Section 1: 10-Q (10-Q)

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

☑ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 28, 2018

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: 001-36341

Vectrus, Inc.

(Exact name of registrant as specified in its charter)

Indiana	38-3924636
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2424 Garden of the Gods Road, Colorado Springs, Colorado 80919

(Address of Principal Executive Offices) (Zip Code)

Registrant’s telephone number, including area code:

(719) 591-3600

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 ☑ No ☐

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☑ No ☐

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

Large accelerated filer ☐	Accelerated filer ☑	Non-accelerated filer ☐
Smaller reporting company ☐	Emerging growth company ☐	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☑

As of November 1, 2018, there were 11,261,071 shares of common stock ($0.01 par value per share) outstanding.

VECTRUS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

VECTRUS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three Months Ended		Nine Months Ended	
(In thousands, except per share data)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Revenue	$ 308,095	$ 269,625	$ 949,744	$ 819,005
Cost of revenue	278,964	245,219	865,078	743,502
Selling, general and administrative expenses	15,125	14,316	48,990	44,560
Operating income	14,006	10,090	35,676	30,943
Interest (expense) income, net	(1,314)	(1,058)	(3,619)	(3,262)
Income from operations before income taxes	12,692	9,032	32,057	27,681
Income tax expense	2,826	3,232	6,884	9,751
Net income	$ 9,866	$ 5,800	$ 25,173	$ 17,930
Earnings per share				
Basic	$ 0.88	$ 0.52	$ 2.25	$ 1.63
Diluted	$ 0.86	$ 0.51	$ 2.21	$ 1.61
Weighted average common shares outstanding - basic	11,248	11,075	11,210	10,991
Weighted average common shares outstanding - diluted	11,406	11,272	11,380	11,168

The accompanying notes are an integral part of these financial statements.

VECTRUS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Net income	$ 9,866	$ 5,800	$ 25,173	$ 17,930
Other comprehensive income, net of tax				
Changes in derivative instrument:				
Net change in fair value of interest rate swap	296	—	1,177	95
Net change in fair value of foreign currency forward contracts	(34)		(196)	
Net gain reclassified to interest expense	—	—	—	—
Tax expense	(64)	—	(254)	(34)
Net change in derivative instruments	198	—	727	61
Foreign currency translation adjustments, net of tax	(43)	893	(943)	2,724
Other comprehensive (loss) income, net of tax	155	893	(216)	2,785
Total comprehensive income	$ 10,021	$ 6,693	$ 24,957	$ 20,715

The accompanying notes are an integral part of these financial statements.

VECTRUS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share information)	September 28, 2018	December 31, 2017
Assets	**(unaudited)**	
Current assets		
Cash	$ 39,584	$ 77,453
Receivables	223,389	174,995
Costs incurred in excess of billings	—	12,751
Other current assets	12,107	6,747
Total current assets	275,080	271,946
Property, plant, and equipment, net	10,512	3,733
Goodwill	234,818	216,930
Intangible assets, net	9,161	121
Other non-current assets	4,014	2,821
Total non-current assets	258,505	223,605
Total Assets	$ 533,585	$ 495,551
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable	$ 121,717	$ 115,899
Billings in excess of costs	—	3,766
Compensation and other employee benefits	46,841	39,304
Short-term debt	4,000	4,000
Other accrued liabilities	24,245	19,209
Total current liabilities	196,803	182,178
Long-term debt, net	70,529	73,211
Deferred tax liability	53,315	55,329
Other non-current liabilities	1,452	1,461
Total non-current liabilities	125,296	130,001
Total liabilities	322,099	312,179
Commitments and contingencies (Note 13)		
Shareholders' Equity		
Preferred stock; $0.01 par value; 10,000,000 shares authorized; No shares issued and outstanding	—	—
Common stock; $0.01 par value; 100,000,000 shares authorized; 11,249,222 and 11,120,528 shares issued and outstanding	113	111
Additional paid in capital	70,759	67,526
Retained earnings	142,510	117,415
Accumulated other comprehensive loss	(1,896)	(1,680)
Total shareholders' equity	211,486	183,372
Total Liabilities and Shareholders' Equity	$ 533,585	$ 495,551

The accompanying notes are an integral part of these financial statements.

VECTRUS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)	Nine Months Ended September 28, 2018	Nine Months Ended September 29, 2017
Operating activities		
Net income	$ 25,173	$ 17,930
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,546	1,141
Loss on disposal of property, plant, and equipment	315	—
Stock-based compensation	3,410	3,341
Amortization of debt issuance costs	318	561
Changes in assets and liabilities:		
Receivables	(15,179)	(96)
Other assets	(5,669)	3,196
Accounts payable	(5,259)	(11,470)
Billings in excess of costs	—	1,649
Deferred taxes	(2,101)	(1,007)
Compensation and other employee benefits	5,002	6,817
Other liabilities	98	336
Net cash provided by operating activities	8,654	22,398
Investing activities		
Purchases of capital assets	(6,115)	(901)
Proceeds from the disposition of assets	33	—
Acquisition of business, net of cash acquired	(36,855)	—
Net cash used in investing activities	(42,937)	(901)
Financing activities		
Repayments of long-term debt	(3,000)	(10,500)
Proceeds from revolver	138,000	27,500
Repayments of revolver	(138,000)	(27,500)
Proceeds from exercise of stock options	1,388	1,886
Payments of employee withholding taxes on share-based compensation	(803)	(612)
Net cash used in financing activities	(2,415)	(9,226)
Exchange rate effect on cash	(1,171)	3,524
Net change in cash	(37,869)	15,795
Cash-beginning of year	77,453	47,651
Cash-end of period	$ 39,584	$ 63,446
Supplemental disclosure of cash flow information:		
Interest paid	$ 3,241	$ 3,014
Income taxes paid	$ 11,222	$ 3,801
Non-cash investing activities:		
Purchase of capital assets on account	$ 1,374	$ 438

The accompanying notes are an integral part of these financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1

DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business and Basis of Presentation

Our Business

Vectrus, Inc. is a leading provider of services to the United States (U.S.) government worldwide. We operate as one segment and offer facility and logistics services and information technology and network communications services.

Vectrus was incorporated in the State of Indiana on February 4, 2014. On September 27, 2014, Exelis Inc. (Exelis) completed a spin-off (the Spin-off) of Vectrus, and Vectrus became an independent, publicly traded company. The Condensed Consolidated Financial Statements reflect the consolidated operations of Vectrus as a separate stand-alone entity.

On January 23, 2018, we acquired 100% of the outstanding common stock of SENTEL Corporation (SENTEL), a U.S. government contractor with expertise in logistics and supply chain management, engineering and advanced information technology solutions for spectrum management systems, sensor networks, border and perimeter surveillance systems and other detection systems, and multidisciplinary mission support for various intelligence community clients. The consolidated results of operations for the three and nine months ended September 28, 2018 contained herein includes SENTEL results beginning on the acquisition date of January 23, 2018. Refer to Note 4, "SENTEL Acquisition" for additional information regarding the acquisition of SENTEL.

Unless the context otherwise requires, references in these notes to "Vectrus", "we," "us," "our," "the Company" and "our Company" refer to Vectrus, Inc. References in these notes to Exelis or "Former Parent" refer to Exelis Inc. and its consolidated subsidiaries (other than Vectrus). Exelis was acquired by Harris Corporation in May 2015.

Equity Investment

In 2011, we entered into a joint venture agreement with Shaw Environmental & Infrastructure, Inc., which is now Aptim Federal Services, LLC. Pursuant to the joint venture agreement, High Desert Support Services, LLC (HDSS) was established to pursue and perform work on the Ft. Irwin Installation Support Services Contract, which was awarded to HDSS in October 2012. We account for our investment in HDSS under the equity method as we have the ability to exercise significant influence, but do not hold a controlling interest. We record our proportionate 40% share of income or losses, which has historically been insignificant, in the Condensed Consolidated Statements of Income. Our investment in HDSS is recorded in other non-current assets in the Condensed Consolidated Balance Sheets. When we receive cash distributions from HDSS, the cash distribution is compared to cumulative earnings and any excess is recorded as a distribution from equity investment in the Condensed Consolidated Statements of Cash Flows. Any remaining cash distribution is recorded in changes to other assets in the Condensed Consolidated Statements of Cash Flows. As of September 28, 2018 and December 31, 2017, our investment balance in HDSS was $2.1 million and $1.7 million, respectively.

Summary of Significant Accounting Policies

Principles of Consolidation

Vectrus consolidates companies in which it has a controlling financial interest. All intercompany transactions and balances have been eliminated.

Basis of Presentation

Our quarterly financial periods end on the Friday closest to the last day of the calendar quarter (September 28, 2018 for the third quarter of 2018 and September 29, 2017 for the third quarter of 2017), except for the last quarter of the fiscal year, which ends on December 31. For ease of presentation, the quarterly financial statements included herein are described as three months ended.

The unaudited interim Condensed Consolidated Financial Statements of Vectrus have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the U.S. (GAAP) have been omitted. These unaudited interim Condensed Consolidated Financial Statements should be read in conjunction with our audited Consolidated Financial Statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017.

It is management's opinion that these financial statements include all normal and recurring adjustments necessary for a fair presentation of the Company's financial position and operating results. Net sales and net earnings for any interim period are not necessarily indicative of future or annual results.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Estimates are revised as additional information becomes available. Estimates and assumptions are used for, but not limited to, revenue recognition, income tax contingency accruals, fair value and impairment of goodwill, useful lives of intangible assets, and valuation of assets and certain contingent liabilities. Actual results could differ from these estimates.

Reclassifications

Certain reclassifications have been made to the presentation of amounts in our Condensed Consolidated Balance Sheets as of December 31, 2017 to conform to the current year presentation. Specifically, certain intangible assets were reclassified from non-current assets and are now presented separately on our Condensed Consolidated Balance Sheets.

Revenue Recognition

The majority of our revenue is derived from long-term contracts and programs that can span several years. We account for revenue in accordance with Accounting Standards Codification (ASC) Topic 606, Revenue from Contracts with Customers, which we adopted on January 1, 2018, using the modified retrospective method.

Our primary customer is the U.S. Department of Defense, with a high concentration in the U.S. Army. For the nine months ended September 28, 2018 and September 29, 2017, we had total revenue of $949.7 million and $819.0 million, respectively, all of which was derived from U.S. government customers. For the nine months ended September 28, 2018 and September 29, 2017, we generated approximately 74% and 83%, respectively, of our total revenue from the U.S. Army.

Refer to Note 3, "Revenue" for additional information regarding our revenue generation and recognition activities.

Derivative Instruments

Derivative instruments are recognized as either an asset or liability at fair value in our Condensed Consolidated Balance Sheets and are classified as current or long-term based on the scheduled maturity of the instrument. Our derivative instruments have been formally designated and qualify as part of a cash flow hedging relationship under applicable accounting standards.

Changes in fair value of foreign currency forward contracts acquired prior to December 31, 2017 are recognized within selling, general and administrative expenses in the Condensed Consolidated Statements of Income. All other derivative instruments are adjusted to fair value through accumulated other comprehensive loss. If we were to determine that a derivative was no longer highly effective as a hedge, we would discontinue the hedge accounting prospectively. Gains or losses would be immediately reclassified from accumulated other comprehensive loss to earnings relating to hedged forecasted transactions that are no longer probable of occurring. Gains or losses relating to terminations of effective cash flow hedges in which the forecasted transactions would still be probable of occurring would be deferred and recognized consistent with the income or loss recognition of the underlying hedged item.

Refer to Note 9, "Derivative Instruments" for additional information regarding our derivative activities.

NOTE 2

RECENT ACCOUNTING PRONOUNCEMENTS

Accounting Standards Issued But Not Yet Effective

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, Leases (Topic 842) (ASU 2016-02). The objective of ASU 2016-02 is to recognize lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. ASU 2016-02 requires lessees to account for leases as finance leases or operating leases. Both finance and operating leases will result in the lessee recognizing a right-of-use asset and corresponding lease liability. For finance leases, the lessee would recognize interest expense and amortization of the right-of-use asset and, for operating leases, the lessee would recognize a straight-line lease expense. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption of ASU 2016-02 is permitted. We have begun analyzing our operating lease agreements, and management anticipates our assets and liabilities will increase proportionally after the adoption of ASU 2016-02. As of September 28, 2018, there are approximately $15 million in future minimum rental payments for operating leases that are not currently on our balance sheet.

