and therefore no amounts have been accrued in regards to this matter.

2004 Securities Litigation

In August 2004, following Kratos' announcement on August 4, 2004 that it intended to restate its financial statements for the fiscal years ended December 31, 2000, 2001, 2002 and 2003, Kratos and certain of its current and former officers and directors were named as defendants ("Defendants") in several securities class action lawsuits filed in the United States District Court for the Southern District of California. These actions were filed on behalf of those who purchased, or otherwise acquired, Kratos' common stock between April 26, 2000 and August 4, 2004. The lawsuits generally allege that, during that time period, Defendants made false and misleading statements to the investing public about Kratos' business and financial results, causing its stock to trade at artificially inflated levels. Based on these allegations, the lawsuits allege that Defendants violated the Securities Exchange Act of 1934, and the plaintiffs seek unspecified damages. These actions have been consolidated into a single action In re Wireless Facilities, Inc. Securities Litigation, Master File No. 04CV1589-JAH. Plaintiffs filed a First Amended Consolidated Class Action Complaint on April 1, 2005. Defendants filed their motion to dismiss this first amended complaint on April 14, 2005. The plaintiffs then requested leave to amend their first amended complaint. The plaintiffs filed their Second Amended Complaint on June 9, 2005, this time on behalf of those who purchased, or otherwise acquired, Kratos' common stock between May 5, 2003 and August 4, 2004. Defendants filed their motion to dismiss this Second Amended Complaint on July 14, 2005. The motion to dismiss was taken under submission on October 20, 2005 and on March 8, 2006, the Court granted the Defendants' motion. However, plaintiffs were granted the right to amend their complaint within 45 days and subsequently filed their Third Amended Consolidated Class Action Complaint on April 24, 2006. Defendants filed a motion to dismiss this complaint on June 8, 2006. On May 7, 2007, the Court denied the Defendants' motion to dismiss. Defendants' filed their answer to the plaintiffs' complaint on July 13, 2007. In February 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. Under the tentative settlement, plaintiffs and the class will dismiss all claims, with prejudice, in exchange for a cash payment in the total amount of $12 million. Kratos' directors' and officers' liability insurers will pay the settlement amount in accordance with its insurance policies, less any applicable retention or co-insurance obligations that are expected to be paid directly by Kratos. Kratos estimates that the amount of its payment toward the settlement will be approximately $2.4 million. Kratos has accrued approximately $2.4 million as of September 28, 2008 related to this matter and paid $1.0 million in October 2008 from its restricted cash account. It expects to fund the remaining $2.0 million towards the settlement in the fourth quarter of 2008 and expects to receive $0.6 million from the insurance carriers for this payment in the first half of 2009.

In June 2008, the parties executed a Memorandum of Understanding documenting the essential terms of the proposed settlement and on August 8, 2008, the parties filed their joint motions for preliminary approval of the proposed settlement with the Court. The final fairness hearing on the proposed settlement is set for December 3, 2008. Kratos makes no assurances at this time that the Court will grant final approval of the proposed settlement terms or that the matter ultimately will be settled. Despite the pending settlement reached in this action, Kratos believes that the allegations lack merit.

In 2004, two derivative lawsuits were filed in the United States District Court for the Southern District of California against certain of Kratos' current and former officers and directors: Pedicini v. Wireless Facilities, Inc., Case No. 04CV1663; and Roth v. Wireless Facilities, Inc., Case No. 04CV1810. These actions were consolidated into a single action in In re Wireless Facilities, Inc. Derivative Litigation, Lead Case No 04CV1663-JAH. These lawsuits contain factual allegations that are substantially similar to those made in the class action lawsuits, but the plaintiffs in these lawsuits assert claims for breach of fiduciary duty, gross mismanagement, abuse of control, waste of corporate assets, violation of Sarbanes Oxley Act section 304, unjust enrichment and insider trading. The plaintiffs in these lawsuits seek unspecified damages and equitable and/or injunctive relief. The lead plaintiff filed a consolidated complaint on March 21, 2005. On May 3, 2005, the defendants filed motions to dismiss this action, to stay this action pending the resolution of the consolidated non-derivative securities case pending in the Southern District of California, and to dismiss the complaint against certain non-California resident defendants. Pursuant to a request by the Court, Defendants' motions were withdrawn without prejudice pending a decision on defendants' motion to dismiss the complaint against the non-California resident defendants. On March 20, 2007, the Court ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the federal derivative complaint. On March 27, 2007, plaintiffs filed an amended derivative complaint setting forth all of the same allegations from the original complaint and adding allegations regarding Kratos' stock option granting practices. Basically, plaintiffs allege that Kratos "backdated" or "springloaded" employee stock option grants so that the options were granted at less than fair market value. The amended complaint names all of the original defendants (including those dismissed for lack of jurisdiction) as well as nine new defendants. On July 2, 2007, the non-California resident defendants moved to dismiss the complaint for lack of personal jurisdiction. On October 17, 2007, the Court took the motion under submission without oral argument. On February 26, 2008, the Court again ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the amended federal derivative complaint. Plaintiffs subsequently moved the Court for certification and entry of final judgment of the Court's order dismissing the non-residents for lack of personal jurisdiction so that the plaintiffs may seek immediate appellate review of the matter. On July 10, 2008, the court granted plaintiffs' motion for certification, which was not opposed by defendants. On August 12, 2008, Plaintiffs filed a notice of appeal of the personal jurisdictional order. Plaintiff's opening brief on the matter is due on or before January 12, 2009, and Defendant's response is due February 11, 2009. A hearing date on the matter has not been set. The parties have conferred and discussed the Court's personal jurisdictional order and notice of appeal and have stipulated to a briefing schedule for any remaining motions to dismiss that Kratos, along with the individual defendants subject to the court's jurisdiction, may bring in an effort to dismiss the complaint as to them. Pursuant to the parties' stipulation, such motions must be brought on or before January 20, 2009. Kratos believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will have a material adverse effect on Kratos.

In April 2007, another derivative complaint was filed in the United States District Court for the Southern District of California, Hameed v. Tayebi, Case No. 07-CV-0680 BTM(RBB) (the "Hameed Action"), against several of Kratos' current and former officers and directors. The allegations in this derivative complaint mirrored the amended allegations in the 2004 federal derivative action. Pursuant to a Court order and agreement of the parties, the defendants' responses to the complaint in the Hameed Action were stayed until the Court ruled on the motion to dismiss for lack of personal jurisdiction in the 2004 derivative litigation. As noted above, on February 26, 2008, the Court ruled that it lacked personal jurisdiction over five of the non-California defendants named in the 2004 derivative action, including three that were also named in the Hameed Action. In August 2008, and before defendants had responded to the complaint, Plaintiff voluntarily dismissed the Hameed Action pursuant to Federal Rule of Civil Procedure 41(a). Kratos believes that the allegations lacked merit and intended to vigorously defend all claims asserted.

In August and September 2004, two virtually identical derivative lawsuits were filed in California Superior Court for San Diego County against certain of Kratos' current and former officers and directors. These actions contain factual allegations similar to those of the federal lawsuits, but the plaintiffs in these cases assert claims for violations of California's insider trading laws, breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiffs in these actions seek unspecified damages, equitable and/or injunctive relief and disgorgement of all profits, benefits and other compensation obtained by defendants. These lawsuits have been consolidated into one action In re Wireless Facilities, Inc. Derivative Litigation, California Superior Court, San Diego County, Lead Case No. GIC 834253. The plaintiffs filed a Consolidated Shareholder Derivative Complaint on October 14, 2004. This action has been stayed pending a decision in federal court on a motion to dismiss the federal derivative lawsuits. In October 2008, the parties notified the Court of the status of the federal action and the court continued the stay for an additional six months. The Court also ordered the parties to file an updated status report in April 2009. Kratos believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will have a material adverse effect on Kratos.

Kratos has recorded an accrual for a contingent liability associated with the legal proceedings related to the derivative actions of $0.7 million based on its estimate of the potential amount it would have to pay in relation to these lawsuits.

2007 Securities Litigation

In March and April 2007, there were three federal class actions filed in the United States District Court for the Southern District of California against Kratos and several of its current and former officers and directors. These class action lawsuits followed Kratos' March 12, 2007 public announcement that it was conducting a voluntary internal review of its stock option granting processes. These actions have been consolidated into a single action, In re Wireless Facilities, Inc. Securities Litigation II, Master File No. 07-CV-0482-BTM-NLS. The consolidated class action complaint was filed on November 19, 2007. In March 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. Under the settlement proposal, plaintiffs and the class will dismiss all claims, with prejudice, in exchange for a cash payment in the amount of $4.5 million. Kratos' directors' and officers' liability insurers will pay the settlement amount, less any applicable retention or co-insurance obligations and contributions that are expected to be paid directly by Kratos. In July 2008, Kratos paid $1.8 million related to the settlement of this litigation.

In May 2008, the parties executed a Memorandum of Understanding documenting the essential terms of the proposed settlement and on August 8, 2008, the parties filed their joint motions for preliminary approval of the proposed settlement with the Court. The final fairness hearing on the proposed settlement is set for December 3, 2008. Kratos makes no assurances at this time that the Court will grant final approval of the proposed settlement terms or that the matter ultimately will be settled. Despite the pending settlement reached in this action, Kratos believes that the allegations lack merit.

Other Litigation and Government Investigations

In January 2005, a former independent contractor of Kratos filed a lawsuit in Brazil against Kratos' subsidiary, WFI de Brazil, to which he had been assigned for a period of time. He sought to be designated an employee of WFI de Brazil and entitled to severance and related compensation pursuant to Brazilian labor law. The individual sought back wages, vacation pay, stock option compensation and related benefits in excess of $0.5 million. This matter was argued before the appropriate labor court in July 2005 and in July, 2006, the labor court awarded the individual the Brazilian currency equivalent of approximately $0.6 million for his back wages, vacation pay and certain other benefits. Kratos filed an appeal in the matter on July 20, 2006 and is challenging the basis for the award on several theories. On August 22, 2007, the appeals court partially upheld Kratos' appeal, although it upheld the individual's designation as an employee. The court is reviewing possible damage calculations before publishing a final decision. Kratos' counsel is preparing a motion for clarification of the judgment due to omissions in the decision. Kratos has accrued approximately $0.5 million as of September 28, 2008 related to this matter.

On March 28, 2007, three plaintiffs, on behalf of a purported class of similarly situated employees and contractors, filed a lawsuit against Kratos in the Superior Court of the State of California, Alameda County. The suit alleges various violations of the California Labor Code and seeks payments for allegedly unpaid straight time and overtime, meal period pay and associated penalties. Kratos and the plaintiffs agreed to venue for the suit in San Diego County. Although Kratos believes that the allegations lack merit, it agreed with the plaintiffs to settle their claims for an aggregate amount in the range of $0.3 million to $0.5 million, to include individual and incentive awards, attorneys' fees and administrative costs. On November 7, 2008, the Court signed the Preliminary Approval Order, approving the terms of the settlement, the Notice and Claim Form, and the appointment of a claims administrator, and set a date for the settlement hearing. The actual amount paid by Kratos will depend upon the number of responses received from members of the purported class of plaintiffs. Kratos has recorded an accrual for a contingent liability associated with this legal proceeding in the amount of $0.3 million.

On May 3, 2007, Kratos announced that it had a filed a lawsuit against a former employee who previously served as its stock option administrator and left Kratos in mid-2004, and his spouse. The lawsuit sought to recover damages resulting from the theft by a former employee of Kratos stock options and common stock valued in excess of $6.3 million. The thefts, which appear to have taken place during 2002 and 2003, were discovered through the Kratos review of its past practices related to the granting and pricing of employee stock options with the assistance of its outside counsel and forensic computer consultants. The complaint also alleged that the former employee attempted to cover up the scheme by, among other things, deleting entries from the records of Kratos.

Kratos promptly reported to the SEC the discovery of the theft. The SEC initiated an inquiry and commenced an enforcement action against the former employee. The U.S. Attorney's Office also forwarded a grand jury subpoena to Kratos seeking records related to the former employee and Kratos' historical option granting practices. The SEC filed a federal lawsuit and obtained a temporary restraining order and asset freeze against the former employee and his spouse. The U.S. Attorney's Office indicted him for the theft and he pled guilty to federal criminal charges and has been sentenced to 46 months in prison and currently is incarcerated. On April 1, 2008, the SEC notified Kratos that it had completed its investigation and that it did not intend to recommend any enforcement action by the SEC against Kratos. Kratos has cooperated with, and continue to cooperate with the U.S.Attorney's Office on this matter and otherwise. The former employee and his wife entered into a settlement agreement with Kratos on October 5, 2007, turning over substantially all of their assets to Kratos in settlement of the damages incurred in the theft. On February 15, 2008, the SEC approved the settlement. On February 19, 2008, the court entered a final judgment approving the settlement. Kratos has obtained the assets, which aggregate approximately $3.4 million, and is in the process of liquidating the remaining assets which approximate $0.1 million in value. In June 2008, Kratos' insurance carrier agreed to reimburse Kratos for $0.6 million related to the theft of stock options. In September 2008, Kratos' directors' and officers' liability insurers agreed to reimburse it for $1 million related to fees previously incurred on the ongoing investigation by the U.S. Attorney's Office. As a result, a benefit for this amount has been recorded in the recovery of unauthorized issuance of stock options and stock option investigation and related fees line item for the three and nine month periods ended September 28, 2008 in the accompanying Consolidated Statements of Operations.

In addition to the foregoing matters, from time to time, Kratos may become involved in various claims, lawsuits and legal proceedings that arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm its business. Kratos is currently not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse affect on its business, financial condition, operating results or cash flows.

In addition to the foregoing matters, from time to time, Kratos may become involved in various claims, lawsuits and legal proceedings that arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm Kratos' business. Kratos is currently not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse affect on its business, financial condition or operating results.

Market Price of and Dividends on Kratos' Common Equity and Related Stockholder Matters

Kratos' common stock has traded on the Nasdaq Global Select Market under the symbol "KTOS" since September 17, 2007. Kratos' common stock traded under the symbol "WFII" from November 5, 1999 through September 14, 2007. According to the records of Kratos' transfer agent, on November 25, 2008 there were approximately 469 stockholders of record of Kratos common stock. The following table sets forth the high and low sales prices for Kratos' common stock for the periods indicated as reported by the Nasdaq Global Select Market.

	High	Low
2008		
Third Quarter	$2.14	$1.33
Second Quarter	$2.05	$1.57
First Quarter	$2.35	$1.50
2007		
Fourth Quarter	$3.09	$1.80
Third Quarter	$2.85	$1.70
Second Quarter	$1.80	$1.01
First Quarter	$2.94	$1.20
2006		
Fourth Quarter	$2.98	$1.98
Third Quarter	$2.94	$1.85
Second Quarter	$4.53	$2.75
First Quarter	$5.56	$3.73

Dividends

Kratos has not declared any cash dividends since becoming a public company. Kratos currently intends to retain any future earnings to finance the growth and development of its business and, therefore, does not anticipate paying any cash dividends in the foreseeable future. In addition, Kratos' credit facility restricts its ability to pay dividends. Any future determination to pay cash dividends will be at the discretion of the Kratos board of directors and will be dependent upon the future financial condition, results of operations, capital requirements, general business conditions and other relevant factors as determined by the board of directors.

Equity Compensation Plan Information

Information about Kratos' equity compensation plans as of December 31, 2007 is as follows (shares in thousands):

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (excluding securities issued in column (a))
Equity Compensation Plans Approved by Stockholders(1)	7,019	$ 4.62	7,321(3)
Equity Compensation Plans Not Approved by Stockholders(2)	1,318	$ 4.86	2,110
Total	8,337		9,431

(1) Includes 1997 Stock Option Plan, 1999 and 2005 Equity Incentive Plan and 1999 Employee Stock Purchase Plan

(2) Includes 2000 Non-Statutory Stock Option Plan

(3) Includes 351,811 shares reserved for issuance under the Employee Stock Purchase Plan which was suspended in 2006.

For more detailed information regarding Kratos' equity compensation plans, see Note 10 to Kratos' Consolidated Financial Statements.

Management's Discussion and Analysis of Financial Condition and Results of Operations

This proxy statement/prospectus contains forward-looking statements. These statements relate to future events or Kratos' future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential" or "continue," the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially. Factors that may cause Kratos' results to differ include, but are not limited to: changes in the scope or timing of Kratos' projects; changes or cutbacks in spending or the appropriation of funding by the federal government of the U.S. Department of Defense, which could cause delays or cancellations of key government contracts; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; risks that the integration of Haverstick and SYS will prove more costly, take more time, or be more distracting than currently anticipated; risks of adverse regulatory action or litigation; risks associated with debt leverage; failure to obtain court approval of the proposed litigation settlement or to ultimately settle the litigation; failure to successfully consummate acquisitions or integrate acquired operations; and competition in the marketplace which could reduce revenues and profit margins.

Although Kratos believes that the expectations reflected in the forward-looking statements are reasonable, it cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither Kratos, nor any other person, assumes responsibility for the accuracy and completeness of the forward-looking statements. Kratos is under no obligation to update any of the forward-looking statements after the filing of this proxy statement/prospectus to conform such statements to actual results or to changes in Kratos' expectations.

Certain of the information set forth herein, including costs and expenses that exclude the impact of stock compensation expense and amortization costs of purchased intangibles in 2007 and 2008, may be considered non-GAAP financial measures. Kratos believes this information is useful to investors because it *provides a basis for measuring the operating performance of Kratos' business and cash flow, excluding the effect of stock compensation expense that would normally be included in the most directly comparable measures calculated and presented in accordance with GAAP. Kratos' management uses these non-GAAP financial measures along with the most directly comparable GAAP financial measures in evaluating its operating performance, capital resources and cash flow. Non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information presented in compliance with GAAP, and non-financial measures as reported by Kratos may not be comparable to similarly titled amounts reported by other companies.*

The following discussion should be read in conjunction with Kratos' unaudited consolidated financial statements and related notes, its audited consolidated financial statements and related notes for the year ended December 31, 2007 and other financial information appearing elsewhere in this proxy statement/prospectus. Readers are also urged to carefully review and consider the various disclosures made by Kratos which attempt to advise interested parties of the factors which affect its business, including without limitation the disclosures made under the caption "Risks Related to Kratos' Business," and in other reports and filings made with the Securities and Exchange Commission.

Overview

Kratos provides mission critical engineering, IT services and warfighter solutions to the U.S. government and government agencies, as well as to state and local agencies and commercial customers. Its principal services are related to, but are not limited to, Command, Control, Communications, Computing, Combat Systems Intelligence, Surveillance and Reconnaissance (C5ISR), weapon systems lifecycle support and extension, military range operations and technical services, missile, rocket and weapon test and evaluation, mission launch services, public safety, security and surveillance, advanced network engineering services and IT services, and critical infrastructure design and integration services. Kratos offers its customers solutions and expertise to support their mission-critical needs by leveraging its skills across these core service areas.

Historically, the majority of Kratos' business was concentrated in the area of wireless network services and its business operated in three reportable segments: Wireless Network Services, Government Network Services, and Enterprise Network Services. In 2006, it was an independent provider of outsourced engineering and network deployment services, security systems engineering and integration services and other technical services for the wireless communications industry, the U.S. government, and enterprise customers.

In 2006 and 2007, Kratos undertook a transformation strategy whereby it divested its wireless-related businesses and chose to pursue business with the federal government, primarily the U.S. Department of Defense, through strategic acquisitions and organic growth. It divested assets in its Wireless Network Services segment and renamed its Enterprise Network Services segment "Public Safety and Security". Today, under the new corporate name of Kratos Defense & Security Solutions, Inc., it is organized into two primary operating segments: Kratos Government Solutions (KGS) and Public Safety & Security (PSS).

The financial statements in this proxy statement/prospectus are presented in a manner consistent with Kratos' new operating structure. For additional information regarding its operating segments, see Note 11 of Notes to Consolidated Financial Statements for the quarter ended September 28, 2008. From a customer and solutions perspective, Kratos views its business as an integrated whole, leveraging its skills and assets wherever possible.

Kratos Government Solutions Segment (KGS)

The Kratos Government Solutions segment provides engineering, information technology and technical services to federal, state, and local government agencies, but primarily the U.S. Department of Defense (DoD). Kratos' work includes weapon systems lifecycle support and extension; C5ISR; military range operations and technical services; missile, rocket, and weapon systems test and evaluation; mission launch services; public safety and security services; advanced network engineering and information technology services; and public safety, security and surveillance systems integration. The KGS segment also focuses on the homeland security market with products and services aimed at supporting first responders.

Public Safety and Security Segment (PSS)

Kratos' Public Safety and Security segment provides system design, deployment, integration, monitoring and support services for public safety, security and surveillance networks for state and local governments and commercial customers. Public safety and security networks have been traditionally segregated into systems such as voice, data, access control, video surveillance, and temperature control and fire and life safety. Kratos provides services that combine such systems and offer integrated solutions on an Ethernet-based platform. It also offers solutions that combine voice, data, electronic security and building automation systems with fixed or wireless connectivity solutions. Kratos' target markets are retail, healthcare, education, sports and entertainment, municipal government, correctional facilities and other public facilities. Its commitments to these markets and its ability to provide feature-rich, cost-effective solutions have allowed it to become one of the larger independent integrators for these types of systems. Kratos maintains regional office locations, comprised of Kratos Mid-Atlantic, Kratos Southeast, and Kratos Southwest, where its is focused on security, surveillance and other building automation and integration services.

Divestiture of Wireless Network Business

On December 28, 2006, the Kratos board of directors approved a plan to divest portions of its business where critical mass had not been achieved. This plan involved the divestiture of its EMEA operations and its remaining South American operations. The EMEA operations were sold to LCC International, Inc. (LCC) on March 9, 2007 for $4.0 million in cash, $3.3 million of which was received on that date. Kratos also received approximately $1.8 million from its EMEA operations prior and subsequent to the closing date as payment on outstanding intercompany debt. The balance of the $0.7 million sales price was withheld as security for the satisfaction of certain indemnification obligations and was payable on March 31, 2008. Based upon Kratos' review of the most recently available financial statements of the buyer, as of December 31, 2007, Kratos had concern about their ability to pay this holdback, due to their available liquidity. Kratos recorded a reserve of $0.7 million for this receivable. In May 2008, it reached an agreement with LCC for the payment of the $0.7 million holdback amount, under which LCC agreed to pay the outstanding balance in $0.1 million increments each month commencing June 30, 2008. Kratos has not yet received any payments due according to the agreement. While it intends to vigorously pursue collection of the amounts, there is a substantial likelihood that it will not receive payment of the amount due, in light of LCC's apparent available liquidity amounts.

