

AI in DEFENSE:

The Cutting-Edge Company Protecting America's Shores



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By Ian King, Editor, *Strategic Fortunes*

WE'RE currently in an "AI arms race." Companies across industries in every corner of the market are competing to either implement artificial intelligence technologies, or *supply* them.

This doesn't just include Big Tech companies, like Nvidia, Microsoft, Google or other members of the "Magnificent 7."

It also includes entertainment, education, manufacturing and even farming.

The rise of AI is mass economic disruption on a scale we haven't seen since the advent of the internet.

Austrian economist Joseph Schumpeter called it "**creative destruction.**" By his definition, it's the "process of industrial mutation that revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one."

It means that new technologies and innovations have the power to create new businesses and new industries...

But they also render previous technologies and processes obsolete. In this process, this both destroys jobs, while simultaneously creating new ones.

Analysts expect AI to add **\$15.7 trillion** to the global economy by 2030. It will also disrupt as many as *one out of every three jobs* on the planet in the process.

We're already seeing this with AI today:

- **Customer Service:** Several companies use AI bots as customer service representatives, whether by phone or Live Chat.
- **Manufacturing:** Repetitive tasks on manufacturing lines like fastening or welding are already being automated. Companies like Amazon continue to implement automation across warehouse fulfillment centers with robotics and AI software. (This puts over 2 million U.S. jobs at risk.)
- **Health Care:** AI is augmenting radiology with enhanced imaging analysis and pattern recognition. This could reduce the need for radiologists. AI algorithms can now also analyze biopsy samples, and even diagnose diseases such as cancer.
- **Finance:** AI is automating loan application processing and credit risk analysis, as well as taking over analyses for writing insurance policies and claims.

These are just a select few examples, in which AI *will* take jobs away...

But they'll also create new ones. This will also give you a chance to invest in companies where early adoption of AI can turn million-dollar companies ... into billion-dollar companies.

The choices you make *today* will determine whether you end up on the losing side, or on the winning side — like investors in John Deere, Apple, Amazon and Netflix ... many of whom went on to become millionaires.

So now, aside from health care and manufacturing, another important sector AI is disrupting is a matter of *national* importance...

The **defense** sector.

Defense: A Massive Sector Primed for An Upgrade

The United States defense sector is massive, thanks to the unique role of America in geopolitics, and the importance the government places on it.

In 2022 alone, the U.S. spent more on defense than the next 10 biggest spenders combined.

And the U.S. is not stopping there. It's actually planning on increasing the amount it spends on national defense.

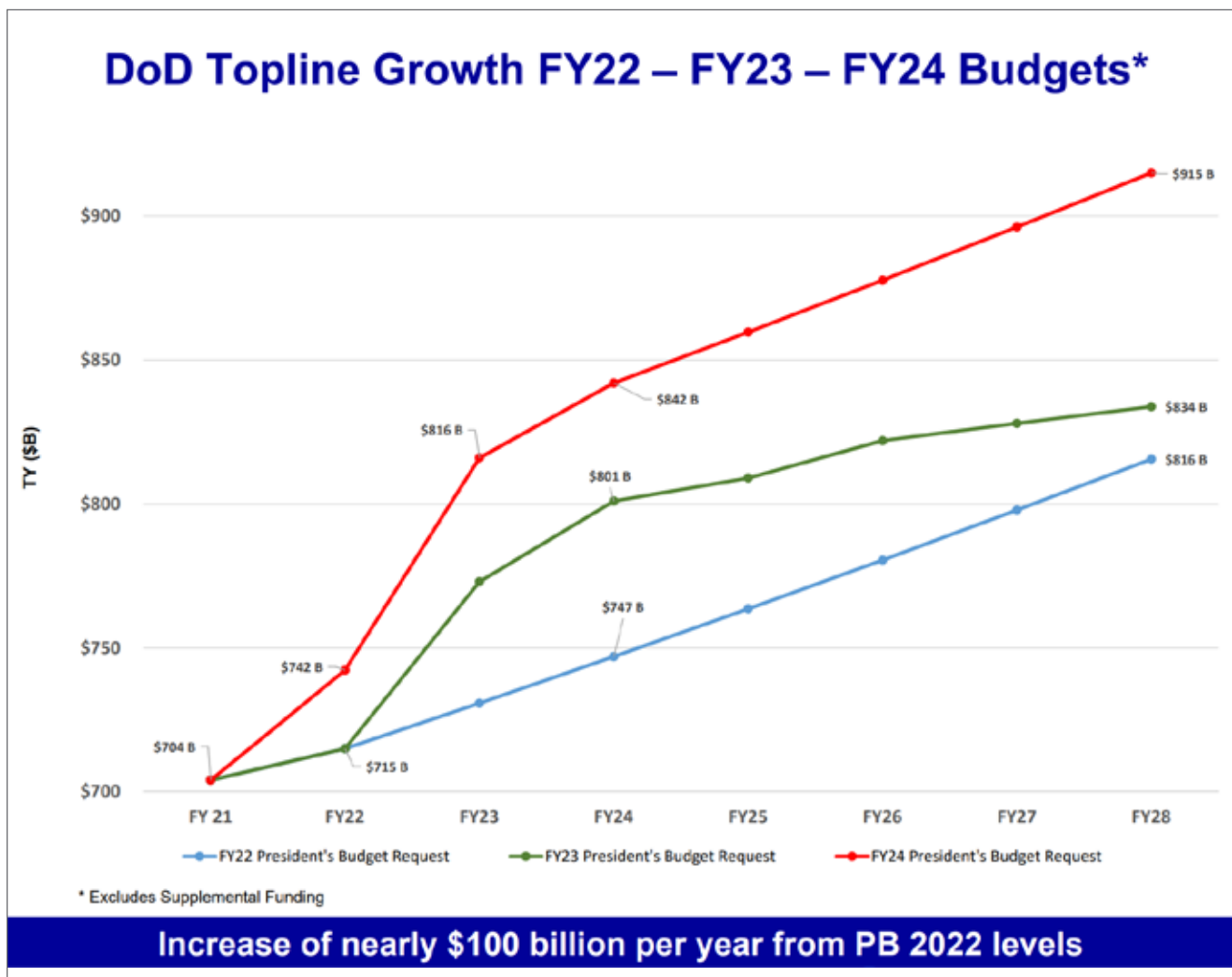
This trend started to pick up with the Russian invasion of Ukraine, but in the future, much of this spending is a matter of strategic initiatives to deal with the challenges posed by China.