In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment (ASU 2017-04). The objective of ASU 2017-04 is to simplify the subsequent measurement of goodwill by entities performing their annual goodwill impairment tests by comparing the fair value of a reporting unit, including income tax effects from any tax-deductible goodwill, with its carrying amount and recognizing an impairment charge for the amount by which the carrying amount exceeds fair value. ASU 2017-04 is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Early adoption of ASU 2017-04 is permitted on goodwill impairment tests performed after January 1, 2017. ASU 2017-04 should be applied on a prospective basis. We are evaluating the impact of adopting ASU 2017-04; however, the standard is not expected to have a material impact on our consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities (ASU 2017-12). The objective of ASU 2017-12 is to improve the transparency and understandability of information conveyed to financial statement users about an entity’s risk management activities by better aligning the entity’s financial reporting for hedging relationships with those risk management activities, and to reduce the complexity of and simplify the application of hedge accounting by preparers. The standard is effective in annual periods beginning after December 15, 2018, and interim periods within those periods. Early adoption is permitted as of the beginning of the annual period. We are evaluating the impact of adopting ASU 2017-12; however, the standard is not expected to have a material impact on our consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, Income Statement – Reporting Comprehensive Income: Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (ASU 2018-02). The standard addresses the “stranded” tax effects resulting from the 2017 Tax Cuts and Jobs Act (the Tax Act) in accumulated other comprehensive loss. The changes in tax laws and rates from the Tax Act did not affect income from operations. The standard is effective for annual periods beginning after December 15, 2018, including interim periods within that reporting period, and early adoption is permitted. Disclosures are required in the period of adoption. We are currently evaluating the new guidance to determine the impact it will have on our consolidated financial statements.

Accounting Standards That Were Adopted

In 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). Several related ASUs have been issued since the issuance of ASU 2014-09, which modify certain sections of ASU 2014-09 and are intended to promote a more consistent interpretation and application of the principles outlined in the standard. We adopted the new standard, ASC Topic 606, using the modified retrospective method with a cumulative-effect adjustment to opening retained earnings as of January 1, 2018. Refer to Note 3, "Revenue" for a description of the impact of the adoption of ASC Topic 606.

In March 2018, the FASB issued ASU 2018-05, Income Taxes (Topic 740), Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118 (ASU 2018-05). The SEC issued Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act (SAB 118), in December 2017. ASU 2018-05 adds various SEC paragraphs pursuant to the issuance of SAB 118, which was effective immediately. The SEC issued SAB 118 to address concerns about reporting entities' ability to timely comply with the accounting requirements to recognize all of the effects of the Tax Act in the period of enactment. SAB 118 allows disclosure that timely determination of some or all of the income tax effects from the Tax Act is incomplete by the due date of the financial statements and requires disclosure of a reasonable estimate, if possible. We have accounted for the tax effects of the Tax Act under the guidance of SAB 118, on a provisional basis. Our accounting for certain income tax effects is incomplete, but we believe that we have determined reasonable estimates for those effects and have recorded provisional amounts in our Condensed Consolidated Financial Statements as of September 28, 2018 and December 31, 2017. Refer to Note 5, "Income Taxes" for further discussion of our income taxes.

Other new pronouncements issued but not effective until after September 28, 2018 are not expected to have a material impact on our financial position, results of operations or cash flows.

NOTE 3

REVENUE

Performance Obligations

We adopted ASC Topic 606 on January 1, 2018, using the modified retrospective method with an unfavorable cumulative-effect adjustment of $0.1 million to opening retained earnings. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer and is the unit of account in ASC Topic 606. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. To determine the proper revenue recognition method, consideration is given as to whether a single contract should be accounted for as more than one performance obligation. For most of our contracts, the customer contracts with us to perform an integrated set of tasks and deliverables as a single service solution, whereby each service is not separately identifiable from other promises in the contract. As a result, when this integrated set of tasks exists, the contract is accounted for as one performance obligation. The vast majority of our contracts have a single performance obligation. Unexercised contract options and indefinite delivery and indefinite quantity (IDIQ) contracts are considered to be separate contracts when the option or IDIQ task order is exercised or awarded.

Our performance obligations are satisfied over time as services are provided throughout the contract term. We recognize revenue over time using the input method (e.g., costs incurred to date relative to total estimated costs at completion) to measure progress. Our over time recognition is reinforced by the fact that our customers simultaneously receive and consume the benefits of our services as they are performed. This continuous transfer of control requires that we track progress towards completion of performance obligations in order to measure and recognize revenue. Determining progress on performance obligations requires us to make judgments that affect the timing of revenue recognition.

Remaining performance obligations represent firm orders by the customer and excludes potential orders under IDIQ contracts, unexercised contract options and contracts awarded to us that are being protested by competitors with the U.S. Government Accountability Office (GAO) or in the U.S. Court of Federal Claims. The level of order activity related to programs can be affected by the timing of government funding authorizations and their project evaluation cycles. Year-over-year comparisons could, at times, be impacted by these factors, among others.

Our contracts are multi-year contracts and typically include an initial period of one year or less with annual one-year (or less) option periods. The number of option periods varies by contract, and there is no guarantee that an option period will be exercised. The right to exercise an option period is at the sole discretion of the U.S. government when we are the prime contractor or of the prime contractor when we are a subcontractor. We expect to recognize a substantial portion of our performance obligations as revenue within the next 12 months. However, the U.S. government or the prime contractor may cancel any contract at any time through a termination for convenience or for cause. Most of our contracts have terms that would permit us to recover all or a portion of our incurred costs and fees for work performed in the event of a termination for convenience.

Remaining performance obligations increased by $55.0 million as of September 28, 2018 as compared to December 31, 2017. We expect to recognize approximately 39% of the remaining performance obligations as of September 28, 2018 as revenue in 2018, and the remaining 61% during 2019. Remaining performance obligations as of September 28, 2018 and December 31, 2017 are presented in the following table:

(In millions)	September 28, 2018	December 31, 2017
Performance Obligations	$ 774	$ 719

Contract Estimates

Accounting for contracts and programs involves the use of various techniques to estimate total contract revenue and costs. For contracts, we estimate the profit on a contract as the difference between the total estimated revenue and expected costs to complete a contract and recognize that profit over the life of the contract.

Contract estimates are based on various assumptions to project the outcome of future events. These assumptions include labor productivity and availability; the complexity of the services being performed; the cost and availability of materials; the performance of subcontractors; and the availability and timing of funding from the customer.

The nature of our contracts gives rise to several types of variable consideration, including award and incentive fees, inspection of supplies and services, and fluctuation in allowable indirect reimbursable costs. We include award or incentive fees in the estimated transaction price when there is certainty and a basis to reasonably estimate the amount of the fee. These estimates are based on historical award experience, anticipated performance and our best judgment at the time. The inspection of supplies and services is a factor because the U.S. government can reduce the transaction price if we do not perform the services in compliance with contract requirements. The fluctuation of allowable indirect reimbursable costs is a factor because the U.S. government has the right to review our accounting records and retroactively adjust the reimbursable rate. Any prior adjustments are reflected in the U.S. government reserve amounts recorded in Vectrus' financial statements. We estimate variable consideration at the most likely amount that we expect to be entitled to receive. Refer to Note 13 "Commitments and Contingencies" for additional information regarding U.S. government reserve amounts.

As a significant change in one or more of these estimates could affect the profitability of our contracts, we review and update our contract estimates regularly. We recognize adjustments in estimated profit on executed contracts cumulatively. The impact of the adjustments on profit recorded to date is recognized in the period the adjustment is identified. Revenue and profit in future periods of contract performance are recognized using the adjusted estimate. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, we recognize the total loss in the quarter it is identified.

Contracts are often modified to account for changes in contract specifications and requirements. If the modification either creates new enforceable rights and obligations or changes the existing enforceable rights and obligations, the modification will be treated as a separate contract. Historically, our contract modifications have not been distinct from the existing contract and have been accounted for as if they were part of that existing contract. The effect of a contract modification that either creates new enforceable rights and obligations or changes the existing enforceable rights and obligations on the transaction price, and our measure of progress for the performance obligation to which it relates, are recognized as an adjustment to revenue (either as an increase or decrease of revenue) on a cumulative basis.

The impact of adjustments in contract estimates on our operating income can be reflected in either revenue or cost of revenue. Cumulative adjustments for the three and nine months ended September 28, 2018 and September 29, 2017 are presented in the following table:

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Favorable adjustments	$ 3,331	$ 5,779	$ 13,765	$ 14,104
Unfavorable adjustments	(4,963)	(2,111)	(8,851)	(5,518)
Net favorable adjustments	$ (1,632)	$ 3,668	$ 4,914	$ 8,586

For the three months ended September 28, 2018, the net unfavorable adjustment to operating income decreased revenue by $2.0 million. For the nine months ended September 28, 2018, the net favorable adjustment to operating income increased revenue by $4.7 million. For the three and nine months ended September 29, 2017, the net favorable adjustments to operating income increased revenue by $2.4 million and $7.1 million, respectively.

Revenue by Category

Generally, the sales price elements for our contracts are cost-plus, cost-reimbursable or firm-fixed-price. We commonly have elements of cost-plus, cost-reimbursable and firm-fixed-price contracts on a single contract. On a cost-plus type contract, we are paid our allowable incurred costs plus a profit, which can be fixed or variable depending on the contract's fee arrangement, up to funding levels predetermined by our customers. On cost-plus type contracts, we do not bear the risks of unexpected cost overruns, provided that we do not incur costs that exceed the predetermined funded amounts. Most of our cost-plus contracts also contain a firm-fixed-price element. Cost-plus type contracts with award and incentive fee provisions are our primary variable contract fee arrangement. Award fees provide for a fee based on actual performance relative to contractually specified performance criteria. Incentive fees provide for a fee based on the relationship between total allowable and target cost. On most of our contracts, a cost-reimbursable element captures consumable materials required for the program. Typically, these costs do not bear fees.

A firm-fixed-price type contract typically offers higher profit margin potential than a cost-plus type contract, which is commensurate with the greater levels of risk we assume on a firm-fixed-price type contract. On a firm-fixed-price type contract, we agree to perform the contractual statement of work for a predetermined contract price. Although a firm-fixed-price type contract generally permits us to retain profits if the total actual contract costs are less than the estimated contract costs, we bear the risk that increased or unexpected costs may reduce our profit or cause us to sustain losses on the contract. Although the overall scope of work required under the contract may not change, profit may be adjusted as experience is gained and as efficiencies are realized or costs are incurred.

The following tables present our revenue disaggregated by different categories. Revenue by contract type for the three and nine months ended September 28, 2018 and September 29, 2017 is as follows:

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Cost-plus and cost-reimbursable [1]	$ 240,338	$ 194,982	$ 713,289	$ 609,323
Firm-fixed-price	67,757	74,643	236,455	209,682
Total revenue	$ 308,095	$ 269,625	$ 949,744	$ 819,005

[1] Includes time and material contracts

Revenue by geographic region in which the contract is performed for the three and nine months ended September 28, 2018 and September 29, 2017 is as follows:

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Middle East	$ 223,636	$ 217,312	$ 662,734	$ 660,020
United States	54,379	36,499	203,015	112,833
Europe	30,080	15,814	83,995	46,152
Total revenue	$ 308,095	$ 269,625	$ 949,744	$ 819,005

Revenue by contract relationship for the three and nine months ended September 28, 2018 and September 29, 2017 is as follows:

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Prime contractor	$ 290,090	$ 262,372	$ 892,206	$ 799,439
Subcontractor	18,005	7,253	57,538	19,566
Total revenue	$ 308,095	$ 269,625	$ 949,744	$ 819,005

Revenue by customer for the three and nine months ended September 28, 2018 and September 29, 2017 is as follows:

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Army	$ 224,038	$ 214,152	$ 700,265	$ 682,891
Air Force	64,278	49,435	189,954	119,896
Navy	8,567	6,038	26,912	16,218
Other	11,212	—	32,613	—
Total revenue	$ 308,095	$ 269,625	$ 949,744	$ 819,005

Contract Balances

The timing of revenue recognition, billings and cash collections results in billed and unbilled accounts receivable (contract assets) and customer advances and deposits (contract liabilities) on the Condensed Consolidated Balance Sheets. Amounts are billed as work progresses in accordance with agreed-upon contractual terms at periodic intervals (e.g., biweekly or monthly). Generally, billing occurs subsequent to revenue recognition, resulting in contract assets. However, we may receive advances or deposits from our customers, before revenue is recognized, resulting in contract liabilities. These advance billings and payments are not considered significant financing components because they are frequently intended to ensure that both parties are in conformance with the primary contract terms. These assets and liabilities are reported on the Condensed Consolidated Balance Sheets on a contract-by-contract basis at the end of each reporting period.