On April 20, 2007, Kratos entered into an Equity Purchase Agreement to sell all of the issued and outstanding equity of its interests of its wholly-owned subsidiary WFI de Brazil Techlogia en Telecommunications LTDA to Strategic Project Services, LLC (SPS). The consideration included the assumption of substantially all outstanding liabilities of WFI Brazil, nominal cash consideration, and additional earn-out consideration based on 25 percent of net receivables collected subsequent to the closing date. With respect to the additional earn-out consideration, Kratos has not received and does not anticipate receiving any payments.

On May 29, 2007, Kratos entered into an Asset Purchase Agreement with LCC International, Inc. for the sale of all of the assets used in the conduct of the operation of its engineering services business of its Wireless Network Services segment that provided engineering services to the non-government wireless communications industry in the United States, for aggregate consideration of $46 million. LCC delivered a subordinated promissory note for the principal amount of $21.6 million (the "Subordinated Promissory Note"), paid $17 million at closing and paid final working capital adjustments of $2.4 million through an amendment to the Subordinated Promissory Note. Kratos retained an estimated $5.0 million in net working capital. The transaction was completed on June 4, 2007. On July 5, 2007, Kratos sold the $21.6 million Subordinated Promissory Note to Silver Point Capital, L.P. ("Silver Point") in a transaction arranged by KeyBanc Capital Markets ("KeyBanc"). Kratos received approximately $19.6 million in net cash proceeds, reflecting a discount from par value of less than five percent and aggregate transaction fees of approximately $1 million, which includes a $0.75 million fee to KeyBanc, an affiliate of its lender. On January 30, 2008, Kratos received net proceeds of approximately $2.3 million on the working capital adjustment from Silver Point, net of a $0.1 million discount from par value. Kratos did not provide any guaranty for LCC's payment obligations under the note.

On July 7, 2007, Kratos entered into a definitive agreement with an affiliate of Platinum Equity to sell its deployment services business of its Wireless Network Services segment for total consideration payable of $24 million, including $18 million in cash at closing (subject to typical post closing working capital adjustments) and an aggregate $6 million in a three-year earn-out arrangement. Kratos also agreed to provide certain transition services for a period of six months. The assets sold to Platinum Equity included all of its wireless deployment business and the Wireless Facilities name. The transaction closed on July 24, 2007. As a result of these engineering and deployment services divestitures in 2007, the Wireless Network Services segment has been classified as a discontinued operation in this Quarterly Report and all prior year results presented herein have been reclassified to reflect these businesses as discontinued operations in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets".

On September 25, 2007, Kratos provided the working capital calculation to Platinum Equity, which indicated a working capital adjustment was due to Platinum Equity primarily due to cash collected on accounts receivables by Kratos prior to the close of the transaction that exceeded its previous estimate of working capital to be delivered to Platinum Equity. On July 16, 2008, Kratos came to an agreement with Platinum Equity on a working capital adjustment of $5.0 million. The adjustment is to be paid in installments with the first amount of $2.5 million due on July 31, 2008 and payments of $0.5 million monthly thereafter until paid in full in December 2008. Kratos did not make the scheduled $2.5 million payment due as of July 31, 2008. Payments of $1.0 million were made in August and September of 2008, respectively. As of September 28, 2008, the balance of $3.0 million plus accrued interest on the payments outstanding has been reflected in other current liabilities.

Recent Acquisitions

On December 31, 2007, Kratos completed its acquisition of Indianapolis, Indiana headquartered Haverstick Consulting, Inc. ("Haverstick") as part of its KGS segment. Haverstick provides rocket and missile test and evaluation, weapons systems support, and professional services to the U.S. Army, U.S. Air Force, U.S. Navy, NASA, and other federal, state and local agencies. Through the Haverstick acquisition, Kratos expanded its customer relationship within the DoD and enhanced its presence with the U.S. Air Force, a key growth area for Haverstick.

The total purchase price was $90.2 million including transaction costs incurred by Kratos of $0.5 million. The purchase price paid to Haverstick of $89.7 million was paid in a combination of $70.3 million of cash and common stock valued at $19.4 million. Kratos paid $66.7 million in cash at closing, $2.4 million in cash shortly thereafter and $12.0 million of common stock. In addition, $1.2 million in cash and $7.4 million in stock was held back to secure any negative working capital adjustments required by the merger agreement and its indemnity rights. The holdback consideration, which accrues interest in accordance with the terms of the agreement until paid, will be released on the

12th month and 21st month after the date of the acquisition. In addition to the indemnity holdback, the agreement also calls for a post closing working capital adjustment. To fund the acquisition, Kratos secured a new credit facility of $85.0 million arranged by KeyBanc Capital Markets. The credit facility, which includes a $25.0 million line of credit and $60.0 million in term notes, replaced its previous credit facility, which had an outstanding principal balance of $6.0 million on December 31, 2007.

In February 2008, Kratos and Haverstick agreed on the working capital calculation called for in the agreement. The calculation resulted in a working capital adjustment due to Haverstick in an amount of $1.5 million. The working capital adjustment was paid in April 2008 with 697,315 shares of common stock valued at $1.3 million and cash of $0.2 million.

Until the date on which the shares of stock became salable interest shall accrued on the value of the closing stock at a floating rate of one-month LIBOR plus four percent (4%) per annum. The shares became saleable on June 30, 2008 and 167,692 additional shares were issued in satisfaction of the accrued interest.

On June 28, 2008, Kratos completed its merger with SYS Technologies ("SYS"), a San Diego-based company. The merger enhances its position as a premier mid-tier federal, state and local government contractor in the United States in the areas of C5ISR, IT services and public safety and homeland security solutions. The merger creates a broad, complementary set of business offerings, and positions the company to deliver capabilities to a wider spectrum of customers.

Kratos issued 25.3 million shares to SYS shareholders in the merger, for a total purchase price of $55.2 million including direct transaction costs of $2.3 million. Each share of SYS common stock was converted into the right to receive 1.2582 shares of Kratos common stock in the merger. The value of the Kratos common stock issued in the merger was derived from the number of shares of Kratos common stock issued, or 25.3 million, at a price of $2.022 per share, the average closing price of Kratos shares of common stock for the two days prior to, including, and two days subsequent to the public announcement of the merger on February 21, 2008.

Key Financial Statement Concepts

As of September 28, 2008, Kratos consider the following factors to be important in understanding its financial statements.

Kratos Government Solutions' business with the U.S. government and prime contractors is generally performed under cost reimbursable, fixed-price or time and materials contracts. Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. Some cost reimbursable contracts include incentive fees that are awarded based on performance on the contract. Under fixed-price contracts, Kratos agrees to perform certain work for a fixed price. Under time and materials contracts, Kratos is reimbursed for labor hours at negotiated hourly billing rates and reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. Public Security and Safety contracts are primarily fixed-price contracts whereby revenue is recognized using the percentage-of-completion method of accounting under the provisions of Statement of Position (SOP) 81-1, "Accounting for Performance of Construction Type and Certain Production Type Contracts." For contracts offered on a time and material basis, Kratos recognizes revenues as services are performed.

Cost of revenues includes direct compensation, living, travel and benefit expenses for project-related personnel, payments to third-party subcontractors, cost of materials, project-related incentive compensation based upon the successful achievement of certain project performance goals, allocation of overhead costs and other direct project-related expenses. Selling, general and administrative expenses include compensation and benefits for corporate service employees and similar costs for billable employees whose time and expenses cannot be assigned to a project (underutilization costs), expendable computer software and equipment, facilities expenses and other operating expenses not directly related and/or allocated to projects. General and administrative costs include all corporate and administrative functions that support existing operations and provide infrastructure to facilitate its future growth. Additionally, its sales personnel and senior corporate executives have, as part of their compensation packages, periodic and annual bonus/commission incentives based on the attainment of specified performance goals.

Kratos considers the following factors when determining if collection of a receivable is reasonably assured: comprehensive collection history; results of its communications with customers; the current financial position of the customer; and the relevant economic conditions in the customer's country. If Kratos has had no prior experience with the customer, it reviews reports from various credit organizations to ensure that the customer has a history of paying its creditors in a reliable and effective manner. If the financial condition of its customers were to deteriorate, and adversely affect their financial ability to make payments, additional allowances would be required. Additionally, on certain contracts whereby Kratos performs services for a prime/general contractor, a specified percentage of the invoiced trade accounts receivable may be retained by the customer until Kratos completes the project. Kratos periodically reviews all retainages for collectibility and record allowances for doubtful accounts when deemed appropriate, based on its assessment of the associated risks.

Kratos believes that its Kratos Government Solutions segment will build and expand its customer relationships within the Department of Defense, Department of Homeland Security and other non-DoD state and local agencies by taking advantage of the significant opportunities for companies with substantial expertise in advanced engineering and information technology. Kratos believes it will experience continued growth in revenues and operating income from this operating segment. The acquisitions of Haverstick on December 31, 2007 and SYS on June 28, 2008 resulted in the addition of nearly 900 highly skilled technical professionals and engineers with expertise in the areas of military weapons and target range support as well as targets and missile operations and maintenance.

Balance Sheet Changes September 28, 2008 Compared to December 31, 2007

Total assets increased from $335.3 million as of December 31, 2007 to $382.8 million as of September 28, 2008. The primary changes are in accounts receivable and goodwill which are directly attributable to the acquisition of SYS. In addition, additional paid-in capital increased $54.1 million, again driven primarily by the SYS acquisition.

Comparison of Results for the Three Months Ended September 30, 2007 to the Three Months Ended September 28, 2008

Revenues. Revenues increased $34.0 million from $47.5 million for the three months ended September 30, 2007 to $81.5 million for the three months ended September 28, 2008. This increase was due to $20.6 million in revenues from Haverstick, which was acquired in December 2007 and $18.9 million in revenues from SYS, which was acquired on June 28, 2008, offset by decreased revenue of $3.1 million as a result of the impact of the conversion of its work as prime to subcontractor on one of its target range projects, which was recently recompeted and awarded to a small business. In addition, revenues in its KGS segment were also impacted by reductions in lower margin materials and subcontract work. Revenue in its PSS segment increased slightly from $12.7 million in the third quarter of 2007 to $13.0 million in the third quarter of 2008.

Revenues by operating segment for the three months ended September 30, 2007 and September 28, 2008 are as follows (in millions):

	2007	2008	$ change	% change
Government Solutions	$34.8	$68.5	$ 33.7	96.8%
Public Safety & Security	12.7	13.0	0.3	2.3%
Total revenues	$47.5	$81.5	$ 34.0	71.6%

As described in the section "Critical Accounting Principles and Estimates" and in the footnotes to Kratos' unaudited consolidated financial statements, a portion of Kratos' revenue is derived from fixed-price contracts whereby revenue is calculated using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. These estimates are reviewed monthly on a contract-by-contract basis, and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision. Significant management judgments and estimates, including the estimated costs to complete projects, which determine the project's percentage of completion, must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of Kratos' revenue for any period if management makes different judgments or utilizes different estimates. During the reporting periods contained herein, Kratos did experience revenue and margin adjustments of certain projects based on the aforementioned factors, but the effect of such adjustments, both positive and negative, when evaluated in total were determined to be immaterial to the consolidated financial statements.

Cost of Revenues. Cost of revenues increased from $39.3 million for the three months ended September 30, 2007 to $63.6 million for the three months ended September 28, 2008, primarily as a result of the increase in revenue related to the acquisitions of Haverstick and SYS. Gross margin increased from 17.3% to 22.0%, for the three months ended September 30, 2007 and September 28, 2008, respectively. The increase in gross margin primarily resulted from higher gross margins in Kratos' KGS segment as a result of the Haverstick and SYS acquisitions due to the mix of revenues as well as due to the classification of costs between cost of sales and SG&A in accordance with government accounting standards, as well as improved operational performance in the PSS segment, for which margins increased from 25.4% to 29.5% for the three month period ended September 30, 2007 and September 28, 2008, respectively.

Selling, General and Administrative Expenses. Selling, general and administrative expenses ("SG&A") increased from $8.9 million in the three months ended September 30, 2007 to $14.6 million in the three months ended September 28, 2008. As a percentage of revenues, SG&A decreased from 18.7% to 17.9% for the three month period ended September 30, 2007 and September 28, 2008, respectively, reflecting the impact of leverage from the SG&A infrastructure as revenues increased. The SG&A increase of $5.7 million was primarily a result of the Haverstick and SYS acquisitions. Included in SG&A for the three months ended September 30, 2007 and September 28, 2008 is amortization of purchased intangibles of $0.7 million and $1.3 million, respectively. Excluding the impact of the amortization of purchased intangibles, SG&A decreased from 17.3% to 16.3% for the three months ended September 30, 2007 and September 28, 2008, respectively.

Research and Development. Research and development expenses increased from zero for the three months ended September 30, 2007 to $1.0 million for the three months ended September 28, 2008 as a result of the SYS acquisition. These expenses relate to products that address the information connectivity needs of target customers in the information technology and PSS markets. Research, engineering and development expenses include burdened labor and material costs to develop new products as well as maintaining and enhancing Kratos' existing product capabilities. These expenses are primarily attributable to research and development as well as sustaining engineering related to network security and management product lines and IP video and data distribution product lines.

Impairment of Assets and Adjustments to the Liability for Unused Office Space. Costs related to the impairment of assets and adjustments to the liability for unused office space decreased from $1.2 million in the three months ended September 30, 2007 to $0.3 million in the three months ended September 28, 2008. The costs in the third quarter of 2007 of $1.2 million were comprised of $0.8 million for an excess facility accrual for obligations under facility leases that were unfavorably impacted by Kratos' divestitures of its wireless network services businesses which resulted in unused office space, $0.2 million related to the impairment of leasehold improvements for these facilities and $0.2 million related to an impairment of fixed assets. The costs in the third quarter of 2008 of $0.3 million are comprised of the write-off of fees related to Kratos' withdrawal of its Form S-3 and S-4 shelf registration statements, which will no longer be able to be used as a result of a change in regulations, partially offset by a favorable adjustment to its unused office space accrual as the result of a sublease of additional space at its corporate office.

Recovery of Unauthorized Issuance of Stock Options and Stock Option Investigation and Related Fees. Costs related to the recovery of unauthorized issuance of stock options and stock option investigation and related fees decreased from an expense of $6.5 million in the three months ended September 30, 2007 to a benefit of $1.0 million in the three months ended September 28, 2008. The costs in the third quarter of 2007 of $6.5 million were comprised of legal, accountant and other professional fees related to Kratos' equity award review, which was completed in September 2007, and the government inquiries by the Department of Justice and recently completed inquiries by the SEC. In September 2008, Kratos' directors' and officers' liability insurers agreed to reimburse Kratos for $1.0 million related to fees previously incurred on the ongoing investigation by the U.S. Attorney's Office which has been recorded as a credit in the three month period ended September 28, 2008.

Other Income (Expense), Net. Net other income (expense) decreased from income of $0.1 million to an expense of $2.9 million for the three months ended September 30, 2007 and September 28, 2008, respectively.

Other income for the three months ended September 30, 2007 was primarily related to the sale of assets. Total interest expense related to Kratos' prior credit facility for the three months ended September 30, 2007 was $0.1 million. In accordance with EITF 87-24, Allocation of Interest to Discontinued Operations, interest expense on the debt of $0.1 million for the three months ended September 30, 2007 that was required to be repaid as a result of the sales of Kratos' Wireless Network Services business was allocated to discontinued operations for the periods presented. See Note 6 to the financial statements included elsewhere herein.

For the three months ended September 29, 2008, Kratos incurred interest expense of $2.7 million primarily as a result of borrowings on its credit facility for the Haverstick acquisition. In addition, other expense of $0.2 million was recorded to reflect primarily marking to market Kratos' $70 million derivative financial instruments it entered into to reduce its exposure to variable rates on its outstanding debt.

Provision for Income Taxes. Provision for income taxes increased from a provision of $0.4 million or a negative 4.8% rate on a loss before income taxes of $8.3 million in the third quarter of 2007, to a provision of $0.5 million, or 500% on income before income taxes of $0.1 million. The tax provision in the third quarter of 2007 and 2008 were primarily due to an increase in the deferred tax liability related to temporary differences on indefinite life intangibles that were not offset by deferred tax assets due to the full valuation allowance Kratos has recorded on these assets, plus certain state taxes.

Income (loss) from Discontinued Operations. Loss from discontinued operations decreased from $4.7 million for the three months ended September 30, 2007 to income $0.2 million for the three months ended September 28, 2008. The loss in 2007 was primarily due to a loss on disposal of $1.9 million on the sale of the Wireless Deployment Services business operations in the third quarter of 2007 as well as a charge for excess facility accrual of approximately $1.1 million related to certain facility leases of deployment field offices that were not assumed by the buyer. Revenues and operating income (loss) generated by these businesses in the third quarter of 2007, excluding the loss on sale of deployment and the charge for the excess facility accrual, through the date of divestiture and quarter end, were approximately $6.1 million and operating loss of $1.4 million, respectively. For the three months ended September 28, 2008, Kratos had no income before tax and a tax benefit of $0.2 million related to foreign exchange adjustments netted with interest accrued for certain foreign tax contingencies.

Comparison of Results for the Nine Months Ended September 30, 2007 to the Nine Months Ended September 28, 2008

Revenues. Revenues increased 53.8% from $144.3 million for the nine months ended September 30, 2007 to $222.0 million for the nine months ended September 28, 2008, offset by decreased revenue of $3.1 million as a result of the impact of the conversion of its work as prime to subcontractor on one of its target range projects, which was recently recompeted and awarded to a small business. In addition, revenues in its Government Solutions segment was also impacted by reductions in lower margin materials and subcontract work. Revenue growth in its PSS segment of $2.5 million was primarily related to an increase in facility automation and security projects performed over the prior year in its mid-Atlantic and southwest markets.

Revenues by operating segment for the nine months ended September 30, 2007 and September 28, 2008 are as follows (in millions):

	2007	**2008**	**$ change**	**% change**
Government Solutions	$107.4	$182.6	$ 75.2	70.0%
Public Safety & Security	36.9	39.4	2.5	6.8%
Total revenues	$144.3	$222.0	$ 77.7	53.8%

As described in the section "Critical Accounting Principles and Estimates" and in the footnotes to its unaudited consolidated financial statements, a portion of Kratos' revenue is derived from fixed-price contracts whereby revenue is calculated using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. These estimates are reviewed monthly on a contract-by-contract basis, and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision. Significant management judgments and estimates, including the estimated costs to complete projects, which determine the project's percent complete, must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of its revenue for any period if management makes different judgments or utilizes different estimates. During the reporting periods contained herein, Kratos did experience revenue and margin adjustments of certain projects based on the aforementioned factors, but the effect of such adjustments, both positive and negative, when evaluated in total were determined to be immaterial to the consolidated financial statements.

Cost of Revenues. Cost of revenues increased from $121.3 million for the nine months ended September 30, 2007 to $178.6 million for the nine months ended September 28, 2008, primarily due to the corresponding aforementioned increase in total revenues related to the Haverstick and SYS acquisitions. Gross margin increased from 15.9% of total revenues for the nine months ended September 30, 2007 to 19.5% for the same period in 2008. The increase in gross margin resulted primarily from increased margins in the Government Solutions segment from the Haverstick and SYS acquisitions due to the mix of revenues as well as due to the classification of costs between cost of sales and SG&A in accordance with government accounting standards, as well as improved operational performance in the PSS segment, for which margins increased from 21.1% to 27.2% for the nine month periods ended September 30, 2007 and September 28, 2008, respectively.

Selling, General and Administrative Expenses. Selling, general and administrative expenses ("SG&A") increased from $28.8 million for the nine months ended September 30, 2007 to $37.7 million for the nine months ended September 28, 2008, primarily reflecting SG&A of $15.5 million incurred by Haverstick and SYS offset by a reduction of $6.6 million related to cost reductions that occurred after the sale of Kratos' legacy wireless business in 2007. Included in the SG&A for the nine months of 2007 and 2008 is amortization of purchased intangibles of $2.1 million and $3.6 million, respectively. The increase in amortization year over year is primarily a result of the Haverstick and SYS acquisitions. As a percentage of revenues, SG&A decreased from 20.0% in the first nine months of 2007 to 17.0% in the first nine months of 2008, reflecting the leverage of its SG&A infrastructure with increased revenues. Excluding the impact of the amortization of purchased intangibles, SG&A decreased from 18.5% to 15.4% of revenues for the first nine months of 2007 and 2008, respectively.

Research and Development. Research and development expenses increased from zero for the nine months ended September 30, 2007 to $1.0 million for the nine months ended September 28, 2008 as a result of the SYS acquisition. These expenses relate to products that address the information connectivity needs of target customers in the information technology and PSS markets. Research, engineering and development expenses include burdened labor and material costs to develop new products as well as maintaining and enhancing Kratos' existing product capabilities. These expenses are primarily attributable to research and development as well as sustaining engineering related to network security and management product lines and IP video and data distribution product lines.

Impairment of Assets and Adjustments to the Liability for Unused Office Space. Costs related to the impairment of assets and adjustments to the liability for unused office space decreased from $1.2 million in the nine months ended September 30, 2007 to a benefit $0.3 million in the nine months ended September 28, 2008. The costs in the nine months ended September 30, 2007 of $1.2 million were comprised of $0.8 million for an excess facility accrual for obligations under facility leases that were unfavorably impacted by the divestitures of its Wireless Network Services business which resulted in unused office space, $0.2 million related to the impairment of leasehold improvements for these facilities and $0.2 million related to an impairment of fixed assets. The benefit in the nine months ended September 28, 2008 of $0.3 million is primarily a result of a change in estimate of excess facility accrual for obligations under facility leases. As a result of the SYS acquisition, Kratos determined that a portion of its corporate facility will be used commencing in the third quarter of 2008. This was partially offset by a write-off of fees related to the withdrawal of Form S-3 and S-4 registration statements that will no longer be able to be used as a result of changes in regulations.

