KEYW HOLDING CORP
Form 10-Q
August 09, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: June 30, 2016
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________________ to ________________

Commission File Number: 001-34891

The KEYW Holding Corporation
(Exact name of registrant as specified in its charter)

Maryland (State or other jurisdiction of incorporation or organization)	27-1594952 (I.R.S. Employer Identification No.)
7740 Milestone Parkway, Suite 400 Hanover, Maryland	21076
(Address of principal executive offices)	(Zip Code)

(443) 733-1600
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No ý

The number of shares outstanding of the issuer’s common stock ($0.001 par value), as of July 29, 2016 was 40,955,243.

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ITEM 1. FINANCIAL STATEMENTS

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

Condensed Consolidated Balance Sheets
(In thousands, except share and par value per share amounts)

	June 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 47,930	$ 21,227
Receivables	39,678	53,111
Inventories, net	16,017	15,616
Prepaid expenses	2,003	1,538
Income tax receivable	354	302
Assets of discontinued operations	3,170	7,765
Total current assets	109,152	99,559
Property and equipment, net	28,227	28,750
Goodwill	289,990	297,223
Other intangibles, net	8,023	10,957
Other assets	1,529	1,508
Non-current assets of discontinued operations	—	15,408
TOTAL ASSETS	$ 436,921	$ 453,405
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 6,796	$ 10,299
Accrued expenses	10,001	9,345
Accrued salaries and wages	9,567	8,916
Deferred income taxes	964	964
Liabilities of discontinued operations	6,597	7,084
Total current liabilities	33,925	36,608
Convertible senior notes, net of discount	129,308	126,188
Non-current deferred tax liability	30,760	26,890
Other non-current liabilities	11,694	11,894
TOTAL LIABILITIES	205,687	201,580
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value; 5 million shares authorized, none issued	—	—
Common stock, $0.001 par value; 100 million shares authorized, 40,787,838 and 39,940,667 shares issued and outstanding	41	40
Additional paid-in capital	331,434	327,045
Accumulated deficit	(100,241)	(75,260)
Total stockholders' equity	231,234	251,825
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 436,921	$ 453,405

The accompanying notes to the condensed consolidated financial statements are an integral part of these condensed consolidated financial statements.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations (unaudited)
(In thousands, except share and per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Revenues	$73,346	$75,869	$146,988	$144,717
Costs of Revenues, excluding amortization	49,467	51,615	100,264	100,222
Gross Profit	23,879	24,254	46,724	44,495
Operating Expenses				
Operating expenses	17,345	16,126	33,784	31,747
Intangible amortization expense	1,467	1,816	2,935	3,607
Total Operating Expenses	18,812	17,942	36,719	35,354
Operating Income	5,067	6,312	10,005	9,141
Non-Operating Expense, net	2,531	2,550	4,164	5,093
Earnings before Income Taxes from Continuing Operations	2,536	3,762	5,841	4,048
Income Tax Expense, net on Continuing Operations	2,972	24,768	4,367	24,924
Net (Loss) Income from Continuing Operations	(436)	(21,006)	1,474	(20,876)
Loss before Income Taxes from Discontinued Operations	(9,136)	(10,214)	(26,945)	(19,848)
Income Tax Expense (Benefit), net on Discontinued Operations	—	456	(490)	(3,201)
Net Loss on Discontinued Operations	(9,136)	(10,670)	(26,455)	(16,647)
Net Loss	$(9,572)	$(31,676)	$(24,981)	$(37,523)
Weighted Average Common Shares Outstanding				
Basic	40,358,983	38,243,184	40,086,725	37,935,621
Diluted	40,358,983	38,243,184	40,741,286	37,935,621
Basic net (loss) earnings per share:				
Continuing operations	$(0.01)	$(0.55)	$0.04	$(0.55)
Discontinued operations	(0.23)	(0.28)	(0.66)	(0.44)
Basic net loss per share	$(0.24)	$(0.83)	$(0.62)	$(0.99)
Diluted net (loss) earnings per share:				
Continuing operations	$(0.01)	$(0.55)	$0.04	$(0.55)
Discontinued operations	(0.23)	(0.28)	(0.65)	(0.44)
Diluted net loss per share	$(0.24)	$(0.83)	$(0.61)	$(0.99)

The accompanying notes to the condensed consolidated financial statements are an integral part of these condensed consolidated financial statements.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statement of Stockholders’ Equity (unaudited)
(In thousands except share amounts)

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total Stockholders’ Equity
	Shares	Amount			
Balance, January 1, 2016	39,940,667	$ 40	$ 327,045	$ (75,260)	$ 251,825
Net loss	—	—	—	(24,981)	(24,981)
Warrant exercise, net	813,791	1	1,919	—	1,920
Option exercise, net	31,500	—	193	—	193
Restricted stock issuances	13,500	—	1,723	—	1,723
Restricted stock forfeitures	(141,150)	—	(905)	—	(905)
Equity issued related to Milestone earnout	129,530	—	1,130	—	1,130
Stock based compensation	—	—	329	—	329
Balance, June 30, 2016	40,787,838	$ 41	$ 331,434	$ (100,241)	$ 231,234

The accompanying notes to the condensed consolidated financial statements are an integral part of these condensed consolidated financial statements.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows (unaudited)
(In thousands except share amounts)

	Six months ended June 30,	
	2016	2015
Net loss	$(24,981)	$(37,523)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Stock compensation	1,147	3,299
Depreciation and amortization expense	7,437	10,080
Impairment of Commercial Cyber Solutions goodwill	6,980	—
Amortization of discount on convertible debt	3,120	2,548
(Gain) loss on disposal of assets	(3,447)	1,148
Loss on sale of assets held for sale	3,568	—
Write-off of deferred financing costs	340	—
Deferred taxes	3,870	21,501
Changes in operating assets and liabilities:		
Receivables	18,294	1,600
Inventories, net	(1,502)	(3,930)
Prepaid expenses	(1,421)	323
Accounts payable	(4,811)	672
Accrued expenses	3,264	3,838
Other	263	959
Net cash provided by operating activities	12,121	4,515
Cash flows from investing activities:		
Acquisitions, net of cash acquired	—	(20,766)
Purchases of property and equipment	(3,758)	(4,921)
Proceeds from sale of assets	16,226	—
Net cash provided by (used in) investing activities	12,468	(25,687)
Cash flows from financing activities:		
Proceeds from option and warrant exercises, net	2,114	125
Net cash provided by financing activities	2,114	125
Net increase (decrease) in cash and cash equivalents	26,703	(21,047)
Cash and cash equivalents at beginning of period	21,227	39,601
Cash and cash equivalents at end of period	$47,930	$18,554
Supplemental disclosure of cash flow information:		
Cash paid for interest	$1,959	$1,920
Cash paid for taxes	$83	$98

Supplemental disclosure of non-cash investing and financing activities:
In conjunction with the Ponte Technology acquisition in the first quarter of 2015, the Company issued 242,250 shares of KEYW common stock with an approximate value of $2 million.
During the second quarter of 2016, in conjunction with the Milestone Intelligence Group acquisition earnout, the Company issued 129,530 shares of KEYW common stock with an approximate value of $1 million.

The accompanying notes to the condensed consolidated financial statements are an integral part of these condensed consolidated financial statements.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

We prepared our interim condensed consolidated financial statements that accompany these notes in conformity with accounting principles generally accepted in the United States of America for interim information and in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X.

The interim financial information is unaudited, but reflects all normal adjustments that are, in our opinion, necessary to provide a fair statement of results for the interim periods presented. Certain information and note disclosures normally included in the annual financial statements have been condensed or omitted pursuant to those instructions. This interim information should be read in conjunction with the consolidated financial statements for the year ended December 31, 2015, contained in our Annual Report on Form 10-K and filed with the Securities and Exchange Commission on March 15, 2016. Interim results may not be indicative of our full fiscal year performance.

Corporate Organization

The KEYW Holding Corporation (“Holdco” or "KEYW") was incorporated in Maryland in December 2009. Holdco is a holding company and conducts its operations through The KEYW Corporation (“Opco”), Hexis Cyber Solutions, Inc. ("Hexis"), and their respective wholly owned subsidiaries. As further described in Note 12, during the second quarter of 2016, the Company sold the Hexis business in its entirety.

KEYW is a highly specialized provider of mission-critical cybersecurity, cyber superiority and geospatial intelligence solutions to US Government defense, intelligence and national security agencies and commercial enterprises. Our core capabilities include solutions, services and products to support the collection, processing, analysis, and use of intelligence data and information in the domains of cyberspace and geospace. Our solutions are designed to respond to meet the critical needs for agile intelligence in the cyber age and to assist the US government in national security priorities.

Principles of Consolidation

The condensed consolidated financial statements include the transactions of KEYW, Opco, Hexis and their wholly owned subsidiaries from the date of their acquisition. All intercompany accounts and transactions have been eliminated.

Revenue Recognition

We derive the majority of our revenue from time-and-materials, firm-fixed-price, cost-plus-fixed-fee, cost-plus-award-fee contracts and software licensing and maintenance.
Revenues from cost reimbursable contracts are recorded as reimbursable costs are incurred, including an estimated share of the applicable contractual fees earned. For performance-based fees under cost reimbursable contracts, we recognize the relevant portion of the expected fee to be awarded by the client at the time such fee can be reasonably estimated, based on factors such as prior award experience and communications with the client regarding performance. For cost reimbursable contracts with performance-based fee incentives, we recognize the relevant portion of the fee upon customer approval. For time-and-materials contracts, revenue is recognized based on billable rates times hours delivered plus materials and other reimbursable costs incurred. For firm-fixed-price service contracts, revenue is recognized using proportional performance based on the estimated total costs of the project. For fixed-price production contracts, revenue and cost are recognized at a rate per unit as the units are delivered or by other methods to measure services provided. This method of accounting requires estimating the total revenues and total contract costs of the contract. During the performance of contracts, these estimates are periodically reviewed and revisions are made as required. The impact on revenue and contract profit as a result of these revisions is included in

the periods in which the revisions are made. This method can result in the deferral of costs or the deferral of profit on these contracts. Because we assume the risk of performing a fixed-price contract at a set price, the failure to accurately estimate ultimate costs or to control costs during performance of the work could result, and in some instances has resulted, in reduced profits or losses on such contracts. Estimated losses on contracts at completion are recognized when identified.