During the nine months ended September 28, 2018, we recognized $0.9 million in revenue from performance obligations that were satisfied in prior periods. No such revenue was recognized during the three months ended September 28, 2018. Cumulative adjustments resulted from a change in transaction price related to variable consideration that was constrained in prior periods.

As of September 28, 2018, we had contract assets of $188.4 million. Refer to Note 7, "Receivables" for additional information regarding the composition of our receivables balances. As of September 28, 2018, our contract liabilities were insignificant.

ASC Topic 606 Impact

The new ASC Topic 606 guidance was only applied to contracts that were not completed as of the effective date of the guidance. During implementation of the standard, we identified performance obligations on the basis of the current version of the executed contract, including any contract modifications since inception; determined the transaction price, including any variable consideration, as of the transition date; and allocated the transaction price determined to the performance obligation identified.

We determined that certain incentive bonuses met the criteria of incremental costs of acquiring contracts. We capitalize these bonuses and amortize them over the terms of the related contracts, including the base year and any subsequent anticipated option years. As of September 28, 2018, we have capitalized $0.3 million and recognized less than $0.1 million of expense related to certain incentive bonuses for the three and nine months ended September 28, 2018.

The adoption of ASC Topic 606 had the most significant impact to our accounting for firm-fixed-price contracts. Under ASC Topic 606 guidance, our firm-fixed-price contracts recognize revenue and earnings over time with the continuous transfer of services to the customer, using an input measure (e.g., costs incurred to date relative to total estimated costs at completion) to reflect progress. Adjustments in estimated costs at completion were previously recorded as costs incurred in excess of billings or billings in excess of costs on the Condensed Consolidated Balance Sheets. Adjustments in contract estimates for firm-fixed-price contracts are now recorded as unbilled receivables. This change will result in more variability to revenue from period to period. Despite this variability, a firm-fixed-price contract's cash flows and overall profitability at contract completion are the same.

The effects of the adoption of ASC Topic 606, using the modified retrospective method on January 1, 2018, are outlined in the following table:

(In thousands)	Year Ended December 31, 2017	Impact	January 1, 2018
Receivables (unbilled)	$ 121,601	$ 10,457	$ 132,058
Costs incurred in excess of billings	$ 12,751	$ (12,751)	$ —
Billings in excess of costs	$ 3,766	$ (3,766)	$ —
Impact to contract liabilities	$ —	$ 1,621	$ 1,621
Retained earnings, net of tax	$ 117,415	$ (77)	$ 117,338

The following table reflects the balances of financial statement line items under the new ASC Topic 606 revenue recognition guidance compared to the former ASC Topic 605 revenue guidance for the nine months ended September 28, 2018:

	Nine Months Ended September 28, 2018	
(In thousands)	New Guidance ASC Topic 606	Former Guidance ASC Topic 605
Revenue	$ 949,744	$ 943,788
Cost of revenue	$ 865,078	$ 856,286
Selling, general and administrative expenses	$ 48,990	$ 48,990
Operating income	$ 35,676	$ 38,512

NOTE 4

SENTEL ACQUISITION

On January 23, 2018, we acquired 100% of the outstanding common stock of SENTEL. In accordance with ASC Topic 805, Business Combinations, we accounted for this transaction using the acquisition method. We conducted valuations of certain acquired assets and liabilities for inclusion in our Condensed Consolidated Balance Sheets as of the date of acquisition. Assets that normally would not be recorded in ordinary operations (i.e., intangibles related to contractual relationships) were recorded at their estimated fair values. The excess of the purchase price over the estimated fair value of the net assets acquired was recorded as goodwill.

The total net consideration paid for the acquisition was $36.9 million, consisting of the purchase price of $36.0 million and $0.9 million in excess of the working capital requirement agreed upon in the stock purchase agreement entered into among our wholly-owned subsidiary Vectrus Systems Corporation (VSC), SENTEL, R&R Enterprises, Inc. and Russell T. Wright (the Stock Purchase Agreement). The acquisition was funded by utilizing cash on hand and available capacity from our Amended Revolver (as defined in Note 8 "Debt").

A breakdown of the preliminary purchase price allocation, net of cash acquired, is as follows:

(in thousands)		Allocation of Purchase Price
Receivables	$	23,228
Property, plant and equipment		810
Goodwill		17,888
Intangible assets		10,500
Other current assets		975
Accounts payable		(10,012)
Other current liabilities		(5,979)
Other non-current liabilities		(555)
Preliminary purchase price, net of cash acquired	$	36,855

We are still in the process of reviewing the details related to the amounts allocated to receivables, intangible assets, and accounts payable. In the second quarter of 2018, goodwill was increased by $3.9 million to reflect the elimination of a deferred tax asset established in our initial allocation of the purchase price. In the third quarter of 2018, goodwill was decreased by $0.3 million to reflect the final working capital requirements. Further adjustments, if any, to the initial purchase accounting for the acquired net assets will be completed prior to the end of the first quarter of 2019, as we obtain additional information regarding facts and circumstances that existed as of the acquisition date.

We recognized two intangible assets related to customer contracts, the backlog and the contract re-competes arising from the acquisition. The fair value of the backlog was $6.5 million and the fair value of the contract re-competes was $4.0 million with an amortization period of 4.0 years and 8.0 years, respectively. The weighted-average remaining useful life of these two intangible assets is 4.93 years. During the three and nine months ended September 28, 2018, we recorded amortization expense of $0.5 million and $1.5 million, respectively. The amortization expense is included in cost of revenue in our Condensed Consolidated Statements of Income.

Additionally, we recognized goodwill of $17.9 million arising from the acquisition, which relates primarily to growth opportunities based on a broader service offering in the converging physical and digital infrastructure market, and enhancing our information technology, technical solutions and logistics capabilities, while expanding our client base to customers in the U.S. intelligence community. The goodwill recognized for the SENTEL acquisition is fully deductible for income tax purposes.

Through September 28, 2018, we have recorded acquisition-related costs of $0.8 million, which are included in selling, general and administrative expenses in our Condensed Consolidated Statements of Income. We do not believe that any additional fees related to the acquisition will be significant. These costs do not reflect any one-time other internal non-recurring integration costs.

SENTEL's results of operations for 2018 have been included in our Condensed Consolidated Statements of Income for the period subsequent to the acquisition on January 23, 2018. For the three and nine months ended September 28, 2018, SENTEL contributed $27.4 million and $80.7 million of revenue, respectively, and an insignificant amount of income from operations before income taxes. For the three and nine months ended September 29, 2017, SENTEL recognized revenue of $26.7 million and $81.4 million, respectively. Income from operations before income taxes for SENTEL was insignificant during the same prior year periods.

NOTE 5

INCOME TAXES

Effective Tax Rate

Our quarterly income tax expense is measured using an estimated annual effective income tax rate. The comparison of effective income tax rates between periods may be significantly affected by discrete items recognized during the periods, the level and mix of earnings by tax jurisdiction and permanent differences.

For the three and nine months ended September 28, 2018, we recorded income tax provisions of $2.8 million and $6.9 million associated with income from operations before income taxes, compared to income tax provisions of $3.2 million and $9.8 million for the three and nine months ended September 29, 2017, representing effective income tax rates of 22.3% and 21.5%, respectively, for the 2018 periods and 35.8% and 35.2%, respectively, for the 2017 periods. The lower effective tax rate for the 2018 periods are a result of the Tax Act enacted on December 22, 2017, and the impact of one-time discretionary items. The effective income tax rates vary from the federal statutory rate of 21.0% due to state taxes, required tax income exclusions, nondeductible expenses and available deductions not reflected in book income.

As the result of the passage of the Tax Act, the SEC released SAB 118 to provide guidance for companies that had not completed accounting for the income tax effects of the Tax Act prior to the release of their financial reports. We will continue to analyze additional information and guidance related to the Tax Act as supplemental legislation, regulatory guidance, or evolving technical interpretations become available. The final impacts may differ from the recorded amounts as of September 28, 2018 and December 31, 2017, and we will continue to refine such amounts within the measurement period provided by SAB 118. We consider the impact of the Tax Act on our state income tax expense to be incomplete due to forthcoming guidance. We expect to complete our analysis no later than December 31, 2018. For interim period financial reports any estimated impacts of the Tax Act will be included in the calculation of our annualized effective tax rate.

Uncertain Tax Provisions

As of September 28, 2018 and December 31, 2017, there were no unrecognized tax benefits from uncertain tax positions.

NOTE 6

EARNINGS PER SHARE

Basic earnings per share (EPS) is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects potential dilution that could occur if securities to issue common stock were exercised or converted into common stock. Diluted EPS includes the dilutive effect of stock-based compensation outstanding after application of the treasury stock method.

	Three Months Ended		Nine Months Ended	
(In thousands, except per share data)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Net income	$ 9,866	$ 5,800	$ 25,173	$ 17,930
Weighted average common shares outstanding	11,248	11,075	11,210	10,991
Add: Dilutive impact of stock options	68	68	75	63
Add: Dilutive impact of restricted stock units	90	129	95	114
Diluted weighted average common shares outstanding	11,406	11,272	11,380	11,168
Earnings per share				
Basic	$ 0.88	$ 0.52	$ 2.25	$ 1.63
Diluted	$ 0.86	$ 0.51	$ 2.21	$ 1.61

The following table provides a summary of securities that could potentially dilute basic earnings per share in the future that were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented:

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Anti-dilutive stock options	1	3	2	12
Anti-dilutive restricted stock units	—	—	—	—
Total	1	3	2	12

NOTE 7

RECEIVABLES

Receivables were comprised of the following:

(In thousands)	September 28, 2018	December 31, 2017
Billed receivables	$ 28,467	$ 50,595
Unbilled receivables (contract assets)	188,396	121,601
Other	6,526	2,799
Total receivables	$ 223,389	$ 174,995

As of September 28, 2018 and December 31, 2017, all billed receivables are due from the U.S. government, either directly as prime contractor to the U.S. government or as subcontractor to another prime contractor to the U.S. government. Because the Company’s billed receivables are with the U.S. government, the Company does not believe it has a material credit risk exposure.

Unbilled receivables are contract assets that represent revenue recognized on long-term contracts in excess of amounts billed as of the balance sheet date. We estimate that approximately $1.7 million of our unbilled receivables as of September 28, 2018 may not be collected within the next 12 months. These amounts relate to the timing of the U.S. government review of indirect rates and contract line item realignments with our customers. Changes in the balance of receivables are primarily due to the timing differences between our performance and customers' payments.

Refer to Note 3, "Revenue" for a discussion of the impact of the adoption of ASC Topic 606 on our receivables.

NOTE 8

DEBT

Senior Secured Credit Facilities

Term Loan and Revolver. In September 2014, we and our wholly-owned subsidiary, VSC, entered into a credit agreement with a group of lenders, including JPMorgan Chase Bank, N.A. as administrative agent. The credit agreement was amended as of April 19, 2016, to modify certain financial and negative covenants (as so amended, the Credit Agreement). On November 15, 2017, we and VSC entered into an Amendment and Restatement Agreement (the Amendment Agreement) with a group of lenders, including JPMorgan Chase Bank, N.A., as administrative agent, which provides for the amendment and restatement of the Credit Agreement. The Amendment Agreement provides for $200.0 million in senior secured financing, consisting of a $80.0 million five-year term loan facility (the Amended Term Loan) and a $120.0 million five-year senior secured revolving credit facility (the Amended Revolver, and together with the Amended Term Loan, the Amended Credit Facilities).