Recovery of Unauthorized Issuance of Stock Options and Stock Option Investigation and Related Fees. Costs related to the recovery of unauthorized issuance of stock options and stock option investigation and related fees decreased from an expense of $13.0 million in the nine months ended September 30, 2007 to a benefit of $1.6 million in the nine months ended September 28, 2008. The costs in the nine months ended September 30, 2007 of $13.0 million were comprised of legal, accountant and other professional fees related to Kratos' equity award review which was completed in September 2007 and the government inquiries by the Department of Justice and recently completed inquiries by the SEC. The benefit of $1.6 million in the nine months ended September 28, 2008 is a result of insurance carriers agreeing to reimburse Kratos for costs previously expensed. In June 2008, Kratos' insurance carrier agreed to reimburse it for $0.6 million related to the theft of stock options. In September 2008, Kratos' directors' and officers' liability insurers agreed to reimburse it for $1.0 million related to fees previously incurred on the ongoing investigation by the U.S. Attorney's Office.

Other Income (Expense), Net. Net other income (expense) decreased from $0.8 million of income to $6.7 million of expense for the nine months ended September 30, 2007 and September 28, 2008, respectively. The year over year change from income to expense was primarily driven by increased interest expense for the nine months ended September 28, 2008.

Other income for the nine months ended September 30, 2007 was primarily related to the sale of assets. Total interest expense related to Kratos' prior credit facility for the nine months ended September 30, 2007 was $2.2 million. In accordance with EITF 87-24, Allocation of Interest to Discontinued Operations, interest expense on the debt of $2.2 million for the nine months ended September 30, 2007 that was required to be repaid as a result of the sales of the wireless network services business was allocated to discontinued operations for the periods presented. See Note 6, Significant Transactions.

For the nine months ended September 28, 2008, Kratos incurred interest expense of $7.5 million primarily as a result of borrowings on its Credit Facility for the Haverstick acquisition. This was partially offset by other income of $0.8 million. The other income was related to $0.4 million in income as a result of marking to market its $70 million derivative financial instruments entered into to reduce its exposure to variable rates on its outstanding debt and $0.4 million related to the sale of assets.

Provision (benefit) for Income Taxes. Kratos' effective income tax rate for the nine months ended September 30, 2007 was a negative 4.7% provision rate, or a $0.9 million provision on a loss before taxes of $19.2 million, compared to a negative 1,400% provision rate for the nine months ended September 28, 2008, or a $1.4 million provision on a loss before taxes of $0.1 million. The tax provisions in 2007 and 2008 were primarily due to an increase in the deferred tax liability related to temporary differences on indefinite life intangibles that were not offset by deferred tax assets due to the full valuation allowance Kratos has recorded on these assets, plus certain state taxes. The negative tax provision of 1,400% in the nine months ended September 28, 2008 is a function of the relationship between certain minimum taxes that Kratos is subject to regardless of its reported book income. It is anticipated that as pretax income increases, the tax rate will decrease substantially as these minimum taxes become a smaller percentage of pretax income.

Income (loss) from Discontinued Operations. Loss from discontinued operations changed from a loss of $9.2 million for the nine months ended September 30, 2007 to $0.2 million of income for the nine months ended September 28, 2008. In 2007, the loss was primarily due to impairment of assets related to the wireless deployment business of $13.4 million and an impairment of goodwill related to this business of $7.2 million recorded in the first quarter of 2007 and the $1.9 million loss from disposal of the deployment business and the $1.1 million excess facility accrual recorded in the third quarter of 2007, all partially offset by a gain of $14.8 million on the sale of the Wireless Engineering Services business operations in the second quarter of 2007 and a gain of $3.3 million on the sale of the EMEA business in the first quarter of 2007. Revenues and operating income (loss) generated by these businesses in the first nine months of 2007, through the date of divestiture for these businesses, excluding the impairment of assets and gains on sales were approximately $85.7 million and an operating loss of $4.5 million, respectively. In 2008, Kratos recognized a tax benefit of $1.1 million primarily related to the expiration of the statute of limitations for certain foreign tax contingencies. This benefit was offset partially by an impairment charge related to retained assets and liabilities from the sale and discontinuance of these operations as well as the settlement of the working capital adjustment with Platinum on the sale of the deployment business.

As of September 28, 2008, Kratos' backlog was approximately $500.0 million, of which $156.0 million was funded. Backlog is Kratos' estimate of the amount of revenue it expects to realize over the remaining life of awarded contracts and task orders that it has in hand as of the measurement date. Total backlog consists of funded and unfunded backlog. Kratos defines funded backlog as estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus its estimate of the future revenue it expects to realize from its commercial contracts that are under firm orders. Funded backlog does not include the full potential value of its contracts, because Congress often appropriates funds to be used by an agency for a particular program of a contract on a yearly of quarterly basis, even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriation and the procuring agency allocates funding to the contract.

Unfunded backlog reflects Kratos' estimate of future revenue under awarded government contracts and task orders for which either funding has not yet been appropriated or expenditure has not yet been authorized. Total backlog does not include estimates of revenue from government-wide acquisition contracts, or GWAC contracts, or General Services Administration, or GSA, schedules beyond awarded or funded task orders, but unfunded backlog does include estimates of revenue beyond awarded or funded task orders for other types of indefinite delivery, indefinite quantity, or ID/IQ, contracts, based on Kratos' experience under such contracts and similar contracts. Unfunded backlog also includes priced options, which consist of the aggregate contract revenues expected to be earned as a result of a customer exercising an option period that has been specifically defined in the original contract award.

Contracts undertaken by Kratos may extend beyond one year. Accordingly, portions are carried forward from one year to the next as part of backlog. Because many factors affect the scheduling of projects, no assurance can be given as to when revenue will be realized on projects included in its backlog. Although funded backlog represents only business which is considered to be firm, Kratos cannot guarantee that cancellations or scope adjustments will not occur. The majority of funded backlog represents contracts under the terms of which cancellation by the customer would entitle Kratos to all or a portion of its costs incurred and potential fees.

Management believes that year-to-year comparisons of backlog are not necessarily indicative of future revenues. The actual timing of receipt of revenues, if any, on projects included in backlog could change because many factors affect the scheduling of projects. In addition, cancellation or adjustments to contracts may occur. Backlog is typically subject to large variations from quarter to quarter as existing contracts are renewed of new contracts are awarded. Additionally, all United States government contracts included in backlog, whether or not funded, may be terminated at the convenience of the United States government.

Results of Operations related to the Year Ended December 31, 2007

Comparison of Results for the Year Ended December 31, 2006 to the Year Ended December 31, 2007

Revenues. Revenues by operating segment for the years ended December 31, 2006 and 2007 are as follows (in millions):

	2006	2007	$ change	% change
Public Safety & Security	$ 55.6	$ 51.1	$ (4.5)	(8.1)%
Government Solutions	97.5	142.5	45.0	46.2%
Total revenues	$153.1	$193.6	$ 40.5	26.5%

Revenues increased $40.5 million from $153.1 million in 2006 to $193.6 million in 2007, reflecting an increase of $45.0 million in the Government Solutions segment, primarily due to the acquisition of Madison Research Corporation, or MRC, in October 2006, which contributed $70.5 million in revenues in 2007 and $17.2 million in 2006. This increase of $53.3 million was partially offset by decreases due to the reduction of one program with annualized revenues of nearly $5.7 million that was consolidated by one of Kratos' federal government customers as well as, to a lesser degree, other program delays and losses resulting in reduced revenues of $2.6 million in other businesses within Kratos' Government Solutions segment. Reductions in Kratos' Public Safety & Security segment of $4.5 million were primarily related to the exit of the municipal wireless business in the first quarter of 2007.

As described in the section "Critical Accounting Principles and Estimates" and in the footnotes to Kratos audited consolidated financial statements, a portion of its revenue is derived from fixed-price contracts whereby revenue is calculated using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. These estimates are reviewed monthly on a contract-by-contract basis, and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision. Significant management judgments and estimates, including the estimated costs to complete projects, which determine the project's percent complete, must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of revenue for any period if management makes different judgments or utilizes different estimates. During the reporting periods contained herein, Kratos did experience revenue and margin adjustments of certain projects based on the aforementioned factors, but the effect of such adjustments, both positive and negative, when evaluated in total were determined to be immaterial to the consolidated financial statements.

Cost of Revenues. Cost of revenues increased $37.8 million or 30.4% from $124.2 million for the year ended December 31, 2006 to $162.0 million for the year ended December 31, 2007 primarily due to the increase in total revenues. The increase was primarily attributable to cost of revenues of approximately $14.6 million related to the MRC acquisition, offset by decreases in cost of revenues as a result of the reduced revenues in the PSS segment discussed above. Gross margin during the year ended December 31, 2007 of 16.3% decreased from a 2006 gross margin of 18.9%. The decrease in gross margin primarily resulted from a change in the mix of Government Services revenue versus Public Safety & Security revenue.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 2.6% from $38.5 million to $39.5 million for the years ended December 31, 2006 and 2007, respectively. The increase of $1.0 million is primarily due to an increase in costs reflecting the acquisition of MRC and an increase in external consulting and professional fees, such as legal and accounting, partially offset by a reduction in stock compensation expense of $4.9 million from 2006, which decreased from $5.9 million in 2006 to $1.0 million in 2007. Included in the selling, general and administrative expenses (SG&A) for 2006 and 2007 is amortization of purchased intangibles of $2.0 million and $2.8 million, respectively. The increase in amortization year over year is also a result of the MRC acquisition. As a percentage of revenues, selling, general and administrative expenses decreased from 25.1% in 2006 to 20.4% in 2007. Excluding the impact of the amortization of purchased intangibles and stock compensation expense, SG&A decreased from 20.0% to 19.0% of revenues for 2006 and 2007, respectively.

Stock Option Investigation, Related Fees and Recoveries. In the summer of 2006, Kratos' current executive management team, which has been in place since 2004, initiated an investigation of Kratos' past stock option granting practices, referred to as the Equity Award Review, in reaction to media reports regarding stock option granting practices of public companies. Kratos' 2007 costs of $10.6 million included $14.0 million in legal, accounting and other professional fees related to its Equity Award Review which was completed in September 2007 and the ongoing government inquiries by the Department of Justice and the SEC. This amount was partially offset by $3.4 million related to the recovery of assets from Kratos' settlement with its former stock option administrator related to damages for the theft of Kratos' stock options and common stock which occurred in 2002 and 2003 and was discovered during Kratos' internal review of option granting practices. See "Legal Proceedings" on page 94 for a further discussion of these items.

Estimated Cost for Settlement of Securities Litigation. In March 2008, following a voluntary mediation of 2004 and 2007 securities litigation, the parties reached a tentative agreement to settle the class action. See "Certain Information About Kratos' Business Legal Proceedings" on page 99 for a further discussion of these items. Kratos has accrued an estimated $4.9 million related to its costs for the settlement of these litigations.

Contingent Acquisition Consideration and Restatement Fees. In September 2004, Kratos amended the purchase agreements related to two of the companies acquired in its ENS segment in 2003 to more accurately reflect the intent of the transactions, resulting in a rescission of the continuous employment clauses from the earn-out arrangements, for which Kratos recorded a $12.4 million accrual at that time. Kratos had $0.1 million in expense associated with contingent acquisition consideration based upon the final payments on these agreements in 2006. There were no charges incurred in 2007.

Impairment and Restructuring Charges. Impairment and restructuring charges decreased $20.6 million from $21.8 million in 2006 to $1.2 million in 2007. During 2006, Kratos recorded $21.8 million in impairment and restructuring charges as a result of a change in strategic focus of its PSS segment and a consolidation of its headquarter facilities, which included $18.3 million for goodwill impairment related to acquisitions made in the PSS segment. This was due in part to changes in the industry and the strategic focus, the impact of recent and future expected operating performance, as well as operational challenges from significant employee turnover that Kratos encountered after the completion of the earn-out periods in early 2006. The balance of the charge was related to an asset impairment of approximately $1.8 million, an unused facility charge of approximately $1.4 million related to facilities consolidation and severance costs associated with restructuring activities of approximately $0.3 million. The costs in 2007 of $1.2 million included $0.8 million for an excess facility accrual for obligations under facility leases with unused office space as a result of the recent divestitures of Kratos wireless network services businesses, $0.2 million related to the impairment of leasehold improvements for these facilities and $0.2 million related to an impairment of fixed assets.

Other Expense, Net. For the year ended December 31, 2006, net other expense was $0.9 million compared to net other expense of $2.3 million for the year ended December 31, 2007. The other expense in 2006 was due to interest income on the note receivable relating to the sale of Kratos' Mexican subsidiary and interest expense for the borrowings on the line of credit used to fund the acquisition of MRC in October 2006. In 2007, in accordance with EITF 87-24, *Allocation of Interest to Discontinued Operations*, interest expense on the debt of $2.2 million that was required to be repaid as a result of the sales of Kratos' wireless network services business was allocated to discontinued operations for the periods presented. See Note 4 of Notes to Consolidated Financial Statements of this proxy statement/prospectus. Consequently, in 2007 the interest cost for the line of credit borrowings used to fund the MRC acquisition was primarily allocated to discontinued operations. The net other expense of $2.3 million in 2007 was primarily attributable to approximately $1.8 million of an impairment charge, recorded in the fourth quarter of 2007, related to the carrying value of investments to fair value as well as $1.2 million of interest expense incurred on Kratos' credit facility.

Provision (benefit) for Income Taxes. Kratos' effective income tax rate for the year ended December 31, 2006 represented a negative 43% income tax provision compared to a negative 5% income tax provision for the year ended December 31, 2007. The tax provision of $13.8 million for the year ended December 31, 2006 included an increase to the valuation allowance of $15.9 million against the deferred tax assets. The tax provision for the year ended December 31, 2007 included an increase to the valuation allowance of $9.8 million against the deferred tax assets.

Income (Loss) from Discontinued Operations. Loss from discontinued operations increased from a loss of $11.7 million in 2006 to a loss of $12.6 million during 2007. The increase was primarily due to the impairment of assets related to the wireless deployment business of $13.4 million, an impairment of goodwill of $7.2 million related to this business, a $1.9 million loss from the disposal of Kratos' deployment business and a $1.1 million excess facility accrual. These charges were all partially offset by a gain of $14.8 million on the sale of the wireless engineering services business operations and a gain of $2.6 million on the sale of the EMEA business. Revenues and net loss before taxes generated by these businesses in 2006 were approximately $201.7 million and $9.8 million, respectively, compared to $85.7 million and $12.7 million, respectively, in 2007. The decrease year over year was impacted by the divestitures of the wireless network services businesses in 2007. See Note 4 to the Notes to the Consolidated Financial Statements for further discussion of these transactions.

Comparison of Results for the Year Ended December 31, 2005 to the Year Ended December 31, 2006

Revenues. Revenues by operating segment for the years ended December 31, 2005 and 2006 are as follows (in millions):

	2005	2006	$ change	% change
Public Safety & Security	$ 67.3	55.6	(11.7)	(17.4)%
Government Solutions	85.0	97.5	12.5	14.7%
Total revenues	$ 152.3	$ 153.1	$ 0.8	0.1%

Revenues increased $0.8 or 0.1% from $152.3 million in 2005 to $153.1 million in 2006. The increase in revenues included an increase of $12.5 million in Kratos' Government Solutions segment, substantially offset by reduced revenue in Kratos' Public Safety & Security segment.

The decreased revenues in the PSS segment of $11.7 million from 2005 to 2006 was primarily a result of significant employee turnover, particularly management sales and business development personnel, that occurred in Kratos' Atlanta and Houston offices following the completion of the three year acquisition earn-out periods at the beginning of 2006. The increased revenue in the Government Solutions segment is a result of the acquisition of MRC in the fourth quarter of 2006, which contributed $17.6 million in revenues in 2006, offset partially by decreases due to program delays and program reductions from two of Kratos' DoD customers.

Cost of Revenues. Cost of revenues increased $8.5 million or 7.3% from $115.7 million for the year ended December 31, 2005 to $124.2 million for the year ended December 31, 2006. Gross margin during the year ended December 31, 2005 of 24.0% decreased to a gross margin of 18.9% for the year ended December 31, 2006. The increase in cost of revenues was partially attributable to cost of revenues of approximately $14.6 million related to the MRC acquisition. The decrease in gross margins resulted from an increased mix of government network services business, which generally reports the classification of cost elements based upon definitions in accordance with government contracting regulations. As a result, cost of revenues in the 2006 periods includes certain cost elements that would otherwise be classified as SG&A expense under a commercial contract arrangement. In addition, the overall decrease in gross margin percentage was partially attributable to a stock-based compensation expense of $0.9 million in 2006 related to Kratos' adoption of SFAS No. 123(R) in January 2006, compared to $0.0 million in 2005 and the impact of cost overruns in the PSS sector as a result of employee and management turnover that occurred following the completion of the earn-out periods in early 2006.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 8.5% from $35.5 million to $38.5 million for the years ended December 31, 2005 and 2006, respectively. As a percentage of revenues, selling, general and administrative increased from 23.3% in 2005 to 25.1% in 2006. The increase of $3.0 million is primarily due to the cost of stock-based compensation which was $5.9 million in 2006 or 3.9% of revenues versus $0.2 million, net of related tax adjustments, in 2005 or 0.1% of revenues partially offset by a reduction in consulting fees. Excluding the stock-based compensation expense, SG&A decreased from $35.3 million, or 23.2% of revenues, in 2005 to $32.6 million, or 21.3% of revenues, in 2006.

Contingent Acquisition Consideration and Restatement Fees. In September 2004, Kratos amended the purchase agreements related to two of the companies acquired in its ENS segment in 2003 to more accurately reflect the intent of the transactions, resulting in a rescission of the continuous employment clauses from the earn-out arrangements, for which Kratos recorded a $12.4 million accrual at that time. In September 2005, Kratos reduced $2.5 million of its contingent acquisition earn-out accruals that was determined to be excess based on the projected performance of the division compared to the minimum performance targets as defined in the earn-out arrangements. In December 2005, Kratos increased its contingent acquisition earn-out accruals by $0.4 million, to reflect the financial performance of one of the acquired entities that exceeded its previously projected performance. Kratos had $0.1 million in expense associated with contingent acquisition consideration based upon the final payments on these agreements in 2006.

Impairment and Restructuring Charges. During 2006, Kratos recorded $21.8 million in impairment and restructuring charges as a result of a change in strategic focus of its ENS segment and a consolidation of its headquarter facilities, which included $18.3 million for goodwill impairment related to acquisitions made in the ENS segment. This was due in part to changes in the industry and Kratos' strategic focus, the impact of recent and future expected operating performance, as well as operational challenges from significant employee turnover that it encountered after the completion of the earn-out periods in early 2006. The balance of the charge was related to an asset impairment of approximately $1.8 million, an unused facility charge of approximately $1.4 million related to facilities consolidation and severance costs associated with restructuring activities of approximately $0.3 million. No impairment or restructuring charges were incurred in 2005.

Other Income (Expense), Net. For the year ended December 31, 2005, net other income was $0.3 million compared to net other expense of $0.9 million for the year ended December 31, 2006. The increase in net other expense of $1.2 million was primarily due to the interest that was incurred on the KeyBank credit facility as a result of the MRC acquisition, partially offset by the interest income earned on the note receivable for the sale of Mexico.

Provision (benefit) for Income Taxes. Kratos' effective income tax rate for the year ended December 31, 2005 represented a 3% income tax benefit compared to a negative 43% income tax provision for the year ended December 31, 2006. The tax benefit of $0.1 million for the year ended December 31, 2005 included a decrease to the valuation allowance on deferred tax assets based upon Kratos' projections of taxable income for 2006, including the reversal of temporary differences. The reduction in the valuation allowance was primarily a result of Kratos' projected forecasts of 2006 taxable income, the estimated timing of reversal of temporary differences and the expected utilization of net operating loss carryforwards. In 2006, the income tax expense of $13.8 million is a result of an increase of $15.9 million in Kratos' valuation allowance for deferred tax assets.

Loss from Discontinued Operations. Loss from discontinued operations increased from a loss of $2.0 million in 2005 to a loss of $11.7 million during 2006. Included in the loss from discontinued operations of $2.0 million for the year ended December 31, 2005 is an approximate $5.0 million charge related to a write off of unrecoverable contract costs incurred on sites Kratos was building for its customers in Mexico and South America which were cancelled prior to the completion of the sites. Although Kratos was under contractual arrangement with these customers to build these sites, these costs were contractually unrecoverable from its customers due to the termination clauses in the contracts, which did not provide for reimbursement for in process cancelled sites, unless agreed upon by the customer. Also included in Kratos' loss from discontinued operation in 2005 is an impairment charge of $0.9 million related to accumulated foreign currency translation losses as well as a $4.4 million valuation allowance established against the deferred tax assets of Kratos' discontinued operations. Included in the loss from discontinued operations of $11.7 million for the year ended December 31, 2006 is an impairment charge of approximately $5.2 million to reduce the current carrying value of the South American operations to their estimated fair value based upon current indications of interest. Also included in Kratos' loss from discontinued operations in 2006 is an impairment charge of $1.7 million related to accumulated foreign currency translation losses. Revenues and net income (loss) before taxes generated by these businesses in 2005 were approximately $265.1 million and net income of $7.1 million, respectively, compared to $201.7 million and a net loss of $9.8 million, respectively, in 2006. The reduction in revenues in 2006 from 2005 reflects the sale of its Latin American operations in February 2006. See Note 4 to the Notes to the Consolidated Financial Statements for further discussion of these transactions.

Liquidity and Capital Resources

Kratos' sources of liquidity include cash and cash equivalents, cash from operations, its credit facility and other external sources of funds. As of September 28, 2008, Kratos had cash and cash equivalents totaling $2.5 million and restricted cash of $1.5 million primarily related to the requirement of its credit facility that it set aside 50% of the proceeds of the recovery amounts from the theft of stock options by its former stock option administrator to fund settlement amounts for its 2004 and 2007 securities litigation. As of December 31, 2007, Kratos had consolidated cash and cash equivalents of $8.6 million, consolidated long-term and short-term debt of $76.7 million, and consolidated stockholders equity of $167.2 million.

Kratos' operating cash flow is used to finance trade accounts receivable, fund ongoing litigation, governmental inquiries and settlements, fund capital expenditures and make strategic acquisitions. Financing trade accounts receivable is necessary because, on average, the customers and payers for Kratos' services do not pay it as quickly as it pays its vendors and employees for their goods and services, primarily due to contractual billing milestones that must be achieved to enable Kratos to bill its customers. Capital expenditures consist primarily of investment in computer hardware and software and improvement of physical properties in order to maintain suitable conditions to conduct Kratos' business.