Contract revenue recognition inherently involves estimation. Examples of estimates include the contemplated level of effort to accomplish the tasks under the contract, the cost of the effort, and an ongoing assessment of our progress toward completing the contract. From time to time, as part of our management processes, facts develop that require us to revise our estimated total costs or revenue. To the extent that a revised estimate affects contract profit or revenue previously recognized, we record the cumulative effect of the revision in the period in which the facts requiring the revision become known.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

In certain circumstances, and based on correspondence with the end customer, management authorizes work to commence or to continue on a contract option, addition or amendment prior to the signing of formal modifications or amendments. We recognize revenue to the extent it is probable that the formal modifications or amendments will be finalized in a timely manner and that it is probable that the revenue recognized will be collected.
The Company recognizes software licenses, maintenance or related professional services revenue only when there is persuasive evidence of an arrangement, delivery to the customer has occurred, the fee is fixed and determinable and collectability is reasonably assured.
Revenue from software arrangements is allocated to each element of the arrangement based on the relative fair values of the elements, such as software licenses, upgrades, enhancements, maintenance contract types and type of service delivered, installation or training. The determination of fair value is based on objective evidence that is specific to the vendor (“VSOE”). The Company determines VSOE for each element based on historical stand-alone sales to third parties for the elements contained in the initial agreement. In determining VSOE, the Company requires that a substantial majority of the selling process fall within a fairly narrow pricing range. The Company has established VSOE of fair value for maintenance and professional services. If VSOE of fair value for each element of the arrangement does not exist, all revenue from the arrangement is deferred until such time as VSOE of fair value exists or until all elements of the arrangement are delivered, except in those circumstances in which the residual method may be used as described below.

Some software products are licensed on a perpetual basis. In addition, the Company provides maintenance under a separate maintenance agreement, typically for twelve months. Maintenance includes technical support and unspecified software upgrades and enhancements if and when available. Revenue from perpetual software licenses is recognized under the relative selling price method, as noted above, for arrangements in which the software is sold with maintenance and/or professional services. When software is licensed on a subscription basis, revenue is recognized ratably over the length of the subscription, typically one to three years.

Software arrangements that also include hardware where the relative hardware and software components are both essential to the functionality are accounted for under ASC 605-25, “Multiple Element Arrangements”. As such, we allocate revenue to each unit of accounting based on an estimated selling price at the arrangement inception. The estimated selling price for each element is based upon the following hierarchy: VSOE of selling price, if available, third-party evidence ("TPE') of selling price if VSOE of selling price is not available, or best estimate of selling price ("BESP") if neither VSOE of selling price nor TPE of selling price are available. The total arrangement consideration is allocated to each separate unit of accounting using the relative estimated selling prices of each unit based on the aforementioned selling price hierarchy. We limit the amount of revenue recognized for delivered elements to an amount that is not contingent upon future delivery of additional products or services or meeting of any specified performance conditions.

To determine the estimated selling price in multiple element arrangements, the Company determines VSOE for each element based on historical stand-alone sales to third parties for the elements contained in the initial agreement, as noted above. If VSOE of selling price cannot be established for a deliverable, we establish TPE of selling price by evaluating similar and interchangeable competitor products or services in standalone arrangements with similarly situated partners. However, as our products contain a significant element of proprietary technology and offer substantially different features and functionality from our competitors, we are unable to obtain comparable pricing of our competitors’ products with similar functionality on a stand-alone basis. Therefore, we have not been able to obtain reliable evidence of TPE of selling price. If neither VSOE nor TPE of selling price can be established for a deliverable, we establish BESP primarily based on our pricing model and our go-to-market strategy or use our established list price.

Cost of Revenues

Cost of revenues consists primarily of compensation expenses for program personnel, the fringe benefits associated with this compensation and other direct expenses incurred to complete programs, including cost of materials and subcontract efforts.

Inventories

Inventories are valued at the lower of cost or net realizable value. Our inventory consists of specialty products that we manufacture on a limited quantity basis for our customers. As of June 30, 2016 and December 31, 2015, we had an inventory reserve balance of $0.2 million and $0.1 million respectively, for certain products where the market has not developed as expected.

Accounts Receivable

Accounts receivable are stated at the amount management expects to collect from outstanding balances. Invoice terms range from net 10 days to net 90 days. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance (allowance for doubtful accounts) based on its assessment of the current status of individual accounts.

Balances that are still outstanding after management has used reasonable collection efforts are written-off through a charge to the valuation allowance and a credit to accounts receivable.

Property and Equipment
All property and equipment are stated at acquisition cost or, in the case of self-constructed assets, the cost of labor and a reasonable allocation of overhead costs (no general and administrative costs are included). The cost of maintenance and repairs, which do not significantly improve or extend the life of the respective assets, are charged to operations as incurred.

Provisions for depreciation and amortization are computed on either a straight-line method or accelerated methods acceptable under accounting principles generally accepted in the United States of America ("US GAAP") over the estimated useful lives of between 3 and 7 years. Leasehold improvements are amortized over the lesser of the lives of the underlying leases or the estimated useful lives of the assets.

Lease Incentives
As part of entering into certain building leases, the lessors have provided the Company with tenant improvement allowances. Typically, such allowances represent reimbursements to the Company for tenant improvements made to the leased space. These improvements are capitalized as property and equipment, and the allowances are classified as a deferred lease incentive liability. This incentive is considered a reduction of rental expense by the lessee over the term of the lease and is recognized on a straight-line basis over the same term.

Software Development Costs
Costs of internally developed software for resale are expensed until the technological feasibility of the software product has been established. In accordance with the Accounting Standards Codification ("ASC"), software development costs are capitalized and amortized over the product's estimated useful life. As of June 30, 2016 and December 31, 2015, we had capitalized $2.1 million and $1.9 million of software development costs, respectively. Capitalized software development costs are amortized using the greater of the straight-line method or as a percentage of revenue recognized from the sale of the capitalized software. During the three months and six months ended June 30, 2016, the Company recorded related amortization of $0.4 million. During the three and six months ended June 30, 2015, the Company had no computer software amortization costs, due to the products still being under development and not having been placed into service during those periods.

Long-Lived Assets (Excluding Goodwill)
The Company follows the provisions of Financial Accounting Standards Board ("FASB") ASC topic 360-10-35, Impairment or Disposal of Long-Lived Assets, in accounting for long-lived assets such as property and equipment and intangible assets subject to amortization. The guidance requires that long-lived assets be reviewed for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be fully recoverable. The possibility of impairment exists if the sum of the long-term undiscounted cash flows is less than the carrying amount of the long-lived asset being evaluated. Impairment losses are measured as the difference between the carrying value of long-lived assets and their fair market value based on discounted cash flows of the related assets. Impairment losses are treated as permanent reductions in the carrying amount of the assets. The Company has not recorded any long-lived asset impairments since inception.

Goodwill
Purchase price in excess of the fair value of tangible assets and identifiable intangible assets acquired and liabilities assumed in a business combination is recorded as goodwill. In accordance with FASB ASC Topic 350-20, Goodwill, the Company tests for impairment at least annually. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair value of each reporting unit is estimated using either qualitative analysis or a combination of income and market

approaches. If the carrying amount of the unit exceeds its fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any.

Determining the fair value of a reporting unit is a judgment involving significant estimates and assumptions. These estimates and assumptions include revenue growth rates, operating margins and working capital requirements used to calculate projected future cash flows, risk-adjusted discount rates, selected multiples, control premiums and future economic and market conditions. We have based our fair value estimates on assumptions that we believe to be reasonable, but that are unpredictable and inherently uncertain. The Company evaluated goodwill at the beginning of the fourth quarter of fiscal year 2015 and found no impairment to the carrying value of goodwill.

Late in the fourth quarter of 2015, management began to evaluate strategic alternatives related to its Commercial Cyber Solutions segment. The Company began exploring the possibility of minority investments into this segment, the sale of the entire segment or the possibility of altering the level of investment going forward. The Company also implemented cost reductions in this segment subsequent to December 31, 2015, to reduce the funding required to cover operating losses and further committed to a reduced level of internal funding targeted to a range of $5 million to $7 million for 2016. Management believed these activities represented a triggering event and further believed that it was more likely than not that as a result of these activities and information, which came to light subsequent to December 31, 2015, relative to indications from potential transaction parties, that the fair value of the segment had fallen below the carrying value. As such the Company completed a Step 1 analysis of goodwill, which indicated the fair value was lower than the segment's carrying value. In accordance with ASC 350-20-35-18 management elected to make an estimate of the goodwill impairment charge as of December 31, 2015, subject to finalizing a Step 2 analysis during the first quarter of 2016. The estimate was based on a number of factors including the estimated fair value of working capital assets, fixed assets, customer relationships, deferred revenue and developed technology as well as relevant market related data. The estimated impairment to goodwill for the Commercial Cyber Solutions segment as of December 31, 2015, was $8 million. During the first quarter of 2016 the Company completed the Step 2 analysis of goodwill for the Commercial Cyber Solutions segment and determined that no additional goodwill impairment charge was needed as of December 31, 2015.

Subsequently, during the first quarter of 2016 the Company determined to divest of the Commercial Cyber Solutions segment (see Note 12). In accordance with applicable accounting guidance for the disposal of long-lived assets, the results of the Commercial Cyber Solutions segment are presented as discontinued operations. As a result, the goodwill attributable to the Commercial Cyber Solutions segment as of December 31, 2015, is excluded from the following table and is reported as part of assets of discontinued operations in the Condensed Consolidated Balance Sheets.

In March 2016, the Company completed the divestiture of its systems engineering and technical assistance ("SETA") business to Quantech Services, Inc. for $11.2 million in cash (see Note 12). The Company has determined that the relative fair value of the goodwill associated with the SETA business disposed of was $7.2 million.
A summary of the changes to goodwill, is as follows (in thousands):

Goodwill as of December 31, 2015	$297,223
Divestiture of SETA	(7,233)
Goodwill as of June 30, 2016	$289,990

Intangibles
Intangible assets consist of the value of customer related intangibles acquired in various acquisitions. Intangible assets are amortized on a straight line basis over their estimated useful lives unless the pattern of usage of the benefits indicates an alternative method is more representative. The useful lives of the intangibles range from one to seven years.

Concentrations of Credit Risk
We maintain cash balances that at times exceed the federally insured limit on a per financial institution basis. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk related to cash. In addition, we have credit risk associated with our receivables that arise in the ordinary course of business. In excess of 90% of our total revenue is derived from contracts where the end customer is the US Government and any disruption to cash payments from our end customer could put the Company at risk.

Use of Estimates
Management uses estimates and assumptions in preparing these condensed consolidated financial statements in accordance with US GAAP. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses. Significant estimates include useful lives of long-lived assets, revenue based on proportional performance, VSOE, TPE, BESP, inventory obsolescence reserves, accruals for medical self-insurance incurred but not reported ("IBNR") claims, income taxes and stock compensation expense. Actual results could vary from the estimates that were used.

Cash and Cash Equivalents

We consider all highly liquid investments purchased with original maturities of three months or less, when purchased, to be cash equivalents.

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THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

Fair Value of Financial Instruments
The balance sheet includes various financial instruments consisting of cash and cash equivalents, accounts receivable, and accounts payable. The fair values of these instruments approximate the carrying values due to the short maturity of these instruments. The balance sheet also includes our convertible senior notes, which the fair value is estimated using a market approach with Level 2 inputs.