We used $74.6 million from the Amended Term Loan to repay principal and accrued but unpaid interest on the Credit Agreement. We also used $1.8 million from the Amended Term Loan to pay debt financing fees, which are included in "Long-term debt, net" in the Consolidated Balance Sheets and are being amortized as an adjustment to interest expense over the life of the Amendment Agreement. Amortization expense relating to debt issuance costs on the Amendment Agreement was $0.1 million and $0.3 million for the three and nine months ended September 28, 2018, respectively. Amortization expense relating to debt issuance costs on the Credit Agreement was $0.2 million and $0.6 million for the three and nine months ended September 29, 2017, respectively. Amortization of debt issuance costs is included in interest (expense) income, net in the Condensed Consolidated Statements of Income.

The Amended Term Loan amortizes in an amount equal to $1.0 million per quarter for the calendar quarters ending December 31, 2017 through September 30, 2019, $1.5 million per quarter for the calendar quarters ending December 31, 2019 through September 30, 2020, $2.0 million per quarter for the calendar quarters ending December 31, 2020 through September 30, 2021, $2.6 million for the calendar quarters ending December 31, 2021 through September 30, 2022, with the balance of $47.6 million due on November 15, 2022. Amounts borrowed under the Amended Term Loan that are repaid or prepaid may not be re-borrowed. Any unpaid amounts must be repaid by the maturity dates. As of September 28, 2018, the balance outstanding under the Amended Term Loan was $76.0 million.

The Amended Revolver is available for working capital, capital expenditures, and other general corporate purposes. Up to $25.0 million of the Amended Revolver is available for the issuance of letters of credit. The Amended Revolver will mature and the commitments thereunder will terminate on November 15, 2022. There were no outstanding borrowings under the Amended Revolver at September 28, 2018. As of September 28, 2018, there were six letters of credit outstanding in the aggregate amount of $10.2 million, which reduced our borrowing availability to $109.8 million under the Amended Revolver.

The Company's aggregate scheduled maturities of the Amended Term Loan as of September 28, 2018, are as follows:

(In thousands)	Payments due
2018	$ 1,000
2019	4,500
2020	6,500
2021	8,600
2022	55,400
Total	$ 76,000

Guarantees and Collateral. The indebtedness and other obligations under the Amended Credit Facilities are unconditionally guaranteed jointly and severally on a senior secured basis by us and certain of our restricted subsidiaries and are secured, subject to permitted liens and other exceptions, by a first-priority lien on substantially all of our tangible and intangible assets and those of each domestic guarantor.

Voluntary Prepayments. We may voluntarily prepay the Amended Term Loan in whole or in part at any time without premium or penalty, subject to the payment of customary breakage costs under certain conditions. Voluntary prepayments of the Amended Term Loan will be applied to the remaining installments thereof as directed by us. We may reduce the commitments under the Amended Revolver in whole or in part at any time without premium or penalty.

Covenants. The Amended Credit Facilities contain customary covenants, including covenants that, under certain circumstances and subject to certain qualifications and exceptions: limit or restrict our ability to incur additional indebtedness; merge, dissolve, liquidate or consolidate; make acquisitions, investments, advances or loans; dispose of or transfer assets; pay dividends; redeem or repurchase certain debt; and enter into certain restrictive agreements. As of September 28, 2018, the maximum amount of dividends we could pay was $10.0 million. For further discussion on dividends, please refer to "Liquidity and Capital Resources - Dividends" in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

In addition, we are required to comply with (a) a maximum ratio of total consolidated indebtedness to consolidated earnings before interest, tax, depreciation and amortization (EBITDA) of 3.00 to 1.00 (3.25 to 1.00 for the 12 months following a qualified acquisition), and (b) a minimum ratio of consolidated EBITDA to consolidated interest expense (net of cash interest income) of 4.50 to 1.00. As of September 28, 2018, we had a ratio of total consolidated indebtedness to EBITDA of 1.29 to 1.00 and a ratio of consolidated EBITDA to consolidated interest expense of 11.40 to 1.00. We were in compliance with all covenants related to the Amended Credit Facilities as of September 28, 2018.

Interest Rates and Fees. Outstanding borrowings under the Amended Credit Facilities accrue interest, at our option, at a per annum rate of (i) LIBOR plus the applicable margin, which ranges from 1.75% to 2.50% depending on the leverage ratio, or (ii) a base rate plus the applicable margin, which ranges from 0.75% to 1.50% depending on the leverage ratio. The interest rate under the Amended Credit Facilities at September 28, 2018 was 4.25%. We pay a commitment fee on the undrawn portion of the Amended Revolver ranging from 0.30% to 0.45%, depending on the leverage ratio.

Carrying Value and Fair Value. The fair value of the Amended Credit Facilities approximates the carrying value as of September 28, 2018 because the debt bears interest at a floating rate of interest. The fair value is based on observable inputs of interest rates that are currently available to us for debt with similar terms and maturities for non-public debt.

Carrying values and fair values of the Amended Term Loan on the Condensed Consolidated Balance Sheets as of September 28, 2018 were as follows:

	September 28, 2018	
(In thousands)	Carrying Amount	Fair Value
Short-term debt	$ 4,000	$ 4,000
Long-term debt	72,000	72,000
Total debt	76,000	$ 76,000
Debt financing fees	(1,471)	
Total debt with debt financing fees	$ 74,529	

Carrying values and fair values of the Amended Term Loan on the Condensed Consolidated Balance Sheets as of December 31, 2017 were as follows:

	December 31, 2017	
(In thousands)	Carrying Amount	Fair Value
Short-term debt	$ 4,000	$ 4,000
Long-term debt	75,000	75,000
Total debt	79,000	$ 79,000
Debt financing fees	(1,789)	
Total debt with debt financing fees	$ 77,211	

NOTE 9

DERIVATIVE INSTRUMENTS

Interest Rate Derivative Instruments

We are exposed to the risk that our earnings and cash flows could be adversely impacted due to fluctuations in interest rates. We periodically enter into interest rate swaps to manage interest costs in which we agree to exchange, at specified intervals, the difference between variable and fixed interest amounts calculated by reference to an agreed-upon notional amount. Derivative instruments are not used for trading purposes or to manage exposure to changes in interest rates for investment securities, and our outstanding derivative instruments do not contain credit risk related contingent features. Collateral is generally not required.

In December 2017, we terminated our former derivative instruments and entered into a new derivative instrument to hedge a portion of our exposure to interest rate risk under the variable-rate portion of the Amended Term Loan (the interest rate swaps). In February 2018 and April 2018, we entered into additional derivative instruments to further hedge our exposure to interest rate risk under the variable-rate portion of the Amended Term Loan. The interest rate swaps are designated and qualify as effective cash flow hedges. The contracts, with notional amounts totaling $57.1 million at September 28, 2018, are recorded at fair value.

The interest rate swaps are measured at fair value on a recurring basis and are determined using the income approach based on a discounted cash flow model to determine the present value of future cash flows over the remaining terms of the contracts incorporating observable market inputs such as prevailing interest rates as of the reporting date (Level 2). Changes in fair value of the interest rate swaps are recorded, net of tax, as a component of accumulated other comprehensive loss in the accompanying Condensed Consolidated Balance Sheets. We reclassify the effective gain or loss from accumulated other comprehensive loss, net of tax, to interest expense on the Condensed Consolidated Statements of Income as the interest expense is recognized on the related debt. The ineffective portion of the change in fair value of the interest rate swap, if any, is recognized directly in earnings in interest expense.

The following table summarizes the amount at fair value and location of the derivative instruments used for our interest rate hedges in the Condensed Consolidated Balance Sheets as of September 28, 2018:

(In thousands)	Fair Value	
	Balance sheet caption	Amount
Interest rate swap designated as cash flow hedge	Other current assets	$ 154
Interest rate swap designated as cash flow hedge	Other non-current assets	$ 956

The following table summarizes the amount at fair value and location of the derivative instruments used for our interest rate hedges in the Condensed Consolidated Balance Sheets as of December 31, 2017:

(In thousands)	Fair Value	
	Balance sheet caption	Amount
Interest rate swap designated as cash flow hedge	Other accrued liabilities	$ 127
Interest rate swap designated as cash flow hedge	Other non-current assets	$ 60

By utilizing interest rate swaps, we are exposed to credit-related losses in the event that the counterparty fails to perform under the terms of the derivative contract. To mitigate this risk, we entered into interest rate swaps with a major financial institution based upon credit ratings and other factors. We regularly assess the creditworthiness of the counterparty. As of September 28, 2018, the counterparty to the interest rate swaps had performed in accordance with its contractual obligations. Both the counterparty credit risk and our credit risk were considered in the fair value determination.

Foreign Currency Derivative Instrument

We transact business in various foreign countries and are therefore exposed to foreign currency exchange rate risk that impacts the reported U.S. dollar amounts of revenues, costs, and certain foreign currency monetary assets and liabilities. In order to manage exposure to fluctuations in foreign currency and to reduce the volatility in cash flows and earnings caused by fluctuations in foreign exchange rates, we entered into forward contracts to buy and sell foreign currency. By policy, we do not enter into these contracts for trading purposes or speculation.

Counterparty default risk is considered low because the forward contracts that we entered into, beginning in November 2017, are over-the-counter instruments transacted with highly-rated financial institutions. We were not required to, and did not, post collateral as of September 28, 2018.

Our foreign currency derivative instruments are recorded at fair value as a derivative asset or liability in the Condensed Consolidated Balance Sheets. The foreign currency forward contracts are measured at fair value on a recurring basis and are determined using the income approach based on a discounted cash flow model to determine the present value of future cash flows over the remaining term of the contract incorporating observable market inputs such as prevailing foreign currency exchange rates as of the reporting date (Level 2).

Changes in fair value for instruments acquired prior to December 31, 2017 are recognized within selling, general and administrative expense in the Condensed Consolidated Statements of Income. Changes in fair value for instruments acquired after December 31, 2017 are recorded, net of tax, as a component of accumulated other comprehensive loss in the accompanying Condensed Consolidated Balance Sheets. We reclassify the effective gain or loss from accumulated other comprehensive loss, net of tax, within selling, general and administrative expense on the Condensed Consolidated Statements of Income as the forward contracts are settled. The ineffective portion of the change in fair value of the forward contracts, if any, is recognized directly in earnings in selling, general and administrative expense. In the Condensed Consolidated Statements of Cash Flows, we classify cash flows from foreign currency derivative instruments at settlement in the same category as the cash flows from the related hedged item, generally within cash provided by operating activities.

The following table summarizes the amount at fair value and location of the derivative instruments used for our forward contract hedges in the Condensed Consolidated Balance Sheets as of September 28, 2018:

(In thousands)	Fair Value	
	Balance sheet caption	Amount
Foreign currency forward designated as cash flow hedge	Other accrued liabilities	$ 183
Foreign currency forward designated as cash flow hedge	Other non-current liabilities	$ 13

We recognized a gain of less than $0.1 million and a $(0.1) million loss from foreign currency derivative instruments within selling, general and administrative expense in the Condensed Consolidated Statements of Income for the three and nine months ended

September 28, 2018, respectively. We also reported $0.1 million in other current liabilities in the Condensed Consolidated Balance Sheets as of September 28, 2018.

The notional amounts of outstanding foreign currency forward contracts shown below report the total U.S. dollar equivalent position of all contracts for each foreign currency position as of September 28, 2018.

(In thousands)	Notional	Fair Value
Euro	$ 8,829	$ (248)
Latest maturity date	June 2020	

NOTE 10

COMPOSITION OF CERTAIN FINANCIAL STATEMENT CAPTIONS

The following tables present financial information underlying certain balance sheet captions.