According to the latest National Defense Strategy (NDS), China is the United States' most "consequential strategic competitor for the coming decades."

The NDS is produced every four years to identify threats to the U.S. and offers long-term guidance for the Department of Defense (DoD).

The NDS went on to describe China as "the only competitor with both the intent to reshape the international order and, increasingly, the economic, diplomatic, military, and technological power to do it."

This is why, in March 2024, the DoD released its in-depth budget documents showcasing an \$842 billion budget for fiscal 2024. The budget is an increase of \$26 billion over fiscal 2023 and \$100 billion more than fiscal 2022.



Secretary of Defense Lloyd J. Austin III explained the size of this budget by saying it was the path to keeping up with the “pacing challenge” of China, and other threats.

The budget comes with an extra emphasis on space-based systems such as satellite communications and deterrence systems, which has the largest ever space budget of \$33.3 billion.

It also contains an \$11 billion allocation for missiles and weapons systems, as well as a \$29.8 billion allocation for radar and missile defense systems.

The budget also focuses on the future of warfare, with a \$61.6 billion allocation to boost air power (with an emphasis on unmanned aerial systems).

Beyond this allocation, the U.S. Air Force is asking the government for \$5.8 billion over the next five years to develop unmanned combat aircrafts.

And to a lesser degree, the budget also includes \$342 million to advance sea power for the U.S. Navy through unmanned surface and undersea vehicles.

That’s why San Diego-based **Kratos Defense & Security Solutions (Nasdaq: KTOS)** is in the right business at the right time.

Founded in 1995, Kratos is a government contractor that designs and implements information technology systems and provides engineering and other technical services to the U.S military, federal, state and local intelligence agencies as well as international commercial customers.

The company’s **primary focus areas** are:

- Unmanned systems (drones).
- Space and satellite communications.
- Cybersecurity/warfare.
- Rocket/missile defense systems.
- Computing and intelligence surveillance.

The company also **operates** in two reportable segments:

- Kratos Government Solutions.
- Unmanned Systems.

The **Kratos Government Solutions** segment generates about 80% of sales.

This segment provides microwave electronic products, space, training and cybersecurity, C5ISR/modular systems, turbine technologies, as well as defense and rocket support services.

The **Unmanned Systems** segment generates nearly 20% of sales.

It provides unmanned aerial systems and unmanned ground, unmanned seaborne, and command, control and communications system products to its customers.

Kratos’s mission is to be the leader in developing and delivering leading technology systems at an affordable cost.

Drones: The AI-Powered Opportunity in Defense

Although it only makes up 20% of Kratos’ revenues, the most lucrative part of its business with the most amount of growth potential is its Unmanned Systems segment.

In 2011, Kratos’ executives could see that large swaths of future U.S. defense budgets would steadily evolve toward robotic unmanned systems of all kinds — aircraft, ground vehicles and boats.

That's when Kratos plunked down \$155 million to buy a privately held maker of drone aircrafts, Composite Engineering.

But Kratos's and its new acquisition staked out a different part of the game: drones built for use by the military as unmanned aerial targets.

For instance, U.S. Air Force pilots need real-time training on a regular basis against simulated "air-to-air" and "ground-to-air" missile threats to maintain combat readiness.

Kratos's 10-foot-long, 2,000-pound, bright red BQM-167A jet-powered target drone (which can fly almost to the speed of sound and be reused multiple times) stands in nicely for these exercises.

That's why the Air Force awarded a contract to Kratos — a \$109 million deal to build dozens of such target drones.

Not to be left out, the U.S. Army later contracted with Kratos to deliver \$93 million worth of these drones.

And Kratos isn't stopping there. It's currently working on taking its unmanned systems to the next level using AI.