Cash from continuing operations is primarily derived from customer contracts in progress and associated changes in working capital components. Cash used by continuing operations was $5.7 million for the nine months ended September 28, 2008 and provided by operations was $4.9 million for the nine months ended September 30, 2007. The change in cash used by continuing operations for the nine months ended September 28, 2008 is primarily the result of the funding requirements of the securities litigation settlements and the timing of payments to Kratos' subcontractors on projects for which it collects receivables on a milestone basis.

A summary of Kratos' net cash provided by operating activities from continuing operations from its consolidated statement of cash flows for fiscal years ended December 31, 2005, 2006 and 2007 is as follows (in millions):

	Years Ended December 31,		
	2005	**2006**	**2007**
Net cash used in operating activities of continuing operations	$(3.4)	$(3.9)	$(1.1)

Cash used in operating activities of continuing operations for 2007 decreased by $2.7 million from 2006 primarily due to a decrease in days sales outstanding from 109 days to 101 days, after adjustment for the MRC transaction in 2006 and the Haverstick transaction in 2007, partially offset by payment related to Kratos' internal stock option investigation, as well as the timing of payments of Kratos' expenses.

Cash provided by investing activities from continuing operations was $51.4 million for the nine months ended September 30, 2007 compared to cash used by investing activities of $3.4 million for the nine months ended September 28, 2008.

During the nine months ended September 30, 2007, investing activities included proceeds of $57.7 million from the disposition of discontinued operations, offset by capital expenditures of $1.1 million and cash paid of $6.2 million for contingent consideration of prior acquisitions.

During the nine months ended September 28, 2008, investing activities included the following:

Proceeds received of $2.3 million from the settlement of the working capital amount owed by LCC on the sale of Kratos' domestic engineering operations which was partially offset by cash paid of $2.0 million to Platinum Equity in partial settlement of the working capital adjustment for the sale of the wireless deployment business.

Payments of $1.8 million, net of cash acquired, related to the Haverstick and SYS acquisitions consisting of primarily transaction related expenses. Additional transaction costs related to the SYS acquisition will be paid in the last quarter of this year. See Notes 6 and 7 to Kratos' unaudited consolidated financial statements for further discussion of its acquisitions and divestitures.

An increase in payments of $1.5 million in Kratos' restricted cash accounts. As a result of the first amendment to Kratos' credit facility in March 2008, it is required to set aside proceeds from the recovery of the theft of stock options in a restricted account to fund the legal settlements related to its securities litigations. During 2008, Kratos funded this account with $2.2 million related to recoveries on the theft and in July 2008, it used $1.2 million of these funds to pay a portion of the $1.8 million related to the 2007 securities litigation settlement. The balance of the increase in restricted cash of $0.5 million is related to cash Kratos is required to maintain in a restricted account related to its worker's compensation self insurance and employee travel card programs. See Note 8 to Kratos' unaudited consolidated financial statements for further discussion of the first amendment to the Credit Facility.

Capital expenditures of $0.7 million and proceeds of the sale of investments $0.3 million.

Cash used in investing activities from continuing operations for the fiscal years ended December 31, 2005, 2006 and 2007 are summarized as follows (in millions):

	2005	2006	2007
Investing activities:			
Sale/maturity of short-term investments	$ 7.6	$	$
Cash paid for contingent acquisition consideration	(17.1)	(8.5)	(8.9)
Cash paid for acquisitions, net of cash acquired	(33.6)	(59.1)	(63.9)
Proceeds from the disposition of discontinued operations		18.9	57.3
Cash transferred from (to) restricted cash		(1.0)	1.0
Capital expenditures	(4.0)	(1.2)	(0.9)
Net cash used in investing activities from continuing operations	$(47.1)	$(50.9)	$(15.4)

Cash paid for acquisitions and contingent acquisition consideration accounted for the most significant outlays for investing activities in each of the three years from 2005 to 2007 as a result of the implementation of Kratos' strategies to diversify its business while focusing on its core competencies. These acquisitions included Haverstick in 2007, MRC in 2006, and TLA in 2005.

Investing activities in 2006 and 2007 also included proceeds of $18.9 million and $57.3 million respectively, directly attributable to the sale of Kratos' wireless discontinued operations.

Capital expenditures consist primarily of investment in computer hardware and software and improvement of Kratos' physical properties in order to maintain suitable conditions to conduct its business.

Cash used in financing activities from continuing operations was $50.4 million for the nine months ended September 30, 2007 and cash provided by financing activities from continuing operations was $3.8 million for the nine months ended September 28, 2008. In 2007, borrowings of $8.0 million under the line of credit were offset by payments of $58.0 million under the line of credit as a result of cash received from the sale of the wireless businesses that was required to be used to reduce debt on Kratos' prior credit facility. The positive cash flow from financing activities for the 2008 period consisted primarily of $6.0 million of borrowings from Kratos' revolver offset by required repayments on its term notes of $2.0 million.

Cash used by discontinued operations was $5.1 million and $0.8 million for the nine months ended September 30, 2007 and 2008, respectively. The decrease was primarily a result of the sale of these operations in 2007.

Cash provided by financing activities from continuing operations for the fiscal years ended December 31, 2005, 2006 and 2007 are summarized as follows (in millions):

	2005	2006	2007
Financing activities:			
Proceeds from issuance of common stock	$ 0.1	$ 0.4	$
Proceeds from issuance of common stock under employee stock purchase plan	0.8		
Borrowings under credit facility and line of credit		85.0	88.5
Repayment under line of credit		(34.0)	(64.0)
Repayment of capital lease obligations	(0.4)	(0.3)	(0.4)
Debt issuance costs	(0.3)	(1.2)	(3.0)
Net cash provided by financing activities from continuing operations	$ 0.2	$ 49.9	$ 21.1

In 2005, Kratos entered into a $15 million credit facility with KeyBank N.A., or KeyBank, for general working capital requirements and to fund future acquisitions. Kratos did not draw on this facility until 2006 and in October 2006 Kratos replaced this facility with an $85 million facility from KeyBank to fund the acquisition of MRC. During 2007, Kratos entered into two amendments to its credit facility, one in March and the other in June, which reduced the total facility to $35 million as a result of the divestitures of its wireless network services businesses. In December 2007, Kratos successfully negotiated a new $85.0 million credit facility with KeyBank, which was used primarily to fund the Haverstick acquisition.

Proceeds from the issuance of common stock in 2005 through 2006 are related to the exercise of employee stock options.

Cash provided by (used in) discontinued operations for the fiscal years ended December 31, 2005, 2006 and 2007 are summarized as follows (in millions):

	2005	2006	2007
Operating cash flows	$ 7.7	6.4	$ 0.2
Investing cash flows	(5.1)	(6.6)	(1.6)
Financing cash flows	4.0	0.1	
Effect of exchange rates on cash and cash equivalents	1.0	2.7	0.0
Net cash flows of discontinued operations	$ 7.6	$ 2.6	$ (1.4)

Investing cash flow consists of capital expenditures incurred by Kratos' wireless network services segment. Financing cash flows is the result of proceeds received on the exercise of stock options by the wireless network services employees.

Contractual Obligations and Commitments as of September 28, 2008

In connection with Kratos' business acquisitions, it has agreed to make additional future payments to sellers based on final purchase price adjustments and the expiration of certain indemnification obligations. Pursuant to the provisions of SFAS No. 141, such amounts are accrued, and therefore, recorded by Kratos when the contingency is resolved beyond a reasonable doubt and, hence, the additional consideration becomes payable. As of September 30, 2008, Kratos had approximately $3.6 million of cash holdback amounts which include accrued interest and $8.2 million of common stock holdback due for the MRC and Haverstick acquisitions; these will be released subject to indemnity rights. As of December 31, 2007, Kratos had approximately $3.5 million of cash in holdback amounts. The MRC holdback of approximately $2.4 million was originally due in April 2008 and this date has been extended to provide additional time to resolve outstanding indemnification obligations. Kratos expects to make this payment in the fourth quarter of this year or the beginning of 2009. The remaining amounts for Haverstick of $1.2 million in cash and $8.2 million in common stock are due in equal payments in December 2008 and September 2009. The holdback arrangements accrue interest in accordance with the terms of the purchase agreements.

In addition to the indemnity holdback, the Haverstick agreement also called for a post closing working capital adjustment. In February 2008, Kratos and Haverstick agreed on the working capital calculation called for in the agreement. The calculation resulted in a working capital adjustment due to Haverstick in an amount of $1.5 million. The working capital adjustment was paid in April 2008 with the issuance of 697,315 common shares of Kratos stock valued at $1.3 million and cash of $0.2 million.

On December 31, 2007, Kratos entered into a new credit facility of $85.0 million with KeyBank National Association ("KeyBank"), which replaced the October 2, 2006 credit agreement with KeyBank. This credit facility provides for two term loans consisting of a first lien term note of $50.0 million and a second lien term note of $10.0 million, as well as a first lien $25 million revolving line of credit. The $10.0 million term loan has a five and one half year term with principal payments required quarterly beginning on March 31, 2008 of $25,000 through March 31, 2013 with the final balance of $9.5 million due on June 30, 2013. The $50.0 million term loan has a five year term with principal payments required quarterly beginning on March 31, 2008 of $0.6 million in 2008, $1.3 million in 2009, $2.5 million in 2110, and $4.1 million in 2011 and 2012. The term loans have a provision which states that once the full amount of the note has been borrowed, the notes cannot be paid down and reborrowed again. The revolving line of credit has a four year term which expires on December 31, 2011 and contains provisions typical in such arrangements. All loans under the new credit facility have an interest rate equal to a base rate defined as a fluctuating rate per annum equal to the higher of (a) the Federal Funds Rate plus 0.5% and (b) the rate of interest in effect for such day as publicly announced from time to time by KeyBank as its "prime rate" plus a margin for the term loans of 6.5%

to 7.5% and a margin of 1.0% to 3.25% on the revolving line of credit. The applicable margin at date of borrowing is determined by the ratio of Kratos' aggregate debt to EBITDA for the previous four fiscal quarters. Kratos used the credit facility to fund the acquisition of Haverstick and to retire outstanding debt under its October 2006 credit facility with KeyBank. The terms of the new credit agreement require Kratos to provide certain customary covenants for a credit agreement, including certain financial covenants which vary by quarter. See Schedules 7.12(a) through (e) to both the First Lien Credit Agreement and the Second Lien Credit Agreement, which were filed with the SEC as Exhibits 10.1 and 10.2 respectively, to Kratos' Current Report on Form 8-K on January 7, 2008. As of September 28, 2008, Kratos' outstanding balance on the facility was $79.5 million and it had availability under the revolver of $2.0 million. As of December 31, 2007, Kratos' outstanding balance on the facility was $75.5 million and the weighted average interest rate on the debt borrowed during 2007 was 8.3%. This includes $3.5 million of interest expense and financing costs related to the October 2006 credit facility and the new facility dated December 31, 2007. The replacement of the October 2006 facility resulted in a write-off of $1.0 million in deferred financing costs. Kratos had $3.3 million in deferred financing costs outstanding as of December 31, 2007 which are related to the new facility and are being amortized over the four, five and five and one half year life of the respective underlying notes.

On February 11, 2008, Kratos entered into three interest swap agreements with KeyBank, to fix its LIBOR rate to an average of 3.16% for the term of the swap agreements. The effective date of the swaps was February 14, 2008. The notional amounts and expiration dates of the swap agreements are $15 million and March 31, 2010; $22.5 million and March 31, 2011; and $32.5 million and March 31, 2011. The net benefit of the swap agreements entered into on February 11, 2008 has been reduced by the LIBOR floor included in the amendment and waiver discussed below.

In March 2008, Kratos entered into a tentative agreement to settle the 2004 and 2007 securities class action litigation actions (described above in Legal Proceedings), and as a result, Kratos recorded a $4.9 million charge in the quarter ended December 31, 2007 to accrue its share of the settlement amounts, and an estimate for a contingent liability associated with legal proceedings related to the derivative actions, net of the amounts to be covered by its insurance carriers. As a consequence of recording this legal settlement, Kratos did not meet certain of the financial covenants in accordance with the credit agreement. Accordingly, on March 27, 2008, Kratos obtained an amendment and waiver from its lenders to waive the impact of the legal settlement amounts on its financial covenants as of December 31, 2007 and the affected future periods. The amendment also amended the credit agreement to provide for an increase in the LIBOR floor rate to 4.25% and to require that Kratos set aside in a restricted account approximately 50% of the proceeds of the recovery from the theft of stock options by its former stock option administrator, or approximately $1.7 million, to fund these settlement amounts. In April 2008, Kratos transferred $1.7 million to a restricted cash account and in July 2008, it transferred an additional $0.6 million that it received from the insurance carriers as settlement on the theft of stock options to this restricted account. The lenders have also reserved the right to require Kratos to utilize the entire amount of the $3.4 million in proceeds received from the theft of stock options to permanently pay down indebtedness. This right can be exercised no earlier than 60 days from March 27, 2008 and expires upon Kratos' compliance with financial covenants under the credit agreement for the four consecutive quarters commencing after January 1, 2008. The cost related to this amendment was recorded as deferred financing costs.

On June 26, 2008, Kratos entered into a second amendment to its credit facility in order to obtain changes necessary to complete the merger with SYS. The amendment specifically approves Kratos' assumption of the unsecured subordinated convertible notes issued by SYS as subordinated debt under the credit facility provided that a subordination agreement is obtained from the note holders representing no less than 95% of the aggregate principal amount of all subordinated notes. This condition was satisfied in July 2008. In addition, the amendment provides for an add-back for amounts representing actual transaction costs incurred by an acquired entity in the computation of Consolidated

EBITDA, as defined in the credit agreement, in any acquisition in which 100% of the purchase price is paid by Kratos' equity securities.

As of September 28, 2008, Kratos had outstanding convertible notes payable which were acquired as the result of the SYS acquisition totaling $3.1 million, of which $0.8 million was payable to related parties. The convertible notes payable are unsecured and subordinate to its bank debt and bear interest at 10% per annum payable quarterly. Principal is due February 14, 2009 and the notes are convertible at any time into shares of common stock at a conversion rate of $2.86 per share.

In the third quarter of 2008, Kratos paid $1.8 million related to the 2007 securities litigation settlement. This amount was partially funded with $1.2 million of the funds placed in the restricted account. In October 2008 Kratos funded $1.0 million related to the 2004 securities litigation settlement from its restricted cash account and expects to pay an additional $2.0 million plus interest accrued from October 2008 at 10% per annum from its operating cash, in the fourth quarter of this year. Kratos expects to be reimbursed for $0.6 million of the payment related to the 2004 securities litigation settlement by its insurance carrier by the final settlement date of the litigation, which is anticipated by the end of the fourth quarter of this year or the first quarter of 2009.

On July 16, 2008, Kratos came to an agreement with Platinum Equity on a working capital adjustment of $5.0 million. The adjustment is to be paid in installments with the first amount of $2.5 million due on July 31, 2008 and payments of $0.5 million monthly thereafter until paid in full in December 2008. Kratos did not make the scheduled $2.5 million payment due as of July 31, 2008; payments of $1.0 million were made in August and September of 2008, respectively. As of September 28, 2008, the balance of $3.0 million, plus accrued interest on the payments outstanding, has been reflected in other current liabilities.

The following table summarizes Kratos' currently existing contractual obligations and other commitments at December 31, 2007, and the effect such obligations could have on Kratos' liquidity and cash flow in future periods (in millions):

	Payments due/forecast by Period				
	Total	**2008**	**2009 - 2010**	**2011 - 2012**	**2013 and After**
Long-term debt, net of interest(1)	$ 75.5	$ 1.9	$ 24.0	$ 43.6	$ 6.0
Capital leases(5)	1.2	0.1	0.2	0.3	0.6
Estimated interest on debt(2)	21.6	7.4	10.6	3.5	0.1
Other liabilities(3)	3.5	2.9	0.6		
Purchase orders(4)	43.7	40.7	1.5	0.6	0.9
Operating leases(5)	16.3	5.6	8.0	1.8	0.9
Interpretation 48 obligations, including interest and penalties(6)	3.9	1.4	1.2	0.5	0.8
Total commitments and recorded liabilities	$165.7	$60.0	$ 46.1	$ 50.3	$ 9.3

(1) The KeyBank Credit Facility. The payments shown are Kratos' present forecast which contemplates that it will pay off the KeyBank Credit Facility by the due date of June 2013. The annual payment requirements for long-term debt obligations are $2.6 million in 2008, $15.2 million in 2009 to 2010, $32.7 million in 2011 to 2012, and $9.5 million in 2013. See "Notes to Consolidated Financial Statements" Note 8(a) for further details.

(2) Includes interest payments based on current interest rates for variable rate debt and fixed rate debt based upon its swap arrangements. See "Notes to Consolidated Financial Statements" Note 8(a) for further details.

(3) Primarily the obligations under the working capital adjustment clause and holdback payments related to the acquisition of MRC and Haverstick. See "Notes to Consolidated Financial Statements" Note 6 for further details.

(4) Purchase orders include commitments in which a written purchase order has been issued to a vendor, but the goods have not been received or services have not been performed.

(5) See "Notes to Consolidated Financial Statements" Note 10 for further details.

(6) The FIN 48 obligations shown in the above table represent certain uncertain tax positions. The years for which the uncertain tax positions will reverse have been estimated in scheduling the obligations in the table above.

As of December 31, 2007 Kratos had $2.4 million of standby letters of credit outstanding. Kratos' letters of credit are related to its workers compensation program, as support for its performance bond program and for its work overseas. Additional information regarding Kratos' financial commitments at December 31, 2007 is provided in the notes to Kratos' consolidated financial statements. See "Notes to Consolidated Financial Statements, Note 16 Commitments and Contingencies."

Other Liquidity Matters

Kratos intends to fund its cash requirements with cash flows from operating activities, and borrowings under its current credit facilities and potential future credit facilities. Kratos believes these sources should be sufficient to meet its cash needs for at least the next 12 months. However, Kratos expects to pay for the remaining settlement of its stockholder litigation in the fourth quarter of 2008 as discussed in Note 13 Legal Matters to the unaudited consolidated financial statements included elsewhere in this proxy statement/prospectus, and Kratos may need to raise additional funds to pay for this settlement. In addition, if Kratos becomes subject to significant judgments, settlements, or fines related to the matters discussed in Legal Proceedings beginning on page 99, or any other matters, or incur legal fees in excess of its current expectations, it could be required to make significant payments that could materially and adversely affect its financial condition, potentially impacting its ability to access the capital markets and its compliance with its debt covenants.

As discussed in the Kratos' risk factors presented elsewhere in this proxy statement/prospectus, Kratos' quarterly and annual operating results have fluctuated in the past and may vary in the future due to a variety of factors, many of which are external to its control. If the conditions in Kratos' industry deteriorate or its customers cancel or postpone projects or if Kratos is unable to sufficiently increase its revenues or further reduce its expenses, or if there is a real likelihood of continuing resolutions in 2009 for civilian and DoD agencies, it may experience, in the future, a significant long-term negative impact to its financial results and cash flows from operations. In such a situation Kratos could fall out of compliance with its financial and other covenants which, if not waived, could limit its liquidity and capital resources. As of December 31, 2007 and September 28, 2008, Kratos was in compliance with all financial covenants under the credit agreements.

Kratos currently carries a significant amount of debt and as such, its ability to execute on additional business opportunities may be limited due to existing borrowing capacity. In addition, given the relatively highly leveraged liquidity position, any down-turn in its operating earnings could impair its ability to comply with the financial covenants of its existing credit facility. If Kratos believes a covenant violation is more than likely to occur in the near future, it would seek relief from its lenders. This relief would have some cost to Kratos and such relief might not be on terms as favorable as those in its existing credit agreement. If Kratos was to actually default due to its failure to meet the financial covenants of its credit agreement and inability to obtain a waiver from the lenders, its credit agreement could require it to immediately repay all amounts then outstanding under the credit agreement and/or require it to pay interest at default rates per the credit agreement.

In the event Kratos was required to repay the amount outstanding under the existing credit facility, it would need to obtain alternative sources of financing to continue its operating activities at existing levels. There can be no assurance that alternative financing would be available on acceptable terms or at all.

Off Balance Sheet Arrangements

Kratos has no material off-balance sheet arrangements as defined in Regulation S-K 303(a)(4)(ii).

Critical Accounting Principles and Estimates

There have been no significant changes to Kratos' Critical Accounting Policies or Estimates during 2008.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," (SFAS 157) which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. This statement applies under other accounting pronouncements that require or permit fair value measurements. The statement indicates, among other things, that a fair value measurement assumes that the transaction to sell an asset or transfer a liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. SFAS 157 defines fair value based upon an exit price model. Relative to SFAS 157, the FASB issued FASB Staff Positions (FSP) 157-1, 157-2, and proposed 157-c. FSP 157-1 amends SFAS 157 to exclude SFAS 13 and its related interpretive accounting pronouncements that address leasing transactions, while FSP 157-2 delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP 157-c clarifies the principles in SFAS 157 on the fair value measurement of liabilities. Kratos adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. Refer to Note 9 to the Condensed Consolidated Financial Statements for additional discussion on fair value measurements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115," (SFAS 159) which is effective for fiscal years beginning after November 15, 2007. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Unrealized gains and losses on items for which the fair value option is elected would be reported in earnings. Kratos has adopted SFAS 159 as of January 1, 2008 and has elected not to measure any additional financial instruments or other items at fair value.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS 141(R)), which replaces SFAS No. 141, "Business Combinations." SFAS 141(R) retains the underlying concepts of SFAS 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting, but SFAS 141(R) changed the method of applying the acquisition method in a number of significant aspects. Acquisition costs will generally be expensed as incurred; noncontrolling interests will be valued at fair value at the acquisition date; in-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date; restructuring costs associated with a business combination will generally be expensed subsequent to the acquisition date; and any adjustments to an entity's deferred tax assets and uncertain tax positions that occur after the measurement period be recorded as a component of income tax expense. SFAS 141(R) is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008. Additionally, SFAS 141 (R) is effective for changes to valuation allowances or acquired uncertain tax positions occurring after the effective date of SFAS 141 (R), where the acquisition date occurs prior to the effective date for SFAS 141 (R). Early adoption is not permitted. Kratos is currently evaluating the effects, if any, that SFAS 141(R) may have on its financial statements; however, since Kratos has significant acquired deferred tax assets for which full valuation allowances were recorded at the acquisition date, SFAS 141(R) could significantly affect the results of operations if changes in the valuation allowances occur subsequent to adoption. For additional discussion on deferred tax valuation allowances, refer to Note 10 to the Consolidated Financial Statements in its 2007 Annual Report filed on Form 10-K.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51." This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, with earlier adoption prohibited. This statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. It also amends certain of ARB No. 51's consolidation procedures for consistency with the requirements of SFAS 141(R). This statement also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. Kratos is currently evaluating this new statement and anticipates that the statement will not have a significant impact on Kratos' results of operations, financial condition or liquidity.