Compensation and other employee benefits

Compensation and other employee benefits are affected by short-term fluctuations in the timing of payments and were comprised of the following:

(In thousands)	September 28, 2018	December 31, 2017
Accrued salaries and wages	$ 25,422	$ 21,879
Accrued bonus	3,849	4,210
Accrued employee benefits	17,570	13,215
Total	$ 46,841	$ 39,304

Other accrued liabilities

Other accrued liabilities were comprised of the following:

(In thousands)	September 28, 2018	December 31, 2017
Workers' compensation, auto and general liability reserve	$ 5,445	$ 4,615
Contract related reserves	7,704	7,426
Other accrued liabilities	11,096	7,168
Total	$ 24,245	$ 19,209

NOTE 11

POST EMPLOYMENT BENEFIT PLANS

We sponsor two defined contribution savings plans, with the addition of SENTEL, which allow employees to contribute a portion of their pre-tax and/or after-tax income in accordance with specified guidelines. We match a percentage of the employee contributions up to certain limits of employee base pay. Our portion of the matching contributions charged to income amounted to $1.0 million and $3.7 million for the three and nine months ended September 28, 2018, respectively, and $0.9 million and $2.3 million for the three and nine months ended September 29, 2017, respectively.

On September 11, 2014, our Board of Directors adopted and approved the Vectrus Systems Corporation Excess Savings Plan (the Excess Savings Plan). Since federal law limits the amount of compensation that can be used to determine employee and employer contribution amounts to our tax-qualified plans, we established the Excess Savings Plan to allow for Company contributions based on an eligible employee's base salary in excess of these limits. No employee contributions are permitted. All balances under the Excess Savings Plan are maintained on the books of the Company and credits and deductions are made to the accumulated savings under the plan based on the earnings or losses attributable to a stable value fund as defined in the Excess Savings Plan. Benefits will be paid in a lump sum generally in the seventh month following the date on which the employee's separation from service occurs. Employees are 100% vested at all times in any amounts credited to their accounts. As of both September 28, 2018 and December 31, 2017, we had accrued $0.1 million of contributions under the Excess Savings Plan.

On November 9, 2016, the Compensation and Personnel Committee of the Board of Directors approved an amendment and restatement of our Senior Executive Severance Pay Plan (as amended and restated, the Amended Plan). The Amended Plan removed (i) a provision that disallowed severance pay in the event of a termination of the executive’s employment by us with a scheduled termination date after the executive’s “Normal Retirement Date” (i.e., the first of the month which coincides with or follows the executive's 65th birthday) and (ii) a provision that used the executive's Normal Retirement Date in determining the maximum period of time for which severance pay is calculated. The Amended Plan did not change the schedule of severance pay. Termination benefits offered under the Amended Plan are other post employment benefits as defined by ASC 712-10 - Compensation - Nonretirement Postemployment Benefits. Benefits under the Amended Plan vest or accumulate with the employee's years of service; however, the payment of benefits is not probable and we do not have the ability to reliably estimate when there will be an involuntary termination without cause under the Amended Plan. Accordingly, we do not accrue a benefit obligation for severance costs under the Amended Plan over the duration of executive employment.

NOTE 12

STOCK-BASED COMPENSATION

We maintain an equity incentive plan (the 2014 Omnibus Plan) to govern awards granted to Vectrus employees and directors, including nonqualified stock options (NQOs), restricted stock units (RSUs), total shareholder return (TSR) awards and other awards. We account for NQOs and stock-settled RSUs as equity-based compensation awards. TSR awards, described below, and cash-settled RSUs are accounted for as liability-based compensation awards.

Stock-based compensation expense and the associated tax benefits impacting our Condensed Consolidated Statements of Income were as follows:

	Three Months Ended		Nine Months Ended	
(In thousands)	September 28, 2018	September 29, 2017	September 28, 2018	September 29, 2017
Compensation costs for equity-based awards	$ 874	$ 695	$ 2,650	$ 2,241
Compensation costs for liability-based awards	14	(349)	760	1,100
Total compensation costs, pre-tax	$ 888	$ 346	$ 3,410	$ 3,341
Future tax benefit	$ 192	$ 123	$ 737	$ 1,188

Liability-based awards are revalued at the end of each reporting period to reflect changes in fair value.

As of September 28, 2018, total unrecognized compensation costs related to equity-based awards and liability-based awards were $5.0 million and $1.9 million, respectively, both of which are expected to be recognized ratably over a weighted average period of 1.88 years.

The following table provides a summary of the activities for NQOs and RSUs for the nine months ended September 28, 2018:

	NQOs		RSUs	
(In thousands, except per share data)	Shares	Weighted Average Exercise Price Per Share	Shares	Weighted Average Grant Date Fair Value Per Share
Outstanding at January 1, 2018	325	$22.74	221	$23.58
Granted	—	—	159	$33.19
Exercised	(63)	$22.07	—	—
Vested	—	—	(100)	$24.78
Forfeited or expired	(1)	$20.62	(9)	$23.58
Outstanding at September 28, 2018	261	$22.91	271	$28.77

During the nine months ended September 28, 2018, we granted long-term incentive awards to employees consisting of 121,931 RSUs with a weighted average grant date value of $33.62 and to our directors consisting of 36,813 RSUs with a weighted average grant date value of $31.78.

For employee RSUs, one-third of the award vests on each of the three anniversary dates following the grant date. Director RSUs are granted on the date of an annual meeting of shareholders and vest on the business day immediately prior to the next annual meeting. The fair value of each RSU grant was determined based on the closing price of Vectrus common stock on the date of grant. Stock compensation expense will be recognized ratably over the vesting period of the awards.

Total Shareholder Return Awards

TSR awards are performance-based cash awards that are subject to a three-year performance period. Any payments earned are made in cash following completion of the performance period according to the achievement of specified performance goals. During the nine months ended September 28, 2018, we granted 2018 TSR awards with aggregate target TSR value of $2.2 million. The fair value of TSR awards is measured quarterly and is based on the Company’s performance relative to the performance of the Aerospace and Defense Companies in the S&P 1500 Index. Depending on the Company’s performance during the three-year performance period, payments can range from 0% to 200% of the target value.

NOTE 13

COMMITMENTS AND CONTINGENCIES

General

From time to time, we are involved in legal proceedings that are incidental to the operation of our business. Some of these proceedings seek remedies relating to employment matters, matters in connection with our contracts and matters arising under laws relating to the protection of the environment. Additionally, U.S. government customers periodically advise the Company of claims and penalties concerning certain potential disallowed costs. When such findings are presented, Vectrus and the U.S. government representatives engage in discussions to enable Vectrus to evaluate the merits of these claims as well as to assess the amounts being claimed. Where appropriate, provisions are made to reflect probable losses related to the matters raised by the U.S. government representatives. Such assessments, along with any assessments regarding provisions for legal proceedings, are reviewed on a quarterly basis for sufficiency based on the most recent information available to us. We have estimated and accrued $8.5 million and $5.8 million as of September 28, 2018 and December 31, 2017, respectively, in "Other accrued liabilities" in the Condensed Consolidated Balance Sheets for legal proceedings and for claims with respect to our government contracts as discussed below, including open years subject to audit. Although the ultimate outcome of any legal matter or claim cannot be predicted with certainty, based on present information, including our assessment of the merits of the particular claim, we do not expect that any asserted or unasserted legal or contractual claims or proceedings, individually or in the aggregate, including the lawsuit discussed below, will have a material adverse effect on our cash flow, results of operations or financial condition.

Legal Proceedings

We are defending a class action employment lawsuit that was initiated in the United States District Court for the Western District of Washington in April 2010 against the predecessor of our Former Parent by individuals who worked on a particular contract in Kuwait after April 12, 2009. The plaintiffs are alleging a breach of employment contract by the predecessor of our Former Parent due to an alleged violation of Kuwait labor law. In November 2016, following an interlocutory appeal by Vectrus, the Ninth Circuit Court of Appeals affirmed the District Court’s decision certifying a class of plaintiffs. Although we continue to dispute liability, the parties have negotiated a settlement, the terms of which include a settlement fund of up to $3.75 million, plus payroll taxes for wages paid to class members. The settlement fund includes the judge's award of attorney's fees, costs and class representative fees, with the remainder available to eligible class members pursuant to an allocation formula. The Company received final approval by the District Court following a fairness hearing on October 16, 2018.

U.S. Government Contracts, Investigations and Claims

We have U.S. government contracts that are funded incrementally on a year-to-year basis. Changes in government policies, priorities or funding levels through agency or program budget reductions by the U.S. Congress or executive agencies could have a material adverse effect on our financial condition or results of operations. Furthermore, our contracts with the U.S. government may be terminated or suspended by the U.S. government at any time, with or without cause. Such contract suspensions or terminations could result in unreimbursable expenses or charges or otherwise adversely affect our financial condition and results of operations.

Departments and agencies of the U.S. government have the authority to investigate various transactions and operations of the Company, and the results of such investigations may lead to administrative, civil or criminal proceedings, the ultimate outcome of which could be fines, penalties, repayments or compensatory or treble damages. U.S. government regulations provide that certain findings against a contractor may lead to suspension or debarment from future U.S. government contracts or the loss of export privileges for a company or an operating division or subdivision. Suspension or debarment could have a material adverse effect on the Company because of its reliance on U.S. government contracts.

U.S. government agencies, including the Defense Contract Audit Agency, the Defense Contract Management Agency and others, routinely audit and review our performance on government contracts, indirect rates and pricing practices, and compliance with applicable contracting and procurement laws, regulations and standards. Accordingly, costs billed or billable to U.S. government customers are subject to potential adjustment upon audit by such agencies. The U.S. government agencies also review the adequacy of our compliance with government standards for our business systems, including our accounting, earned value management, estimating, materials management and accounting, purchasing, and property management systems.

As a result of final indirect rate negotiations between the U.S. government and our Former Parent, we may be subject to potential adjustments to costs previously allocated by our Former Parent to our business, which was formerly Exelis' Mission Systems Business, from 2007 through 2014. Because we do not participate in indirect rate negotiations between the U.S. government and our Former Parent, we cannot predict the outcome of any negotiated adjustment or the ultimate responsible party. Accordingly, we cannot reasonably predict the likelihood of such adjustments or estimate the amount of any potential impact to the company.

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

The following discussion of our financial condition and results of operations should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and notes thereto included in this Quarterly Report on Form 10-Q as well as the audited Consolidated Financial Statements and notes thereto and the information under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our Annual Report on Form 10-K for the year ended December 31, 2017. This Quarterly Report provides additional information regarding the Company, our services, industry outlook and forward-looking statements that involve risks and uncertainties. The forward-looking statements are not historical facts, but rather are based on current expectations, estimates, assumptions and projections about our industry, business and future financial results. Our actual results could differ materially from the results contemplated by these forward-looking statements. Refer to "Forward-Looking Information" for further information regarding forward-looking statements. Amounts presented in and throughout this Item 2 are rounded and, as such, any rounding differences could occur in period over period changes and percentages reported.

Overview

Vectrus is a leading provider of services to the U.S. government worldwide. We operate in one segment and offer facility and logistics services and information technology and network communications services.

Our primary customer is the U.S. Department of Defense (DoD), with a high concentration in the U.S. Army. For the nine months ended September 28, 2018 and September 29, 2017, we had total revenue of $949.7 million and $819.0 million, respectively, all of which was derived from U.S. government customers. For the nine months ended September 28, 2018 and September 29, 2017, we generated approximately 74% and 83%, respectively, of our total revenue from the U.S. Army.

Executive Summary

Our revenue increased by $38.5 million, or 14.3%, for the three months ended September 28, 2018 compared to the three months ended September 29, 2017. The increase in revenue was attributable to increases from our U.S. programs of $17.9 million (consisting of a $27.4 million increase related to our acquisition of SENTEL offset by a $9.5 million decrease in other US programs), our European programs of $14.3 million, and our Middle East programs of $6.3 million.

Operating income for the three months ended September 28, 2018, was $14.0 million, an increase of $3.9 million, or 38.8%, compared to the three months ended September 29, 2017. This increase was primarily due to increases of $3.1 million from our Middle East programs and $0.4 million each from our U.S. and European programs. In the third quarter of 2018, we successfully closed an unresolved item on a closed contract that created a one-time benefit of $1.4 million.