Kratos's XQ-58 Valkyrie is a drone that can be flown using an AI pilot software. In this way, the drone can operate on its own or act as an AI-powered aerial teammate to a human-piloted jet.

The U.S. Airforce is currently working with Kratos on this jet because it has recently seen the vulnerabilities of traditional drones in theaters of war.

At one point during the war, Ukraine was losing 10,000 drones per month due to Russian electronic warfare that jams communications and GPS.

That means that these drones could no longer receive commands and directions from their remote pilots, rendering them useless.

But if they are equipped with AI pilots, they just need to be given an initial set of directions and don't require constant communication with remote pilots.

Kratos is also bringing this same technology to the U.S. Navy by installing an AI pilot on a variation of the earlier mentioned BQM-167A to enhance the Navy's fleet protection capabilities.

Kratos is in a very favorable position in this sector because it currently produces around 150 jet drones annually. It does so at a relatively inexpensive cost of \$400,000 to \$6.5 million per unit compared to human-piloted jets, which go for just under \$200 million per unit.

This low cost, plus its budding AI angle allows it to win multiple contracts with the Air Force, Navy, Army, Marine Corps and other military forces.

In other words, the target drone business is a growing part of Kratos's revenue picture.

In 2012, the first year of operations for the company's Unmanned Systems division, drone sales accounted for about 9% of Kratos's total revenue.

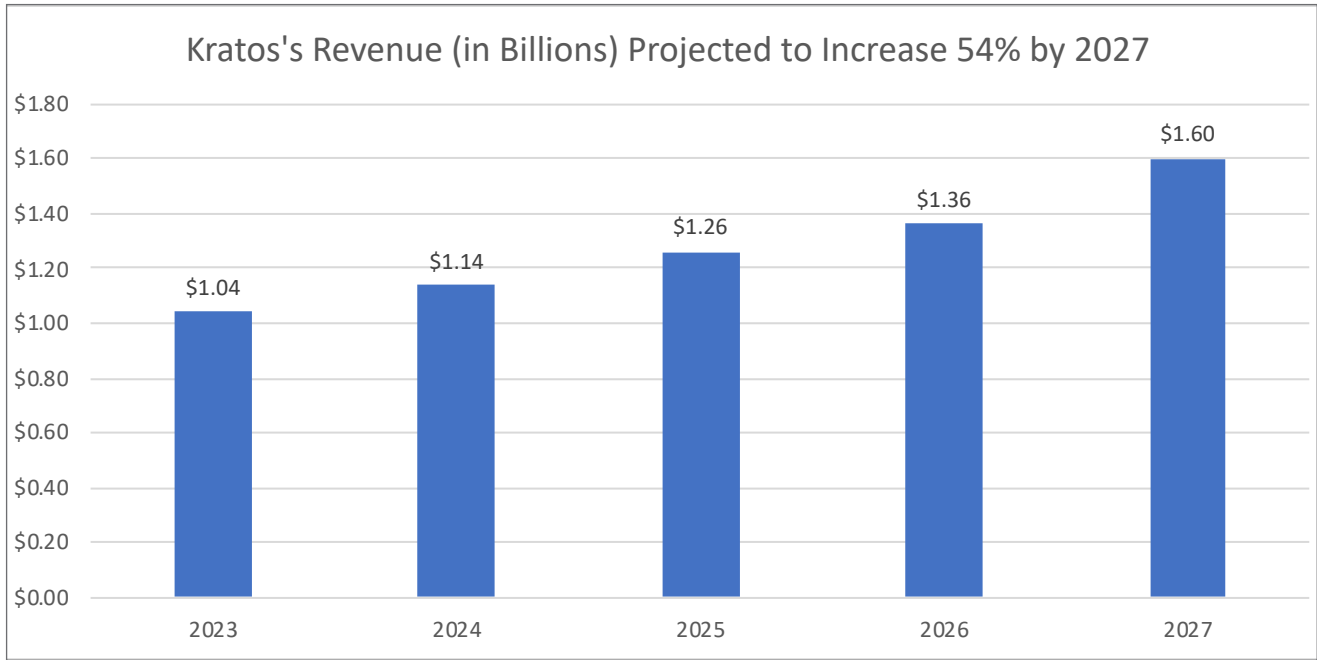
By 2022, they made up 20% of revenue (**\$273.8 million**) and should continue to grow in the years ahead.

Kratos: Our AI Defense & Drone Play

Although defense sector stocks usually tend to be slow-growing, large-cap value stocks, Kratos offers a shot at investing for *growth* within this sector.

Kratos's company revenue is projected to reach 1.6 billion by 2027. This is from 1.04 billion in 2023, and so is an increase of **54%**.

The company's annual earnings per share is also forecasted to reach \$1.05 from \$0.42 in fiscal year 2023.



The way I see it, Kratos is the right stock at the right time for us.

We'll be benefiting on two fronts: The overall business will allow us to take advantage of steady growth in overall U.S. defense spending, while Kratos's drone programs will allow us to profit from the AI-powered evolution of the military.

Action to Take: Buy Kratos Defense & Security Solutions (Nasdaq: KTOS).

Regards,

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