Research and Development
Internally funded research and development expenses are expensed as incurred and are included in operating expenses in the accompanying condensed consolidated statement of operations. In accordance with FASB ASC Topic 730, Research and Development, such costs consist primarily of payroll, materials, subcontractor and an allocation of overhead costs related to product development. Research and development costs totaled $1.2 million and $0.8 million for the three months ended June 30, 2016 and 2015, respectively. Research and development costs totaled $2.1 million and $1.4 million for the six months ended June 30, 2016 and 2015, respectively.

Income Taxes
Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enacted date. In evaluating our ability to realize our deferred tax assets, we consider all available positive and negative evidence, including cumulative historic earnings, reversal of deferred tax liabilities, projected taxable income, and tax planning strategies. The assumptions utilized in evaluating both positive and negative evidence require the use of significant judgment concerning our business plans.

For a tax position that meets the more-likely-than-not recognition threshold, the Company initially and subsequently measures the tax liability or benefit as the largest amount that it judges to have a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority. The liability associated with unrecognized tax benefits is adjusted periodically due to changing circumstances, such as the progress of tax audits, case law developments and new or emerging legislation. Such adjustments are recognized entirely in the period in which they are identified. The effective tax rate includes the net impact of changes in the liability for unrecognized tax obligations or benefits and subsequent adjustments as considered appropriate by management. The Company's policy is to record interest and penalties as an increase in the liability for uncertain tax obligations or benefits and a corresponding increase to the income tax provision. No such adjustments were recorded during the three or six months ended June 30, 2016 or the respective periods for 2015.

(Loss) Earnings per Share
Basic net (loss) earnings per share is calculated by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) earnings per share is calculated by dividing net (loss) income by the diluted weighted average common shares, which reflects the potential dilution of stock options, warrants, and contingently issuable shares that could share in our (loss) income if the securities were exercised.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

The following table presents the calculation of basic and diluted net loss per share (in thousands except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Net (Loss) Income from Continuing Operations	$(436)	$(21,006)	$1,474	$(20,876)
Loss on Discontinued Operations	(9,136)	(10,670)	(26,455)	(16,647)
Net loss	$(9,572)	$(31,676)	$(24,981)	$(37,523)
Weighted average shares – basic	40,359	38,243	40,087	37,936
Effect of dilutive potential common shares	—	—	654	—
Weighted average shares – diluted	40,359	38,243	40,741	37,936
Net (Loss) Income per share from Continuing Operations – basic	$(0.01)	$(0.55)	$0.04	$(0.55)
Net Loss per share from Discontinued Operations – basic	(0.23)	(0.28)	(0.66)	(0.44)
Net Loss per share – basic	$(0.24)	$(0.83)	$(0.62)	$(0.99)
Net (Loss) Income per share from Continuing Operations – diluted	$(0.01)	$(0.55)	$0.04	$(0.55)
Net Loss per share from Discontinued Operations – diluted	(0.23)	(0.28)	(0.65)	(0.44)
Net Loss per share – diluted	$(0.24)	$(0.83)	$(0.61)	$(0.99)
Outstanding options and warrants, total	2,264	6,777	2,264	6,777

Employee equity share options, restricted shares and warrants granted by the Company are treated as potential common shares outstanding in computing diluted earnings (loss) per share. Diluted shares outstanding include the dilutive effect of in-the-money options and in-the-money warrants and unvested restricted stock. The dilutive effect of such equity awards is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible, are collectively assumed to be used to repurchase shares.

The Company uses the treasury stock method for calculating any potential dilutive effect of the conversion spread of our Convertible Senior Notes due 2019 (the "Notes") on diluted earnings per share, if applicable. The conversion spread will have a dilutive impact on diluted earnings per share of common stock when the average market price of our common stock for a given period exceeds the Notes' conversion price of $14.83. For the three and six months ended June 30, 2016, 10.1 million shares related to the Notes have been excluded from the computation of diluted earnings per share as the effect would be anti-dilutive since the conversion price of the Notes exceeded the average market price of the Company’s common shares for the three and six months ended June 30, 2016.

Stock Based Compensation

As discussed in Note 10, the Company applies the fair value method that requires all share-based payments to employees and non-employee directors, including grants of employee stock options, to be expensed over their requisite service period based on their fair value at the grant date, using a prescribed option-pricing model. The expense recognized is based on the straight-line amortization of each individually vesting piece of a grant. The calculated expense is required to be based upon awards that ultimately vest and we have accordingly reduced the expense by estimated forfeitures.

The following assumptions were used for options granted.

Dividend Yield — The Company has never declared or paid dividends on its common stock and has no plans to do so in the foreseeable future.

Risk-Free Interest Rate — Risk-free interest rate is based on US Treasury zero-coupon issues with a remaining term approximating the expected life of the option term assumed at the date of grant.

Expected Volatility — Volatility is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company's expected volatility is based on its historical volatility for a period that approximates the estimated life of the options.

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Expected Term of the Options — This is the period of time that the options granted are expected to remain unexercised. The Company estimates the expected life of the option term based on the expected tenure of employees and historical experience.
Forfeiture Rate — The Company estimates the percentage of options granted that are expected to be forfeited or canceled on an annual basis before stock options become fully vested. The Company uses the forfeiture rate that is a blend of past turnover data and a projection of expected results over the following twelve-month period based on projected levels of operations and headcount levels at various classification levels with the Company.

Segment Reporting
FASB ASC Section 280, Segment Reporting, establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that these enterprises report selected information about operating segments in interim financial reports. The guidance also establishes standards for related disclosures about products and services, geographic areas and major customers. The Company defines its reportable segments based on the way the chief operating decision maker ("CODM"), currently its chief executive officer, manages the operations of the Company for allocating resources and assessing performance. The Company has historically operated two segments, Government Solutions and Commercial Cyber Solutions. The Company disposed of the assets and liabilities of its Commercial Cyber Solutions during the second quarter of 2016, (see Note 12). Therefore, we have also reclassified the results of our Hexis business, which comprised our entire Commercial Cyber Solutions reportable segment, as discontinued operations for all periods presented in our condensed consolidated financial statements and determined that the Company is now operating one reporting segment.

Recently Issued Accounting Pronouncements
In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, an accounting pronouncement related to revenue recognition (FASB ASC Topic 606), which amends the guidance in former ASC Topic 605, Revenue Recognition, and provides a single, comprehensive revenue recognition model for all contracts with customers. This standard contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The entity will recognize revenue to reflect the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This pronouncement is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. The FASB also approved permitting early adoption of the standard, but not before January 1, 2017. We are currently evaluating the impact of this pronouncement on our consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, Income Taxes, amending the accounting for income taxes and requiring all deferred tax assets and liabilities to be classified as non-current on the consolidated balance sheet. The ASU is effective for reporting periods beginning after December 15, 2016, with early adoption permitted. The ASU may be adopted either prospectively or retrospectively. We are currently evaluating the method of adoption and the impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases. The new standard establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. We are currently evaluating the impact of this pronouncement on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting. The amendments in ASU 2016-09 to Topic 718, Compensation - Stock Compensation, require recognition of all excess tax benefits and tax deficiencies through income tax expense or benefit in the income statement. Other amendments in this new standard include guidance on the classification of share-based payment transactions in the statement of cash flows and an option to account for forfeitures of share-based awards as they occur rather than estimating the compensation cost based on the number of awards that are expected to vest. The amendments in the new standard are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted in any interim or annual period. We are currently evaluating the impact of this pronouncement on our consolidated financial statements.

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2. ACQUISITIONS

The Company has completed multiple acquisitions since it began operations in August 2008. The acquisitions were made to increase the Company's skill sets and to create sufficient critical mass to be able to serve as prime contractor on significant contracts. Most of the acquisitions resulted in the Company recording goodwill and other intangibles. The goodwill was primarily a result of acquiring cleared personnel to expand our presence with our main customers. The value of having that personnel generated the majority of the goodwill from the transactions and drove much of the purchase price in addition to other identified intangibles including contracts, customer relationships, contract rights and intellectual property. Several of the acquisitions involved issuance of Company common stock. The stock price for acquisition accounting was determined by the fair value on the acquisition date.

Details of the acquisitions completed since January 1, 2015 are outlined below:

2015 Acquisitions

During the first and second quarters of 2015, the Company acquired Milestone Intelligence Group, Inc. ("Milestone"), Ponte Technologies, LLC ("Ponte Tech") and certain assets of Innovative Engineering Solutions, Inc. in three separate transactions. The total consideration paid for these three acquisitions was $21.4 million in cash and 242,250 shares of KEYW stock valued at $1.9 million. These acquisitions are not considered material to the financial results of KEYW. During the second quarter of 2016, in conjunction with the Milestone Intelligence Group acquisition earnout, the Company issued 129,530 shares of KEYW common stock with an approximate value of $1 million.

The total purchase price paid for the acquisitions described above have been allocated as follows (in thousands):

	2015 Acquisitions
Cash	$ 643
Current assets, net of cash acquired	1,533
Fixed assets	155
Intangibles	5,059
Goodwill	16,706
Total Assets Acquired	24,096
Total Liabilities Assumed	844
Net Assets Acquired	$ 23,252
Net Cash Paid	$ 20,751
Equity Issued	1,858
Actual Cash Paid	$ 21,394

All acquisitions were accounted for using the acquisition method of accounting. Results of operations for each acquired entity were included in the condensed consolidated financial statements from the date of each acquisition.

Pro forma income statements are not presented for the six months ended June 30, 2015, as there were no material acquisitions during that period.

3. FAIR VALUE MEASUREMENTS

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure the fair value of financial assets and liabilities on a recurring basis into three broad levels:

Level 1 Inputs are unadjusted quoted prices in active markets for identical assets or liabilities the Company has the ability to access.

Level 2	Inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

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Level 3 Inputs are unobservable for the asset or liability and rely on management’s own assumptions about what market participants would use in pricing the asset or liability.

At June 30, 2016, we did not have any assets or liabilities measured at fair value on a recurring basis that would require disclosure based on the fair value hierarchy of valuation techniques.

4. RECEIVABLES

Receivables consist of the following:

	June 30, 2016	December 31, 2015
	(In thousands)	
Receivables		
Billed	$24,988	$ 36,278
Unbilled	14,690	16,833
Total Receivables	$39,678	$ 53,111

Unbilled amounts represent revenue recognized which could not be billed by the period end based on contract terms. The majority of the unbilled amounts were billed subsequent to period end. Retainages typically exist at the end of a project and/or if there is a disputed item on an invoice received by a customer, at June 30, 2016 and December 31, 2015, retained amounts are insignificant and are expected to be collected subsequent to the balance sheet date. Most of the Company's revenues are derived from contracts with the US Government, in which we are either the prime contractor or a subcontractor, depending on the award.

5. INVENTORIES

Inventories at June 30, 2016 and December 31, 2015 consist of work in process at various stages of production and finished goods. This inventory, which consists primarily of mobile communications devices, aeroptic cameras and radars, are valued at the lower of cost (as calculated using the weighted average method) or net realizable value. The cost of the work in process consists of materials put into production, the cost of labor and an allocation of overhead costs. At June 30, 2016, and December 31, 2015, we had an inventory reserve balance of $0.2 million and $0.1 million respectively, for certain products where the market has not developed as expected.