During the performance of our contracts, we periodically review estimated final contract prices and costs and make revisions as required, which are recorded as changes in revenue and cost of revenue in the periods in which they are determined. Additionally, the fees under certain contracts may be increased or decreased in accordance with cost or performance incentive provisions which measure actual performance against established targets or other criteria. Such incentive fee awards or penalties are included in revenue when there is sufficient information to reasonably assess anticipated contract performance. Amounts representing contract change orders, claims, requests for equitable adjustment, or limitations in funding on contracts are recorded only if it is probable the claim will result in additional contract revenue and the amounts can be reliably estimated. Changes in estimated revenue, cost of revenue and the related effect to operating income are recognized using cumulative adjustments, which recognizes in the current period the cumulative effect of the changes on current and prior periods based on a contract's percentage of completion. Cumulative adjustments due to aggregate changes in contract estimates decreased operating income by $1.6 million for the three months ended September 28, 2018 and increased operating income by $3.7 million for the three months ended September 29, 2017. Cumulative adjustments are driven by changes in contract terms, program performance, customer scope changes and changes to estimates in the reported period. These changes can increase or decrease operating income depending on the dynamics of each contract.

The adoption of ASC Topic 606 had the most significant impact to our accounting for firm-fixed-price contracts. Under ASC Topic 606 guidance, our firm-fixed-price contracts recognize revenue over time with the continuous transfer of services to the customer, using an input measure (e.g., costs incurred to date relative to total estimated costs at completion) to reflect progress. Adjustments in estimated costs at completion were previously recorded as costs incurred in excess of billings or billings in excess of costs on the Condensed Consolidated Balance Sheets. Adjustments in contract estimates for firm-fixed-price contracts are now recorded as unbilled receivables. This change will result in more variability to revenue from period to period. Despite this variability, a firm-fixed-price contract's cash flows and overall profitability at contract completion are the same.

Further details related to our financial results for the three and nine months ended September 28, 2018, compared to the three and nine months ended September 29, 2017, are contained in the "Discussion of Financial Results" section.

Recent Developments

On April 27, 2018, Vectrus Systems Corporation (VSC), our wholly-owned subsidiary, received notice of a $106.0 million modification to the Operations, Maintenance and Defense of Army Communications in Southwest Asia and Central Asia contract (OMDAC-SWACA) for enterprise network capabilities and services support of the U.S. Central Command. Work will be based in Kuwait City, Kuwait with additional locations throughout Southwest Asia. The estimated completion date is November 30, 2018. We are in active discussions to extend our period of performance into 2019.

On January 23, 2018, we acquired SENTEL, a U.S. government contractor with expertise in logistics and supply chain management, engineering and advanced information technology solutions for spectrum management systems, sensor networks, border and perimeter surveillance systems and other detection systems, and multidisciplinary mission support for various intelligence community clients. The acquisition advances our strategy to be a leader in the converging physical and digital infrastructure market and enhances our information technology, technical solutions and logistics capabilities while expanding our client base to customers in the U.S. intelligence community. SENTEL's customers also include the U.S. Army, U.S. Navy, U.S. Air Force, Federal Aviation Administration, and the Internal Revenue Service. Headquartered in Alexandria, Virginia, and founded in 1986, SENTEL has approximately 700 employees. For the fiscal year ended September 30, 2017, SENTEL generated revenue of $107 million. The total consideration paid for the acquisition, net of cash acquired, was $36.9 million, consisting of the purchase price of $36.0 million and $0.9 million in excess of the working capital requirement in the Stock Purchase Agreement and finalized during the third quarter of 2018. The acquisition was funded by utilizing cash on hand and available capacity from our existing Amended Revolver (refer to Note 4 "SENTEL Acquisition" for additional information related to our acquisition of SENTEL).

The Kuwait Base Operations and Security Support Services (K-BOSSS) contract commenced in November 2010 and currently is exercised through December 28, 2018. We recently received a letter of intent from the U.S. government to exercise the option to extend the period of performance through March 28, 2019. K-BOSSS, our largest base operations support services contract, supports geographically-dispersed locations within the State of Kuwait, including several camps and a range training complex. K-BOSSS provides critical base operations support and security support services, including forms, publications, and reproductive services; U.S. Army postal operations; range operations and maintenance; logistics; information management; public works; environmental services; medical administrative support; morale, welfare and recreation; and security, fire and emergency services. The K-BOSSS contract extension was from March 29, 2017 to March 28, 2018, with a nine-month option of March 29, 2018 through December 28, 2018, which was exercised, and a three-month option of December 29, 2018 through March 28, 2019 for which we have received a letter of intent. The right to exercise an option period is at the sole discretion of the U.S. government. The K-BOSSS contract will be re-competed as a task order under the LOGCAP V contract vehicle. The U.S. government has stated that its anticipated timeline for the LOGCAP V award announcement is April 2019. If we are unsuccessful in securing a position on LOGCAP V, our ability to pursue some future bids with our Army client could be adversely affected. The K-BOSSS contract contributed $384 million of revenue during the nine months ended September 28, 2018 and $476 million of revenue during the year ended December 31, 2017.

Information regarding certain significant contracts is discussed in "Significant Contracts" below.

Significant Contracts

The following table reflects contracts that accounted for more than 10% of our total revenue for the nine months ended September 28, 2018 and September 29, 2017:

	% of Total Revenue	
	Nine Months Ended	
Contract Name	September 28, 2018	September 29, 2017
Kuwait Base Operations and Security Support Services (K-BOSSS)	40.4%	42.5%
Operations, Maintenance and Defense of Army Communications in Southwest Asia and Central Asia (OMDAC-SWACA)	14.2%	15.1%

Revenue associated with a contract will fluctuate based on increases or decreases in the work being performed on the contract, award fee payments, and other contract modifications within the term of the contract resulting in changes to the total contract value.

U.S. government contracts are multi-year contracts and typically include an initial period of one year or less with annual one year (or less) option periods for the remaining contract period. The number of option periods vary by contract, and there is no guarantee that an option period will be exercised by the U.S. government. The right to exercise an option period is at the sole discretion of the U.S. government. The U.S. government may also extend the term of a program by issuing extensions or bridge contracts, typically for periods of one year or less.

For a discussion of the K-BOSSS contract, see "Recent Developments" above.

Performance on the OMDAC-SWACA contract commenced in July 2013 with a base period of 11 months and four option years. The U.S. government has exercised the four option years, which ran through May 2018. On April 27, 2018, we received notice of a modification to, among other things, extend the contract through November 30, 2018. We are in active discussions to extend our period of performance into 2019. The U.S. government has stated that its anticipated timeline for the re-competition award is for the draft solicitation to be released in February 2019 and performance to commence later in 2019.

Backlog

Total backlog includes remaining performance obligations, consisting of funded backlog (firm orders for which funding is contractually obligated by the customer) and unfunded backlog (firm orders for which funding is not currently contractually obligated by the customer, and unexercised contract options). Total backlog excludes potential orders under IDIQ contracts and contracts awarded to us that are being protested by competitors with the GAO or in the U.S. Court of Federal Claims. The value of the backlog is based on anticipated revenue levels over the anticipated life of the contract. Actual values may be greater or less than anticipated. Total backlog is converted into revenue as work is performed. The level of order activity related to programs can be affected by the timing of government funding authorizations and their project evaluation cycles. Year-over-year comparisons could, at times, be impacted by these factors, among others.

Our contracts are multi-year contracts and typically include an initial period of one year or less with annual one-year (or less) option periods for the remaining contract period. The number of option periods vary by contract, and there is no guarantee that an option period will be exercised. The right to exercise an option period is at the sole discretion of the U.S. government when we are the prime contractor or of the prime contractor when we are a subcontractor. We expect to recognize a substantial portion of our funded backlog as revenue within the next 12 months. However, the U.S. government or the prime contractor may cancel any contract at any time through a termination for convenience. Most of our contracts have terms that would permit us to recover all or a portion of our incurred costs and fees for work performed in the event of a termination for convenience.

For the nine months ended September 28, 2018, total backlog increased by $74.5 million. Excluding the backlog increase of $347.6 million related to our SENTEL acquisition, total backlog decreased by $273.1 million. As of September 28, 2018, total backlog (funded and unfunded) was $3.0 billion as set forth in the following table:

(In millions)	September 28, 2018	December 31, 2017
Funded backlog	$ 773	$ 719
Unfunded backlog	2,234	2,214
Total backlog	$ 3,007	$ 2,933

Funded orders (different from funded backlog) represent orders for which funding was received during the period. We received funded orders of $915.0 million during the nine months ended September 28, 2018, which was a decrease of $63.7 million compared to the nine months ended September 29, 2017.

Economic Opportunities, Challenges and Risks

The U.S. government’s investment in services and capabilities in response to changing security challenges creates a complex and fluid business environment for Vectrus and other firms in this market segment. The pace and depth of U.S. government acquisition reform and cost savings initiatives, combined with increased industry competitiveness to win long-term positions on key programs, could add pressure to revenue levels and profit margins going forward. However, we expect the U.S. government will continue to place a high priority on national security and will continue to invest in affordable solutions for its facilities, logistics, equipment and communication needs, which aligns with our services and strengths. Further, the DoD budget remains the largest in the world and management believes our addressable portion of the DoD budget offers substantial opportunity for growth.

We anticipate and will be experiencing reductions in revenue and profitability related to certain programs in which we participate, including from the contracts that are expiring without an award to Vectrus of the re-compete contract. However, other programs are expanding. We believe spending on operation and maintenance of defense assets, as well as civilian agency infrastructure and equipment, will continue to be a U.S. government priority. Our focus is on sustaining facilities, equipment and IT networks, which we believe aligns with our customers' intent to utilize existing equipment and infrastructure rather than executing new purchases. Many of the core functions we perform are mission-essential. The following are examples of a few of these core functions: (i) keeping communications networks operational; (ii) maintaining airfields; and (iii) providing emergency services. While customers may reduce the level of services required from us, we do not currently anticipate the complete elimination of these services.

The information provided above does not represent a complete list of trends and uncertainties that could impact our business in either the near or long-term and should be considered along with the risk factors identified under the caption “Risk Factors” identified in Part 1, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2017 and the matters identified under the caption “Forward-Looking Information" herein.

DISCUSSION OF FINANCIAL RESULTS

Three months ended September 28, 2018, compared to three months ended September 29, 2017

Selected financial highlights are presented in the following table:

	Three Months Ended		Change	
(In thousands, except for percentages)	September 28, 2018	September 29, 2017	$	%
Revenue	$ 308,095	$ 269,625	$ 38,470	14.3 %
Cost of revenue	278,964	245,219	33,745	13.8 %
% of revenue	90.5%	90.9%		
Selling, general and administrative	15,125	14,316	809	5.7 %
% of revenue	4.9%	5.3%		
Operating income	14,006	10,090	3,916	38.8 %
Operating margin	4.5%	3.7%		
Interest (expense) income, net	(1,314)	(1,058)	(256)	24.2 %
Income before taxes	12,692	9,032	3,660	40.5 %
% of revenue	4.1%	3.3%		
Income tax expense	2,826	3,232	(406)	(12.6)%
Effective income tax rate	22.3%	35.8%		
Net Income	$ 9,866	$ 5,800	$ 4,066	70.1 %

Revenue

Revenue for the three months ended September 28, 2018 was $308.1 million, an increase of $38.5 million, or 14.3%, as compared to the three months ended September 29, 2017. The increase in revenue was attributable to an increase in revenue from our U.S. programs of $17.9 million (consisting of $27.4 million related to our acquisition of SENTEL, offset by a $9.5 million decrease in other U.S. programs), from our European programs of $14.3 million and from our Middle East programs of $6.3 million.

Cost of Revenue

Cost of revenue as a percentage of revenue was 90.5% compared to 90.9% for the three months ended September 28, 2018 and the three months ended September 29, 2017, respectively. The increase in cost of revenue of $33.7 million, or 13.8%, for the three months ended September 28, 2018, as compared to the three months ended September 29, 2017, was primarily due to increased revenue as described above.

Selling, General & Administrative (SG&A) Expenses

For the three months ended September 28, 2018, SG&A expenses of $15.1 million increased by $0.8 million, or 5.7%, as compared to the three months ended September 29, 2017 due primarily to the addition of SENTEL's SG&A expenses of $1.0 million, increased sales and marketing expenses of $1.3 million and one-time acquisition and integration costs related to the SENTEL acquisition of $0.5 million, partially offset by decreased legal expenses of $2.0 million.