In December 2007, the EITF issued Issue No. 07-1, "Accounting for Collaborative Arrangements." This Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and shall be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. This Issue requires that transactions with third parties (i.e., revenue generated and costs incurred by the partners) should be reported in the appropriate line item in each company's financial statement pursuant to the guidance in EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent." This Issue also includes enhanced disclosure requirements regarding the nature and purpose of the arrangement, rights and obligations under the arrangement, accounting policy, mount and income statement classification of collaboration transactions between the parties. Kratos is currently evaluating this new statement and anticipates that the statement will not have a significant impact on Kratos' results of operations, financial condition or liquidity.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" (SFAS 161). This statement is intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity's derivative instruments and hedging activities and their effects on the entity's financial position, financial performance, and cash flows. SFAS 161 applies to all derivative instruments within the scope of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) as well as related hedged items, bifurcated derivatives, and nonderivative instruments that are designated and qualify as hedging instruments. Entities with instruments subject to SFAS 161 must provide more robust qualitative disclosures and expanded quantitative disclosures. SFAS 161 is effective prospectively for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. Kratos is currently evaluating the disclosure implications of this statement and anticipates that the statement will not have a significant impact on Kratos' results of operations, financial condition or liquidity.

In April 2008, the FASB issued FSP FAS No. 142-3, which amends the factors that must be considered in developing renewal or extension assumptions used to determine the useful life over which to amortize the cost of a recognized intangible asset under FAS No. 142, "Goodwill and Other Intangible Assets." The FSP requires an entity to consider its own assumptions about renewal or extension of the term of the arrangement, consistent with its expected use of the asset, and is an attempt to improve consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141, "Business Combinations." The FSP is effective for fiscal years beginning after December 15, 2008, and the guidance for determining the useful life of a recognized intangible asset must be applied prospectively to intangible assets acquired after the effective date. The FSP is not expected to have a significant impact on Kratos' results of operations, financial condition or liquidity.

In May 2008, the FASB issued Financial Accounting Standard (FAS) No. 162, "The Hierarchy of Generally Accepted Accounting Principles." The statement is intended to improve financial reporting by identifying a consistent hierarchy for selecting accounting principles to be used in preparing financial statements that are prepared in conformance with generally accepted accounting principles. Unlike Statement on Auditing Standards (SAS) No. 69, "The Meaning of Present in Conformity With GAAP," FAS No. 162 is directed to the entity rather than the auditor. The statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with GAAP," and is not expected to have any impact on Kratos' results of operations, financial condition or liquidity.

In June 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Emerging Issues Task Force (EITF) No. 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." Under the FSP, unvested share-based payment awards that contain rights to receive nonforfeitable dividends (whether paid or unpaid) are participating securities, and should be included in the two-class method of computing EPS. The FSP is effective for fiscal years beginning after December 15, 2008, and interim periods within those years, and is not expected to have a significant impact on Kratos' results of operations, financial condition or liquidity.

Quantitative and Qualitative Disclosures about Market Risk

Kratos is exposed to market risk in connection with changes in interest rates, primarily in connection with outstanding balances under its credit facility with KeyBank N. A. Based on Kratos' average outstanding balances during the nine months ended September 28, 2008, a 1% change in the LIBOR rate would not impact Kratos' financial position and results of operations as a result of the 4.25% LIBOR floor rate on its credit facility. Kratos manages exposure to these risks through its operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. Derivative financial instruments are viewed as risk management tools and are not used for speculation or for trading purposes. Derivative financial instruments are contracted with investment grade counterparties to reduce exposure to nonperformance on such instruments.

Cash and cash equivalents as of September 28, 2008 were $2.5 million and are primarily invested in money market interest bearing accounts. A hypothetical 10% adverse change in the average interest rate on Kratos' money market cash investments and short-term investments would have had no material effect on net income for the nine months ended September 28, 2008.

CERTAIN INFORMATION ABOUT DIGITAL FUSION'S BUSINESS

Digital Fusion is an information technology, research and engineering, and acquisition and business support services company that helps its customers make the most of technology to meet their business needs. Digital Fusion's IT Services business unit provides solutions to both government and commercial customers, focused in the following areas: Business Process Automation, Application Development and Data Management, Application Security, Web Portals and Digital Dashboards, System Integration, and IT Support. Digital Fusion's Research and Engineering Services business unit supports a variety of customers with state-of-the-art solutions that include: Systems Development and Engineering; Applied Aerodynamics/Computational Fluid Dynamics; Missile Engineering; Thermal-Structural Modeling; Program, Data and Financial Management Support; Modeling and Simulation; Control System Design and Analysis; Mechanical Design and Analysis; Optical Systems Design, Development and Test; Hardware-in-the-Loop Testing; and Test and Evaluation. Digital Fusion's Acquisition and Business Support Services business unit provides solutions focused on the following areas: Budget Integration and Analysis; Accounting Operations; Travel Management; SAP Expertise; Business System Development, Evaluation and Operation; Assessing Best Business Practices and Tools; Contracts Management and Administration; Purchasing Expertise; Procurement Documentation Generation and Evaluation; Price and Cost Analysis; Earned Value Management and Policy Evaluation and Support.

Digital Fusion is incorporated in Delaware with its main offices located in Huntsville, Alabama. Digital Fusion has satellite offices in Texas and Washington, D.C. Digital Fusion's website address is *www.digitalfusion.com.*

Description of Business

Form and History of Organization

Digital Fusion, Inc. was incorporated in February 1995 in Delaware as Internet Broadcasting Systems, Inc. Digital Fusion's name was changed to IBS Interactive, Inc. when it went public in May 1998. During October 2001, stockholders approved the corporate name change to Digital Fusion, Inc. Its stock is traded on Pink Sheets under the symbol "DIGF."

Acquisitions and Divestitures

On January 3, 2005, pursuant to a Stock Purchase Agreement dated October 28, 2004 by and between Digital Fusion and the Chief Executive Officer of Summit Research Corporation ("Summit"), Digital Fusion acquired all of the outstanding capital stock of Summit.

Description of Services

Digital Fusion is composed of five business units with the following core competencies:

Research and Engineering

Computational Engineering

- Control System Design and Analysis
- Applied Aerodynamics/Computational Fluid Dynamics
- Thermal-Structural Modeling
- Mechanical Design and Analysis
- Missile Engineering
- High Performance Computational Lab

Sensors

- Electro-optical Systems
- Terahertz Spectroscopy3
- Chemical/Biological
- Sensor Systems FPA, Optical Train
- Image/Data Analysis
- Aero-optical Quality Analysis
- Physics-based Modeling

Space Systems

- Payload Design and Development
- Microsatellite Design and Development
- Situational Awareness Sensors
- Mission Requirements, Analysis and Concept Development
- Interface Definition and Design
- Assembly, Integration and Testing

Systems Engineering and Integration

- System Requirements and Analysis
- Testing and Lifecycle Support
- Comprehensive Prototype Development Facility

Modeling and Simulation

- Simulation Architectures
- Training Solutions (Virtual, Live, Constructive)
- Engineering and System Analysis (HWIL, SWIL, OITL)

Test and Evaluation

- Planning
- Execution
- Flight Testing
- Ground Testing

Test Data Reduction and Analysis

Information Technology

Software Application Development and Support

Application Security

Data Architecture, Management and Integration

Secure Web Portal Development and Digital Dashboard

Extranets and Intranets

Systems Architecture

Department of Defense Architecture Framework

Service Oriented Architecture

System Migration and Integration

Information Assurance and Accreditation

Hardware Support Services

- Servers and Software
- Information Assurance
- Army Logistics Information Systems Expertise

Enterprise Resource Planning

Acquisition and Business Management Support

Financial Management

- Budget Integration and Analysis
- Comprehensive Accounting Operations

Program Management

- Business System Development, Evaluation and Operation
- Best Business Practices and Tools Assessment
- Earned Value Management

Procurement and Purchasing Support

- Procurement Documentation, Generation and Evaluation
- Purchasing Systems Expertise
- Price and Cost Analysis
- Travel Management

Policy Evaluation and Support

Integrated Enterprise Management Program

Combat Development, Training, Test and Exercise

Training Solutions and Support

Army, Joint, Live, Virtual, Constructive

Training, Exercise, Test and Certification Events

Technical and Operational Validation

Systems, Programs, Processes, Missions

Combat Development Assessments & Products

After Action Reviews and Rehearsal Products

Program/Process Management and Assessments

Risk Management and Mitigation

Fault Identification, Isolation and Recovery

Lean Six Sigma Assessments

Battlelab/Test Bed Design and Operations

Integrated Warfighting Solutions Development

Operational Research and Systems Analyses

Existing Contract Profile

Contract Types. In Digital Fusion's contract engagements, one of three types of price structures is employed: cost-plus-fee, time-and-materials, and fixed-price.

Cost-plus-fee contracts. Cost-plus-fee contracts provide for reimbursement of allowable costs and the payment of a fee, which is Digital Fusion's profit. Cost-plus-fixed-fee contracts specify the contract fee in dollars. Cost-plus-award-fee contract may provide for a base fee amount plus an award fee that varies, within specified limits, based upon the customer's assessment of Digital Fusion's performance as compared to contractual targets for factors such as cost, quality, schedule, and performance.

Time-and-materials contracts. Under a time-and-materials contract, Digital Fusion is paid a fixed hourly rate for each direct labor hour expended and is reimbursed for allowable material costs and out-of-pocket expenses. To the extent Digital Fusion's actual direct labor and associated costs vary in relation to the fixed hourly billing rates provided in the contract, Digital Fusion will generate more or less profit or could incur a loss.

Fixed-price contracts. Under a fixed-price contract, Digital Fusion agrees to perform the specified work for a pre-determined price. To the extent Digital Fusion's actual costs vary from the estimates upon which the price was negotiated, Digital Fusion will generate more or less than the anticipated amount of profit or could incur a loss. Some fixed-price contracts have a performance-based component, pursuant to which Digital Fusion can earn incentive payments or incur financial penalties based on Digital Fusion's performance. Digital Fusion generally does not undertake complex, high-risk work under fixed-price terms.

Digital Fusion holds three GSA schedule contracts. GSA schedule contracts are popular contract award methods, offering more flexible, cost-effective, and rapid procurement processes.

The following table sets forth Digital Fusion's GSA schedule contract on which Digital Fusion currently acts as a prime contractor. The period of performance indicated below includes all option years.

Contract Name	Host agency	Period of Performance	Contract ceiling value
GSA Schedule 70	GSA FAS	October 2002 - October 2012	No ceiling
GSA PES	GSA FAS	February 2004 - February 2014	No ceiling
GSA LOGWORLD	GSA FAS	July 2005 - July 2015	No ceiling

Corporate Marketing

Digital Fusion's marketing efforts are focused on teaming and developing strategic partnerships to successfully compete for government and commercial contract opportunities. Digital Fusion's goal is to build the its brand by growing business with existing customers and winning contracts with targeted agencies.

Digital Fusion markets and sells its services through multiple channels by using Digital Fusion's business development staff, leveraging existing customer relationships, capitalizing on Digital Fusion's task order contracts, responding to competitive solicitations, attending marketing events and engaging in other public relations activities. Digital Fusion employs marketing research services to identify and track potential contract opportunities. Digital Fusion also cultivates relationships with leading-edge technology vendors and first tier prime contractors to identify and obtain project leads consistent with Digital Fusion's capabilities. Digital Fusion employs a team marketing approach, whereby Digital Fusion's business developers and technical operations managers work closely together to identify new customers, qualify contract opportunities, conduct marketing visits and manage customer relationships.

Customers

Digital Fusion's customer base consists of government organizations and commercial businesses. Digital Fusion has greatly expanded its federal customer base and is pursuing an aggressive program to further penetrate new agencies and targeted geographical markets.

Major customers during the year ended December 28, 2007 included:

Major Customers*

United States Army

- US Army Aviation and Missile Research, Development and Engineering Center (AMRDEC)
- US Army Space and Missile Defense Command (USASMDC)
- Program Executive Office (PEO), Aviation
- Program Executive Office (PEO), Enterprise Information Systems (EIS)
- Logistics Support Activity (LOGSA)
- Fort Hood
- Fort Bliss
- Redstone Arsenal Garrison, Directorate of Information Management (DOIM)
- Aberdeen Proving Ground, Edgewood

National Aeronautics and Space Administration

- Marshall Space Flight Center
- Johnson Space Center
- Langley Research Center

United States Navy

- Office of Naval Research (ONR)

Aegis Technologies

Aerodyne

Auburn University

ALUTIIQ

Analytical Services Inc

ARINC

Aviation & Mission Solutions

BAE Systems

Calibre Systems

Computer Science Corp.

Defense Advanced Research Projects Agency (DARPA)

Defense Intelligence Agency

Missile and Space Intelligence Center (MSIC)

Dynetics

United States Air Force

Air Force Research Lab (AFRL)

Gray Research, Inc

General Dynamics

Intergraph

Intuitive Research & Technology

Missile Defense Agency (MDA)

Northrop Grumman

Raytheon

SAAB

SAIC

Sparta

State of Tennessee

Child Welfare Services

Teledyne Brown Solutions

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* **List includes both end customers and customers who subcontract to Digital Fusion.**

Competition

Digital Fusion's current competitors include, and may in the future include, the following: High-technology companies with a similar focus on the federal contract market and core competencies in information technology, research and engineering, acquisition and business support and combat development, training, test and exercise services. Numerous small and large businesses are active in the federal market space: Accenture, Booz, Allen & Hamilton, Computer Sciences Corporation, Electronic

Data Systems, Bearing Point, International Business Machines, Science Applications International Corporation, Unisys, Lockheed Martin, Boeing, Raytheon, General Dynamics, L-3 Corp, Qinetiq, CACI, and Northrop Grumman are just a few examples of large businesses that dominate the federal market.

The major competitive factors in the federal market relate to a company's distinctive technical capabilities, successful past contract performance, reputation for quality and experience of key management and marketing staff. While many competitors have longer operating histories, strong customer relationships, greater financial, technical, marketing and public relations resources, larger customer bases and greater brand or name recognition than Digital Fusion has, Digital Fusion has been very successful competing as a prime contractor for small business opportunities and has dramatically expanded strategic relationships with corporate partners with a focus on developing strong teams for future competitive contract opportunities.

Employees and Corporate Culture

Digital Fusion's success as an information technology, research and engineering, and acquisition and business support services company is highly dependent on Digital Fusion's employees. Digital Fusion believes it has been successful in developing a culture that enables Digital Fusion's employees to succeed. Digital Fusion emphasizes three essential attributes an ethic of honesty and service, quality work and customer satisfaction, and caring about Digital Fusion's people. Digital Fusion reinforces these principles regularly in Digital Fusion's recruiting process, training programs, proposals, company meetings, and internal communications. Digital Fusion's active recruiting effort is aligned with Digital Fusion's strategic business units and relies heavily on employee referrals in addition to a variety of other recruiting methods. As of November 21, 2008, Digital Fusion had 282 employees, of which 265 are full-time employees, including 10 executive officers, one sales and marketing employee, and 17 administrative personnel. There were 260 billable employees.

Geographic Area

The majority of Digital Fusion's customers are from the United States with less than 1% derived elsewhere. This is also representative of where its revenues are derived. Digital Fusion's assets are primarily located in the Eastern part of the United States.

Seasonality

Quarterly operating results are affected by the number of billable days in the quarter, holiday seasons and vacations. Demand for Digital Fusion's billable services has historically been lower during the fourth quarter as a result of holidays and vacations.

Description of Property

Digital Fusion serves its customers through its corporate headquarters, located in Huntsville, Alabama, and regional offices located in Texas and Washington, D.C. Digital Fusion does not own any real property and is currently conducting its operations at the following leased premises:

Location	Description of Facility	Approximate Square Footage	Approximate Annual Leased Cost	Lease Term
5030 Bradford Drive Building 1, Suites 120 and 210 Huntsville, AL 35805	Corporate headquarters, administration, sales, customer support	25,487	$ 438,000	05/01/06 - 10/11/11
330 Wynn Drive Huntsville, AL 35805	Customer support	14,629	$ 200,000	07/01/07 - 6/30/12
5 Butterfield Trail Suite 5A El Paso, TX 79906	Customer support	1,866	$ 25,000	03/01/06 - 02/28/09
2001 Jeff. Davis Hwy. Suite 309 Arlington, VA 22202	Customer support	1,475	$ 41,500	08/01/06 - 07/31/09

Digital Fusion believes that all of its leased premises are in good condition, well maintained, and adequate for current operations.

From time to time, Digital Fusion is involved in certain legal actions arising from the ordinary course of business. While it is not feasible to predict or determine the outcome of these matters, Digital Fusion believes that the resolution of these proceedings will not have a material adverse effect on its business, financial condition or results of operations.

Legal Proceedings

From time to time, Digital Fusion is involved in certain legal actions arising from the ordinary course of business. While it is not feasible to predict or determine the outcome of these matters, Digital Fusion believes that the resolution of these proceedings will not have a material adverse effect on its business, financial condition or results of operations.

Market Price of and Dividends on Digital Fusion's Common Equity and Related Stockholder Matters

Digital Fusion's common stock was traded on the NASDAQ Small Cap Market under the symbol "DIGF" from May 15, 1998 to May 8, 2003. Prior to May 15, 1998 there was no established market for its common stock. Effective May 9, 2003, Digital Fusion was de-listed by the NASDAQ Small Cap Market, and was being traded on the OTC Bulletin Board under the symbol "DIGF." On September 11, 2006, Digital Fusion filed a Form 15 with the SEC to deregister its common stock. Digital Fusion's common stock is currently trading on the Pink Sheets.

The following table indicates high and low sales quotations for the periods indicated. Such quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

2008	**High**	**Low**
First Quarter	$2.05	$1.62
Second Quarter	$1.95	$1.55
Third Quarter	$2.00	$1.35

2007	**High**	**Low**
First Quarter	$1.87	$1.43
Second Quarter	$3.25	$1.65
Third Quarter	$2.25	$1.41
Fourth Quarter	$2.23	$1.40

2006	**High**	**Low**
First Quarter	$4.10	$2.90
Second Quarter	$3.70	$2.30
Third Quarter	$3.00	$1.20
Fourth Quarter	$1.85	$1.50

According to the records of Digital Fusion' transfer agent, on December 2, 2008 there were approximately 104 stockholders of record of Digital Fusion common stock.

Dividend Policy

There were no dividends or other distributions made by Digital Fusion during the fiscal year ended December 28, 2007 with respect to its common stock. Digital Fusion currently intends to retain any earnings to provide for the operation and expansion of its business and does not anticipate paying any cash dividends to the holders of its common stock in the foreseeable future.

Equity Compensation Plan Information

Information about Digital Fusion's equity compensation plans as of December 28, 2007 is as follows (shares in thousands):

Plan Category	**Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights**	**Weighted Average Exercise Price of Outstanding Options, Warrants and Rights**	**Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (excluding securities issued in column (a))**
Equity Compensation Plans Approved by Stockholders	3,094,495	$ 1.91	870,364
Equity Compensation Plans Not Approved by Stockholders	3,031,746	$ 2.10	0
Total	6,096,241		870,364

For more detailed information regarding Digital Fusion's equity compensation plans, see the Notes to Digital Fusion's Consolidated Financial Statements.

Management's Discussion and Analysis of Financial Condition and Results of Operations of Digital Fusion

Overview

Digital Fusion, Inc. (used herein, "Digital Fusion", "DFI", and the "Company", refer to Digital Fusion, Inc.) is an information technology, research and engineering, and acquisition and business support services company that helps its customers make the most of technology to meet their business needs. Digital Fusion's IT Services business unit provides solutions to both government and commercial customers, focused in the following areas: Business Process Automation, Application Development and Data Management, Application Security, Web Portals and Digital Dashboards, System Integration, and IT Support. Digital Fusion's Research and Engineering Services business unit supports a variety of customers with state-of-the-art solutions that include: Systems Development and Engineering; Applied Aerodynamics/ Computational Fluid Dynamics; Missile Engineering; Thermal-Structural Modeling; Program, Data and Financial Management Support; Modeling and Simulation; Control System Design and Analysis; Mechanical Design and Analysis; Optical Systems Design, Development and Test; Hardware-in-the-Loop Testing; and Test and Evaluation. Digital Fusion's Acquisition and Business Support Services business unit provides solutions focused on the following areas: Budget Integration and Analysis; Accounting Operations; Travel Management; SAP Expertise; Business System Development, Evaluation and Operation; Assessing Best Business Practices and Tools; Contracts Management and Administration; Purchasing Expertise; Procurement Documentation Generation and Evaluation; Price and Cost Analysis; Earned Value Management and Policy Evaluation and Support. Digital Fusion is incorporated in Delaware with its main offices located in Huntsville, Alabama. Digital Fusion has satellite offices in El Paso, Texas and Washington, D.C. Digital Fusion's Website address is *www.digitalfusion.com*.

Revenues are derived primarily from fees earned in connection with the performance of services provided to customers. Digital Fusion typically invoices on a time and materials basis. The majority of costs are associated with personnel. Attracting and retaining billable employees is vital for Digital Fusion's success. Quarterly operating results are affected by the number of billable days in the quarter, holiday seasons, and vacations. Demand for Digital Fusion's billable services has historically been lower during the fourth quarter because of holidays and vacations.

Digital Fusion had net income of $1,592,000 and $1,257,000 in 2007 and 2006, respectively, and cash flow generated from operations of $2,508,000 and $1,902,000 in 2007 and 2006, respectively. In the last two years, Digital Fusion has greatly expanded its services offerings and past performance with governmental customers.

Digital Fusion will continue to focus on consistent collections of accounts receivable and continued improvements in its operational performance. Company management believes that it currently has sufficient cash to meet its funding requirements over the next year.

The following discussion and analysis should be read together with the consolidated financial statements and notes to such statements appearing elsewhere herein.