6. PREPAID EXPENSES

Prepaid expenses at June 30, 2016 and December 31, 2015, primarily consist of prepaid insurance, deferred financing costs and software licenses.

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7. PROPERTY AND EQUIPMENT

Property and equipment are as follows:

	June 30, 2016	December 31, 2015
	(In thousands)	
Property and Equipment		
Aircraft	$12,165	$11,296
Leasehold Improvements	22,889	22,469
Manufacturing Equipment	5,738	5,452
Software Development Costs	2,132	1,942
Office Equipment	11,765	10,967
Total	54,689	52,126
Accumulated Depreciation	(26,462)	(23,376)
Property and Equipment, net	$28,227	$28,750

Depreciation expense charged to operations was $1.9 million and $1.4 million for the three months ended June 30, 2016 and 2015, respectively. Depreciation expense charged to operations was $3.5 million and $2.7 million for the six months ended June 30, 2016 and 2015, respectively.

8. AMORTIZATION OF INTANGIBLE ASSETS

The following values were assigned to intangible assets (other than goodwill) for the acquisitions noted below:

		June 30, 2016 (In thousands)		
Acquisition	Intangible	Gross Book Value	Accumulated Amortization	Net Book Value
Poole	Contracts	$20,914	$ (15,686)	$ 5,228
Milestone	Contracts	2,170	(1,055)	1,115
Innovative Engineering Solutions	Contracts	1,225	(493)	732
Ponte Tech	Customer Relationships	1,664	(716)	948
		$25,973	$ (17,950)	$ 8,023

The Company recorded amortization expense of $1.5 million and $1.8 million for the three months ended June 30, 2016 and 2015, respectively. The Company recorded amortization expense of $2.9 million and $3.6 million for the six months ended June 30, 2016 and 2015, respectively.

Estimated future intangible amortization expense by year as of June 30, 2016 (In thousands):

Remainder of 2016	2017	2018
$2,935	$4,823	$265

9. DEBT

2.5% Convertible Senior Notes

In July 2014, the Company initially issued $130.0 million aggregate principal amount of Notes in an underwritten public offering. The Company granted an option to the underwriters to purchase up to an additional $19.5 million aggregate principal amount of Notes, which was subsequently exercised in full in August 2014, resulting in a total issuance of $149.5 million aggregate principal amount of Notes. The Notes bear interest at a rate of 2.50% per annum on the principal amount, payable semi-annually in arrears on January 15 and July 15 of each year, beginning on January 15, 2015, to holders of record at the close of business on the preceding January 1 and July 1, respectively. The Notes mature on July 15, 2019, unless earlier repurchased or converted. The Company may not redeem the Notes prior to their stated maturity date.

Holders of the Notes may convert their notes at their option under the following circumstances: (i) during any calendar quarter commencing after the calendar quarter ending September 30, 2014, if the last reported sale price of the Company's common stock for at least 20 trading days (whether or not consecutive) in the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price for the Notes on each applicable trading day; (ii) during the five business day period immediately after any five consecutive trading day period in which the trading price per $1,000 principal amount of Notes for each trading day of that period was less than 98% of the product of the last reported sale price of Company's common stock and the conversion rate for the Notes for each such trading day; or (iii) upon the occurrence of specified corporate events; or (iv) following the Company's delivery of a notice of the spin-off of its subsidiary, Hexis Cyber Solutions, Inc. On and after January 15, 2019, holders may convert their Notes at any time, regardless of the foregoing circumstances.

Upon conversion, the Company will settle the Notes in cash, shares of Company common stock or a combination of cash and shares of Company common stock, at the Company's election. The Notes have an initial conversion rate of 67.41 shares of common shares per $1,000 principal amount of the Notes, which is equal to an initial conversion price of approximately $14.83 per common share. The conversion price is subject to adjustments upon the occurrence of certain specified events, including the initial public offering of the Company's subsidiary, Hexis Cyber Solutions, Inc., as set forth in the Note Indenture (the "Indenture").

In addition, upon the occurrence of a fundamental change (as defined in the Indenture), holders of the Notes may require the Company to repurchase the Notes at a purchase price of 100% of the principal amount of the Notes, plus accrued and unpaid interest, if any, to, but excluding, the fundamental change repurchase date.

The Company incurred approximately $5.7 million of debt issuance costs during the third quarter of 2014 as a result of issuing the Notes. Of the approximately $5.7 million incurred, the Company recorded $4.6 million and $1.1 million to deferred financing costs and additional paid-in capital, respectively, in proportion to the allocation of the proceeds of the Notes as discussed below. The Company is amortizing the deferred financing costs over the contractual term of the Notes using the effective interest method.

The Company used the net proceeds from the Notes to repay the outstanding balances under the credit facility the Company entered into in 2012, (the "2012 Credit Agreement"). Net proceeds also will be used for working capital, capital expenditures and other general corporate purposes, including potential acquisitions.

The Company allocated the $149.5 million proceeds from the issuance of the Notes between long-term debt, the liability component, and additional paid-in-capital, the equity component, in the amounts of $122.1 million and $27.4 million, respectively. The initial value of liability component was measured using the nonconvertible debt interest rate. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the face value of the Notes. Since the Company must still settle the Notes at face value at or prior to maturity, the Company will accrete the liability component to its face value resulting in additional non-cash interest expense being recognized in the Company's condensed consolidated statements of operations while the Notes remain outstanding. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

As of June 30, 2016, the outstanding principal of the Notes was $149.5 million, the unamortized debt discount was $17.4 million, the unamortized deferred financing costs were $2.8 million and the carrying amount of the liability component was $129.3 million, which was recorded as long-term debt within the Company's condensed consolidated balance sheet. As of June 30, 2016, the fair value of the liability component relating to the Notes, based on a market approach, was approximately $133.5 million and represents a Level 2 valuation.

During the three months ended June 30, 2016, the Company recognized $2.5 million of interest expense related to the Notes, which included $1.3 million for noncash interest expense relating to the debt discount and $0.2 million relating to amortization of deferred financing costs. During the six months ended June 30, 2016, the Company recognized $5.0 million of interest expense related to the Notes, which included $2.7 million for noncash interest expense relating to the debt discount and $0.5 million relating to amortization of deferred financing costs. During the three months ended June 30, 2015, the Company recognized $2.4 million of interest expense related to the Notes, which included $1.3 million for noncash interest expense relating to the debt discount and $0.2 million relating to amortization of deferred financing costs. During the six months ended June 30, 2015, the Company recognized $4.9 million of interest expense relating to the Notes, which included $2.5 million for noncash interest expense relating to the debt discount and $0.5 million relating to amortization of deferred financing costs.

Capped Call

During the third quarter of 2014 in conjunction with the issuance of the Notes, the Company paid approximately $18.4 million to enter into capped call transactions with respect to its common shares, (the "Capped Call Transactions"), with certain financial institutions. The Capped Call Transactions generally are expected to reduce the potential dilution to the Company's common stock upon conversion of the Notes and/or offset any cash payments the Company is required to make in excess of the principal amount of any converted Notes, as the case may be, in the event that the market price of the common stock is greater than the strike price of the Capped Call Transactions, initially set at $14.83, with such reduction of potential dilution subject to a cap based on the cap price, which is initially set at $19.38. The strike price and cap price are subject to anti-dilution adjustments under the terms of the Capped Call Transactions.

2014 Revolving Credit Facility
In July 2014, the Company, as guarantor and certain of the Company's subsidiaries, entered into a senior secured credit agreement, (the "2014 Credit Agreement") with certain financial institutions. The 2014 Credit Agreement provided the Company a $42.5 million revolving credit facility (the "2014 Revolver"). The 2014 Revolver includes a swing line loan commitment of up to $10 million and a letter of credit facility of up to $15 million. The Company has not drawn on the 2014 Credit Agreement.

Borrowings under the 2014 Credit Agreement bear interest at a rate equal to an applicable rate plus, at the Company’s option, either (a) adjusted LIBOR or (b) a base rate. The Company is required to pay a facility fee to the Lenders for any unused commitments and customary letter of credit fees.

The 2014 Revolver will mature on the earlier to occur of (i) the fifth anniversary of the closing of the 2014 Credit Agreement, and (ii) the date that is 180 days prior to the maturity date of the Notes unless the Notes are converted into equity, repaid, refinanced or otherwise satisfied on terms permitted under the 2014 Credit Agreement. The Company may voluntarily repay outstanding loans under the 2014 Revolver at any time without premium or penalty, subject to customary fees in the case of prepayment of LIBOR based loans.

In February 2016, the Company amended the 2014 Credit Agreement. The amendment permanently decreases the amount available under the revolver to $20.0 million. At June 30, 2016, we were in compliance with all of our debt covenants under the 2014 Credit Agreement. As a result of the amendment permanently decreasing the amount available under the revolver the Company wrote off $0.3 million of unamortized deferred financing costs, which were included as part of interest expense.

10. STOCK - BASED COMPENSATION

At June 30, 2016, KEYW had stock-based compensation awards outstanding under the following plans: The 2008 Stock Incentive Plan ("2008 Plan"), The 2009 Stock Incentive Plan ("2009 Plan") and The Amended and Restated 2013 Stock Incentive Plan ("2013 Plan").

On August 15, 2012, the shareholders approved the 2013 KEYW Holding Corporation Stock Incentive Plan. The 2013 plan, which took effect on January 1, 2013, replaced the 2009 Plan and provides for the issuance of additional restricted stock, stock options, and restricted stock units. Pursuant to an amendment approved by the Company’s shareholders on August 12, 2015, the number of shares available for issuance under the 2013 Plan was increased by 700,000 shares to a maximum of 2,700,000 shares.

2013 Stock Incentive Plan	
Total equity available to issue	2,700,000
Total equity outstanding or exercised	1,413,298
Total equity remaining for future grants	1,286,702

Stock Options
The Company has issued stock option awards that vest over varying periods, ranging from three to five years, and have a ten-year life. We estimate the fair value of stock options using the Black-Scholes option-pricing model. We use

historical data to determine volatility of our stock. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards. All option awards terminate within ninety days or sooner after termination of service with the Company, except as provided in certain circumstances under our senior executive employment agreements.

No stock options were issued during the six months ended June 30, 2016. Historically all equity issuances have an exercise price at market value or higher based upon our publicly-traded share price on the date of grant. The Black-Scholes model requires inputs related to dividend yield, risk-free interest rate, expected volatility and forfeitures in order to price the option values.