Operating Income

Operating income for the three months ended September 28, 2018 increased by $3.9 million, or 38.8%, as compared to the three months ended September 29, 2017. This increase was primarily due to increases of $3.1 million from our Middle East programs and $0.4 million each from our U.S. and European programs. In the third quarter of 2018, we successfully closed an unresolved item on a closed contract that created a one-time benefit of $1.4 million.

Operating income as a percentage of revenue was 4.5% for the three months ended September 28, 2018, compared to 3.7% for the three months ended September 29, 2017.

Aggregate cumulative adjustments decreased operating income by $1.6 million for the three months ended September 28, 2018 and increased operating income by $3.7 million for the three months ended September 29, 2017. The aggregate cumulative adjustments for the three months ended September 28, 2018 relate to lower margins associated with labor-related items partially offset by management of contract staffing. The aggregate cumulative adjustments for the three months ended September 29, 2017 relate to approved extensions with higher margins associated with labor-related items, management of contract staffing, and favorable resolution of contract claims, offset by higher subcontractor costs.

The gross aggregate effects of these favorable and unfavorable changes in estimates in the three months ended September 28, 2018 and September 29, 2017 were $3.3 million and $5.8 million favorable to operating income, respectively, and $4.9 million and $2.1 million unfavorable to operating income, respectively.

Nine months ended September 28, 2018, compared to nine months ended September 29, 2017

Selected financial highlights are presented in the following table:

	Nine Months Ended		Change	
(In thousands, except for percentages)	September 28, 2018	September 29, 2017	$	%
Revenue	$ 949,744	$ 819,005	$ 130,739	16.0 %
Cost of revenue	865,078	743,502	121,576	16.4 %
% of revenue	91.1%	90.8%		
Selling, general and administrative	48,990	44,560	4,430	9.9 %
% of revenue	5.2%	5.4%		
Operating income	35,676	30,943	4,733	15.3 %
Operating margin	3.8%	3.8%		
Interest (expense) income, net	(3,619)	(3,262)	357	10.9 %
Income before taxes	32,057	27,681	4,376	15.8 %
% of revenue	3.4%	3.4%		
Income tax expense	6,884	9,751	(2,867)	(29.4)%
Effective income tax rate	21.5%	35.2%		
Net Income	$ 25,173	$ 17,930	$ 7,243	40.4 %

Revenue

Revenue for the nine months ended September 28, 2018 was $949.7 million, an increase of $130.7 million, or 16.0%, as compared to the nine months ended September 29, 2017. The increase in revenue was attributable to increases from our U.S. programs of $90.2 million, of which $80.7 million related to our acquisition of SENTEL, $37.8 million from our European programs, and $2.7 million from our Middle East programs.

Cost of Revenue

Cost of revenue as a percentage of revenue was 91.1% compared to 90.8% for the nine months ended September 28, 2018 and the nine months ended September 29, 2017, respectively. The increase in cost of revenue of $121.6 million, or 16.4%, for the nine months ended September 28, 2018, as compared to the nine months ended September 29, 2017, was primarily due to increased revenue as described above.

Selling, General & Administrative (SG&A) Expenses

For the nine months ended September 28, 2018, SG&A expenses of $49.0 million increased by $4.4 million, or 9.9%, as compared to the nine months ended September 29, 2017 due to the addition of SENTEL's SG&A expenses of $3.8 million, increased sales and marketing expenses of $3.3 million and one-time acquisition and integration costs related to the SENTEL acquisition of $2.2 million partially offset by lower legal expenses of $3.1 million and $1.8 million of other SG&A expenses.

Operating Income

Operating income for the nine months ended September 28, 2018 increased by $4.7 million, or 15.3%, as compared to the nine months ended September 29, 2017. This increase was primarily due to higher operating income of $3.3 million from our Middle East programs, $1.0 million from our European programs and $0.4 million from our U.S. programs.

Operating income as a percentage of revenue was 3.8% for the nine months ended September 28, 2018, compared to 3.8% for the nine months ended September 29, 2017.

Aggregate cumulative adjustments for the nine months ended September 28, 2018 and the nine months ended September 29, 2017 increased operating income by $4.9 million and $8.6 million, respectively. The aggregate cumulative adjustments for the nine months ended September 28, 2018 related to higher margins associated with labor-related items and management of contract staffing. The aggregate cumulative adjustments for the nine months ended September 29, 2017 related to approved extensions with higher margins associated with labor-related items, management of contract staffing, favorable resolution of contract claims, and contract close out costs, offset by higher subcontractor costs. The gross

aggregate effects of these favorable and unfavorable changes in estimates in the nine months ended September 28, 2018 and September 29, 2017 were $13.8 million and $14.1 million favorable to operating income, respectively, and $8.9 million and $5.5 million unfavorable to operating income, respectively.

Interest (Expense) Income, Net

Interest (expense) income, net for the three and nine months ended September 28, 2018 and September 29, 2017 was as follows:

	Three Months Ended		Change		Nine Months Ended		Change	
(In thousands, except for percentages)	September 28, 2018	September 29, 2017	$	%	September 28, 2018	September 29, 2017	$	%
Interest income	98	20	78	390 %	137	34	103	303 %
Interest expense	(1,412)	(1,078)	(334)	(31)%	(3,756)	(3,296)	(460)	(14)%
Interest (expense) income, net	(1,314)	(1,058)	(256)	(24)%	(3,619)	(3,262)	(357)	(11)%

Interest income is directly related to interest earned on our cash. Interest expense is directly related to borrowings under our senior secured credit facilities, the amortization of debt issuance costs and derivative instruments used to hedge a portion of our exposure to interest rate risk.

Income Tax Expense

We recorded income tax expense of $2.8 million and $6.9 million, for the three and nine months ended September 28, 2018, respectively, and $3.2 million and $9.8 million for the three and nine months ended September 29, 2017, respectively, representing effective income tax rates of 22.3% and 21.5%, respectively, for the 2018 periods and 35.8% and 35.2%, respectively, for the 2017 periods. The lower effective income tax rates for the 2018 periods are a result of the Tax Act and the impact of one-time discretionary items.

As a result of the passage of the Tax Act, the SEC released SAB 118 to provide guidance for companies that had not completed accounting for the income tax effects of the Tax Act prior to the release of their financial reports. We will continue to analyze additional information and guidance related to the Tax Act as supplemental legislation, regulatory guidance, or evolving technical interpretations become available. The final impacts may differ from the recorded amounts as of December 31, 2017, and we will continue to refine such amounts within the measurement period provided by SAB 118. We consider the impact of the Tax Act on our state income tax expense to be incomplete due to forthcoming guidance. We expect to complete our analysis no later than December 31, 2018. For interim period financial reports any estimated impacts of the Tax Act will be included in the calculation of our annualized effective tax rate.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

Historically, we have generated operating cash flow sufficient to fund our working capital, capital expenditure and financing requirements. We expect to fund our ongoing working capital, capital expenditure and financing requirements through cash flows from operations, cash on hand and access to capital markets. When necessary we will utilize our revolving credit facility to satisfy short-term working capital requirements.

If our cash flows from operations are less than we expect, we may need to access the long-term or short-term capital markets. Although we believe that our current financing arrangements will permit us to finance our operations on acceptable terms and conditions, our access to and the availability of financing on acceptable terms and conditions in the future will be impacted by many factors, including: (i) our credit ratings or absence of a credit rating, (ii) the liquidity of the overall capital markets and (iii) the current state of the economy. We cannot provide assurance that such financing will be available to us on acceptable terms or that such financing will be available at all.

The cash presented on our Condensed Consolidated Balance Sheets consists of U.S. and international cash from wholly owned subsidiaries. Approximately $15.7 million of our total $39.6 million in cash at September 28, 2018 is held by our foreign subsidiaries and is not available to fund U.S. operations unless repatriated. We do not currently expect that we will be required to repatriate undistributed earnings of foreign subsidiaries. We expect our U.S. domestic cash resources will be sufficient to fund our U.S. operating activities and cash commitments for financing activities.

In September 2014, we and our wholly-owned subsidiary, VSC, entered into a credit agreement with a group of lenders, including JPMorgan Chase Bank, N.A. as administrative agent. The credit agreement was amended as of April 19, 2016, to modify certain financial and negative covenants (as so amended, the Credit Agreement). On November 15, 2017, we and VSC entered into an Amendment and Restatement Agreement (the Amendment Agreement) with a group of lenders, including JPMorgan Chase Bank, N.A., as administrative agent, which provides for the amendment and restatement of the Credit Agreement. The Amendment Agreement provides for $200.0 million in senior secured financing, consisting of a $80.0 million five-year term loan facility (the Amended Term Loan) and a $120.0 million five-year senior secured revolving credit facility (the Amended Revolver, and together with the Amended Term Loan, the Amended Credit Facilities). We used $74.6 million from the Amended Term Loan to repay principal and accrued but unpaid interest on the Credit Agreement. There were no outstanding borrowings under the Amended Revolver at September 28, 2018. At September 28, 2018, there were six letters of credit outstanding in the aggregate amount of $10.2 million, which reduced our borrowing availability under the Amended Revolver to $109.8 million.

Dividends

We do not currently plan to pay a regular dividend on our common stock. The declaration of any future cash dividends and if declared, the amount of any such dividends, will depend upon our financial condition, earnings, capital requirements, financial covenants and other contractual restrictions and the discretion of our Board of Directors. In deciding whether to pay future dividends on our common stock, our Board of Directors may take into account such matters as general business conditions, industry practice, our financial condition and performance, our future prospects, our cash needs and capital investment plans, income tax consequences, applicable law and such other factors as our Board of Directors may deem relevant. As of September 28, 2018, the maximum amount of dividends we could pay was $10.0 million.

Sources and Uses of Liquidity

Cash, accounts receivable, unbilled receivables, and accounts payable are the principal components of our working capital and are generally driven by our level of revenue with other short-term fluctuations related to payment practices by our customers and the timing of our billings. Our receivables reflect amounts billed to our customers, as well as the revenue that was recognized in the preceding month, which is normally billed the month following each balance sheet date.

The total amount of our accounts receivable can vary significantly over time and is sensitive to revenue levels and the timing of payments received from our customers. Days sales outstanding (DSO) is a metric used to monitor accounts receivable levels. Our DSO was 66 and 54 days as of September 28, 2018 and December 31, 2017, respectively. The impact of ASC Topic 606 on our receivables (refer to Note 3, "Revenue") and the timing of payments received from our customers contributed to a higher DSO as of September 28, 2018.

The following table sets forth net cash provided by (used in) operating activities, investing activities and financing activities:

(In thousands)	September 28, 2018	September 29, 2017
Operating activities	$ 8,654	$ 22,398
Investing activities	(42,937)	(901)
Financing activities	(2,415)	(9,226)
Foreign exchange[1]	(1,171)	3,524
Net change in cash	$ (37,869)	$ 15,795

[1] Impact on cash balances due to changes in foreign exchange rates.

Trends in our operating cash flows tend to follow trends in operating income, excluding non-cash charges. Net cash provided by operating activities for the nine months ended September 28, 2018 consisted of net income of $25.2 million, increased by non-cash items of $6.6 million offset by unfavorable net working capital changes of $23.1 million primarily due to the timing of cash collections, as reflected in our increase in receivables as of September 28, 2018.

Net cash provided by operating activities during the nine months ended September 29, 2017 consisted of net income of $17.9 million, increased by non-cash items of $5.1 million and offset by unfavorable net working capital changes of $0.6 million due to the timing of cash collections and payments, as reflected in accounts payable, compensation and other employee benefits, other assets, and receivables.

Net cash used in investing activities for the nine months ended September 28, 2018 consisted of $36.9 million for the acquisition of SENTEL and $6.1 million of capital expenditures for the purchase of equipment, leasehold improvements, hardware and software related to ongoing operations. Net cash used in investing activities during the nine months ended

September 29, 2017 consisted of capital expenditures for the purchase of capital assets of $0.9 million for hardware and software related to ongoing operations.

Net cash used in financing activities during the nine months ended September 28, 2018 consisted of repayments of long-term debt of $3.0 million and payments related to employee withholding taxes on share-based compensation in the amount of $0.8 million, offset by $1.4 million in cash received from the exercise of stock options. During the nine months ended September 28, 2018, we borrowed and repaid a total of $138.0 million from the Amended Revolver to meet short-term working capital requirements and to fund a portion of the purchase price for the acquisition of SENTEL.