Results of Operations for the fiscal years ended December 28, 2007 and December 31, 2006

Revenues

Services revenues increased approximately $6,263,000 or 21.9%, from $28,617,000 for the year ended December 31, 2006, to $34,880,000 for the year ended December 28, 2007. Reimbursed costs revenue increased approximately $7,073,000 or 128.5%, from $5,504,000 for the year ended December 31, 2006 to $12,577,000 for the year ended December 28, 2007. The increase in services revenues during the year ended December 28, 2007 compared to the year ended December 31, 2006 was primarily related to the increase in the number of billable employees, the NASA Marshall Space

Flight Center contract, and growth in engineering and IT services. The increase in reimbursed costs revenue during the year ended December 28, 2007 compared to the year ended 2006 was primarily related to sub-contracting activities and material purchases to support new contracts.

Product revenues decreased approximately $222,000 or 96.9%, from $229,000 for the year ended December 31, 2006, to $7,000 for the year ended December 28, 2007. The decrease in product revenue resulted from a reduction of software re-sales to governmental organizations.

Cost of Sales

Cost of sales consists primarily of labor, or the salaries and wages of Digital Fusion's employees, plus fringe benefits, and other direct costs. Services cost of sales increased by $4,782,000 from $23,630,000 for the year ended December 31, 2006 to $28,412,000 for the year ended December 28, 2007. The increase in services cost of sales is primarily related to the increase in services revenues.

Reimbursed costs include the costs of subcontracted labor and travel related expenses that are reimbursed and third-party materials, such as hardware and software that Digital Fusion purchase for customer solutions and resell to customers. Reimbursed costs increased $6,625,000 from $5,402,000 for the year ended December 31, 2006 to $12,027,000 for the year ended December 28, 2007. The increase in reimbursed costs is primarily related to the increase in reimbursed costs revenue.

Product cost of sales are primarily related to sales of the Intuit product Track-It! and SPI Dynamics Information Assurance product line Web Inspect. Product cost of sales decreased by $173,000 from $180,000 for the year ended December 31, 2006 to $7,000 for the year ended December 28, 2007.

Gross Profit

Gross profit increased $1,880,000 or 36.6% from $5,138,000 in the year ended December 31, 2006 to $7,018,000 in the year ended December 28, 2007. Gross profit is 14.8% of revenues in the year ended December 28, 2007 compared to 15.0% of revenues in the year ended December 31, 2006. The decrease in gross profit as a percentage of total revenue is primarily related to an increase in lower margin reimbursed costs revenue.

Selling, General and Administrative

Total selling, general and administrative ("SG&A") expenses include pension termination costs associated with the termination of a non-qualified, non-contributory defined benefit pension plan held by a company that was acquired by Digital Fusion. Costs incurred related to this plan termination were $9,000 and $227,000 for the years ended December 28, 2007 and December 31, 2006, respectively. All other SG&A expenses consist primarily of salaries and expenses associated with marketing, accounting, finance, sales, and administrative personnel, as well as professional fees and other corporate costs related to the administration of Digital Fusion. SG&A expenses increased $886,000 from $4,870,000 in the year ended December 31, 2006 to $5,736,000 in the year ended December 28, 2007. The increase in SG&A expense is primarily related to an increase in support personnel associated with the growth in revenue. Total SG&A as a percent of revenue was 12.1% and 14.8% for the years ended December 28, 2007 and December 31, 2006, respectively.

Net Interest Expense

Net interest expense decreased $15,000 from $217,000 in the year ended December 31, 2006 to $202,000 in the year ended December 28, 2007. The majority of 2007 and 2006 interest expense is related to Digital Fusion's line of credit facility and debt issued to the former Summit shareholders for the acquisition of Summit.

Amortization of Discount on Debt and Intrinsic Value of Convertible Debt

The $610,000 amortization of debt discount and intrinsic value of the convertible debt in the year ended December 31, 2006 is related to the convertible debt issued to the former Summit shareholder. This amount represents a write off of the remaining value of the debt discount and intrinsic value of convertible debt that existed at December 31, 2005.

Other Income

The $1,000 of other income recorded in the year ended December 28, 2007 is primarily related to forfeiture of benefits in an employee benefit plan from a previous year. The $36,000 of other expenses recorded in the year ended December 31, 2006 is primarily related to a loss on abandonment of leasehold improvements caused by relocation to new corporate headquarters' facilities.

Amortization of Intangible Assets

Amortization of intangible assets related to the Summit acquisition was $427,000 for the years ended December 28, 2007 and December 31, 2006. Digital Fusion allocated $1,669,000 to the customer base intangible assets and allocated $275,000 to employment agreements acquired in the Summit acquisition. Digital Fusion is amortizing the customer base and employment agreements over five and four years, respectively.

Income Tax Benefit

Digital Fusion recognized a net income tax benefit in the amount of $947,000 and $2,506,000 for its continuing operations for the year ended December 28, 2007 and December 31, 2006, respectively, based on projected taxable income.

Income taxes payable were $235,000 and $34,000 for the years ended December 28, 2007 and December 31, 2006, respectively. In future periods, tax benefits and related deferred tax assets will be recognized when management considers realization of such amounts to be more likely than not.

Net Income

As a result of the above factors, net income increased $335,000 from $1,257,000 for the year ended December 31, 2006 to $1,592,000 for the year ended December 28, 2007. The increase in net income for the year ended December 28, 2007 compared to the year ended December 31, 2006 is primarily the result of the increase in revenue and gross profit, partially offset by the decrease in income tax benefit.

Liquidity and Capital Resources

Net cash generated by operating activities increased from $1,902,000 in 2006 to $2,508,000 in 2007. The largest cost of sales is personnel costs, and this cost must be paid timely and cannot be delayed; thus, as Digital Fusion's revenues grow, this will cause a use of cash in the interim period until the revenue can be collected. Digital Fusion is able to borrow on its line of credit up to 85% of its eligible accounts receivable to a maximum borrowing of $4.5 million. This borrowing capability helps Digital Fusion's cash flow until the accounts receivable are collected. The increase in cash provided by operations is primarily related to the increase in net income and liabilities; partially offset by an increase in accounts receivables.

During the year ended December 28, 2007 and December 31, 2006, Digital Fusion invested $165,000 and $914,000, respectively, primarily in software, computer equipment, and furniture. Digital Fusion expects to have higher capital expenditures during 2008 than 2007.

Net cash expended for financing activities for the year ended December 28, 2007 was $2,342,000. Digital Fusion received $119,000 of proceeds from the exercise of warrants and options. This payment receipt was offset by the payment of $1,861,000 on its line of credit and $600,000 on the Summit acquisition note. Digital Fusion's working capital, which consists of current assets less current liabilities, was $3,092,000 as of December 28, 2007. Included in current maturities of long-term debt on Digital Fusion's consolidated balance sheet at December 28, 2007 are Digital Fusion's $262,000 line of credit and the $1,500,000 Summit notes payable. During 2007, Digital Fusion has funded its cash needs through consistent collections of accounts receivable, through the exercise of warrants and options, and by borrowing on its line of credit, which is secured by Digital Fusion's receivables, at an interest rate equal to First Commercial Bank's prime rate.

Net cash expended for financing activities for the year ended December 31, 2006 was $988,000. Digital Fusion received $125,000 of proceeds from the exercise of warrants and options. This payment receipt was offset by the payment of $513,000 on its line of credit and $600,000 on the Summit acquisition note. Digital Fusion's working capital, which consists of current assets less current liabilities, was $945,000 as of December 31, 2006. Included in current maturities of long-term debt on Digital Fusion's consolidated balance sheet at December 31, 2006 is Digital Fusion's $2,349,000 line of credit.

Digital Fusion's ability to grow substantially may be dependent upon obtaining cash flow from its operations and other external sources. Digital Fusion has taken numerous actions to restructure and streamline its operations and has obtained a line of credit secured with its receivables. Because of these actions, management believes it has enough cash to meet its funding requirements over the next year. Digital Fusion's current growth has been funded through internally generated funds, the exercise of warrants and options, and its line of credit. Future growth will be supported with revenue from continuing operations. If Digital Fusion fails to meet its goals, seeks to expand its operations at a level above its current cash flow from operations, or does not collect its accounts receivable in a timely manner, it may require an infusion of working capital of which the availability and terms cannot be predicted.

Off-Balance Sheet Arrangements

Digital Fusion does not have any off-balance sheet arrangements.

Fluctuations in Operating Results

Digital Fusion's operating results may fluctuate significantly from period to period as a result of the length of its sales cycles, customer budgeting cycles, the introduction of new products and services by competitors, the timing of expenditures, pricing changes in the industry, technical difficulties, and general economic conditions. The nature of Digital Fusion's business generally requires making expenditures and using significant resources prior to receipt of corresponding revenues. Operating results can also fluctuate based upon the number of billable days in a reporting period and the fourth quarter results are normally lower due to the holiday season and vacation time.

Inflation

Inflation has not had a significant impact on Digital Fusion's results of operations.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that have a significant impact on the results reported in the financial statements. Some of the accounting policies require management to make difficult and subjective judgments, often because of the need to make estimates of matters that are inherently uncertain. Digital Fusion's most critical accounting policies include revenue recognition, accounts receivable reserves, and the valuation of goodwill. Actual results may differ from the estimates under different assumptions or conditions. These policies are discussed below, as are the estimates and judgments involved:

Revenue Recognition

Digital Fusion recognizes revenue when persuasive evidence of an arrangement exists, services have been rendered or goods delivered, the contract price is fixed or determinable, and collectability is reasonably assured. The majority of the Company's current contracts are with Federal Government Departments or Agencies, or subcontracts to companies whose prime contracts are with the Federal Government. Most of these contracts are Time and Material (T&M) or Firm Fixed Price Level of Effort (FFP LOE). The LOE clause requires Digital Fusion to have a certain number of labor hours and that these hours are worked by personnel qualified to perform under certain labor categories. Revenue on these contracts is recognized as time is expended and or materials are delivered. The price is based on effort expended, not results achieved. The revenue on these contracts is recognized by hours worked which serves as a proxy for output. Revenue on cost-plus-fee contracts is recognized to the extent of costs or hours actually incurred plus a proportional amount of the fee earned. Digital Fusion considers fixed fees under cost-plus-fee contracts to be earned in proportion to the allowable cost actually incurred or by hours actually worked in performance of the contract. Digital Fusion's deferred revenue relates to payments received in advance of services (hours worked).

From time to time, Digital Fusion may proceed with work based on customer direction prior to the completion and signing of formal contract documents. Digital Fusion has a formal review process for approving any such work. Revenue associated with such work is recognized only when it can be reliably estimated and realization is probable. Digital Fusion's estimates are based on previous experiences with the customer, communications with the customer regarding funding status, and Digital Fusion's knowledge of available funding for the contract or program.

Allowance for Doubtful Accounts

Digital Fusion's accounts receivable are reduced by $167,000 for an allowance for amounts that may become uncollectible in the future. The estimated allowance for uncollectible amounts is based on a specific analysis of accounts in the receivable portfolio and a general reserve based on the aging of receivables and historical write-off experience. Digital Fusion's management believes the allowance to be reasonable. Digital Fusion does not accrue interest on past due accounts receivable. Certain of Digital Fusion's trade accounts receivable are subject to bad debt losses. A reserve has been recorded to reflect expected bad debt losses based on past experience with similar accounts receivable. The reserve is reviewed on a regular basis and adjusted as necessary. Although management believes the reserve is a reasonable approximation, there can be no assurance that Digital Fusion can accurately estimate bad debt losses on its accounts receivable.

Valuation of Goodwill and Intangible Assets

Goodwill and intangible assets are reviewed annually for impairment or more frequently if impairment indicators arise. This annual impairment test is performed in the last quarter of each fiscal year. The goodwill impairment test requires a comparison of the fair value of Digital Fusion to the amount of goodwill recorded. If this comparison reflects impairment, then the loss would be measured as the excess of recorded goodwill over its implied fair value. Although Digital Fusion's management believes that the estimates and assumptions used are reasonable, actual results could differ.

Results of Operations for the twelve weeks ended September 19, 2008, and September 21, 2007

Revenues

Services revenues increased approximately $733,000 or 9.1%, from $8,083,000 for the twelve weeks ended September 21, 2007, to $8,816,000 for the twelve weeks ended September 19, 2008. Reimbursed costs revenue increased approximately $1,511,000 or 37.7%, from $4,009,000 for the twelve weeks ended September 21, 2007 to $5,520,000 for the twelve weeks ended September 19, 2008. The increase in services revenues during the twelve weeks ended September 19, 2008 compared to the twelve weeks ended September 21, 2007 was primarily related to the increase in the number of billable employees, resulting from growth in engineering and IT services. The increase in reimbursed costs revenue during the revenues during the twelve weeks ended September 19, 2008 compared to the twelve weeks ended September 21, 2007 was primarily related to sub-contracting activities and material purchases to support new contracts.

Cost of Sales

Cost of sales consists primarily of labor, or the salaries and wages of Digital Fusion's employees, plus fringe benefits, and other direct costs. Services cost of sales increased by $374,000 from $6,571,000 for the twelve weeks ended September 21, 2007 to $6,945,000 for the twelve weeks ended September 19, 2008. The increase in services cost of sales is primarily related to the increase in services revenues.

Reimbursed costs include the costs of subcontracted labor and travel related expenses that are reimbursed and third-party materials, such as hardware and software that Digital Fusion purchases for customer solutions and resells to customers. Reimbursed costs increased $1,482,000 from $3,793,000 for the twelve weeks ended September 21, 2007 to $5,275,000 for the twelve weeks ended September 19, 2008. The increase in reimbursed costs is primarily related to the increase in reimbursed costs revenue.

Gross Profit

Gross profit increased $388,000 or 22.5% from $1,728,000 in the twelve weeks ended September 21, 2007 to $2,116,000 in the twelve weeks ended September 19, 2008. Gross profit is 14.8% of revenues in the twelve weeks ended September 19, 2008 compared to 14.3% of revenues in the twelve weeks ended September 21, 2007. The increase in gross profit as a percentage of total revenue is primarily related to an increase in margin on services revenue.

Selling, General and Administrative

SG&A expenses consist primarily of salaries and expenses associated with marketing, accounting, finance, sales, and administrative personnel, as well as professional fees and other corporate costs related to the administration of Digital Fusion. SG&A expenses decreased $168,000 from $1,389,000 in the twelve weeks ended September 21, 2007 to $1,221,000 in the twelve weeks ended September 19, 2008. The decrease in SG&A expense is primarily related to cost reduction efforts and controlling discretionary spending. Total SG&A as a percent of revenue was 8.5% and 11.5% for the twelve weeks ended September 19, 2008 and September 21, 2007, respectively.

Net Interest Expense

Net interest expense decreased $44,000 from $58,000 in the twelve weeks ended September 21, 2007 to $14,000 in the twelve weeks ended September 19, 2008. The decrease in interest expense is primarily related to a reduction in use of the line of credit facility resulting from Digital Fusion's ability to generate cash flow from operations.

Amortization of Intangible Assets

Amortization of intangible assets related to the Summit acquisition was $107,000 for the twelve weeks ended September 19, 2008 and September 21, 2007. Digital Fusion allocated $1,669,000 to the customer base intangible assets and allocated $275,000 to employment agreements acquired in the Summit acquisition. Digital Fusion is amortizing the customer base and employment agreements over five and four years, respectively.

Income Tax Expense

Digital Fusion recognized net income tax expense in the amount of $115,000 and $5,000 for its continuing operations for the for the twelve weeks ended September 19, 2008 and September 21, 2007, respectively, based on projected taxable income.

In future periods, tax benefits and related deferred tax assets will be recognized when management considers realization of such amounts to be more likely than not.

Net Income

As a result of the above factors, net income increased $490,000 from $169,000 for the twelve weeks ended September 21, 2007 to $659,000 for the twelve weeks ended September 19, 2008. The increase in net income for the twelve weeks ended September 19, 2008 compared to the twelve weeks ended September 21, 2007 is primarily the result of the increase in revenue and gross profit, partially offset by the increase in income tax expense.

Results of Operations for the thirty-eight weeks ended September 19, 2008, and September 21, 2007

Revenues

Services revenues increased approximately $3,349,000 or 13.3%, from $25,108,000 for the thirty-eight weeks ended September 21, 2007, to $28,457,000 for the thirty-eight weeks ended September 19, 2008. Reimbursed costs revenue increased approximately $8,583,000 or 112.2%, from $7,647,000 for the thirty-eight weeks ended September 21, 2007 to $16,230,000 for the thirty-eight weeks ended September 19, 2008. The increase in services revenues during the thirty-eight weeks ended September 19, 2008 compared to the thirty-eight weeks ended September 21, 2007 was primarily related to the increase in the number of billable employees, resulting from growth in engineering and IT services. The increase in reimbursed costs revenue during the revenues during the thirty-eight weeks ended September 19, 2008 compared to the thirty-eight weeks ended September 21, 2007 was primarily related to sub-contracting activities and material purchases to support new contracts.

Cost of Sales

Cost of sales consists primarily of labor, or the salaries and wages of Digital Fusion's employees, plus fringe benefits, and other direct costs. Services cost of sales increased by $2,147,000 from $20,649,000 for the thirty-eight weeks ended September 21, 2007 to $22,796,000 for the thirty-eight weeks ended September 19, 2008. The increase in services cost of sales is primarily related to the increase in services revenues.

Reimbursed costs include the costs of subcontracted labor and travel related expenses that are reimbursed and third-party materials, such as hardware and software that Digital Fusion purchase for customer solutions and resell to customers. Reimbursed costs increased $8,322,000 from $7,282,000 for the thirty-eight weeks ended September 21, 2007 to $15,604,000 for the thirty-eight weeks ended September 19, 2008. The increase in reimbursed costs is primarily related to the increase in reimbursed costs revenue.

Gross Profit

Gross profit increased $1,463,000 or 30.3% from $4,824,000 in the thirty-eight weeks ended September 21, 2007 to $6,287,000 in the thirty-eight weeks ended September 19, 2008. Gross profit is 14.1% of revenues in the thirty-eight weeks ended September 19, 2008 compared to 14.7% of revenues in the thirty-eight weeks ended September 21, 2007. The decrease in gross profit as a percentage of total revenue is primarily related to an increase in lower margin reimbursed costs revenue.

Selling, General and Administrative

SG&A expenses consist primarily of salaries and expenses associated with marketing, accounting, finance, sales, and administrative personnel, as well as professional fees and other corporate costs related to the administration of Digital Fusion. SG&A expenses decreased $39,000 from $4,237,000 in the thirty-eight weeks ended September 21, 2007 to $4,198,000 in the thirty-eight weeks ended September 19, 2008. The decrease in SG&A expense is primarily related to cost reduction efforts and controlling discretionary spending. Total SG&A as a percent of revenue was 9.4% and 12.9% for the thirty-eight weeks ended September 19, 2008 and September 21, 2007, respectively.

Net Interest Expense

Net interest expense decreased $116,000 from $180,000 in the thirty-eight weeks ended September 21, 2007 to $64,000 in the thirty-eight weeks ended September 19, 2008. The majority of 2007 interest expense is related to Digital Fusion's line of credit facility and debt issued to the former Summit shareholders for the acquisition of Summit. Interest expense is 2008 is primarily related to Digital Fusion's line of credit facility.

Other Income

Other income was $9,000 and $5,000 for the thirty-eight weeks ended September 19, 2008 and September 21, 2007, respectively. This income is primarily related to forfeiture of benefits in an employee benefit plan from a previous year.

Amortization of Intangible Assets

Amortization of intangible assets related to the Summit acquisition was $321,000 for the thirty-eight weeks ended September 19, 2008 and September 21, 2007. Digital Fusion allocated $1,669,000 to the customer base intangible assets and allocated $275,000 to employment agreements acquired in the Summit acquisition. Digital Fusion is amortizing the customer base and employment agreements over five and four years, respectively.

Income Tax Expense

Digital Fusion recognized net income tax expense in the amount of $349,000 and $13,000 for its continuing operations for the for the thirty-eight weeks ended September 19, 2008 and September 21, 2007, respectively, based on projected taxable income.

In future periods, tax benefits and related deferred tax assets will be recognized when management considers realization of such amounts to be more likely than not.

Net Income

As a result of the above factors, net income increased $1,286,000 from $78,000 for the thirty-eight weeks ended September 21, 2007 to $1,364,000 for the thirty-eight weeks ended September 19, 2008. The increase in net income for the thirty-eight weeks ended September 19, 2008 compared to the thirty-eight weeks ended September 21, 2007 is primarily the result of the increase in revenue and gross profit, partially offset by the increase in income tax expense.

Liquidity and Capital Resources

Net cash generated by operating activities increased from $1,735,000 in the thirty-eight weeks ended September 21, 2007 to $3,111,000 in the thirty-eight weeks ended September 19, 2008. The largest cost of sales is personnel costs, and this cost must be paid timely and cannot be delayed; thus, as Digital Fusion's revenues grow, this will cause a use of cash in the interim period until the revenue can be collected. Digital Fusion is able to borrow on its line of credit up to 85% of its eligible accounts receivable to a maximum borrowing of $4.5 million. This borrowing capability helps Digital Fusion's cash flow until the accounts receivable are collected. The increase in cash provided by operations is primarily related to the increase in net income.

During the thirty-eight weeks ended September 19, 2008 and September 21, 2007, Digital Fusion invested $305,000 and $110,000, respectively, primarily in software and computer equipment. Digital Fusion expects to have higher capital expenditures during 2008 than 2007.

Net cash expended for financing activities for the thirty-eight weeks ended September 19, 2008 was $1,751,000. During the thirty-eight weeks ended September 19, 2008, Digital Fusion received $11,000 of proceeds from the exercise of warrants and options. This payment receipt was offset by the payment of $262,000 on its line of credit and $1,500,000 on the Summit acquisition note. Digital Fusion's working capital, which consists of current assets less current liabilities, was $5,975,000 as of September 19, 2008. During the thirty-eight weeks ended September 19, 2008, Digital Fusion funded its cash needs through consistent collections of accounts receivable, through the exercise of warrants and options, and by borrowing on its line of credit, which is secured by Digital Fusion's receivables, at an interest rate equal to First Commercial Bank's prime rate.