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A summary of stock option activity for the period ended June 30, 2016 is as follows:

	Number of Shares	Option Exercise Price	Weighted Average Exercise Price
Options Outstanding January 1, 2016	2,332,889		
Granted	—	—	—
Exercised	(31,500)	$5.00 - $9.25	$ 6.14
Cancelled	(405,647)	$5.00 - $17.71	$ 12.55
Options Outstanding June 30, 2016	1,895,742		

As of June 30, 2016, outstanding stock options were as follows:

Exercise Price	Options Outstanding	Intrinsic Value	Options Vested	Intrinsic Value	Weighted Average Remaining Life (Years)
$5.00 – $5.50	285,450	$1,299,723	285,450	$1,299,723	3.10
$6.90 – $7.66	218,011	546,573	218,011	546,573	5.58
$7.96 – $8.14	68,500	134,694	68,500	134,694	5.37
$9.17 – $10.98	145,263	62,633	145,263	62,633	4.53
$11.18 - $11.99	204,025	—	203,575	—	5.79
$12.28 - $12.97	320,299	—	317,738	—	6.23
$13.00 - $13.48	104,000	—	98,803	—	6.64
$14.03 - $14.88	184,174	—	184,174	—	4.80
$16.08 - $17.11	366,020	—	275,142	—	7.60
	1,895,742	$2,043,623	1,796,656	$2,043,623	

Restricted Stock Awards

During the first half of 2016, the Company issued 13,500 shares of restricted stock for new hires under the 2013 Plan. The expense for these shares will be recognized over the vesting life of each individual tranche of shares based upon the fair value of a share of stock at the date of grant. All of the above shares cliff vest in three years. All restricted stock awards have no exercise price.

As of June 30, 2016, outstanding unvested restricted stock awards were as follows:

	Unvested Shares
Outstanding January 1, 2016	959,733
Granted	13,500
Vested	(226,325)
Cancelled	(141,150)
Outstanding June 30, 2016	605,758

2015 CEO Grant

In October 2015, pursuant to the commencement of William J. Weber's employment as our CEO, and in accordance with the terms of Mr. Weber's employment agreement, we issued Mr. Weber (i) 100,000 restricted shares of the Company's common stock as a sign-on inducement, and (ii) the right to acquire 400,000 shares of our common stock as a long-term incentive inducement. Mr. Weber's sign-on inducement and long-term incentive rights were granted outside the 2013 Plan, in accordance with Section 4(2) of the Securities Act of 1933.

Mr. Weber's sign-on shares will vest as follows: (i) 50,000 shares on October 1, 2016; (ii) 25,000 shares on October 1, 2018, and (iii) 25,000 shares on October 1, 2019.

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The long-term incentive shares will be subject to a two-year holding period following the grant date. The granting and vesting of the above-described inducement shares will be contingent upon Mr. Weber's continued employment with KEYW, subject to acceleration upon certain events. Mr. Weber's long-term incentive grant consists of five vesting tranches, which will vest at any time prior to the fifth anniversary of October 1, 2015 that the closing market price of the Company's common stock over any 30 consecutive trading days is at or greater than the target price, set forth in the table below.

Target Price Per Share	Long-Term Incentive Shares
$13.00	50,000
$16.00	50,000
$20.00	100,000
$25.00	100,000
$30.00	100,000

We measured the fair value of the CEO's long-term incentive grant using a Monte Carlo simulation approach with the following assumptions: risk-free interest rate of 1.67%, weighted-average derived service period of 4.7 years, expected volatility of 59.8% and dividend yield of 0%. The weighted-average grant-date fair value of this grant is $2.96 per share. The expense for this grant will be recognized over the derived service period of each individual tranche.

2016 Long-term Incentive Share Grants

During the first half of 2016, the Company issued 535,000 long-term incentive shares for new hires of which, 505,000 of the long-term incentive shares were granted outside of the 2013 Plan, in accordance with Section 4(2) of the Securities Act of 1933. The long-term incentive shares will be subject to a two-year holding period following the grant date. The granting and vesting of the long-term incentive shares will be contingent upon the employees continued employment with KEYW, subject to acceleration upon certain events. The long-term incentive grants consist of five vesting tranches, which will vest at any time prior to the fifth anniversary of their grant date that the closing market price of the Company's common stock over any 30 consecutive trading days is at or greater than the target price, set forth in the table below.

Target Price Per Share	Long-Term Incentive Shares
$13.00	66,875
$16.00	66,875
$20.00	133,750
$25.00	133,750
$30.00	133,750

We measured the fair value of the long-term incentive grants using a Monte Carlo simulation approach with the following assumptions: risk-free interest rate ranging between 1.01% and 1.76%, weighted-average derived service period ranging between 4.2 years and 4.9 years, expected volatility of 59.5% and dividend yield of 0%. The weighted-average grant-date fair value of these grant is $4.66 per share. The expense for this grant will be recognized over the derived service period of each individual tranche.

All stock based compensation has been recorded as part of operating expenses. Accounting standards require forfeitures to be estimated at the time an award is granted and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the periods ended June 30, 2016 and 2015, share-based compensation expense is based on awards ultimately expected to vest and has been reduced for estimated forfeitures. The Company recorded total stock compensation expense of $0.7 million and $2.1 million for the three months ended June 30, 2016 and 2015, respectively. The Company recorded total stock compensation expense of $1.1 million and $3.3 million for the six months ended June 30, 2016 and 2015, respectively. The total unrecognized stock compensation expense at June 30, 2016, is approximately $8.0 million, which will be recognized over the next five years.

11. WARRANTS

During the six months ended June 30, 2016, warrant holders exercised 2,163,934 warrants, with 349,143 exercised for cash and 1,814,791 exercised cashlessly. The 349,143 warrants exercised for cash were exercised at $5.50 per share. The total cash received from these exercises was $1.9 million. Under our warrant agreements, warrants may be exercised cashlessly based on the average price of the Company's common stock for the five days prior to exercise. Under this methodology the warrants that were exercised cashlessly were exchanged for 464,647 shares of the Company's common stock.

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As of June 30, 2016, outstanding warrants were as follows:

Exercise Price	Warrants Outstanding	Warrants Vested	Weighted Average Remaining Life (Years)
$9.25	210,000	210,000	0.71
$12.65	158,116	158,116	3.41
	368,116	368,116	

12. BUSINESSES HELD FOR SALE, DISCONTINUED OPERATIONS AND DISPOSITIONS

Dispositions - Discontinued Operations

In our annual report for the fiscal year ended December 31, 2015, we announced that we were exploring strategic alternatives for our Hexis business. Our Hexis business markets our HawkEye products and related maintenance and services to the commercial cyber sector and comprised our entire former Commercial Cyber Solutions reportable segment. As previously announced, the alternatives that we were evaluating included seeking an investment in or an outright sale of this business in one or more transactions to unrelated buyers.

During the first quarter of fiscal year 2016, we completed our assessment of the alternatives for the Hexis business and, the Company committed to a plan to sell the business in its entirety. Management and the Board decided that although the Hexis business has consistently demonstrated impressive capabilities in its product suites and gained some commercial traction in the marketplace, the progress had not been sufficient for the Company to continue to operate the business in the manner that it has been operated in the past. Accordingly, management decided that rather than continuing to commit the resources and investment that would be required to continue to grow the Hexis business, the Company would sell the business and refocus the use of resources and its strategy on the Government Solutions business.

The Company determined that the assets and liabilities of its Commercial Cyber Solutions business meet the held for sale criteria set forth in ASC 360 - Property, Plant, and Equipment, as (a) management with appropriate authority has committed to a plan to sell the disposal group, (b) the disposal group is available for immediate sale in its present condition, (c) actions to locate a buyer have been initiated, (d) management has concluded that the sale and transfer of the disposal is probable to occur within one year, (e) the disposal group is being actively marketed at a price that is reasonable in relation to its current fair value, and (f) management has concluded that it is unlikely that the Company will make significant changes to or withdraw its plan to sell the disposal group.

ASC 360 requires a disposal group that is reclassified as held for sale, but not yet sold, to be measured at the lower of its carrying amount or fair value less cost to sell. In addition, an entity ceases to recognize depreciation on assets included in the disposal group that has been classified as held for sale. Based upon this guidance, we compared the carrying value of the Hexis business to our estimate of the disposal group's fair value less cost to sell. Development of an estimate of the fair value of the disposal group in this circumstance is complex, as consideration must be given to the nature of the potential sales transaction(s); the composition of the disposal group; market participant expectations regarding the performance, risks, and required returns of and for the disposal group; and the expected results of ongoing negotiations with potential buyers of the business - amongst other factors. These considerations require the application of assumptions that are deemed to be Level 3 inputs on the fair value hierarchy. Based upon our estimate of the fair value of the disposal group less cost to sale, we determined that the carrying value of the Hexis business was greater than its fair value less cost to sell and, accordingly, we recorded an additional impairment charge of $7.0 million to our Commercial Cyber Solutions segment goodwill based on the preliminary asset purchase agreements and additional expense of $2.3 million representing the estimated cost to sell the disposal group. As a result we reduced the recorded carrying value of our Commercial Cyber Segment to $3.1 million at the end of the first quarter of 2016. The sale of the Hexis Cyber Solutions product lines during the second quarter of 2016, resulted in a pre-tax loss of approximately $5.5 million. This loss reflects the difference between the consideration received for Hexis and the net carrying value of the business less transaction costs.

We further note that from inception of the Hexis business through our decision to sell the business, we have been a relatively new participant in the commercial cyber security market. Accordingly, the Hexis business has historically required a significant amount of investment of the Company’s resources. The business has historically incurred losses and was expected to continue to include losses until we gained sufficient traction within the marketplace. Upon completion of the sale of the Hexis business, the Company will no longer offer or market any products or services to the commercial cyber security market and does not intend to make similar investments in the development of commercial cyber security products. After consideration of these factors, we have concluded that our decision to sell the Hexis business constitutes a strategic shift that is expected to have a major effect on our operations and financial results. Therefore, we have also reclassified the results of our Hexis business, which comprised our entire Commercial Cyber Solutions reportable segment, as discontinued operations for all periods presented in our condensed consolidated financial statements. The results of our Commercial Cyber Solutions segment previously included the allocation of certain general corporate costs, which we have reallocated to our remaining continuing operations on a retrospective basis.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

The following table summarizes the aggregate carrying amounts of the major classes of Hexis assets and liabilities included in discontinued operations as of June 30, 2016 and December 31, 2015 (in thousands):

	June 30, 2016	December 31, 2015
Receivables	$3,170	$ 5,256
Inventories, net	—	2,164
Prepaid expenses	—	345
Property and equipment, net	—	5,341
Goodwill	—	7,467
Other intangibles, net	—	2,600
Total assets classified as held for sale:	$3,170	$ 23,173
Accounts payable and other accrued expenses	$6,597	$ 3,686
Deferred revenue	—	3,398
Total liabilities held for sale	$6,597	$ 7,084

The following table provides a summary of the operating results of Hexis, which we have reflected as discontinued operations for the three and six months ended June 30, 2016 and 2015 (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Revenues	800	2,518	2,878	5,304
Costs of Revenues, excluding amortization	711	986	1,687	1,970
Operating expenses	5,991	10,500	15,266	20,657
Impairment of goodwill	—	—	6,980	—
Intangible amortization expense	—	1,246	381	2,525
Loss on disposal of Hexis	3,234	—	5,509	—
Loss before Income Taxes from Discontinued Operations	(9,136)	(10,214)	(26,945)	(19,848)
Income Tax Expense (Benefit), net on Discontinued Operations	—	456	(490)	(3,201)
Loss on Discontinued Operations	(9,136)	(10,670)	(26,455)	(16,647)