Net cash used in financing activities for the nine months ended September 29, 2017 consisted of repayments of long-term debt of $10.5 million and payments related to employee withholding taxes on share-based compensation in the amount of $0.6 million, offset by $1.9 million in cash received from the exercise of stock options. During the nine months ended September 29, 2017, we borrowed and repaid a total of $27.5 million from the prior revolving credit facility to meet short-term working capital requirements.

Capital Resources

At September 28, 2018, we held cash of $39.6 million, which included $15.7 million held by foreign subsidiaries, and had $109.8 million of available borrowing capacity under the Amended Revolver, which expires on November 15, 2022. We believe that our cash at September 28, 2018, as supplemented by cash flows from operations and the Amended Revolver, will be sufficient to fund our anticipated operating costs, capital expenditures and current debt repayment obligations for at least the next 12 months.

Contractual Obligations

During the nine months ended September 28, 2018, we paid $3.0 million in quarterly installment payments on the Amended Term Loan. With the acquisition of SENTEL, we assumed contractual obligations, primarily consisting of operating building leases with remaining lease commitments of $3.6 million.

Off-Balance Sheet Arrangements

We have obligations relating to operating leases and letters of credit outstanding. Our Amended Revolver permits borrowings up to $120.0 million, of which $25.0 million is available for the issuance of letters of credit. At September 28, 2018, there were six letters of credit outstanding in the aggregate amount of $10.2 million, which reduced our borrowing availability under the Amended Revolver to $109.8 million. These arrangements have not had, and management does not believe it is likely that they will in the future have, a material effect on our liquidity, capital resources, operations or financial condition. At September 28, 2018, we had no material off-balance sheet arrangements other than operating leases.

CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGMENTS

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Estimates are revised as additional information becomes available. Management believes that the accounting estimates employed and the resulting balances are reasonable; however, actual results in these areas could differ from management's estimates under different assumptions or conditions.

We believe that the assumptions and estimates associated with revenue recognition, goodwill impairment assessments and income taxes have the greatest potential impact on our financial statements. Therefore, we consider these to be our critical accounting policies and estimates.

Beginning January 1, 2018, we adopted ASC Topic 606. Refer to Note 3, "Revenue" for further discussion regarding the impact of this adoption. There have been no other material changes in our critical accounting policies and estimates from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2017.

New Accounting Pronouncements

Refer to Part I, Item 1, Note 2 "Recent Accounting Pronouncements" in the notes to our unaudited Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for information regarding accounting pronouncements and accounting standards updates.

FORWARD-LOOKING INFORMATION

This Quarterly Report on Form 10-Q and certain information incorporated herein by reference contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange

Act), and Section 27A of the Securities Act of 1933, as amended (the Securities Act), and the Private Securities Litigation Reform Act of 1995 and, as such, may involve risks and uncertainties. All statements included or incorporated by reference in this report, other than statements that are purely historical, are forward-looking statements. Forward-looking statements generally can be identified by the use of forward-looking terminology such as “may,” “will,” “expect,” “intend,” “estimate,” “anticipate,” “believe,” “could,” “potential,” “continue” or similar terminology. These statements are based on the beliefs and assumptions of the management of the Company based on information currently available to management. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements.

We undertake no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. In addition, forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and our present expectations or projections. These risks and uncertainties include, but are not limited to: our ability to submit proposals for and/or win all potential opportunities in our pipeline; our ability to retain and renew our existing contracts; protests of new awards; our recent acquisition of SENTEL and its integration into our business; economic, political and social conditions in the countries in which we conduct our businesses; changes in U.S. or international government defense budgets; government regulations and compliance therewith, including changes to the DoD procurement process; changes in technology; intellectual property matters; governmental investigations, reviews, audits and cost adjustments; contingencies related to actual or alleged environmental contamination, claims and concerns; delays in completion of the U.S. government's budget; our success in extending, deepening, and enhancing our technical capabilities; our success in expanding our geographic footprint or broadening our customer base; our ability to realize the full amounts reflected in our backlog; impairment of goodwill; misconduct of our employees, subcontractors, agents, prime contractors and business partners; our ability to control costs; our level of indebtedness; subcontractor performance; economic and capital markets conditions; our ability to retain and recruit qualified personnel; security breaches and other disruptions to our information technology and operations; changes in our tax provisions or exposure to additional income tax liabilities and other risks and uncertainties relating to the Spin-off; changes in U.S. generally accepted accounting principles; and other factors described in Item 1A, “Risk Factors,” and elsewhere in our Annual Report on Form 10-K for the year ended December 31, 2017 and described from time to time in our future reports filed with the SEC.

ITEM 3. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*

Our earnings, cash flows and financial position are exposed to market risks relating to fluctuations in interest rates and foreign currency exchange rates. All of the potential changes noted below are based on information available at September 28, 2018.

Interest Rate Risk

Each one percentage point change associated with the variable rate Amended Term Loan would result in a $0.8 million change in our annual cash interest expenses. However, we have interest rate swaps in place to hedge a portion of this risk. Refer to Note 9, "Derivative Instruments" for additional information regarding our interest rate swaps.

Assuming our Amended Revolver was fully drawn to a principal amount equal to $120.0 million, each one percentage point change in interest rates would result in a $1.2 million change in our annual cash interest expense.

As of September 28, 2018, the notional value of our interest rate swap agreements totaled $57.1 million. The difference to be paid or received under the terms of the interest rate swap agreements is accrued as interest rates change and recognized as an adjustment to interest expense for the related debt in the period incurred. Changes in the variable interest rates to be paid pursuant to the terms of the interest rate swap agreements will have a corresponding effect on future cash flows.

Foreign Currency Exchange Risk

The majority of our business is conducted in U.S. dollars. However, we are required to transact in foreign currencies for some of our contracts, resulting in some assets and liabilities denominated in foreign currencies. Therefore, our earnings may experience some volatility related to movements in foreign currency exchange rates. We enter into forward foreign exchange contracts to buy or sell various foreign currencies to selectively protect against volatility in the value of non-functional currency denominated monetary assets and liabilities. Changes in the fair value of these forward contracts are recognized in earnings. As of September 28, 2018, the U.S. dollar notional value of our outstanding foreign currency forward contracts was approximately $8.8 million. The net fair value of these contracts at September 28, 2018 was a liability of $0.2 million.

We perform a sensitivity analysis to determine the effects that market risk exposures may have on the fair values of our foreign currency forward contracts. To perform the sensitivity analysis, we assess the risk of loss in fair values from the effect of hypothetical changes in foreign currency exchange rates. This analysis assumes a like movement by the foreign currencies in our hedge portfolio against the U.S. dollar. As of September 28, 2018, a 5% appreciation in the value of the U.S. dollar would result in a net decrease in the fair value of our derivative portfolio of approximately $0.3 million.

ITEM 4. *CONTROLS AND PROCEDURES*

Evaluation of Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 28, 2018. Based on such evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of September 28, 2018, the Company’s disclosure controls and procedures were effective to ensure that information required to be disclosed in reports the Company files or submit under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) accumulated and communicated to management to allow timely decisions regarding required disclosure. Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

Changes in Internal Control over Financial Reporting

Beginning January 1, 2018, we implemented ASC Topic 606. In connection with its adoption, we implemented changes to our processes and control activities related to revenue recognition. These changes included updating policies to reflect the five-step model, contract review requirements, and disclosure requirements. There were no changes in our internal control over financial reporting that occurred during the quarter ended September 28, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

On January 23, 2018, we completed our acquisition of SENTEL. We are in the process of integrating SENTEL’s operations with our operations, including integration of financial reporting processes and procedures and internal controls over financial reporting. In the course of integrating SENTEL’s financial reporting processes and procedures with ours, we may implement changes to financial reporting processes and procedures and internal controls over financial reporting and will disclose any such changes, if material, as required by the rules of the SEC. Management intends to complete its assessment of the effectiveness of internal controls over financial reporting for SENTEL within one year of the date of the acquisition.

PART II. OTHER INFORMATION

ITEM 1. *LEGAL PROCEEDINGS*

From time to time, we are involved in legal proceedings that are incidental to the operation of our business. Some of these proceedings seek remedies relating to employment matters, matters in connection with our contracts and matters arising under laws relating to the protection of the environment.

We are defending a class action employment lawsuit that was initiated in the United States District Court for the Western District of Washington in April 2010 against the predecessor of our Former Parent by individuals who worked on a particular contract in Kuwait after April 12, 2009. The plaintiffs are alleging a breach of employment contract by the predecessor of our Former Parent due to an alleged violation of Kuwait labor law. In November 2016, following an interlocutory appeal by Vectrus, the Ninth Circuit Court of Appeals affirmed the District Court’s decision certifying a class of plaintiffs. Although we continue to dispute liability, the parties have negotiated a settlement, the terms of which include a settlement fund of up to $3.75 million, plus payroll taxes for wages paid to class members. The settlement fund includes the judge's award of attorney's fees, costs and class representative fees, with the remainder available to eligible class members pursuant to an allocation formula. The Company received final approval by the District Court following a fairness hearing on October 16, 2018.

As a result of final indirect rate negotiations between the U.S. government and our Former Parent, we may be subject to potential adjustments to costs previously allocated by our Former Parent to our business, which was formerly Exelis’ Mission Systems business, from 2007 through 2014. Because we do not participate in indirect rate negotiations between the U.S. government and our Former Parent, we cannot predict the outcome of any negotiated adjustment or the ultimate responsible party. Accordingly, we cannot reasonably predict the likelihood of such adjustments or estimate the amount of any potential impact to the company.

Refer to Note 13 "Commitments and Contingencies" in the notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for further information.

ITEM 1A. *RISK FACTORS*

None.

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

Not applicable.

ITEM 3. *DEFAULTS UPON SENIOR SECURITIES*

None.

ITEM 4. *MINE SAFETY DISCLOSURES*

None.

ITEM 5. *OTHER INFORMATION*

None.

ITEM 6. *EXHIBITS*

31.1	Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 +
31.2	Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 +
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) (32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any future filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference. +
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) (32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any future filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference. +
101	The following materials from Vectrus, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 28, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) Unaudited Condensed Consolidated Statements of Income, (ii) Unaudited Condensed Consolidated Statements of Comprehensive Income, (iii) Unaudited Condensed Consolidated Balance Sheets, (iv) Unaudited Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements. #

+ Indicates this document is filed as an exhibit herewith.
# Submitted electronically with this report.

The Company's Commission File Number for Reports on Form 10-K, Form 10-Q and Form 8-K is 001-36341.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

VECTRUS, INC.

/s/ William B. Noon

By: William B. Noon

Corporate Vice President and Chief Accounting Officer

(Principal Accounting Officer)

Date: November 6, 2018

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Section 2: EX-31.1 (EXHIBIT 31.1)

EXHIBIT 31.1

CERTIFICATIONS PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Charles L. Prow, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Vectrus, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 6, 2018

/s/ Charles L. Prow

Charles L. Prow
President and Chief Executive Officer

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Section 3: EX-31.2 (EXHIBIT 31.2)

EXHIBIT 31.2

CERTIFICATIONS PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Matthew M. Klein, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Vectrus, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

    a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

    c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 6, 2018

/s/ Matthew M. Klein

Matthew M. Klein
Senior Vice President and Chief Financial Officer

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Section 4: EX-32.1 (EXHIBIT 32.1)

Exhibit 32.1

Certification of President and Chief Executive Officer

CERTIFICATION PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the Quarterly Report on Form 10-Q of Vectrus, Inc. (the “Company”) for the period ended September 28, 2018 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), the undersigned certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 6, 2018

/s/ Charles L. Prow

Charles L. Prow
President and Chief Executive Officer

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Section 5: EX-32.2 (EXHIBIT 32.2)

Exhibit 32.2

Certification of Senior Vice President and Chief Financial Officer

CERTIFICATION PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the Quarterly Report on Form 10-Q of Vectrus, Inc. (the "Company") for the period ended September 28, 2018 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 6, 2018

/s/ Matthew M. Klein

Matthew M. Klein
Senior Vice President and Chief Financial Officer

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