Net cash expended for financing activities for the thirty-eight weeks ended September 21, 2007 was $1,624,000. During the thirty-eight weeks ended September 21, 2007, Digital Fusion received $77,000 of proceeds from the exercise of warrants and options. This payment receipt was offset by the payment of $1,101,000 on its line of credit and $600,000 on the Summit acquisition note. Digital Fusion's working capital, which consists of current assets less current liabilities, was $3,092,000 as of September 21, 2007. Included in current maturities of long-term debt on Digital Fusion's consolidated balance sheet at September 21, 2007 are Digital Fusion's $262,000 line of credit and the $1,500,000 Summit notes payable.

Digital Fusion's ability to grow substantially may be dependent upon obtaining cash flow from its operations and other external sources. Digital Fusion has taken numerous actions to restructure and streamline its operations and has obtained a line of credit secured with its receivables. Because of these actions, management believes it has enough cash to meet its funding requirements over the next year. Digital Fusion's current growth has been funded through internally generated funds, the exercise of warrants and options, and its line of credit. Future growth will be supported with revenue from continuing operations. If Digital Fusion fails to meet its goals, seeks to expand its operations at a level above its current cash flow from operations, or does not collect its accounts receivable in a timely manner, it may require an infusion of working capital of which the availability and terms cannot be predicted.

Off-Balance Sheet Arrangements

Digital Fusion does not have any off-balance sheet arrangements.

Fluctuations in Operating Results

Digital Fusion's operating results may fluctuate significantly from period to period as a result of the length of its sales cycles, customer budgeting cycles, the introduction of new products and services by competitors, the timing of expenditures, pricing changes in the industry, technical difficulties, and general economic conditions. The nature of Digital Fusion's business generally requires making expenditures and using significant resources prior to receipt of corresponding revenues. Operating results can also fluctuate based upon the number of billable days in a reporting period and the fourth quarter results are normally lower due to the holiday season and vacation time.

Inflation

Inflation has not had a significant impact on Digital Fusion's results of operations.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that have a significant impact on the results reported in the financial statements. Some of the accounting policies require management to make difficult and subjective judgments, often because of the need to make estimates of matters that are inherently uncertain. Digital Fusion's most critical accounting policies include revenue recognition, accounts receivable reserves, and the valuation of goodwill. Actual results may differ from the estimates under different assumptions or conditions. These policies are discussed below, as are the estimates and judgments involved:

Revenue Recognition

Digital Fusion recognizes revenue when persuasive evidence of an arrangement exists, services have been rendered or goods delivered, the contract price is fixed or determinable, and collectability is reasonably assured. The majority of the Company's current contracts are with Federal Government Departments or Agencies, or subcontracts to companies whose prime contracts are with the Federal Government. Most of these contracts are Time and Material (T&M) or Firm Fixed Price Level of Effort (FFP LOE). The LOE clause requires Digital Fusion to have a certain number of labor hours and that these hours are worked by personnel qualified to perform under certain labor categories. Revenue on these contracts is recognized as time is expended and or materials are delivered. The price is based on effort expended, not results achieved. The revenue on these contracts is recognized by hours worked which serves as a proxy for output. Revenue on cost-plus-fee contracts is recognized to the extent of costs or hours actually incurred plus a proportional amount of the fee earned. Digital Fusion considers fixed fees under cost-plus-fee contracts to be earned in proportion to the allowable cost actually incurred or by hours actually worked in performance of the contract. Digital Fusion's deferred revenue relates to payments received in advance of services (hours worked).

From time to time, Digital Fusion may proceed with work based on customer direction prior to the completion and signing of formal contract documents. Digital Fusion has a formal review process for approving any such work. Revenue associated with such work is recognized only when it can be reliably estimated and realization is probable. Digital Fusion's estimates are based on previous experiences with the customer, communications with the customer regarding funding status, and Digital Fusion's knowledge of available funding for the contract or program.

Allowance for Doubtful Accounts

Digital Fusion's accounts receivable are reduced by $8,000 for an allowance for amounts that may become uncollectible in the future. The estimated allowance for uncollectible amounts is based on a specific analysis of accounts in the receivable portfolio and a general reserve based on the aging of receivables and historical write-off experience. Digital Fusion's management believes the allowance to be reasonable. Digital Fusion does not accrue interest on past due accounts receivable. Certain of Digital Fusion's trade accounts receivable are subject to bad debt losses. A reserve has been recorded to reflect expected bad debt losses based on past experience with similar accounts receivable. The reserve is reviewed on a regular basis and adjusted as necessary. Although management believes the reserve is a reasonable approximation, there can be no assurance that Digital Fusion can accurately estimate bad debt losses on its accounts receivable.

Valuation of Goodwill and Intangible Assets

Goodwill and intangible assets are reviewed annually for impairment or more frequently if impairment indicators arise. This annual impairment test is performed in the last quarter of each fiscal year. The goodwill impairment test requires a comparison of the fair value of Digital Fusion to the amount of goodwill recorded. If this comparison reflects impairment, then the loss would be measured as the excess of recorded goodwill over its implied fair value. Although Digital Fusion's management believes that the estimates and assumptions used are reasonable, actual results could differ.

UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS

On December 31, 2007, Kratos acquired Indianapolis, Indiana headquartered Haverstick Consulting, Inc. (Haverstick). On June 28, 2008, Kratos acquired San Diego, California headquartered SYS Technologies (SYS). On November 24, 2008 Kratos and Digital Fusion announced the execution of an Agreement and Plan of Merger.

The unaudited pro forma condensed combined balance sheet combines the historical consolidated balance sheets of Kratos (which includes Haverstick and SYS) and Digital Fusion, giving effect to the mergers as if they had been consummated on September 28, 2008.

The unaudited pro forma condensed combined statement of operations for the year ended December 31, 2007, combines the Kratos consolidated statement of operations for the year ended December 31, 2007 with (i) the Haverstick statement of operations for the year ended December 31, 2007, (ii) the SYS statement of operations for the year ended December 31, 2007 which were compiled by aggregating quarterly statement of operations data, and (iii) the Digital Fusion statement of operations for the year ended December 28, 2007 giving effect to the mergers as if they had occurred on January 1, 2007.

The unaudited pro forma condensed combined statement of operations for the nine months ended September 28, 2008, combines the Kratos consolidated statement of operations for this period which includes Haverstick for the nine month period ended September 28, 2008 and SYS for the three month period ended September 28, 2008 with (i) the SYS statement of operations for the period from January 1, 2008 through June 28, 2008 which were compiled by aggregating quarterly statement of operations data, and (iii) the Digital Fusion statement of operations for the nine months ended September 19, 2008 giving effect to the mergers as if they had occurred on January 1, 2007.

The historical consolidated financial information has been adjusted to give effect to pro forma events that are (i) directly attributable to the merger, (ii) factually supportable, and (iii) with respect to the statement of operations, expected to have a continuing impact on the combined results.

Kratos reports its financial results on a calendar year basis ending December 31. Haverstick reported its financial results on a calendar year basis which ended on December 31. SYS reported its financial results on a fiscal year basis which ended on June 30 of each year. Digital Fusion reports its financial results on a fiscal year basis ending on the last Friday of the year. In addition, Kratos' and Digital Fusion's interim periods do not end on the same dates. The fiscal period covering 2007 ended on December 28, 2007 for SYS and Digital Fusion and on December 31, 2007 for Kratos and Haverstick. SYS's and Digital Fusion's results for the year ended December 28, 2007 have been used to prepare the unaudited pro forma condensed combined statement of operations for the year ended December 31, 2007. Digital Fusion's financial statements as of September 19, 2008 have been used to prepare the unaudited pro forma condensed combined balance sheet as of September 28, 2008, and the unaudited pro forma condensed statement of operations for the nine month period ended September 28, 2008.

These unaudited pro forma condensed combined financial statements should be read in conjunction with the historical audited and unaudited consolidated financial information and accompanying notes of Kratos and Digital Fusion, which have been included in this Proxy Statement. The unaudited pro forma condensed combined financial statements are not necessarily indicative of the operating results or financial position that would have occurred if the merger had been completed at the dates indicated.

The unaudited pro forma condensed combined financial statements assume the merger is completed on or before December 28, 2008. The merger will be accounted for under the purchase method of accounting in accordance with Statement of Financial Accounting Standards No. 141, "Business Combinations" with Kratos treated as the acquiring entity. Accordingly, consideration expected to be paid by Kratos to complete the merger with Digital Fusion will be allocated to Digital Fusion's assets and liabilities based upon their estimated fair values as of the date of completion of the merger. The allocation is dependent upon certain valuations and other studies that have not progressed to a stage where there is sufficient information to make a final allocation. Additionally, a final determination of the fair value of Digital Fusion's assets and liabilities, which cannot be made prior to the completion of the transaction, will be based on the actual fair values of the net tangible and intangible assets of Digital Fusion that exist as of the final completion date of the merger. Accordingly, the pro forma purchase price adjustments are preliminary, subject to further adjustments as additional information becomes available and as additional analyses are performed and have been made solely for the purpose of providing the unaudited pro forma condensed combined financial information presented below. Kratos estimated the fair value of Digital Fusion's assets and liabilities based on discussions with Digital Fusion's management, due diligence and information presented in public filings. Valuations of tangible and intangible assets and liabilities and related pro forma adjustments are based on Kratos management's good faith estimates of fair value. Upon completion of the merger, final valuations will be performed. Increases or decreases in the fair value of relevant balance sheet amounts including property and equipment, debt and intangible assets will result in adjustments to the unaudited pro forma condensed combined balance sheet and/or statement of operations. There can be no assurance that the final determination will not result in material changes.

In addition, the unaudited pro forma condensed combined financial statements do not include the realization of any cost savings from operating efficiencies, synergies or other restructurings resulting from the acquisition. Therefore, the actual amounts recorded as of the completion of the mergers and thereafter may differ materially from the information presented herein.

If the merger is consummated on or after December 29, 2008, the merger will be accounted for under Statement of Financial Accounting Standards (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R would require that the purchase price be determined based on Kratos's closing stock price on the date the merger is consummated, and that contingent assets and liabilities be recorded at fair value. Further, SFAS 141R would require that merger-related transaction costs and exit and termination costs be recorded to expense as incurred rather than capitalized as part of goodwill.

The accompanying notes are an integral part of these unaudited pro forma combined financial statements.

UNAUDITED PRO FORMA CONDENSED COMBINED BALANCE SHEET

September 28, 2008

(in millions)

	Kratos	Digital Fusion	Digital Fusion Pro Forma adjustments	Pro Forma Combined
Assets				
Current assets:				
Cash and cash equivalents	$ 2.5	$ 1.0	$ (2.3)(a)	$ 1.2
Restricted cash	1.5			1.5
Accounts receivable, net	90.7	10.4		101.1
Prepaid expenses	5.0	0.2		5.2
Deferred tax assets, current		2.1	(2.1)(d)	
Other current assets	8.9			8.9
Current assets of discontinued operations	0.7			0.7
Total current assets	109.3	13.7	(4.4)	118.6
Property and equipment, net	7.0	1.1		8.1
Goodwill	237.3	5.9	23.0(b,d)	266.2
Other intangibles, net	25.0	0.5	7.8(c)	33.3
Deferred tax assets, long-term		1.7	(1.7)(d)	
Other assets	3.9	0.4		4.3
Non-current assets of discontinued operations	0.3			0.3
Total assets	$ 382.8	$ 23.3	$ 24.7	$ 430.8
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payable	$ 16.2	$ 2.8	$	$ 19.0
Accrued expenses	14.5	0.7		15.2
Accrued compensation	12.3	3.8	0.4(b)	16.5
Billings in excess of costs and earnings on uncompleted contracts	7.9			7.9
Current portion of long-term debt	6.3			6.3
Other current liabilities	15.9	0.4	(0.1)(d)	16.2
Current liabilities of discontinued operations	4.0			4.0
Total current liabilities	77.1	7.7	0.3	85.1
Long-term debt, net of current portion	76.4			76.4
Deferred tax liabilities	3.2		2.9(d)	6.1
Other long-term liabilities	3.9	0.7		4.6
Non current liabilities of discontinued operations	2.2			2.2
Total liabilities	162.8	8.4	3.2	174.4
Stockholders' equity:				
Preferred stock, 5,000,000 shares authorized, Series B Convertible Preferred Stock, $.001 par value; 10,000 shares outstanding at September 28, 2008, (liquidation preference $5.0 million)				
Common stock, $.001 par value, 195,000,000 shares authorized; 105,130,415 shares issued and outstanding at September 28, 2008		0.1	(0.1)(b)	

Additional paid-in capital		466.8		49.3		21.6(b,c,d)		537.7
Accumulated deficit		(246.8)		(34.5)				(281.3)
Total stockholders' equity		220.0		14.9		21.5		256.4
Total liabilities and stockholders' equity	$	382.8	$	23.3	$	24.7	$	430.8

UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS

FOR THE NINE MONTHS ENDED SEPTEMBER 28, 2008

(in millions, except per share data)

	Kratos	SYS	SYS Pro Forma Adjustments	Pro Forma Combined	Digital Fusion	Digital Fusion Pro Forma Adjustments	Pro Forma Combined
Revenues	$222.0	$36.5	$	$ 258.5	$ 44.7	$	$ 303.2
Cost of revenues	178.6	27.2		205.8	38.4		244.2
Gross profit	43.4	9.3		52.7	6.3		59.0
Selling, general and administrative expenses	37.7	7.1	(j)	44.8	4.5	0.7(n)	50.0
Merger transaction costs		3.1	(3.1)(k)				
Research and development	1.0	2.2		3.2			3.2
Impairment of assets and adjustments to the liability for unused office space	(0.3)			(0.3)			(0.3)
Recovery of unauthorized issuance of stock options and stock option investigation and related fees	(1.6)			(1.6)			(1.6)
Operating income (loss) from continuing operations	6.6	(3.1)	3.1	6.6	1.8	(0.7)	7.7
Other income (expense), net:							
Interest income (expense), net	(7.5)	(0.2)		(7.7)	(0.1)	0.1(o)	(7.7)
Other income, net	0.8			0.8			0.8
Other income (expense), net	(6.7)	(0.2)		(6.9)	(0.1)	0.1	(6.9)
Income (loss) from continuing operations before income taxes	(0.1)	(3.3)	3.1	(0.3)	1.7	(0.6)	0.8
Provision (benefit) for income taxes	1.4	(0.4)	0.5(l)	1.5	0.3	0.1(p)	1.9
Income (loss) from continuing operations	(1.5)	(2.9)	2.6	(1.8)	1.4	(0.7)	(1.1)
Basic earnings (loss) per common share:							
Income (loss) from continuing operations	$ (0.02)			$ (0.02)	$ 0.12		$ (0.01)
Diluted earnings (loss) per common share:							
Income (loss) from continuing operations	$ (0.02)			$ (0.02)	$ 0.10		$ (0.01)
Weighted average common shares outstanding:							
Basic	88.0		16.7(m)	104.7	11.7	25.4(q)	130.1
Diluted	88.0		16.7(m)	104.7	13.6	25.4(q)	130.1

UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS

FOR THE YEAR ENDED DECEMBER 31, 2007

(in millions, except per share data)

	Kratos	Haverstick	Haverstick Pro Forma adjustments	Pro Forma Combined	SYS	SYS Pro Forma Adjustments	Pro Forma Combined	Digital Fusion	Digital Fusion Pro Forma Adjustments	Pro Forma Combined
Revenues	$ 193.6	$ 94.2	$	$ 287.8	$ 79.0	$	$ 366.8	$ 47.5	$	$ 414.3
Cost of revenues	162.0	73.4		235.4	59.2		294.6	40.4		335.0
Gross profit	31.6	20.8		52.4	19.8		72.2	7.1		79.3
Selling, general and administrative expenses	39.5	17.0	(0.1)(e),(f)	56.4	15.5	(j)	71.9	6.2	0.9(n)	79.0
Research, engineering and development expenses					4.3		4.3			4.3
Stock option investigation and related fees	14.0			14.0			14.0			14.0
Recovery of unauthorized issuance of stock options	(3.4)			(3.4)			(3.4)			(3.4)
Estimated cost for settlement of securities litigation	4.9			4.9			4.9			4.9
Contingent acquisition consideration and restatement fees										
Impairment and restructuring charges	1.2			1.2			1.2			1.2
Operating income (loss) from continuing operations	(24.6)	3.8	0.1	(20.7)			(20.7)	0.9	(0.9)	(20.7)
Other income (expense), net:										
Interest income (expense), net	(1.2)	(14.9)	6.3(g)	(9.8)	(0.6)		(10.4)	(0.2)	0.2(o)	(10.4)
Impairment of investment in unconsolidated affiliates	(1.8)			(1.8)			(1.8)			(1.8)
Other income, net	0.7			0.7	0.1		0.8			0.8
Total other income (expense), net	(2.3)	(14.9)	6.3	(10.9)	(0.5)		(11.4)	(0.2)	0.2	(11.4)
Income (loss) from continuing operations before income taxes	(26.9)	(11.1)	6.4	(31.6)	(0.5)		(32.1)	0.7	(0.7)	(32.1)
Provision (benefit) for income taxes from continuing operations	1.3	0.5	(0.1)(h)	1.7	0.2	0.1(l)	2.0	(0.9)	1.5(p)	2.6
Income (loss) from continuing operations	(28.2)	(11.6)	6.5	(33.3)	(0.7)	(0.1)	(34.1)	1.6	(2.2)	(34.7)
Basic earnings (loss) per common share:										
Income (loss) from continuing operations	$ (0.38)			$ (0.42)	$ (0.04)		$ (0.33)	$ 0.14		$ (0.27)
Diluted earnings (loss) per common share:										
Income (loss) from continuing operations	$ (0.38)			$ (0.42)	$ (0.04)		$ (0.33)	$ 0.12		$ (0.27)
Weighted average common shares outstanding:										
Basic	74.0		5.3(i)	79.3	19.4	25.3(m)	104.6	11.6	25.4(q)	130.0
Diluted	74.0		5.3(i)	79.3	19.4	25.3(m)	104.6	13.6	25.4(q)	130.0

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRO FORMA PRESENTATION

On December 31, 2007, Kratos acquired Indianapolis, Indiana headquartered Haverstick Consulting, Inc. (Haverstick). On June 28, 2008, Kratos acquired San Diego, California headquartered SYS. On November 24, 2008 Kratos and Digital Fusion announced the execution of an Agreement and Plan of Merger.

The accompanying unaudited pro forma condensed combined financial statements present:

1) the pro forma combined consolidated balance sheet of the combined companies based upon the historical financial statements of Kratos (which includes Haverstick and SYS) and Digital Fusion after giving effect to the Digital Fusion merger and adjustments described in these footnotes.

2) the pro forma consolidated results of operations of the combined companies based upon the historical financial statements of Kratos, Haverstick, SYS and Digital Fusion after giving effect to the Haverstick, SYS and Digital Fusion mergers and adjustments described in these footnotes.

The unaudited pro forma condensed combined balance sheet reflects the merger as if it was completed on September 28, 2008 and includes pro forma adjustments for Kratos' preliminary estimates of the fair value of Digital Fusion's assets and liabilities, including intangible assets. Digital Fusion's line of credit is assumed to be fully retired upon completion of the merger (see note 2(q)). These adjustments are subject to further adjustment as additional information becomes available and additional analyses are performed. The unaudited pro forma condensed combined statement of operations reflect the merger as if it had been completed on January 1, 2007.

The pro forma condensed combined balance sheet has been adjusted to reflect the acquisition of Digital Fusion and the preliminary allocation of the preliminary estimated purchase consideration to identifiable tangible and intangible assets acquired and liabilities assumed, with the remainder recognized as goodwill. The purchase price allocation included within these unaudited pro forma condensed combined financial statements is based upon a purchase price of approximately $37.7 million, which includes estimated direct transaction costs of $1.4 million to be paid by Kratos. This amount was derived from the estimated number of shares of Kratos common stock to be issued of approximately 25.4 million. This was based on 12.2 million shares of Digital Fusion common stock outstanding and 1.9 million of Digital Fusion stock options outstanding and in the money. The options were calculated using the treasury stock method. Digital shares were assumed to be converted into common stock at the close of the transaction at the exchange ratio of 1.7933 per each Digital Fusion share, at a price of $1.36 per share, the average closing price of Kratos shares of common stock for the five days prior to the public announcement of the merger on November 24, 2008. The treasury stock method was utilized to estimate the number of outstanding options potentially converted into Digital Fusion common stock due to a number of factors including the ability under the Digital Fusion stock option plans to do a net exercise. The actual number of newly issued shares of Kratos common stock to be delivered in connection with the merger will be based upon the actual number of Digital Fusion shares issued and outstanding when the merger closes.

The purchase price also includes the estimated fair value of Kratos stock options which will be exchanged for stock options of Digital Fusion which are currently out of the money. Digital Fusion stock options will be converted to Kratos stock options at the exchange ratio of 1.7933 per each Digital Fusion stock option and the exercise price will be the exercise price of the Digital Fusion stock options divided by this exchange ratio. Vested stock options are considered part of the purchase price.

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

NOTE 1. BASIS OF PRO FORMA PRESENTATION (Continued)

Accordingly, the purchase price includes an estimated fair value of Kratos stock options of $1.8 million. The fair value of the Kratos unvested stock options to be issued to holders of Digital Fusion stock options as of September 28, 2008 is $0.4 million. Annual compensation expense related to these awards is expected to approximate the historic compensation expense.

The value of Kratos stock options was estimated by using the Black-Scholes option pricing model with market assumptions. Option pricing models require the use of highly subjective market assumptions, including expected stock price volatility, which if changed can materially affect fair value estimates. The more significant assumptions used in estimating the fair value of Kratos options include the following weighted average assumptions: volatility of 56%, an expected life of 4 years based upon the age of the original award, and a risk free interest rate of 2%.

The accompanying unaudited pro forma condensed combined financial statements are presented for illustrative purposes only and do not give effect to any cost savings, revenue synergies or restructuring costs which may result from the integration of Kratos, Haverstick, SYS and Digital Fusion's operations.

Preliminary Estimated Purchase Price Allocation

The preliminary allocation of the purchase price to Digital Fusion's tangible and identifiable intangible assets acquired and liabilities assumed was based on their estimated fair values. The valuation of these tangible and identifiable intangible assets and liabilities is subject to further management review and may change materially between the preliminary valuation date and the completion of the merger.