The following table presents the operating and investing cash flows of our discontinued Hexis business as of June, 2016 and 2015 (in thousands):

	Six months ended June 30,	
	2016	2015
Non-Cash Operating Items		
Depreciation and amortization expense	$1,016	$3,755
Impairment of Commercial Cyber Solutions Goodwill	6,980	—
Loss on disposal of long-lived assets	3,568	—
Cash Flows from Investing Activities		
Purchases of property and equipment	(471)	(464)
Proceeds from Hexis asset divestiture	$5,000	$—

Other Dispositions

In March 2016, we completed the sale of our SETA business to Quantech Services, Inc. for approximately $11.2 million in cash. The SETA business was not deemed an individually significant component of our Company. Management decided to sell the SETA business in connection with the ongoing strategic review of our overall business, through which we have determined that the growth potential of both KEYW's core business and the SETA business could be maximized if the two businesses were separated. The sale of SETA eliminated KEYW’s conflicts at two key government agencies and will allow our Company to focus 100% on technology development opportunities across the Intelligence Community. However, the sale of SETA did not represent a strategic shift that will have a major effect on our operations and financial results and, accordingly, the business historical results and the gain on sale were classified within continuing operations on our Condensed Consolidated Statements of Operations. Because the sale of SETA was not deemed a discontinued operation, its assets and liabilities of the business were not reclassified as held for sale on our December 31, 2015, balance sheet.

In connection with the sale of SETA, we recognized a pre-tax gain of approximately $3.0 million. This gain was reported within non-operating expense, net on our condensed consolidated statement of operations and reflects the difference between the consideration received for SETA and the net carrying value of the business less transaction costs. The net carrying value of the SETA business was deemed to include approximately $7.2 million of goodwill that, in accordance with ASC 350, was allocated to the business based upon the relative fair values of SETA and the overall Government Solutions reporting unit within which the SETA business has been historically reported.

13. INCOME TAXES

The Company’s quarterly provision for income taxes is measured using an estimated annual effective tax rate adjusted for discrete items that occur within the quarter. The provision for income taxes for continuing operations in the quarter ended June 30, 2016 and 2015 was an expense of $3.0 million and $24.8 million, respectively. For the six months ended June 30, 2016 and 2015, the provision for income taxes for continuing operations was an expense of $4.4 million and $24.9 million, respectively. The provision for income tax expense for the three and six months ended June 30, 2015 includes the recording of a valuation allowance of $19.6 million to as a discrete item resulting in an effective rate that is significantly different than the Company’s statutory rate. The effective tax rate on income from continuing operations was 117.2% and 658.4% for the three months ended June 30, 2016 and 2015, respectively. The effective tax rate on income from continuing operations was 74.8% and 615.7% for the six months ended June 30, 2016 and 2015, respectively.

A full valuation allowance was established during the second quarter 2015 due to the uncertainty of the utilization of deferred tax assets in future periods. In evaluating the Company’s ability to realize the deferred tax assets we considered all available positive and negative evidence, including cumulative historical earnings, reversal of temporary difference, projected taxable income and tax planning strategies. The Company’s negative evidence currently outweighs its positive evidence, therefore it is more likely than not that we will not realize a significant portion of our deferred tax asset. The amount of the deferred tax asset to be realized in the future could however be adjusted if objective negative evidence is no longer present.

14. SUBSEQUENT EVENTS

In connection with the preparation of its condensed consolidated financial statements for the six months ended June 30, 2016, the Company has evaluated events that occurred subsequent to June 30, 2016, to determine whether any of these events required recognition or disclosure in the first three or six months of the 2016 condensed consolidated financial statements. The Company is not aware of any subsequent events which would require recognition or disclosure in the condensed consolidated financial statements.

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THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion provides information that management believes is relevant to an assessment and an understanding of the Company's operations and financial condition. This discussion should be read in conjunction with the attached unaudited condensed consolidated financial statements and accompanying notes as well as our Annual Report on Form 10-K for the year ended December 31, 2015, filed with the Securities and Exchange Commission on March 15, 2016.

FORWARD-LOOKING STATEMENTS

The matters discussed in this Quarterly Report may constitute forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. These statements involve known and unknown risks, uncertainties, and other factors that may cause our actual results, activity levels, performance or achievements to be materially different from any future results, activity levels, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify these statements by forward-looking words such as "could", "expect", "estimate", "may", "potential", "will", and "would", or similar words. You should read statements that contain these words carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial position, or state other forward-looking information. There may be events in the future that we are not able to predict or control accurately, and numerous factors may cause events, our results of operations, financial performance, achievements, or industry performance, to differ materially from those reflected in the forward-looking statements. The factors listed in the section captioned "Risk Factors" contained in our Annual Report on Form 10-K for the year ended December 31, 2015, filed with the Securities and Exchange Commission on March 15, 2016, as well as any other cautionary language in this Quarterly Report, provide examples of such risks, uncertainties, and events.

You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Quarterly Report. Subsequent events and developments may cause our views to change. While we may elect to update the forward-looking statements at some point in the future, we specifically disclaim any obligation to do so.

DESCRIPTION OF THE COMPANY

KEYW is a highly specialized provider of mission-critical cybersecurity, cyber superiority and geospatial intelligence solutions to US Government defense, intelligence and national security agencies and commercial enterprises. Our core capabilities include solutions, services and products to support the collection, processing, analysis, use of intelligence data and information in the domains of cyberspace and geospace, and the protection of networks and related infrastructure. Our solutions are designed to respond to meet the critical needs for agile intelligence in the cyber age and to assist the US Government in national security priorities.

We provide a full range of engineering services, cyber security and analytic products, and fully integrated platforms that support the entire intelligence process, including collection, processing, analysis and impact. Our platforms include a number of modified commercial turboprop aircraft for imagery and light detection and ranging (LIDAR), collection, products that we manufacture, as well as hardware and software that we integrate using the engineering services of our highly skilled and security-cleared workforce.

KEYW's Government solutions are focused on Intelligence Community customers including the National Security Agency (NSA), the National Reconnaissance Office (NRO), the National Geospatial Intelligence Agency (NGA), the Army Geospatial Center (AGC) and various other agencies within the Intelligence Community and Department of Defense (DoD). In addition, we provide our products and services to US federal, state and local law enforcement agencies and commercial enterprises. Our innovative solutions, understanding of intelligence and national security missions, management's long-standing and successful customer relationships and operational capabilities, and best-in-class employee base position us to continue our growth as we continue to expand into the cybersecurity market. We are highly focused on assisting our customers in achieving their mission of cyber superiority both defensively and offensively within the entire domain of cyberspace and doing so in time to observe, respond to and where possible prevent threat events, actions and agents from inflicting harm. Our solutions also encompass a broad spectrum of geospatial intelligence or GEOINT, capabilities. We believe today's complex, geographically distributed cyber threat environment is driving a convergence of cyber intelligence and geospatial intelligence.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

KEYW's primary areas of expertise include:

- providing sophisticated engineering services and solutions that help our customers solve discreet and complex cybersecurity, cyber superiority, and geospatial and other intelligence challenges;
- using multiple intelligence collection techniques to collect data and information in cyberspace, encompassing the entire electromagnetic spectrum;
- processing data and information from cyberspace to make it accessible to a wide range of analytical needs and resources;
- analyzing data and information that have been collected, processed, correlated, and made easily accessible to transform them into usable information for our customers;
- developing next generation cyber defense and security incident response platforms designed to detect, investigate, and remove advanced cyber threats from enterprise information technology networks;
- developing data warehousing and business intelligence solutions to address the most advanced use cases in Security Information and Event Management, log management, and Call Detail Record (CDR) retention and retrieval;
- providing specialized training, field support, and test and evaluation services;
- development, integration, rapid deployment and sustainment of agile airborne intelligence, surveillance, and reconnaissance collection platforms to austere environments; and
- responding quickly and decisively to demanding and emergent customer requirements, with agile processes and methods that enable us to satisfy requirements that are constantly changing to meet an agile, aggressive and ever-changing threat environment.

CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations are based upon our condensed consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and determine whether contingent assets and liabilities, if any, are disclosed in the financial statements. On an ongoing basis, we evaluate our estimates and assumptions, including those related to long-term contracts, product returns, bad debts, inventories, fixed asset lives, income taxes, environmental matters, litigation, and other contingencies. These estimates and assumptions are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2015. We base our estimates and assumptions on historical experience and on various factors that are believed to be reasonable under the circumstances, including current and expected economic conditions, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from our estimates under different assumptions or conditions. There have been no material changes to our critical accounting policies, estimates and assumptions or the judgments affecting the application of those estimates and assumptions since the filing of our Annual Report on Form 10-K for year ended December 31, 2015.

COMPARISON OF THREE MONTHS ENDED JUNE 30, 2016 AND JUNE 30, 2015

The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements (and notes thereto) and other financial information of the Company appearing elsewhere in this report.

CONSOLIDATED OVERVIEW (In thousands)	Three months ended June 30, 2016	% of Revenue	Three months ended June 30, 2015	% of Revenue
Revenue	$73,346	100.0 %	$75,869	100.0 %
Gross Profit	23,879	32.6 %	24,254	32.0 %

Operating Expenses	17,345	23.6 %	16,126	21.3 %
Intangible Amortization	1,467	2.0 %	1,816	2.4 %
Non-operating Expense, net	2,531	3.5 %	2,550	3.4 %
Income Tax Expense, net on Continuing Operations	2,972	4.1 %	24,768	32.6 %
Loss on Discontinued Operations	(9,136)	(12.5)%	(10,670)	(14.1)%

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

Revenue decreased by $2.5 million, or 3.3%, for the three months ended June 30, 2016, as compared to the three months ended June 30, 2015. The largest drivers of the decrease in revenue were related to the SETA divestiture and certain solutions contracts that ended in the second quarter of 2016, partially offset by increased product sales and the continued expansion of our government cyber training initiatives.

Gross profit decreased by $0.4 million for the quarter ended June 30, 2016, as compared to the quarter ended June 30, 2015. The decrease in gross profit was due to the decrease in revenue described above. Gross margin increased by 60 basis points for the three months ended June 30, 2016, as compared to the three months ended June 30, 2015. The increase in gross margin resulted primarily as a result of higher-margin product sales and cyber training revenue.

Our operating expenses for the three months ended June 30, 2016 increased by $1.2 million and as a percentage of revenue compared to the same period ended June 30, 2015. The increase is due primarily to the costs associated with the new Milestone facility, which we moved into during the third quarter of 2015, increased costs related to the ramp-up of our business development function and higher professional fees.

Intangible amortization expense decreased for the three months ended June 30, 2016 due to certain intangibles from prior acquisitions becoming fully amortized.