The calculation of purchase price and goodwill and other intangible assets is estimated as follows (dollars in millions):

Estimated fair value of Kratos common stock issued to Digital Fusion shareholders	$34.5
Estimated fair value of outstanding Digital Fusion options	1.8
Estimated transaction costs	1.4
Assumed total purchase price	$37.7
Purchase price allocated to:	
Tangible assets acquired less liabilities assumed	$ 7.5
Deferred tax adjustments	(6.6)
Unrecognized compensation expense on unvested stock options	(0.4)
Identifiable intangible assets	8.3
Goodwill	28.9
	$37.7

Tangible Assets Acquired and Liabilities Assumed

Kratos has estimated the fair value of tangible assets acquired and liabilities assumed. These estimates are based on a preliminary valuation and are subject to further review by management, which may result in material adjustments at the completion of the mergers. The fair values of the assets

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

NOTE 1. BASIS OF PRO FORMA PRESENTATION (Continued)

acquired and liabilities assumed may be affected and materially changed by the results of Digital Fusion's operations and changes in market values up to the completion of the merger.

Identifiable Intangible Assets

Kratos has estimated the fair value of the acquired identifiable intangible assets, which are subject to amortization, using the income approach. These estimates are based on a preliminary valuation and are subject to further review by management and adjustments (which may be material) at the completion of the merger, which may reflect, among other considerations, the effect of Digital Fusion's operations between the preliminary valuation and the closing date. The following table sets forth the components of these intangible assets and their estimated useful lives (dollars in millions):

	Fair Value	Estimated Useful Life
Funded backlog	$ 0.8	3 years
Unfunded backlog	$ 3.1	6 years
Existing contractual relationships	$ 1.3	7 years
Contractual relationships	$ 2.2	9 years
Other existing contractual relationships	$ 0.9	10 years

NOTE 2. PRO FORMA ADJUSTMENTS

The following is a summary of the adjustments to the pro forma balance sheet:

a. To reflect the payment of $2.3 million in transaction costs of which $0.9 million is paid by Digital Fusion, which include legal and financial advisory costs and $1.4 million is paid by Kratos.

b. To record the residual goodwill resulting from the merger. The amount of goodwill reflects the goodwill of $28.9 million offset by the elimination of preexisting Digital Fusion goodwill of $5.9 million and includes $0.4 million related to deferred compensation cost for unvested Kratos stock options to be issued to holders of Digital Fusion stock options.

c. To reflect a preliminary allocation of the preliminary estimated purchase consideration to Digital Fusion's identifiable intangible assets of $8.3 million offset by the elimination of preexisting Digital Fusion intangible assets of $0.5 million.

d. To record adjustments to deferred taxes resulting from the inclusion of Digital Fusion tax accounts including impact of indefinite lived deferred tax liability.

The following is a summary of the adjustments to the statement of operations for Haverstick, SYS and Digital Fusion:

e. To include amortization expense related to identifiable intangible assets of $2.3 million. The identifiable intangible assets of Haverstick are $9.3 million with assumed useful lives of

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

NOTE 2. PRO FORMA ADJUSTMENTS (Continued)

1-9 years. The assets will be amortized on a straight line basis and the adjustments to SG&A to give effect to the acquisition are presented below (in millions):

Amortization of:	**Year ended December 31, 2007**
Funded backlog	$ 1.0
Unfunded backlog	0.8
Existing contractual relationships	0.5
Total amortization expense	$ 2.3

f. To eliminate transaction costs of $2.4 million.

g. To present the adjustments related to interest expense. This is comprised of:

Interest expense of $7.9 million on the outstanding balance of $66.7 million drawn on the credit facility provided by KeyBank National Association (KeyBank) on December 31, 2007, as described in the Current Report on Form 8-K, dated December 31, 2007 and filed with the U.S. Securities and Exchange Commission on January 6, 2008 as though the balance was outstanding for the entire period. The pro forma adjustment for interest expense related to the Company's line of credit is based upon a variable rate of interest that was 11.8 percent as of December 31, 2007.

Amortization of deferred financing costs of $0.7 million related to the KeyBank credit facility.

Elimination of Haverstick interest expense of $14.9 million on debt and amortization of deferred financing costs and discount on Haverstick's term note which was retired at closing.

The amount of interest expense in each of the periods presented would not change by more than $0.1 million if the interest rate changed by $^1/_8$ percent.

h. To record a tax benefit related to Haverstick indefinite life items not previously recognized by Haverstick.

i. To adjust the common shares outstanding to reflect the number of Kratos weighted average common shares that would have been outstanding had the Haverstick Acquisition been completed at the beginning of the period presented.

j. The preliminary estimate of the identifiable intangible assets of SYS is $8.9 million with estimated assumed useful lives of 5-10 years. The assets will be amortized on a straight line

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

NOTE 2. PRO FORMA ADJUSTMENTS (Continued)

basis and the adjustments to SG&A to give effect to the acquisition are presented below (in millions):

Amortization of:	Year ended December 31, 2007	Nine months ended September 28, 2008
Funded backlog	$ 0.1	$ 0.0
Unfunded backlog	0.1	0.0
Existing contractual relationships	0.2	0.1
Developed technology and trade names	0.5	0.3
Customer relationships	0.1	0.1
	1.0	0.5
Elimination of SYS's previously-recorded amortization of acquisition-related intangible assets	(1.0)	(0.5)
Pro Forma adjustment to amortization of acquisition-related intangible assets	$ 0.0	$ 0.0

The amount of purchase price allocated to tangible and intangible assets, and the associated assumptions regarding useful lives, represent preliminary estimates by Kratos management that were derived using estimated discounted cash flows and are subject to change pending completion of a restructuring analysis which is in progress and may impact the final valuation. The amount of purchase price allocated to tangible and intangible assets, as well as the associated useful lives, may increase or decrease and could materially affect the amount of pro forma depreciation and amortization expense.

k. To eliminate transaction costs of $3.1 million.

l. To adjust tax expense for amount as if SYS had been combined with Kratos for this period.

m. To record the issuance of 25.3 million common shares to the stockholders of SYS to effect the transaction as if the shares were outstanding as of the beginning of the period presented. During the nine months ended September 28, 2008, the difference between the 25.3 million common shares issued and the 8.6 million shares already included in Kratos's basic and diluted share count as a result of the completion of the transaction on June 28, 2008 was recorded. Shares of 1.1 million related to the SYS convertible debt were not included in the calculation of diluted shares as they were anti-dilutive for the periods presented.

n. The preliminary estimate of the identifiable intangible assets of Digital Fusion is $8.3 million with estimated assumed useful lives of 3-10 years. The assets will be amortized on a straight

NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS (Continued)

NOTE 2. PRO FORMA ADJUSTMENTS (Continued)

line basis and the adjustments to SG&A to give effect to the acquisition are presented below (in millions):

Amortization of:	Year ended December 31, 2007	Nine months ended September 28, 2008
Funded backlog	$ 0.3	$ 0.2
Unfunded backlog	0.5	0.4
Contractual relationships	0.5	0.4
	1.3	1.0
Elimination of Digital Fusion's previously-recorded amortization of acquisition-related intangible assets	(0.4)	(0.3)
Pro Forma adjustment to amortization of acquisition-related intangible assets	$ 0.9	$ 0.7

The amount of purchase price allocated to tangible and intangible assets, and the associated assumptions regarding useful lives, represent preliminary estimates by Kratos management that were derived using estimated discounted cash flows and are subject to change pending completion of a final valuation. The amount of purchase price allocated to tangible and intangible assets, as well as the associated useful lives, may increase or decrease and could materially affect the amount of pro forma depreciation and amortization expense.

o. To eliminate interest expense related to debt that was retired upon close of the transaction.

p. To adjust tax expense for amount as if Digital Fusion had been combined with Kratos for this period.

q. To record issuance of 25.4 million common shares to the stockholders of Digital Fusion to effect the transaction as if the shares were outstanding as of the beginning of the period presented. This amount was based on 12.2 million shares of Digital Fusion common stock outstanding and 1.9 million of Digital Fusion stock options outstanding and in the money, calculated using the treasury stock method, and assumed to be converted into common stock at the close of the transaction at the exchange ratio of 1.7933 per each Digital Fusion share.

(2) Reclassifications

Certain reclassifications have been made to the financial statements of Haverstick and Digital Fusion to conform to Kratos' presentation.

MANAGEMENT OF KRATOS

The current directors and executive officers of Kratos will continue to serve as directors and executive officers of the company following the completion of the merger. Below is information about Kratos' current directors and executive officers.

Current Board of Directors and Executive Officers of Kratos

Board of Directors

The Kratos board of directors is elected annually and currently consists of five members:

Name	Age	Committees
Scott I. Anderson	49	Audit Committee Chair and Nominating and Corporate Governance Committee
Bandel L. Carano	46	Compensation Committee and Nominating and Corporate Governance Committee
Eric M. DeMarco	45	
William A. Hoglund	54	Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee Chair
Scot B. Jarvis	47	Audit Committee, Compensation Committee Chair and Nominating and Corporate Governance Committee

Scott I. Anderson, 49, has been a director since February 1997. Since 1997, Mr. Anderson has been a principal of Cedar Grove Partners, LLC, an investment and advisory concern. Since 1998, Mr. Anderson has also been a principal of Cedar Grove Investments, LLC, a private seed capital firm. Mr. Anderson was with McCaw Cellular/AT&T Wireless, most recently as Senior Vice President of the Acquisitions and Development group. Mr. Anderson served on the board of directors of SunCom Wireless until its acquisition by T-Mobile in February 2008 and currently serves on the boards of directors of mInfo, Inc., GotVoice, Inc., CosComm International, Inc., Globys, Inc. and Anvil Corp. Mr. Anderson is a member of the control groups of Von Donop Inlet PCS, LLC and LCW Wireless, LLC, both wireless licensees. He holds a B.A. in History from the University of Washington, Magna Cum Laude, and a J.D. from the University of Washington Law School, with highest honors.

Bandel L. Carano, 46, originally served as a director from August 1998 to June 2001, and re-joined the Kratos board of directors in October 2001. Since 1987, he has been a general partner of Oak Investment Partners, a multi-stage venture capital firm. Mr. Carano also serves on the Investment Advisory Board of the Stanford Engineering Venture Fund, the boards of directors of Airspan Networks, Inc. and FiberTower Corporation, the supervisory board of Tele Atlas N.V. and the board of directors of numerous private companies, including MobiTV, NeoPhotonics, nLight Photonics, Tensilica and Visto Corporation. Mr. Carano holds a B.S. and an M.S. in Electrical Engineering from Stanford University. Mr. Carano was nominated and elected as one of Kratos' directors pursuant to the terms of a purchase agreement among Kratos and certain of its stockholders in connection with the sale of Kratos' Series A Convertible Preferred Stock in October 2001.

Eric M. DeMarco, 45, joined Kratos in November 2003 as President and Chief Operating Officer. Mr. DeMarco was appointed a director and assumed the role of Chief Executive Officer effective April 1, 2004. Prior to coming to Kratos, Mr. DeMarco most recently served as President and Chief Operating Officer of The Titan Corporation ("Titan"), a Delaware corporation. Prior to his being named President and Chief Operating Officer, Mr. DeMarco served as Executive Vice President and Chief Financial Officer of Titan. Prior to joining Titan, Mr. DeMarco served in a variety of public accounting positions primarily focusing on large multinational corporations and publicly traded companies. Mr. DeMarco holds a Bachelor of Science, Business Administration and Finance, Summa Cum Laude, from the University of New Hampshire.

William A. Hoglund, 54, has been a director since February 2001. Mr. Hoglund is also a member of Safeboats International, LLC. From 1996 to 2000 Mr. Hoglund served as the Vice President and Chief Financial Officer of Eagle River, LLC, a private investment company. During his tenure at Eagle River, Mr. Hoglund was also a director of Nextel Communications, Inc. and Nextlink Communications, Inc. Mr. Hoglund holds a B.A. in Management Science and German Literature from Duke University and an MBA from the University of Chicago.

Scot B. Jarvis, 47, joined the Kratos board of directors in February 1997. Mr. Jarvis co-founded Cedar Grove Partners, LLC in 1997, an investment and consulting/advisory partnership, and currently is its managing member. Prior to co-founding Cedar Grove, Mr. Jarvis served as a senior executive of Eagle River, Inc., a McCaw investment firm. While at Eagle River he founded Nextlink Communications on behalf of McCaw and served as its president. He also served as a regional president for Nextel Communications. From 1985 to 1994, Mr. Jarvis served in several executive capacities at McCaw Cellular Communications up until it was sold to AT&T. Mr. Jarvis serves on the corporate boards of Cantata Technology, Inc., Wavelink Corporation, Visto Corporation, SkyPipeline and Slingshot Sports. Mr. Jarvis holds a B.A. in Business Administration from the University of Washington.

Management

Each of Kratos' executive officers, his or her respective position and biographical information for each executive officer who is not also a director is set forth following the table. There are no family relationships between any director or executive officer and any other directors or executive officers. Executive officers serve at the discretion of the Kratos board of directors.

Name	**Position**	**Age**	**Year in Which He/She Became Officer**
Eric M. DeMarco	Chief Executive Officer and President	45	2003
Deanna H. Lund	Senior Vice President and Chief Financial Officer	41	2004
Laura L. Siegal	Vice President, Corporate Controller and Acting Secretary	46	2006

Deanna Lund has served as Kratos' Senior Vice President and Chief Financial Officer since April 2004. Prior to joining Kratos, Ms. Lund most recently served as Vice President of The Titan Corporation from July 1998 and Titan's Corporate Controller from December 1996. Ms. Lund was also Titan's Corporate Manager of Operations Analysis from 1993 to 1996. Prior thereto, Ms. Lund worked for Arthur Andersen LLP. Ms. Lund received her bachelor's degree in accounting from San Diego State University, magna cum laude, and is a Certified Public Accountant.

Laura Siegal has served as Kratos' Vice President and Corporate Controller since April 4, 2006. Prior thereto Ms. Siegal served as Vice President, Finance and Treasurer and Risk Management since September 2004. Ms. Siegal joined Kratos in August 2000 and has served as Treasurer since December 2003, Director of Corporate Planning from August 2002 to December 2003, Director of Financial Planning and Analysis from January 2001 to August 2002, and Director of Purchasing from August 2000 to January 2001. Throughout her career, Ms. Siegal has held a variety of financial management positions in technology and consulting companies including Controller of MEC Analytical Systems. Ms. Siegal received a bachelor's degree in Economics from the University of California, San Diego.

Director Independence

The Kratos board of directors has unanimously determined that four of its directors, Messrs. Anderson, Carano, Hoglund and Jarvis, who constitute a majority of the Kratos board of directors, are "independent" as that term is defined by the NASDAQ Marketplace Rule 4200(a)(15). In making this determination, the Kratos board of directors has affirmatively determined, considering broadly all relevant facts and circumstances regarding each independent director, that none of the independent directors has a material relationship with Kratos (either directly or as a partner, stockholder, officer or affiliate of an organization that has a relationship with Kratos). In addition, based upon such standards, the Kratos board of directors determined that Mr. DeMarco is not "independent" because he is the President and Chief Executive Officer.

Certain Relationships and Related Person Transactions

On May 30, 2002, Kratos issued an aggregate of 90,000 shares of Series B Convertible Preferred Stock, at an aggregate purchase price of $45.0 million, in a private placement to entities affiliated with one of the directors of Kratos (40,000 shares), to a brother of the previous Chairman and Chief Executive Officer of Kratos (10,000 shares) and to an unrelated third-party investor (40,000 shares). Kratos received $44.9 million of net proceeds. Each share of Series B Convertible Preferred Stock is initially convertible into 100 shares of common stock for a conversion price of $5.00 per share, which was the fair market value of the common stock at the closing, at the option of the holder at any time, subject to certain provisions in the Series B Preferred Stock Purchase Agreement. Prior to December 31, 2004, 64,517 shares of Series B Convertible Preferred Stock were converted into 6,451,700 shares of the Kratos' common stock. On April 5, 2006, 15,483 shares of Series B Convertible Preferred Stock were converted into 1,548,300 shares of Kratos' common stock.

Through December 31, 2007, Kratos has received notices from the holders to convert an aggregate number of 80,000 shares of Series B Convertible Preferred Stock into an aggregate 8,000,000 shares of Kratos' common stock. On December 31, 2007, the total liquidation preference equaled $5.0 million.

On February 17, 2006, Kratos entered into a definitive agreement to divest all of its operations in Mexico for total approximate cash consideration of $18.0 million subject to adjustments for the closing net asset calculations, with $1.5 million payable in cash on signing of the Equity Purchase Agreement and $16.5 million by means of a secured promissory note payable in installments through December 2006, which approximates the net book value of the operations. The purchaser, Sakoki LLC, is a newly-formed entity controlled by Massih Tayebi. Although Massih Tayebi has no current role with Kratos, he was a co-founder of Kratos, having served as Chief Executive Officer from inception in 1994 through September 2000 and as a director from inception through April 2002. In addition, as of July 31, 2007, Massih Tayebi owns or controls approximately 8.2% of the total voting power of Kratos' capital stock. He is also the brother of Masood Tayebi, who was Kratos' Chairman of the board of directors until March 6, 2007. Masood Tayebi had no personal financial interest in the transaction and has no role with the entity that has purchased the Mexico operations. The transaction was approved by the disinterested members of Kratos' board of directors after consideration of other expressions of interest and an independent valuation analysis.

The final closing balance sheet as of February 17, 2006 resulted in net asset adjustments aggregating to a total approximate $18.9 million consideration, $1.5 million which was paid on February 17, 2006, with the remaining $17.4 million payable by means of the promissory note in installments through December 31, 2006 with an interest rate of 7.5% per annum. On June 26, 2006, Kratos entered into an Addendum with the buyer to finalize the closing net asset calculations, pursuant to which the parties agreed that the resulting total purchase price was $18.9 million. The Addendum also provided for a conditional waiver that permits the purchaser to make the payment due on August 17, 2006 by September 30, 2006, and for the installments due on November 17, 2006 and December 31, 2006 to be made on or before December 29, 2006. Failure to make the payments on such later dates would have resulted in a restoration of the original terms of the note. The first scheduled note payment of $3.3 million was received from the buyer on May 19, 2006, and the second scheduled note payment of $5.5 million was received in installments of $5.2 million on September 29, 2006 and $0.3 million on October 10, 2006. The remaining note receivable balance of $9.5 million which included accrued interest through December 29, 2006, was paid in full on December 29, 2006.

Other than as disclosed above, since January 1, 2005, there has not been, nor is there currently proposed, any transaction or series of similar transactions to which Kratos was or is a party in which the amount involved exceeds $120,000 and in which any director, officer or beneficial holder of more than 5% of any class of voting securities or member of such person's immediate family had or will have a direct or indirect material interest.

Procedures for Approval of Related Party Transactions

Under its charter the Audit Committee of the Kratos board of directors is charged with reviewing all potential related party transactions. Kratos' policy has been that the Audit Committee, which is comprised solely of independent, disinterested directors, then recommends such related party transactions to the entire Kratos board of directors for further review and approval. All such related party transactions are then required to be reported under applicable SEC rules. Otherwise, Kratos has not adopted procedures for review of, or standards for approval of, these transactions, but instead reviews such transactions on a case-by-case basis.

KRATOS EXECUTIVE COMPENSATION

Compensation Discussion and Analysis

Overview

This compensation discussion and analysis explains the material elements of the compensation awarded to, earned by, or paid to each of the Kratos executive officers who served as named executive officers of Kratos during the last completed fiscal year.

Compensation Program Objectives and Philosophy

The Compensation Committee of the Kratos board of directors, which is referred to in this section as the Committee, currently oversees the design and administration of the executive compensation program at Kratos. The Committee has adopted an executive compensation policy that has as its primary objective serving Kratos' stockholders by attracting, retaining and motivating talented and qualified individuals to manage and lead Kratos' business. The Committee's primary objectives in structuring and administering the executive compensation policy are to:

- attract, motivate and retain talented and dedicated executive officers;
- tie annual and long-term cash and stock incentives to achievement of measurable corporate and individual performance objectives;
- reward individual performance; and
- reinforce business strategies and objectives for enhanced stockholder value.

The Committee evaluates both performance and compensation of employees to ensure that Kratos has the ability to attract and retain employees and that compensation provided to employees remains competitive relative to the compensation paid to similarly situated employees of peer companies. The Committee endeavors to ensure that the total paid to executive officers is fair, reasonable and competitive.

The principal elements of the current executive compensation program are base salary, annual incentive cash bonus awards, long-term equity incentives in the form of restricted stock units, a deferred compensation plan, other benefits and perquisites, post-termination severance and accelerated vesting of previously granted equity awards upon termination and/or a change in control. Other benefits and perquisites at Kratos consist of life and health insurance benefits and a qualified 401(k) savings plan equivalent to those offered to all employees.

The Committee views these components of compensation as related but distinct. Although the Committee does review total compensation, Kratos does not believe that significant compensation derived from one component of compensation should negate or offset compensation from other components. Kratos determines the appropriate level for each compensation component based in part, but not exclusively, on compensation for similar positions at peer companies, the Committee's view of internal equity and consistency, and other considerations it deems relevant, such as rewarding extraordinary performance.

Determination of Compensation Awards

The Committee has historically performed at least annually a strategic review of executive officers' compensation to determine whether they provide adequate incentives and motivation to Kratos' executive officers and whether they adequately compensate executive officers relative to comparable officers in other similarly situated companies. The Committee's most recent review occurred in March 2008.

Committee meetings typically have included, for all or a portion of each meeting, not only the Committee members but also Kratos' chief executive officer, chief financial officer and general counsel.

For compensation decisions relating to executive officers other than the chief executive officer, the Committee typically considers recommendations from the chief executive officer. When determining compensation for the chief executive officer, the Committee takes into account, but does not rely upon, the recommendation of the chief executive officer. Compensation for the chief executive officer has been determined by discussion among and action by the members of the Committee acting in consultation with the other independent members of the Board and market data obtained on behalf of the Committee.

It is Kratos' policy generally to qualify compensation paid to executive officers for deductibility under Section 162(m) of the Internal Revenue Code. Section 162(m) generally prohibits the company from deducting the compensation of officers that exceeds $1,000,000 unless that compensation is based on the achievement of objective performance goals. Kratos believes that its 1999 and 2005 Equity Incentive Plans, which is referred to collectively as the Equity Plans, are structured to qualify stock options, restricted share and stock unit awards under such Equity Plans as performance-based compensation and to maximize the tax deductibility of such awards. However, Kratos reserves the discretion to pay compensation to its officers that may not be deductible.

Base Compensation

Kratos provide its named executive officers and other executives with base salaries that it believes enables it to hire and retain individuals in a competitive environment and to reward individual performance and contribu