Non-operating expense was essentially flat for the quarter ended June 30, 2016 compared with the quarter ended June 30, 2015.

The effective tax rate on income from continuing operations was 117.2% and 658.4% for the three months ended June 30, 2016 and 2015, respectively. The effective tax rate for the three months ended June 30, 2016 and 2015 was impacted by the valuation allowance that was established during the second quarter of 2015 due to the uncertainty of the utilization of deferred tax assets in future periods. We currently believe it is not likely that we will realize a significant portion of our deferred tax asset.

Loss on discontinued operations decreased by $1.5 million, or 14.4% for the three months ended June 30, 2016, as compared to the three months ended June 30, 2015. The largest drivers of the decrease were due to cost-saving measures put in place in January 2016 and the sale of Hexis Cyber Solutions product lines in the second quarter of 2016.

COMPARISON OF SIX MONTHS ENDED JUNE 30, 2016 AND JUNE 30, 2015

The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements (and notes thereto) and other financial information of the Company appearing elsewhere in this report.

CONSOLIDATED OVERVIEW (In thousands)	Six months ended June 30, 2016	% of Revenue	Six months ended June 30, 2015	% of Revenue
Revenue	$146,988	100.0 %	$144,717	100.0 %
Gross Profit	46,724	31.8 %	44,495	30.7 %
Operating Expenses	33,784	23.0 %	31,747	21.9 %
Intangible Amortization	2,935	2.0 %	3,607	2.5 %
Non-operating Expense, net	4,164	2.8 %	5,093	3.5 %
Income Tax Expense, net on Continuing Operations	4,367	3.0 %	24,924	17.2 %
Loss on Discontinued Operations	(26,455)	(18.0)%	(16,647)	(11.5)%

Revenue increased by $2.3 million, or 1.6%, for the six months ended June 30, 2016, as compared to the six months ended June 30, 2015. The largest drivers of the increase were related to increased product sales and the continued expansion of our government cyber training initiatives, which were partially offset by the decrease in revenue related to the SETA divestiture and certain solutions contracts ending.

Gross profit increased by $2.2 million for the six months ended June 30, 2016, as compared to the period ended June 30, 2015. Gross margin increased by 110 basis points for the six months ended June 30, 2016, as compared to the period ended June 30, 2015. The increase in gross profit and as a percentage of revenue was predominately due to the increase in higher-margin product sales discussed above.

Our operating expenses for the six months ended June 30, 2016, increased by $2.0 million and as a percentage of revenue compared to the same period ended June 30, 2015. The increase is due primarily to the costs associated with the new Milestone facility,

which we moved into during the third quarter of 2015, increased costs related to the ramp-up of our business development function and higher professional fees.
Intangible amortization expense decreased due to certain intangibles from prior acquisitions becoming fully amortized, partially offset by the amortization of intangible assets associated with our 2015 acquisitions.
Non-operating expense decreased by $0.9 million for the six months ended June 30, 2016, compared with the six months ended June 30, 2015. The decrease in non-operating expense was driven by the pre-tax gain related to the sale of our systems engineering and technical assistance ("SETA") business of $3.0 million, which was partially offset by increased interest expense and certain operating lease disposal costs.

The effective tax rate on income from continuing operations was 74.8% and 615.7% for the six months ended June 30, 2016 and 2015, respectively. The effective tax rate for the six months ended June 30, 2016 and 2015, was impacted by the valuation allowance that was established during the second quarter of 2015 due to the uncertainty of the utilization of deferred tax assets in future periods. We currently believe it is not likely that we will realize a significant portion of our deferred tax asset.

Loss on discontinued operations increased by $9.8 million, or 58.9% for the six months ended June 30, 2016, as compared to the six months ended June 30, 2015. The largest drivers of the increase were related to the additional goodwill impairment of $7.0 million and the $5.5 million pre-tax loss recognized on the sale of the Hexis Cyber Solutions product lines. These increases were partially offset by cost-saving measures put in place in January 2016 and the sale of Hexis Cyber Solutions product lines in the second quarter of 2016.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents totaled approximately $47.9 million at June 30, 2016. Our working capital, defined as current assets minus current liabilities, was $75.2 million, which represents an increase of approximately $12.3 million from December 31, 2015. The increase in working capital is primarily due to the sale of our SETA business for approximately $11.2 million in cash. At June 30, 2016, we were in compliance with all of our debt covenants under our senior credit agreement.
We believe that cash from operations, cash and cash equivalents on hand, and the additional funds available under the Revolver will be sufficient to fund our operations as we continue to grow. We may also use our 2014 Revolver (defined below) to fund acquisitions and to provide liquidity in the event of federal government budgetary issues, including the failure or delay by Congress and the President in approving federal budgets in the future. We may also raise additional capital through future debt or equity financing.

Convertible Notes

During the third quarter of 2014, we issued $149.5 million aggregate principal amount of the Company's 2.50% Convertible Senior Notes due July 15, 2019 (the "Notes") pursuant to an underwriting agreement, dated July 16, 2014. The Notes bear interest at a rate of 2.50% per annum on the principal amount, payable semi-annually in arrears on January 15 and July 15 of each year, beginning on January 15, 2015, to holders of record at the close of business on the preceding January 1 and July 1, respectively. The Notes mature on July 15, 2019, unless earlier repurchased or converted. The Company may not redeem the Notes prior to their stated maturity date.
The Notes are senior unsecured obligations of the Company and will rank equal in right of payment to all of the Company’s existing and future senior unsecured indebtedness. The Notes will be senior in right of payment to any existing or future indebtedness which is subordinated by its terms. The Notes are structurally subordinated to all liabilities of the Company’s subsidiaries and are effectively junior to the secured indebtedness of the Company to the extent of the value of the assets securing such indebtedness.
Holders may convert their Notes under the following conditions at any time prior to the close of business on the business day immediately preceding January 15, 2019, in multiples of $1,000 principal amount, under the following circumstances:

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- during any calendar quarter (and only during such calendar quarter) commencing after the calendar quarter ending September 30, 2014, if the last reported sale price of the Company’s common stock, for at least 20 trading days (whether or not consecutive) in the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price for the Notes on each applicable trading day;
- during the five business day period immediately after any five consecutive trading day period in which the trading price per $1,000 principal amount of Notes for each trading day of that period was less than 98% of the product of the last reported sale price of Company common stock and the conversion rate for the Notes for each such trading day;
- upon the occurrence of specified corporate events as described in the Indenture; or

- following the Company’s delivery of a notice of the spin-off of its subsidiary, Hexis Cyber Solutions, Inc. (the “Hexis spin-off”).

In addition, holders may convert their Notes at their option at any time on or after January 15, 2019 until the close of business on the second scheduled trading day immediately preceding the stated maturity date of the Notes, without regard to the foregoing circumstances.

Upon conversion, the Company will settle the Notes in cash, shares of Company common stock or a combination of cash and shares of Company common stock, at the Company’s election. The Notes have an initial conversion rate of 67.41 shares of common shares per $1,000 principal amount of the Convertible Notes, which is equal to an initial conversion price of approximately $14.83 per common share. The conversion price is subject to adjustments upon the occurrence of certain specified events, including the initial public offering of the Company’s subsidiary, Hexis Cyber Solutions, Inc., as set forth in the Indenture.

In addition, upon the occurrence of a fundamental change (as defined in the Indenture), holders of the Notes may require the Company to repurchase the Notes at a purchase price of 100% of the principal amount of the Notes, plus accrued and unpaid interest, if any, to, but excluding, the fundamental change repurchase date.

Capped Call Transactions

During the third quarter of 2014 in conjunction with the issuance of the Notes, the Company paid approximately $18.4 million to enter into capped call transactions with respect to its common shares, (the "Capped Call Transactions"), with certain financial institutions. The Capped Call Transactions generally are expected to reduce the potential dilution to the Company's common stock upon conversion of the Notes and/or offset any cash payments the Company is required to make in excess of the principal amount of any converted Notes, as the case may be, in the event that the market price of the common stock is greater than the strike price of the Capped Call Transactions, initially set at $14.83, with such reduction of potential dilution subject to a cap based on the cap price, which is initially set at $19.38. The strike price and cap price are subject to anti-dilution adjustments under the terms of the Capped Call Transactions.

The Capped Call Transactions are separate transactions entered into by and between the Company and the Counterparties and are not part of the terms of the Notes. Holders of the Notes will not have any rights with respect to Capped Call Transactions.

2014 Revolving Credit Facility

In July 2014, the Company, as guarantor and certain of the Company's subsidiaries, entered into a senior secured credit agreement, (the "2014 Credit Agreement") with certain financial institutions. The 2014 Credit Agreement provides the Company a $42.5 million revolving credit facility (the "2014 Revolver"). The 2014 Revolver includes a swing line loan commitment of up to $10 million and a letter of credit facility of up to $15 million.

Borrowings under the 2014 Credit Agreement bear interest at a rate equal to an applicable rate plus, at the Company’s option, either (a) adjusted LIBOR or (b) a base rate. The Company is required to pay a facility fee to the Lenders for any unused commitments and customary letter of credit fees.

The 2014 Revolver will mature on the earlier to occur of (i) the fifth anniversary of the closing of the 2014 Credit Agreement, and (ii) the date that is 180 days prior to the maturity date of the Notes unless the Notes are converted into equity, repaid, refinanced or otherwise satisfied on terms permitted under the 2014 Credit Agreement. The Company may voluntarily repay outstanding loans under the 2014 Revolver at any time without premium or penalty, subject to customary fees in the case of prepayment of LIBOR based loans.

The Credit Agreement contains a number of negative covenants that will, among other things, restrict, subject to certain exceptions, the Company and its subsidiaries' ability to: incur additional indebtedness; incur additional liens; sell all or substantially all of the Company's assets; consummate certain fundamental changes; change the Company's lines of business or make certain restricted payments (including cash payments upon conversion of the Notes if a default or event of default exists under the facility or if, after giving effect to such payments and any debt incurred to make such payments, the Company is not in pro forma compliance with the financial covenants and other financial tests under the facility, or cash payments to pay the purchase price of the Notes). The Credit Agreement also contains certain customary affirmative covenants and events of default.

The Credit Agreement requires the Company to maintain a maximum consolidated senior secured leverage ratio and a minimum cash interest coverage ratio. The consolidated senior secured leverage ratio test measures the ratio of the Company's consolidated funded indebtedness (other than consolidated funded indebtedness that is unsecured) to trailing four quarter Consolidated EBITDA (as defined in the Credit Agreement). This ratio is permitted to be no greater than 2.25 to 1.00 as of the end of any fiscal quarter during the applicable period. The cash interest coverage ratio test measures the ratio of trailing four quarter Consolidated EBITDA minus taxes paid in such period to consolidated interest expense paid in such period in cash. This ratio is permitted to be no less than 3.50 to 1.00.

The 2014 Revolver is secured by a security interest and lien on substantially all of the Company's, the Borrower's and the Subsidiary Guarantors' assets including a pledge of one hundred percent of the equity securities of the Borrower and the Subsidiary Guarantors.

In February 2016, the Company amended the Credit Agreement by adjusting the minimum cash interest coverage ratio covenant effective for the quarters ended December 31, 2015, and March 31, 2016 to 2.25:1.00 and 3.25:1.00, respectively, and increasing the applicable interest rates with respect to the Credit Agreement's consolidated senior secured leverage ratio pricing tiers. The amendment permanently decreases the amount available under the revolver to $20.0 million. At June 30, 2016, we were in compliance with all of our debt covenants under the Credit Agreement.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In addition to the risks inherent in our operations, we are exposed to financial, market, political and economic risks. The following discussion provides additional detail regarding our exposure to interest rates and foreign exchange rate risks.

Interest Rate Risk

At June 30, 2016, we had $149.5 million aggregate principal amount of 2.5% convertible senior notes due 2019 (the "Notes"). As the Notes are fixed rate instruments, as of June 30, 2016, our results of operations are not subject to fluctuations in interest rates.

Foreign Exchange Risk

We currently do not have any material foreign currency risk, and accordingly estimate that an immediate 10 percent change in foreign exchange rates would not have a material impact on our reported net income. We do not currently utilize any derivative financial instruments to hedge foreign currency risks.

Equity Price Risk

We do not currently own nor have we ever owned any marketable equity investments to include marketable equity securities and equity derivative instruments such as warrants and options. Therefore, since we do not currently own investments that are subject to market price volatility, our equity price risk is very low.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our filings and submissions to the Securities and Exchange Commission (the “SEC”) under the Exchange Act is recorded, processed, and reported within the time periods specified in the SEC’s rules and forms. Such controls include those designed to ensure that information is accumulated and communicated to management, including our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), as appropriate, to allow timely decisions regarding required disclosures.

An evaluation was conducted under the supervision and with the participation of management, including the CEO and CFO, on the effectiveness of our disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based on this evaluation, the CEO and CFO concluded that as of December 31, 2015, our disclosure controls and procedures were not effective because of the material weaknesses described in Management's Annual Report on Internal Control Over Financial Reporting contained in our Annual Report on Form 10-K for the year ended December 31, 2015, filed with the Securities and Exchange Commission on March 15, 2016. In light of the material weaknesses identified at December 31, 2015, management has implemented processes and procedures to begin to remediate the identified material weaknesses.

We have also conducted an evaluation, under the supervision and with the participation of our management, including our CEO and CFO, pursuant to Rule 13a-15 of the Exchange Act, of the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2016. Based on that evaluation, our CEO and CFO concluded that, because the material weakness in our internal control over financial reporting described above had not been fully remediated as of June 30, 2016, our disclosure controls and procedures were not effective as of June 30, 2016. Notwithstanding the existence of this material weakness, our management has concluded that our condensed consolidated financial statements in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial position, results of operations and cash flows for all periods and dates presented.

Management's Plan for Remediation

Our management and Board of Directors are committed to the remediation of the identified material weaknesses, as well as the continued improvement of our overall system of internal control over financial reporting. We are currently working to remediate the underlying causes of the control deficiencies that gave rise to the material weaknesses as follows:

- We are enhancing our procedures to better formalize our process over the creation of long term forecasts, and to improve the level of documentation that exists with respect to the development of our annual long-term forecast. Specific enhancements will include procedures to improve our process of retaining documentation throughout forecast creation, along with the documentation of management's review.

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- We are augmenting our internal controls over financial reporting related to inventory to include controls designed specifically to assess costs capitalized into inventory at a higher level of precision. Management has completed a change in its internal processes and has enhanced monitoring activities designed to review and conclude proper accounting treatment for inventory and related period costs is applied consistently.
- We are enhancing our internal controls over financial reporting to properly assess the revenue recognition of individual multiple element sales, which may include software, hardware, training and professional services to ensure they are properly recognizing revenue in accordance with US GAAP. Controls will be enhanced to capture and document the impact of complex transactions that are unique in nature and require additional consideration prior to concluding on the proper revenue recognition.
- As a global approach to addressing these material weaknesses, management will enhance their approach to evaluating complex transactions at a level of precision that minimizes the risk of material misstatement to an acceptable level and document these conclusions.

As we perform our interim testing, we may take additional measures or modify the remediation plan. We believe these measures will remediate the control deficiencies; however, the material weakness will not be considered remediated until management has concluded, through required testing, that these controls are operating effectively.

Changes in Internal Control over Financial Reporting

Except for the implementation of the remediation measures described above, there have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

As of June 30, 2016, and the date of this filing, the Company is not party to any material on-going legal proceedings.

ITEM 1A. RISK FACTORS

Except as set forth below, there have been no material changes from the risk factors previously disclosed under "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015.

The risk factor entitled "Acquisitions have formed a significant part of our growth strategy in the past and we expect to continue this strategy in the future. If we are unable to identify suitable acquisition candidates, integrate the businesses we acquire or realize the intended benefits, this aspect of our growth strategy may not succeed. Acquisitions involve numerous risks, including risks related to integration and undisclosed or underestimated liabilities" in our Annual Report on Form 10-K for the year ended December 31, 2015 is hereby amended in its entirety as follows:

We have made and may continue to make acquisitions and divestitures that involve numerous risks and uncertainties.

Historically, part of our growth strategy has relied on acquisitions. We expect to selectively pursue acquisitions and upon completion to integrate those businesses into our existing operations. We intend to seek acquisition opportunities both to expand into new markets and to enhance our position in our existing markets. However, our ability to make acquisitions will depend on a number of steps, including our ability to:

- identify suitable acquisition candidates;
- negotiate appropriate acquisition terms;
- obtain debt or equity financing that we may need to complete proposed acquisitions;
- complete the proposed acquisitions; and
- integrate the acquired business into our existing operations.

In addition, acquisitions involve numerous risks, including difficulties in the assimilation of the operations accounting systems, technologies, services and products of the acquired company, the potential loss of key employees of the acquired company and the diversion of our management's attention from other business concerns. This is the case particularly in the fiscal quarters immediately following the completion of an acquisition to the extent the operations of the acquired business are integrated into the acquiring businesses' operations during this period. We cannot be sure that we will accurately anticipate all of the changing demands that any future acquisition may impose on our management, our operational and management information systems, and our financial systems.

We may underestimate or fail to discover liabilities relating to a future acquisition during due diligence and we, as the successor owner, might be responsible for any such liabilities. Although we seek to minimize the impact of underestimated or potential undiscovered liabilities by structuring acquisitions to minimize liabilities and obtaining indemnities and warranties from the selling party, these methods may not fully protect us from the impact of undiscovered liabilities. Indemnities or warranties are often limited in scope, amount or duration, and may not fully cover the liabilities for which they were intended. The liabilities that are not covered by the limited indemnities or warranties could have a material adverse effect on our business and financial condition. In addition, acquisitions can raise potential Organizational Conflict of Interest (OCI) issues that can impact the nature and timing of the acquisition or the acquiring entity’s ability to compete for future contracts where the acquired entity may have been involved.

In addition, we have divested, and may in the future divest, businesses that are no longer a part of our ongoing strategic plan. These divestitures similarly require significant investment of time and resources, may disrupt our business, distract management from other responsibilities and may result in losses on disposal or continued financial involvement in the divested business, including through indemnification, guarantee or other financial arrangements, for a period of time following the transaction, which could adversely affect our financial results.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

During the six months ended June 30, 2016, 505,000 long-term incentive shares were granted to new hires outside of the 2013 Plan, in accordance with Section 4(2) of the Securities Act of 1933.

ITEM 6. EXHIBITS

Exhibits – See Exhibit Index

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

		THE KEYW HOLDING CORPORATION
Date:	August 9, 2016	By: /s/ William J. Weber William J. Weber President and Chief Executive Officer
Date:	August 9, 2016	By: /s/ Michael J. Alber Michael J. Alber Executive Vice President and Chief Financial Officer

THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

Exhibit No.	Exhibit Description	
3.1	Amended and Restated Articles of Incorporation of the Company, as filed on October 6, 2010	(1)
3.2	Certificate of Correction of Articles of Amendment and Restatement	(2)
3.3	Amended and Restated Bylaws of the Company, effective as of August 13, 2014	(3)
4.1	Specimen of Common Stock Certificate	(4)
4.2	Indenture, dated July 21, 2014, between the Company and Wilmington Trust, National Association, as trustee.	(5)
4.3	First Supplemental Indenture, dated July 21, 2014, between the Company and Wilmington Trust, National Association, as trustee.	(5)
4.4	Form of 2.50% Convertible Senior Note due 2019 (incorporated by reference to Exhibit 4.2 hereto).	(5)
10.1	Amendment No. 5, dated as of May 2, 2016, to Credit Agreement, dated as of July 21, 2014, among The KEYW Corporation, as the Borrower, certain subsidiaries of the Borrower and the Company, as Guarantors, the lenders identified in the Credit Agreement and Royal Bank of Canada, as Administrative Agent.	(6)
10.2	First Amendment to Employment Agreement, dated as of May 23, 2016, by and between Hexis Cyber Solutions, Inc. and Philip L. Calamia.	(7)
10.3	Employment Agreement, dated as of May 23, 2016, by and between The KEYW Corporaiton and Michael J. Alber.	(8)
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a)	x
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a)	x
32.1*	Certification of the Chief Executive Officer and the Chief Financial Officer and Principal Accounting Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002	x
101.INS**	XBRL Instance Document	x
101.SCH**	XBRL Taxonomy Extension Schema Document	x
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document	x
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document	x
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document	x
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document	x

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THE KEYW HOLDING CORPORATION AND SUBSIDIARIES

x Filed herewith.

(1) Filed as Exhibit 3.1 to the Registrant's Form 10-K filed March 29, 2011, File No. 001-34891.
(2) Filed as Exhibit 3.1 to the Registrant's Form 8-K filed July 15, 2014, File No. 001-34891.
(3) Filed as Exhibit 3.1 to the Registrant's Form 8-K reporting under Items 5.02, 5.03, 5.07, filed August 15, 2014, File No. 001-34891.
(4) Filed as Exhibit 4.3 to the Registrant's Registration Statement on Form S-1, as amended, File No. 333-167608.
(5) Filed as Exhibits 4.1, 4.2, and 4.3, respectively to the Registrant's Current Report on Form 8-K filed July 21, 2014, File No. 001-38491.

(6) Filed as 10.1 to the Registrant's Current Report on Form 8-K, filed May 5, 2016.
(7) Filed as Exhibit 10.1 to the Registrant's Form 8-K filed May 27, 2016.
(8) Filed as Exhibit 10.2 to the Registrant's Form 8-K filed May 27, 2016.

* This exhibit is being “furnished” with this periodic report and are not deemed “filed” with the Securities and Exchange Commission and are not incorporated by reference in any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation by reference language in any such filing.

** Pursuant to Regulation S-T, this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.